Monitoring financial resilience

Ofwat
November 2017

Introduction and context

Stakeholders rightly expect companies to deliver resilient water and wastewater services both now and in the longer term. We explained in 'Resilience in the Round' that companies should not just focus on the resilience of their assets and processes, but also consider their corporate and financial resilience. By considering these together companies can give stakeholders confidence that they understand the challenges they face and can deliver resilient services.

This second annual monitoring report under our Financial Monitoring Framework focuses on the issue of financial resilience, by which we mean a company's ability to avoid, cope with and recover from, disruption to its finances. A company that is not financially resilient might not be able to deliver the quality or breadth of service that customers expect.

Through this report we aim to enhance the visibility and transparency of company financial performance and financial and capital structures in the sector. This enables Ofwat and other stakeholders (including investors and potential investors, ratings agencies, analysts, government and customers) to monitor the businesses which we regulate and to challenge the sector in its identification and management of risk.

We will continue to review whether reporting can be improved, in particular in relation to the transparency of group structures and payments between group companies to ensure that we and other stakeholders have clear information about how companies are managed.

This report draws on financial information published by individual companies in their Annual Performance Reports ("APR") for the year to 31 March 2017. We have also considered other publicly available information (e.g. reports from the credit rating agencies) and financial information published after the APRs. We use this information[1] to highlight key issues for the financial resilience and performance of the sector.

Key points (1)

Our financial monitoring framework allows us to build up a picture of the sector's performance and structure over time. Overall the evidence suggests that the sector is rising to the challenge of PR14, and we haven't identified actions this year by companies that would indicate any increased risk of company failure. However, companies do need to ensure that they are resilient to changes, including changes that may come in the next price control period. We have also identified a number of areas that warrant further attention.

We have drawn out key messages from the information companies publish about financial resilience and their performance so far against the expectations set at PR14:

- Companies need to take responsibility for securing their long term resilience. We require all water and wastewater companies to produce a Long Term Viability Statement that confirms the financial viability of the company under an appropriate set of stress tests and over an appropriate forward looking period. This aims to provide stakeholders with greater transparency about the steps companies take to ensure long term resilience. Last year we challenged those companies whose Long Term Viability Statements covered 3 or 4 years to look at periods of at least five years in the future. But this year, five companies have only looked forward as far as the end of the price control period. There is also significant variation in the detail companies included about the approach and assumptions they have made in preparing their Long Term Viability statements. We expect all companies to follow best practice and we will be working with them to make improvements in the clarity of their reporting in this area.

- Most companies' licences include a requirement with respect to maintaining an investment grade credit rating. All the companies with this requirement currently have credit ratings which are at least one notch above the minimum investment grade level. Some companies face challenges to their rating, for example, one agency has placed Southern Water and Northumbrian Water on negative outlook (however Northumbrian Water's rating is one notch higher than Southern's at Baa1 and so it has slightly more flexibility in the event of a downgrade). Where necessary, companies should act to address issues, and we note that Yorkshire Water's financial restructuring resulted in Moody's moving it from negative to stable outlook in July 2017.

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Key points (2)

- There have not been significant changes in gearing this year, and therefore this metric does not in itself indicate any increase in risks. We would however be concerned by any significant increases in gearing, particularly by those companies that are already highly geared. We are also interested in the choices (such as paying dividends) that companies make to not reduce gearing when they have the opportunity to do so.

- Companies need to factor into their consideration of their resilience all of their liabilities. This includes pension liabilities. The majority of the water and sewerage companies have significant pension deficits – the deficits fluctuate for a variety of reasons, but the overall increase this year is £1.25bn, principally due to the reduction in market based discount rates. As we have previously set out, we have capped the level of funding from customers for pension deficits, with the majority ending by 2025. The remainder of the deficits are the responsibility of company shareholders. Water companies have long term licences and relatively predictable cash flows (compared with other sectors) which should help them manage these deficits. We would however expect to see the treatment of pension deficits being considered by companies as part of their work on long term viability statements.

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- Reported RORE figures suggest a wide spread in performance across companies and across the different areas (expenditure, financing and service incentives) that affect the level of returns against regulated equity. Some companies are reporting returns above those of the RORE base case in their final determinations, and others are below the base case expectations. Overall, the average annual RORE varied from 3.9% to 11%.

- What comes through clearly from the RORE figures is that there is opportunity for outperformance (or indeed a risk of underperformance) across all the activities companies undertake. This emphasises the importance of companies thinking carefully about how they deliver services in the round and continually challenging themselves to improve all aspects. In the first two years of this control period:

    - Companies are reporting that they are, on average, outperforming their regulatory cost allowances by 0.7%. This totex outperformance is the main reason the sector is achieving a 6.22% return (compared to the base equity return set at PR14 of 5.65%). The cost allowances were designed to be challenging (targeting an upper quartile efficiency level at PR14) and many companies have risen to this challenge. We will take company performance against our cost allowances into account when we set cost benchmarks at PR19.

    - Reported performance for financing varies from -2.27% to 1.9% (average -0.35%). Over the control period 12 companies are underperforming in respect of financing costs, however rising inflation levels mean that fewer companies are expected to underperform in the next financial year.

    - Reported performance relating to service incentives (ODIs) ranged between -0.6% and 1.05% (average 0.14%). At PR14 companies considered they faced more downside than upside risks on their ODIs, although our view was that a notionally efficient company's risks should be neutral on its ODIs overall. However, the majority of companies have managed to rise to the challenge of delivering more for their customers and, so far in this price control period, are reporting net outperformance payments. This performance will ultimately benefit customers as companies drive new levels of service. We consulted in July on having stronger incentives for outcome delivery at PR19.

Company financial results – an introduction

In this section we set out information about the financial performance, cash flows and balance sheet of each company.

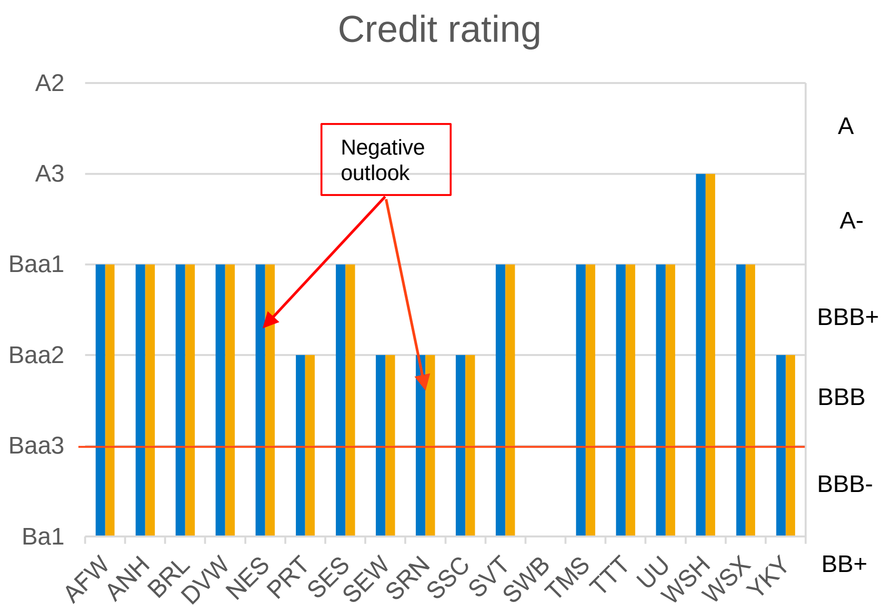
Most of this information has been extracted from the APRs and statutory accounts published by each appointed company.

We have reviewed the information that companies have published, and present highlights from the APRs and from the other information that we have reviewed commenting on issues where they have arisen.

The metrics considered on the following pages are follows:

- Credit ratings
- Long term viability statements
- Gearing
- Interest cover metrics
- FFO/Net Debt and RCF/Capex
- Return on regulated equity (RORE)
- Return on RCV and post tax return
- Dividends
- Company borrowings
- Interest rates
- Wholesale revenue
- Retail revenue
- Taxation
- Pensions

The delivery of the outcomes that were outlined in each company’s final determination at PR14 will be reviewed in more detail in our report on overall service delivery which will be published later in the year.



Most companies' licences include a requirement with respect to maintaining an investment grade credit rating[2]. All the companies with this requirement currently have credit ratings which are at least one notch above the minimum investment grade level.

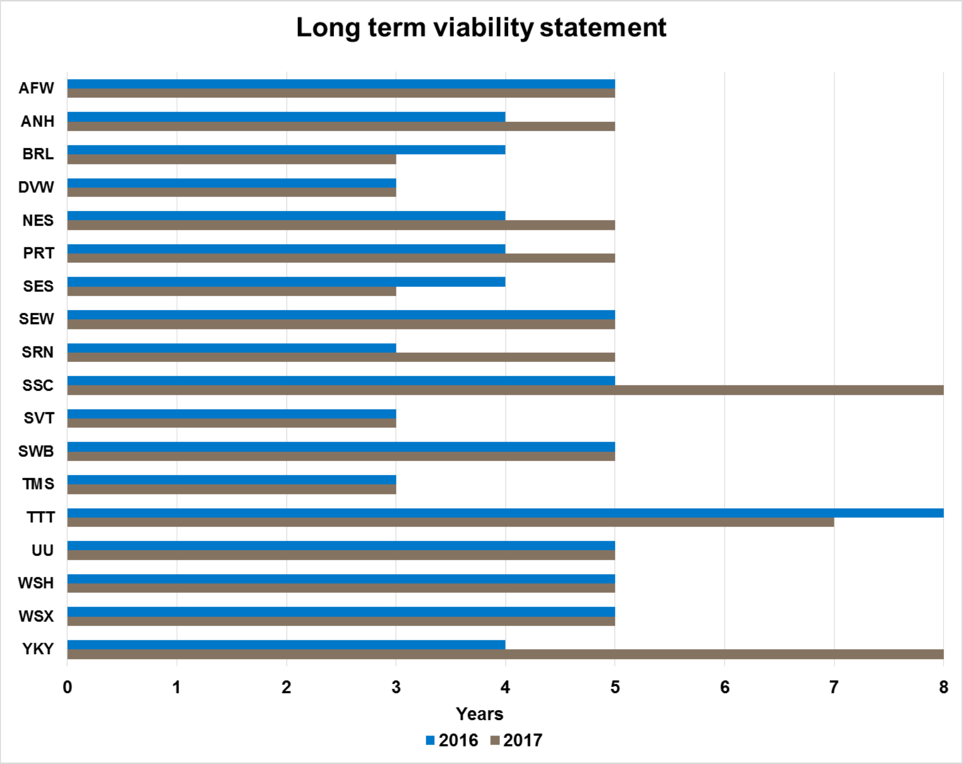
Southern Water was placed on negative outlook in 2016 as a result of the company's exposure to a persistently low interest rate environment, given the company's leveraged capital structure and funding arrangements.

Northumbrian Water is also on negative outlook, however its rating is one notch higher than Southern at Baa1 and so it has slightly more flexibility in the event of a downgrade.

Until July 2017, Yorkshire Water was on negative outlook, however following actions taken by the company to restructure its financing, it has now been reclassified as stable.

The risks associated with adopting complex financing arrangements or different capital structures are borne by shareholders not customers.

We expect companies to be thinking about how changes to the allowed cost of capital might impact on their financing arrangements, and whether there is a need to make changes to their capital structures and financing arrangements to address the impact of this rather than waiting until the start of the next control period in 2020.



We want companies to test their long term financial resilience. Last year we challenged those companies who had used 3 or 4 years in their Long Term Viability Statements[3] to look at periods of at least five years in the future.

This year however, **five companies** (Thames Water, Severn Trent, Bristol Water, Dee Valley Water and SES Water) have only looked forward as far as the end of the current control period. Wessex Water have included a statement covering a period of 5 years in their APR but only considered a period of 3 years in their statutory accounts.

We have been clear that the end of the current price control period should not be a constraint, and note that some companies have reviewed longer–term business plans.

There are also significant variances in the level of detail that companies have published about the approach and assumptions they have made in preparing their long term viability statements. Some companies have provided details of the input assumptions and scenarios used in their stress testing. However, a number of companies' statements contain little detail on the approach they have taken, the nature of the stress tests they have applied and the forward-looking assumptions they have used. We expect the Statements to include an appropriate level of detail so that stakeholders can understand how companies are assessing their long term viability; the different scenarios and assumptions they have used in making their assessments and any mitigating actions that they have considered.

We expect all companies to follow best practice and we will be working with them to make improvements in the clarity of their reporting in this area.

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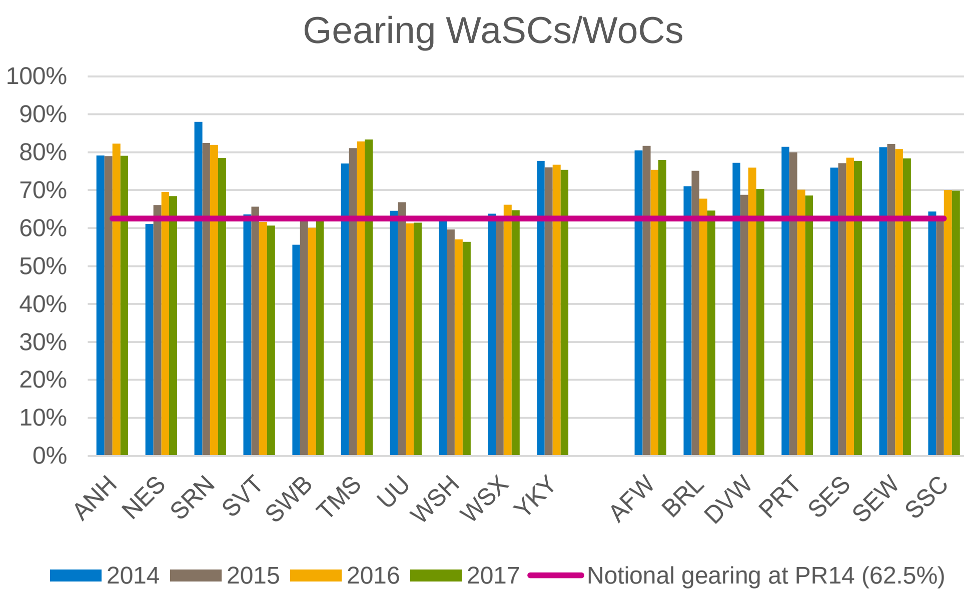
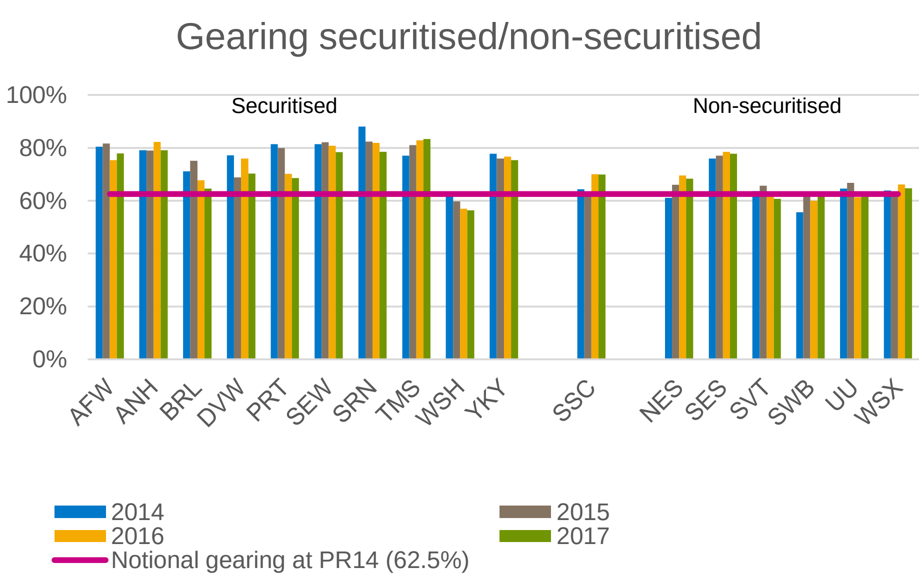




High levels of gearing potentially expose companies to increased levels of risk and increased debt costs. We would encourage companies to consider whether high levels of gearing are sustainable and would be concerned where companies are actively seeking to increase gearing.

There have not been any significant changes in gearing in the year.

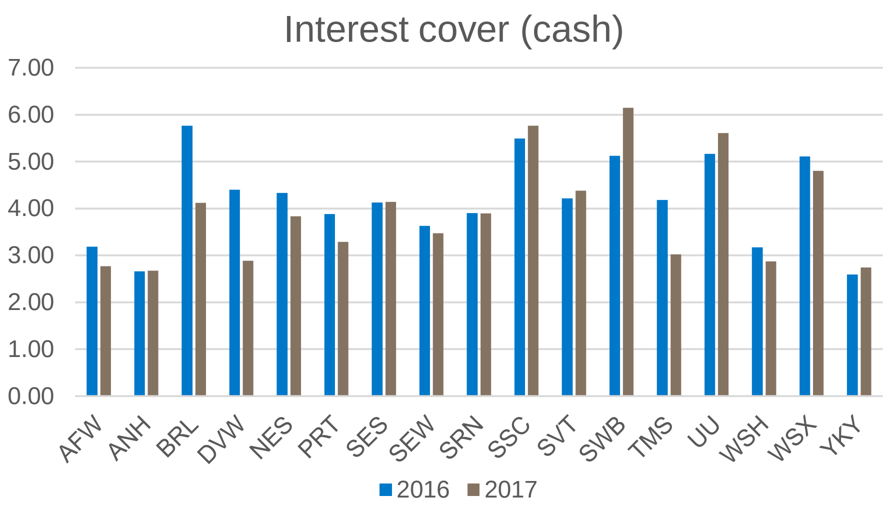
Four companies (South West, Thames Water, United Utilities and Affinity Water) show small increases in their reported gearing (for UU it is negligible) and these movements have largely been driven by operational issues.

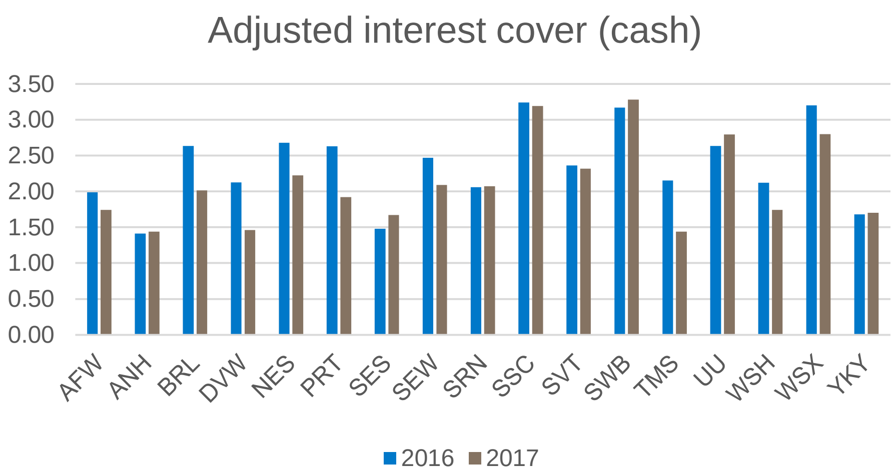
The increase in gearing at Thames Water reflects the additional costs to deal with the issues that have arisen in the year, while Affinity Water's performance has also been below expectations in the period. Combined with the impact of dividends, this has driven an increase in their gearing.

South West Water has increased its gearing through payment of a dividend, however gearing remains in line with the PR14 notional capital structure.

Given Thames Water and Affinity Water both have high levels of gearing we will continue to monitor any further movements closely.

Regulatory gearing is the ratio of net debt for the appointed business to its regulatory capital value (RCV). Net debt excludes any pension deficit liability and mark-to-market accounting adjustments. For AMP6 (2015-20) we have assumed a notional efficient capital structure with a notional gearing level of 62.5%.





The interest cover figures are directly impacted by companies' operational performance, and failure to collect revenue or increases in operational costs will reduce the level of interest cover.

There have been some variances between the metrics reported by companies in 2016 and 2017. Nine companies have shown interest covers which have fallen in 2017 and 11 companies have shown adjusted interest covers which have fallen.

The interest covers for the regulated water companies do not indicate that there are any significant issues or that companies are struggling to meet their interest repayments.

For an investment grade company interest covers are usually expected to be above 1.8 and adjusted interested covers are expected to be above 1.2. However, these measures are only one part of a suite of information which the rating agencies consider. Each credit rating agency has their own calculation of these ratios which may differ slightly from the calculations here.

During the PR14 price review a number of companies indicated that the revenue allowed by Ofwat would result in significant pressure on certain metrics including interest covers, however based on the published results this does not appear to be the case so far.

Interest cover ratios illustrate a company's ability to pay interest on its outstanding debt. Companies have provided two interest cover ratios in their APRs and these metrics are also used in Ofwat's assessment of financeability during price reviews. The interest cover ratio looks at the ratio of Funds from Operations (FFO) before the payment of interest to cash interest payable. In the adjusted interest cover metric, the numerator is adjusted to subtract regulatory depreciation which is an approximation of the capital cost that would be incurred if companies were to maintain the RCV at a constant level.

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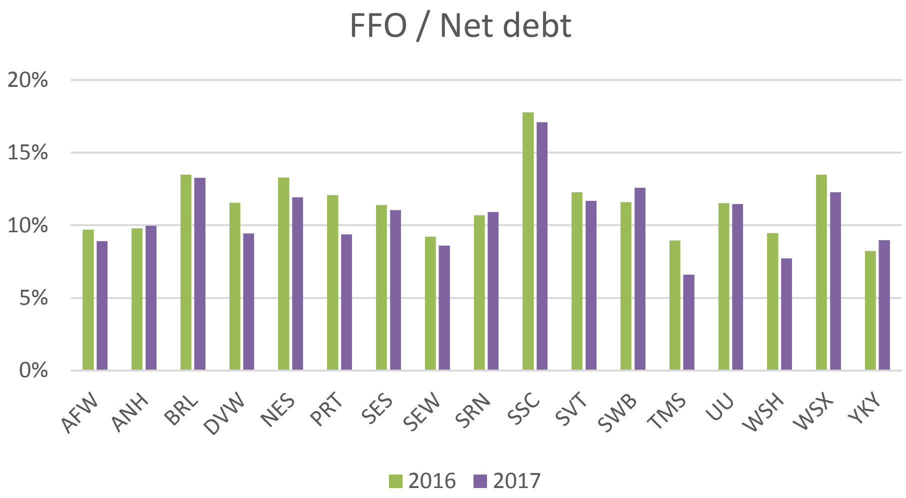
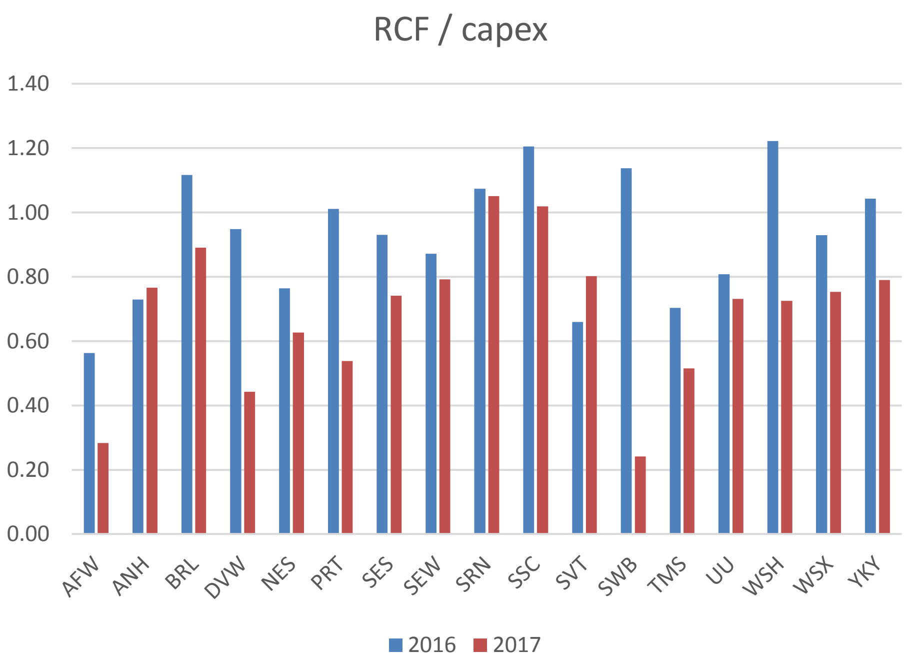




Companies' choices and performance affect these metrics, and the assessment of their financeability.

There has been some variance in the FFO/debt metrics in 2017 compared to 2016, however on the whole these variances are small and do not indicate any significant concerns. The lowest ratio is for Thames Water as a result of its relatively poor performance and high level of debt.

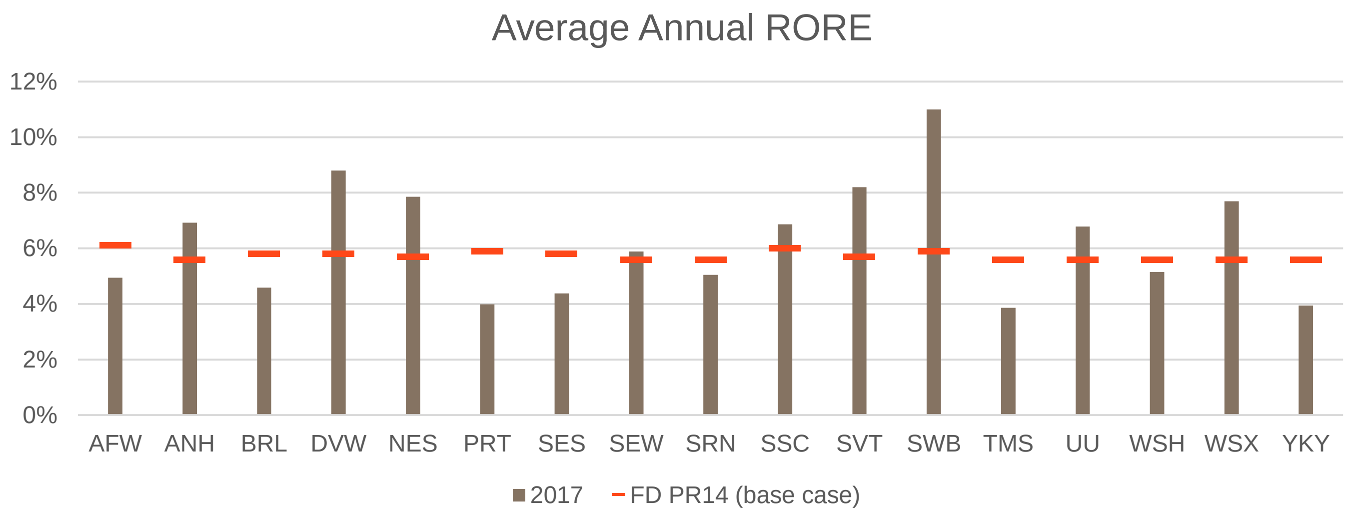
The RCF/Capex measure is impacted by poor financial performance or the payment of large dividends which reduces the numerator. The ratio will increase where companies incur relatively low levels of capex. Both South West Water and Affinity Water have paid higher levels of dividends in 2017 compared to 2016 and this has caused a reduction in their metrics.

The Funds from Operations (FFO)/Debt and Retained Cash Flow (RCF)/Capex look at the ability of companies to repay their debt and to fund their capital expenditure requirements. FFO is also one of the metrics which Ofwat uses to assess financeability during price reviews.

FFO/Debt is calculated as FFO after the payment of interest as a proportion of net debt (excluding any pension liabilities). It relates to each company's ability to repay its long-term debt.

RCF/Capex is the ratio of retained cash flow after the payment of dividends but before capital expenditure and relates to a company's ability to meet its capital expenditure requirements.

Return on Regulatory Equity (RORE) (1)

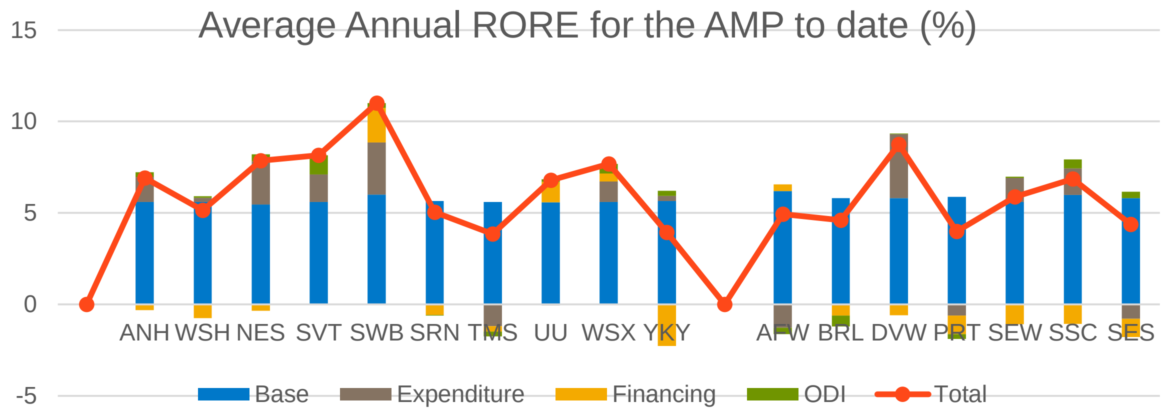


At PR14 we calculated an expected RORE for each company which is shown by the red line in the chart. Actual performance reported by each company shows a reasonable spread around the PR14 expectations with 9 companies reporting a RORE above the PR14 expectations and 8 companies reporting returns below the PR14 expectations.

These variances are driven by both operational (including ODI rewards and penalties and performance against cost allowances) and financial performance by companies and further analysis of the individual components of this performance is shown on the next page.

Companies are incentivised to deliver their performance commitments to their customers on the services they will receive. Where companies underperform against those performance commitments with financial incentives, they receive ODI penalties and where they outperform they can earn ODI rewards. Where companies have outperformed against the allowed costs, this will influence the level of costs we allow at the next price review. Some companies have opted to share an element of their outperformance with customers – South West Water do this via their WaterShare scheme.

Return on regulatory equity (RORE) measures the returns (after tax and interest) that companies have earned by reference to the notional regulated equity, where regulatory equity is calculated from the RCV and notional net debt (62.5% of RCV). The calculations presented are the responsibility of company management and have not been verified by Ofwat. The calculations require an element of judgement by company management particularly in relation to expenditure where companies have to determine whether any over or underspend in each year amounts to genuine additional costs or cost savings or is simply due to re-profiling of expenditure within the current price control period. The impact of this judgement can be seen most starkly for Dee Valley Water where a new management team this year has resulted in a significantly different view regarding the company's performance in both 2015/16 and 2016/17 against the expenditure allowed at the last price review.



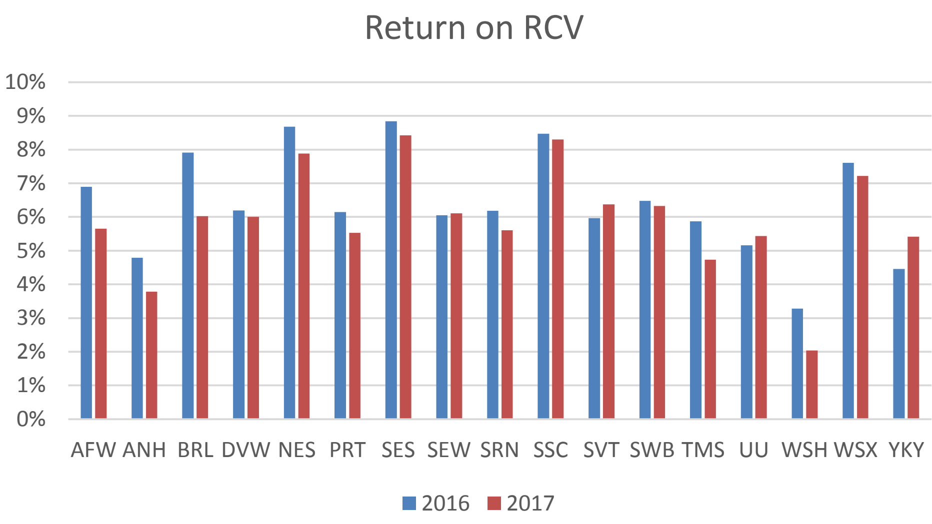
The chart on the previous slide showed that companies are performing above and below the base level assumed in their final determinations. This chart shows that there are also variations in the sources of companies' out/underperformance. If we look at outperformance, 1.1% of Severn Trent's RORE comes from ODIs, but 1.9% of South West's comes from financial outperformance. When looking at underperformance, Thames Water's RORE fell by 1.2% due to additional expenditure while Yorkshire Water's RORE was reduced by 2.3% due to financing costs.

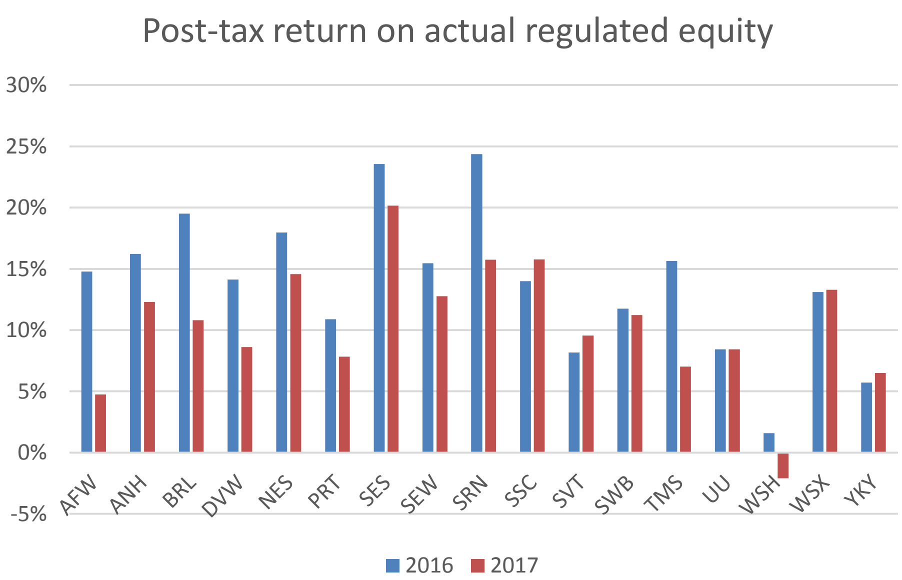
The RORE impact of expenditure variances ranged from -1.28% to 3.5% (average 0.7%), financing variances ranged from -2.27% to 1.9% (average - 0.35%) and service incentives (ODIs) were between -0.6% and 1.05% (average 0.14%).

Performance against expenditure reflects company reported actual out or underperformance and does not include expenditure re-profiled within the current control period. In the first two years of this control period, companies are reporting that they are, on average, outperforming their regulatory cost allowances by 0.7%. This totex outperformance is the main reason the sector is achieving a 6.22% return (compared to the base equity return set at PR14 of 5.65%). The cost allowances were designed to be challenging (targeting an upper quartile efficiency level at PR14) and many companies are achieving this. We will take company performance against our cost allowances into account when we set cost benchmarks at PR19.

Twelve companies are underperforming in respect of financing costs, however rising inflation levels mean that fewer companies are expected to underperform in the next financial year. Where companies outperform they can choose to share the benefits with customers before the end of the price control period. South West Water and Dŵr Cymru are examples of companies that are already sharing some of their outperformance with customers.

At PR14 companies considered they faced more downside than upside risks on their ODIs, although our view was that a notionally efficient company risks should be neutral on its ODIs overall. However, the majority of companies have so far managed to rise to the challenge of delivering more for their customers and are reporting net outperformance payments so far in this price control period. This performance will ultimately benefit customers as companies drive new levels of service. We consulted in July on having stronger incentives for outcome delivery at PR19.





The return on RCV shows small variances between 2016 and 2017. The most significant difference is for Dŵr Cymru and is due to the company sharing its out performance with customers.

Like the return on RCV the post tax return on regulated equity reflects the performance of each company. Those companies which have returned revenue to customers (e.g. Dŵr Cymru) and those companies which have incurred additional costs have seen a negative impact on their returns.

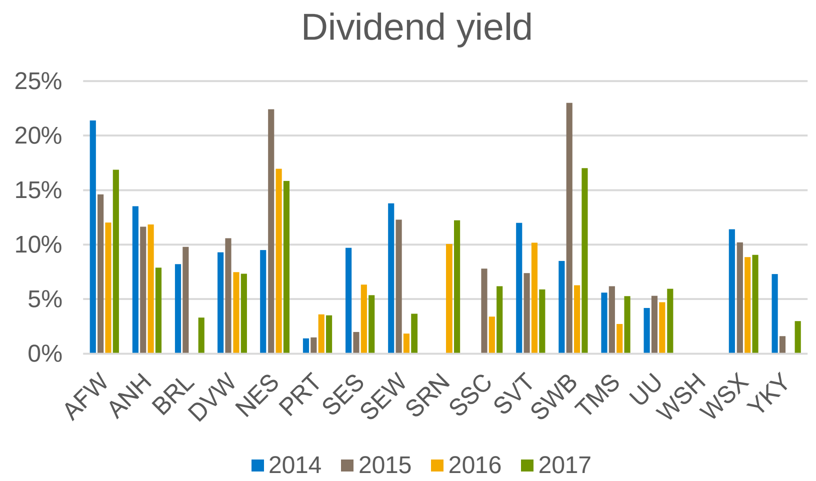
Those companies which have a higher gearing tend to have a higher post tax return on regulated equity due to having a smaller proportion of regulated equity.

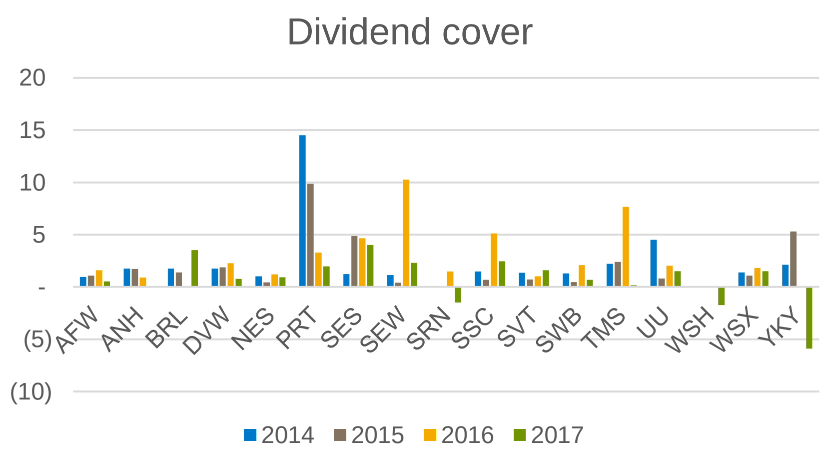
Anglian Water have used a slightly different basis for their published figures and remove the impact of intra-group interest received in their calculations. We have therefore adjusted the company figures to report them in the chart opposite on the same basis as the other companies.

Return on RCV is measured as the profit for the year after tax but before the payment of interest.

This calculation differs from the base return on RCV set at PR14, calculated using the regulatory building blocks, which was 3.7% for Affinity and South West, 3.75% for Bournemouth and Portsmouth and 3.6% for all other companies.

The return used in the post tax return on regulated equity is calculated as profit after tax and interest paid. In this metric regulated equity is RCV less actual net debt.





The dividend yield varies across companies and years, reflecting the circumstances and policies of individual companies.

Two companies have paid significantly higher dividends than the previous year. South West Water paid a dividend in the year to reflect outperformance in the control period to date and to maintain gearing in line with the notional capital structure.

Affinity Water increased their dividend to reflect improvements made to their business since the previous control period and some one off profits relating to bond issuances and the disposal of the non household retail business.

Where companies are highly geared, they have a lower proportion of regulated equity and as a result a higher dividend yield for the same level of dividend relative to profits.

The level of dividend paid will impact on each companies' gearing. Dividends paid in excess of the distributable profits earned in each year will result in an increase in gearing, whereas dividends below the level of profits will reduce gearing.

Dividends in excess of distributable profits earned in each year are effectively a withdrawal of equity.

Transparency is important to help stakeholders understand the choices that companies make. We are looking at what further information would be helpful, and we are challenging companies to publish information about how the position under their actual structure compares with what it would have been under the notional structure.

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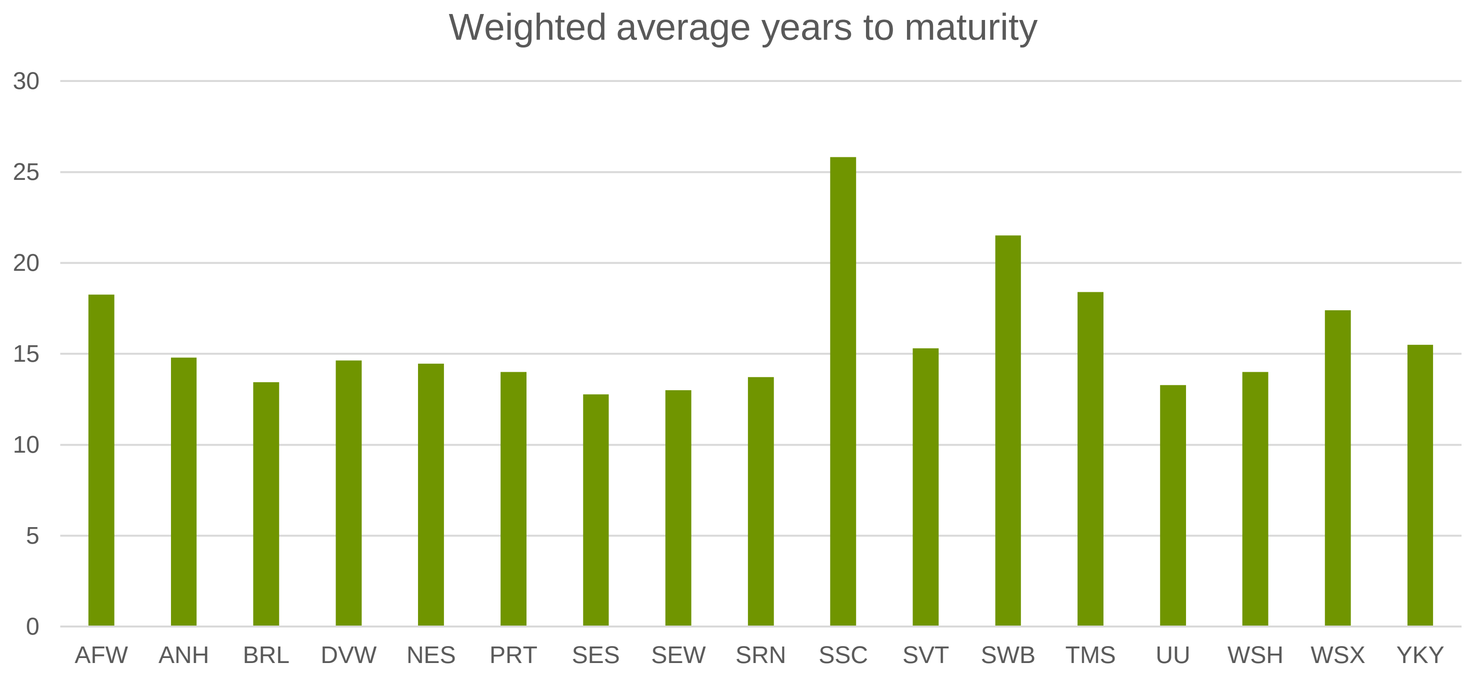
Dividend yield is calculated as dividend paid as a percentage of actual regulated equity. Dividend cover is the number of times the dividend can be paid from the distributable profits earned in each year. The dividend yield is based on the adjusted dividend paid by each company. This is the total dividend declared in the year less any dividends paid to holding companies to enable those companies to pay interest on intra-group loans from the regulated company and therefore captures only that part of the dividend that is paid out to external shareholders. For PR14 we assumed a real dividend yield of 4% - based on a notional capital structure with gearing of 62.5%.

Maturity of company debt (1)

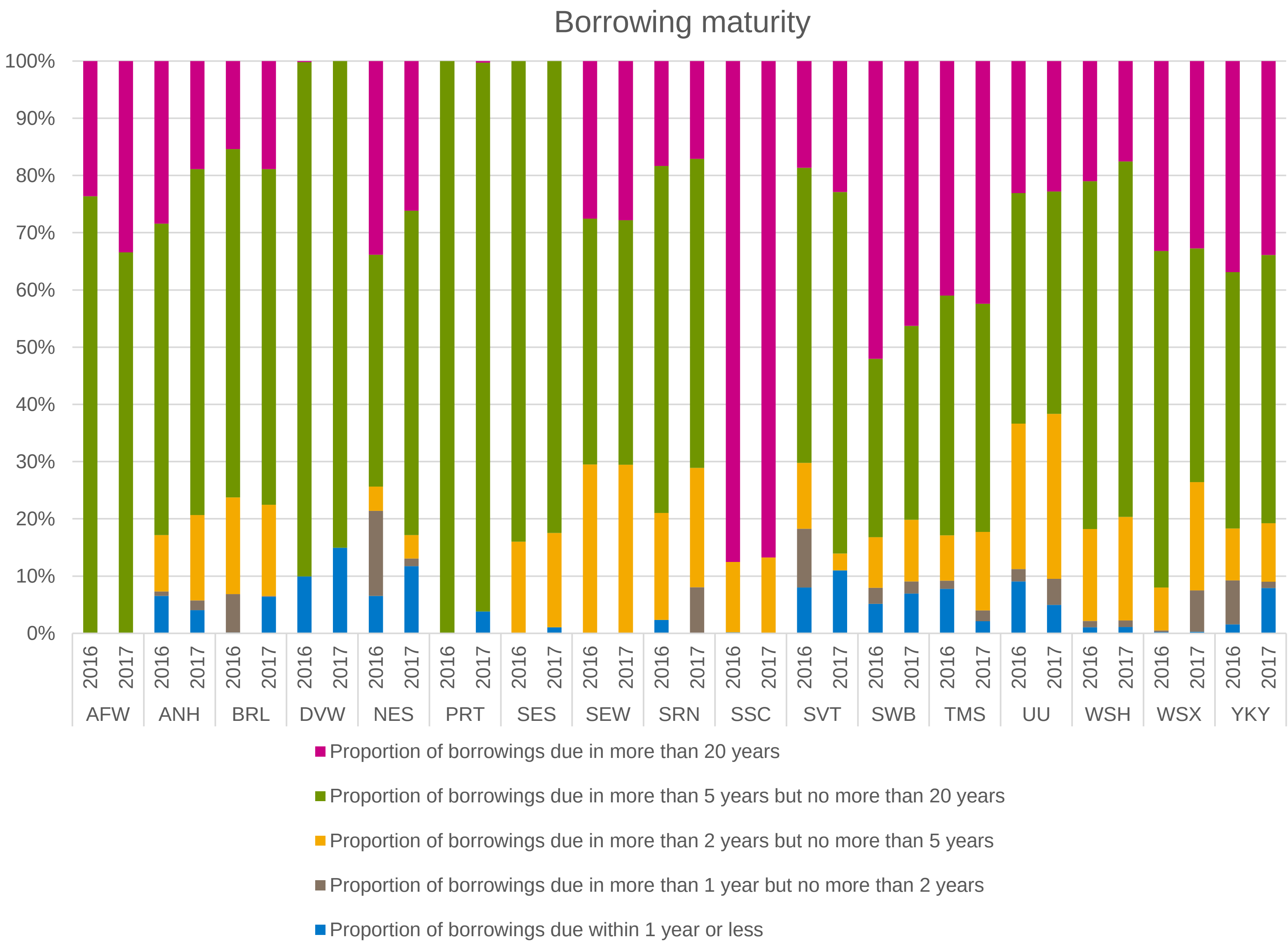


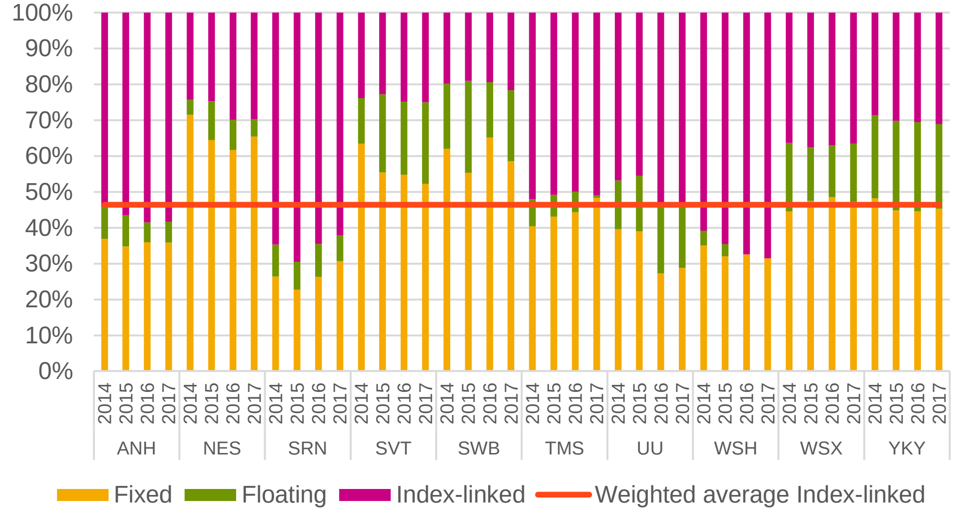
Companies use a portfolio of both long and short term debt to finance their business, with each company determining what it considers to be appropriate. Companies tend to use long-term debt to finance their operations, with the tenor of debt reflecting the lives of the assets that they are financing. The majority of debt is due for repayment in more than five years.

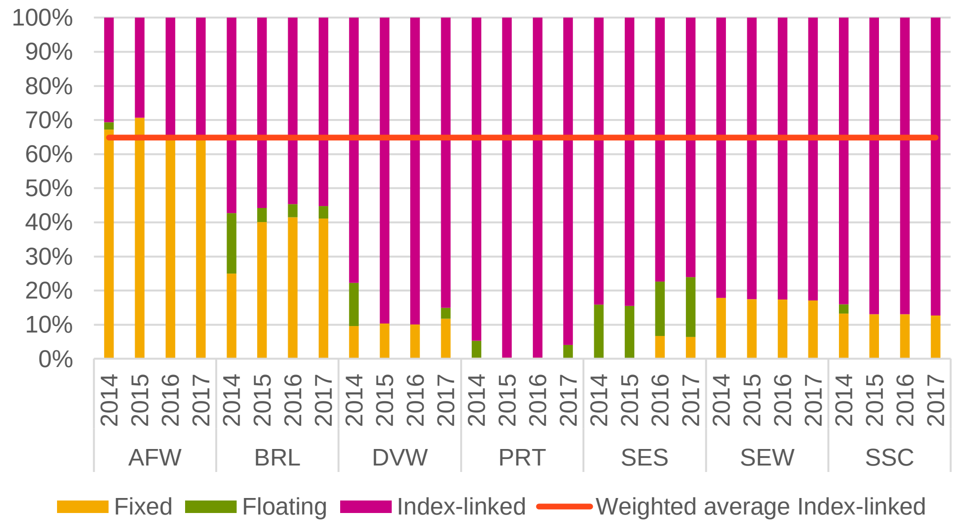
The chart shows that the average outstanding debt term (tenor) reported at 31 March 2017 was 16 years. Companies did not publish this information in this way in 2016. If we compare the tenors reported here to the tenors reported in 2015, it indicates that for most companies the average tenor of outstanding debt has reduced since 2015.

The chart on the next slide shows when the debt is due for repayment.

Maturity of company debt (2)







The data indicates that there have been no significant changes to the composition of debt in the last financial year.

Companies are continuing to use a significant proportion of index linked debt to manage their exposure to inflation risk, with WoCs typically using more index linked debt than WaSCs.

For WaSCs approximately 46% of debt was index linked compared to 46% in 2016, while for WoCs it was 65% compared to 66% in 2016.

The index linked debt that the companies have in place is linked to RPI. From 2020 allowed revenues and further totex will be linked to CPIH not RPI and the RCV at 1 April 2020 will be 50% linked to RPI and 50% linked to CPI.

United Utilities are the first of the appointed companies to issue CPI linked debt, having issued £100 million of CPI linked debt in the year. Tideway have also raised £75 million of CPI linked debt since March 2017. Tideway debt is not included above. At 31 March 2017 and 31 March 2016, its debt comprised shareholder loan notes with a fixed coupon.

The charts show the gross debt of each company. Net debt (gross debt less cash) is used when calculating companies' regulatory gearing. At PR14 we assumed 33% of companies' net debt was index linked (linked to RPI). The use of index linked debt impacts the cash interest payments required each year. This can improve short term financeability but does not impact on companies' overall levels of debt.

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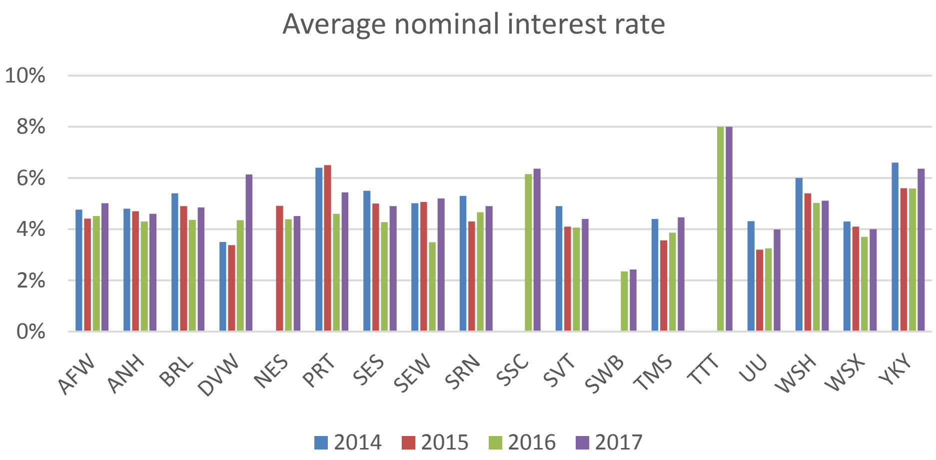
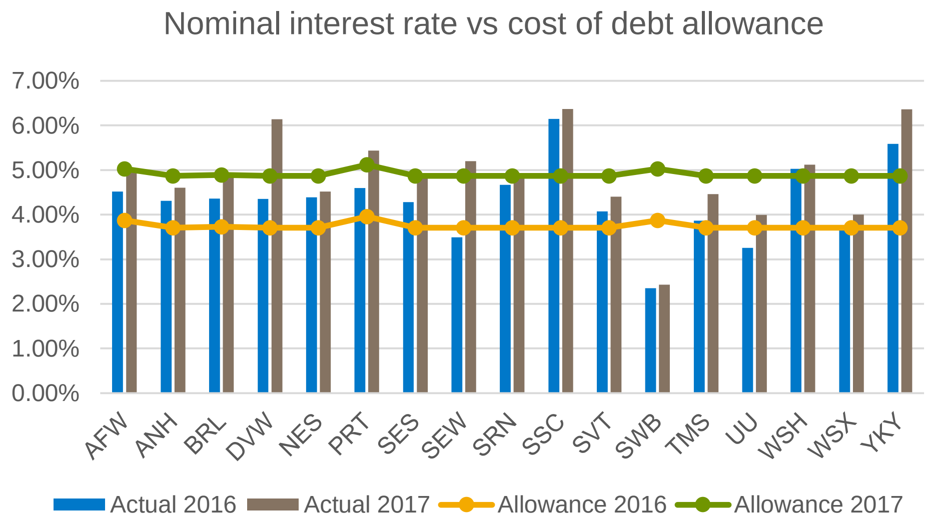




The top chart shows the average nominal interest rate paid by companies.

The average RPI inflation rate has increased in 2016-17 compared to the previous year and as many companies have index linked debt this accounts for some of the increases in rates seen. (https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/czbh/mm23)

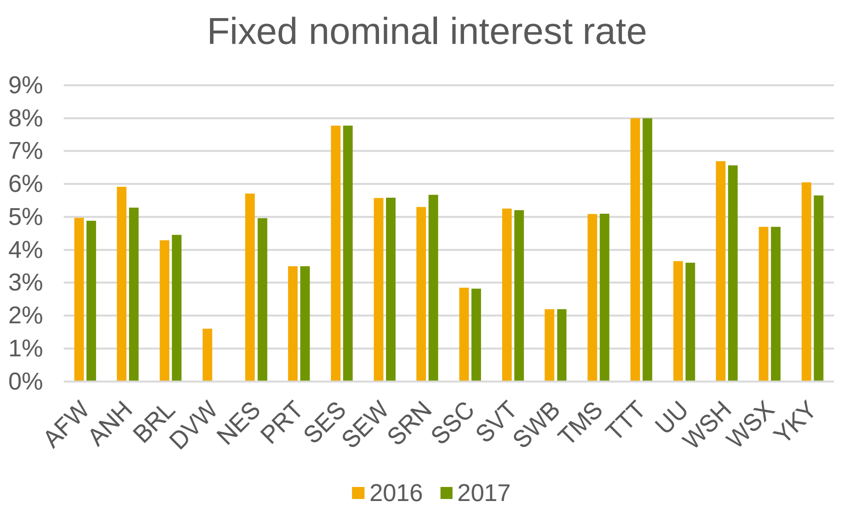
Thames Tideway debt comprises shareholder loan notes with a fixed coupon.

Yorkshire Water is in the process of restructuring its debt portfolio to reduce costs and has made a number of changes since this data was reported. This has resulted in their credit rating being taken off negative outlook.

We have compared the average nominal interest rates to the cost of debt allowed at PR14. The cost of debt allowances are set in real terms, therefore we have used year average inflation to present these in nominal terms to allow a comparison to be made with the nominal rates paid.

The higher inflation rates in 2016-17 compared to the previous year result in fewer companies paying interest rates which are in excess of the allowances.

Where companies are able to outperform against our cost of debt, as a result of low real interest rates or due to inflation levels being higher than anticipated, we would expect companies to consider how best to use that outperformance. This could be reducing gearing, reducing pension deficits, improving services for customers or reducing bills.

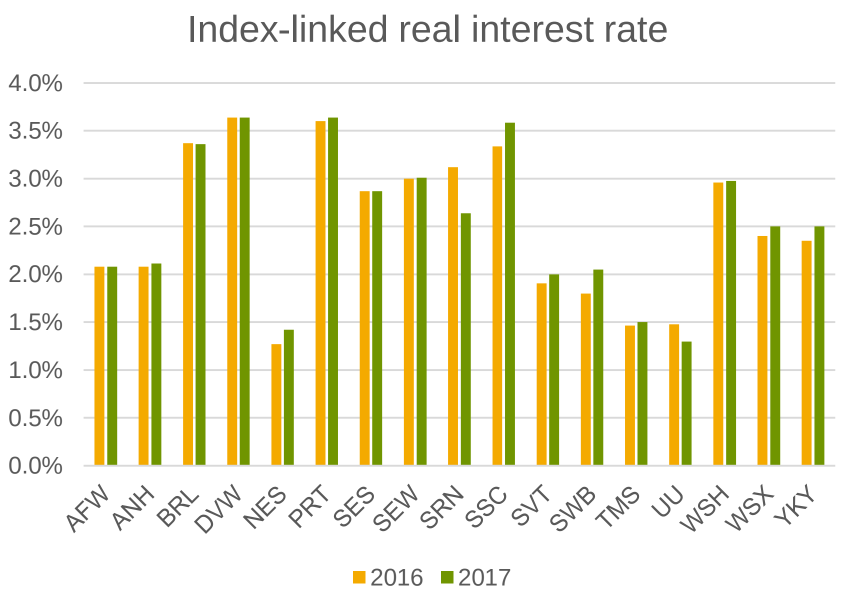


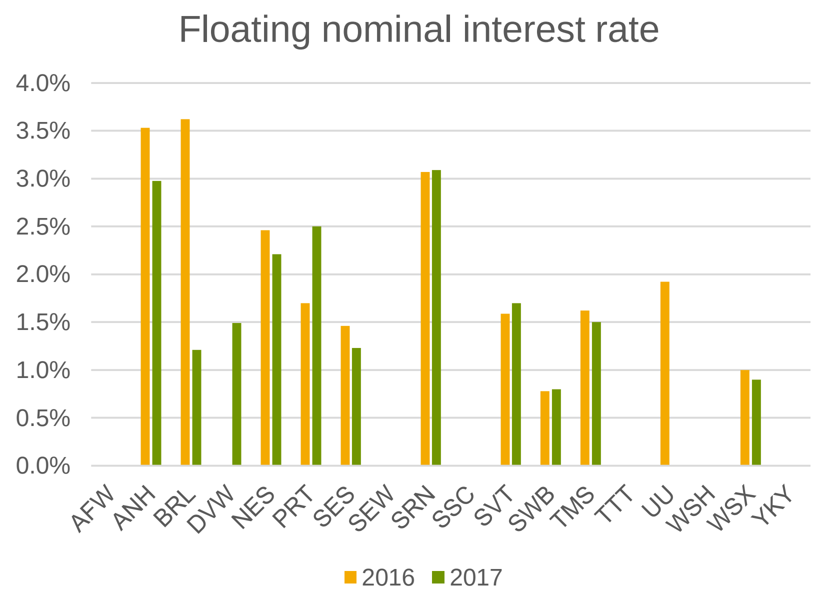
Companies have also published details of the interest rates paid in respect of their fixed, floating and index-linked debt.

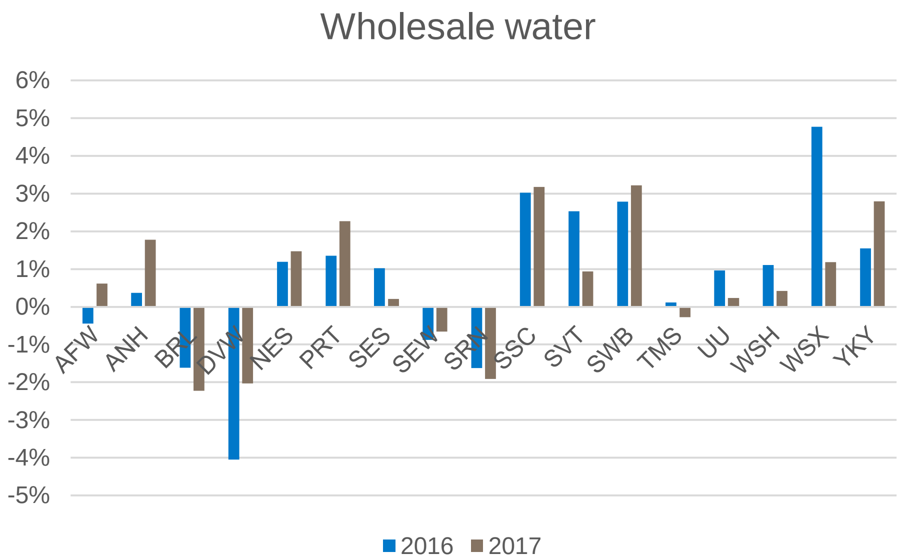
These three charts present the nominal interest rates paid in respect of fixed rate debt, floating rate debt and the real interest coupon paid in respect of index linked debt.

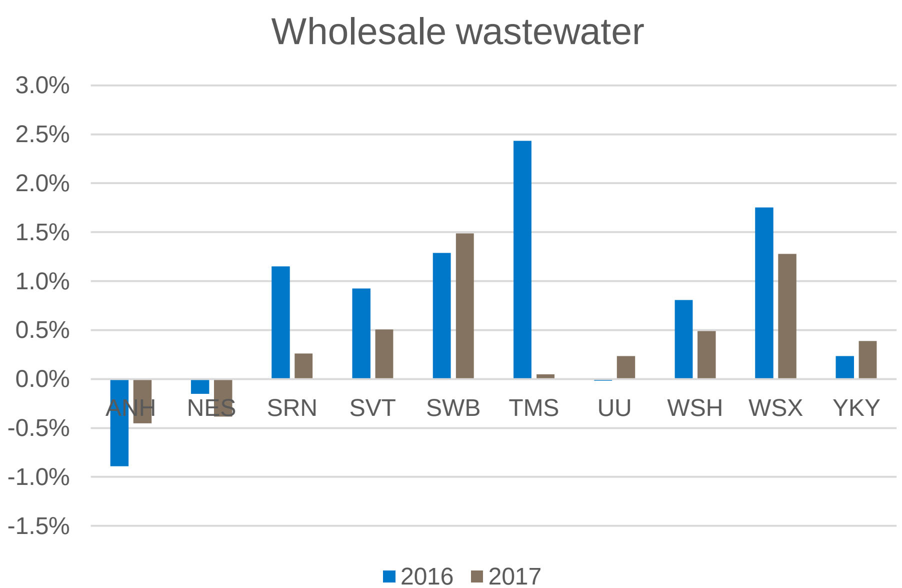
There have been no significant changes in the rates being paid by companies on the fixed rate and index linked debt.

Floating rate debt makes up a relatively small proportion of the overall debt and the variances in the rates being paid on that debt will have a more limited impact on the overall costs.









We set binding separate revenue controls for both water and wastewater. Any over/under recovery in one control cannot be offset against the other control.

These charts demonstrate how much wholesale water and waste water revenue companies have collected compared to the amounts allowed at PR14.

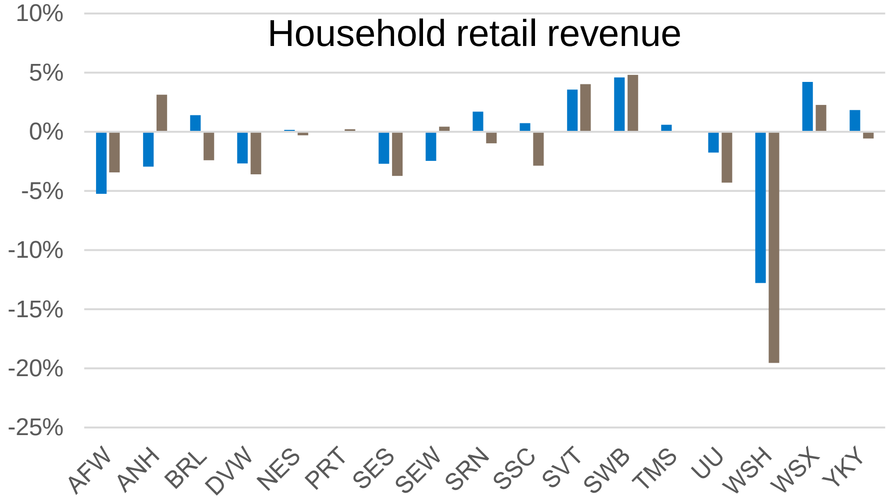
Small over or under recovery in any year is corrected in the following year, however we would expect reported revenues to be consistent with the PR14 allowances.

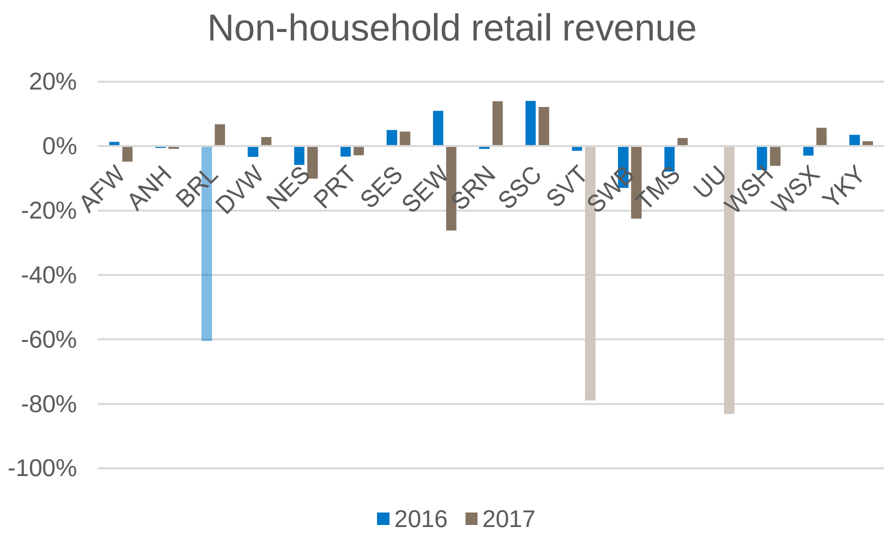
Over recovery of revenue in any year reduces the amount that can be recovered in the remaining years of the control period, while the risk of under recovery in the control period remains with companies.

Dee Valley Water shows the greatest under recovery of wholesale water revenue in the 2015-16 year. The company noted in their accounts that this was due to a reduction in demand from large non-household customers and the actual number of customers being lower than their original forecast.

We will continue to monitor company performance in this area as the control period progresses.

The wholesale revenue forecasting incentive mechanism (WRFIM) is in place to encourage companies to forecast revenue accurately, with companies being penalised for poor forecasts.





These charts show the household retail component of revenue and non-household retail component of revenue compared to the amounts allowed at the PR14 final determination. The household and non-household controls are separate.

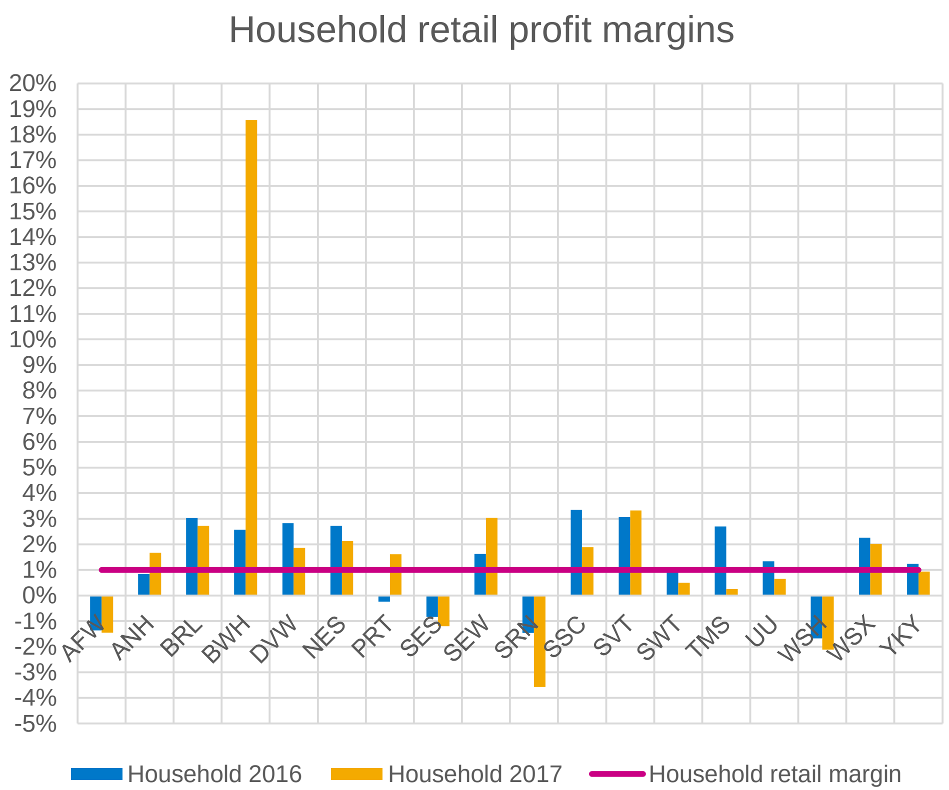
The household revenue chart suggests a substantive under recovery of revenue by Dŵr Cymru, due to the provision of affordability tariffs and prior year adjustments.

The non-household revenue chart suggests significant under recovery of revenue for a number of companies, which in most cases is due to demand not matching forecasts.

Bristol Water noted a misallocation of non-household revenue in their APR submission for 2015-16. This will be corrected so that they report the correct cumulative figures for the period to Ofwat.

On 1 June 2016 Severn Trent and United Utilities transferred their non-household retail activities into a joint venture. In the period up to 31 March 2017, this revenue formed part of each company’s final determination, as neither could exit the retail market until 1 April 2017 (indeed Severn Trent has not exited the non-household retail market yet), but only two months (April and May 2016) activities have been reported in their APRs.

From 1 April 2017 eligible non-household customers in England and Wales are able to choose their water and, in England, wastewater suppliers. Eleven undertakers have chosen to exit the non household market to date.



As part of the PR14 price review we introduced separate price controls for household and non-household retail services.

At the start of the year Bournemouth Water became part of South West Water and the companies combined their household retail operations. This has resulted in significant cost savings within the Bournemouth Water business.

In setting allowed revenue within the final determinations, companies operating wholly or mainly in England were allowed a 1% margin for household retail and a 2.5% margin for non-household retail. For companies operating wholly or mainly in Wales a 1% margin was allowed for both controls.

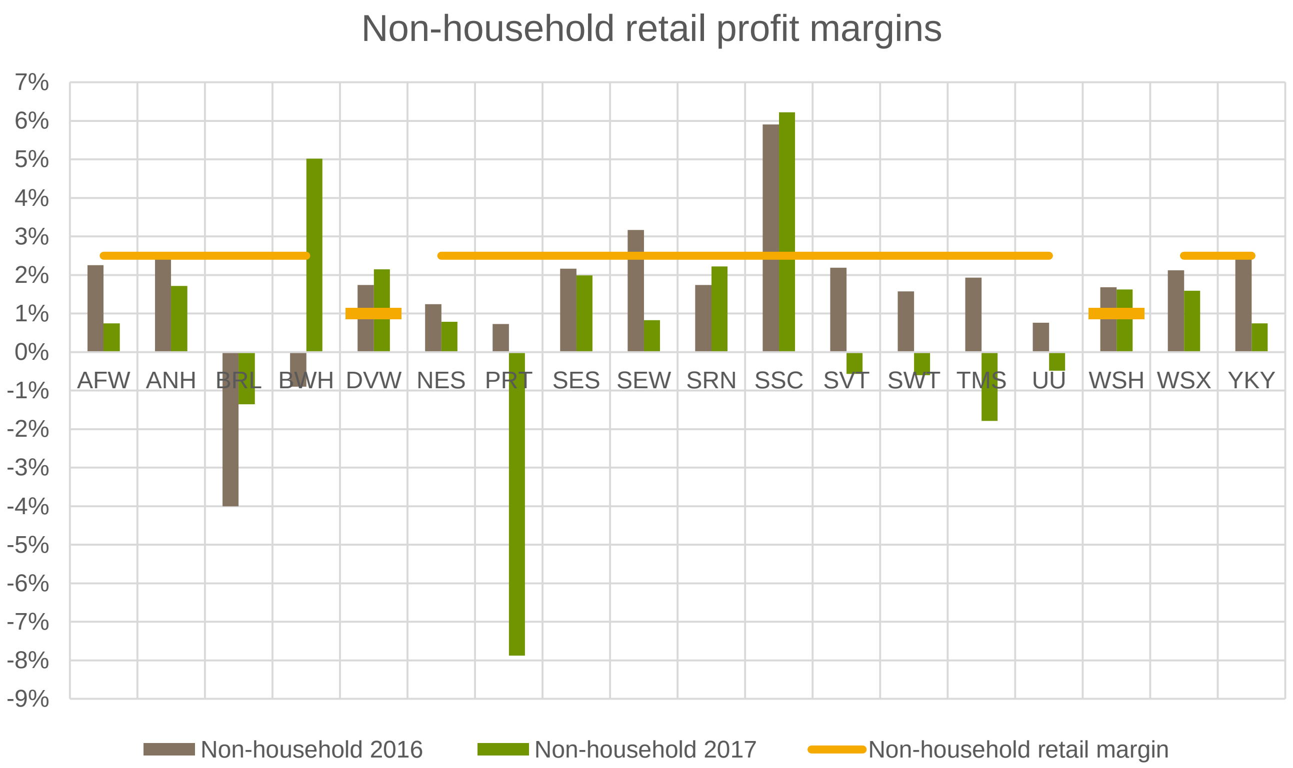
If companies outperform our cost assumptions for PR14 this insight will be used when setting the allowed costs at PR19, which should reduce future costs for customers.

Margins were calculated by reference to the allowed costs at FD and companies' actual margins earned can vary from the amounts allowed in the final determination if their retail costs differ from the average cost to serve that we assumed in each companies' final determination. Companies can earn household margins above the levels allowed, by reducing costs below the levels allowed in the final determinations and by managing bad debts, but must bear the costs if their costs rise above the allowance.

The household and non household controls are separate binding controls and costs (and revenues) must be allocated to the control to which they relate.

Further information about each company's performance can be found in their APRs which each company publishes on its website.

Non-household retail profit margins

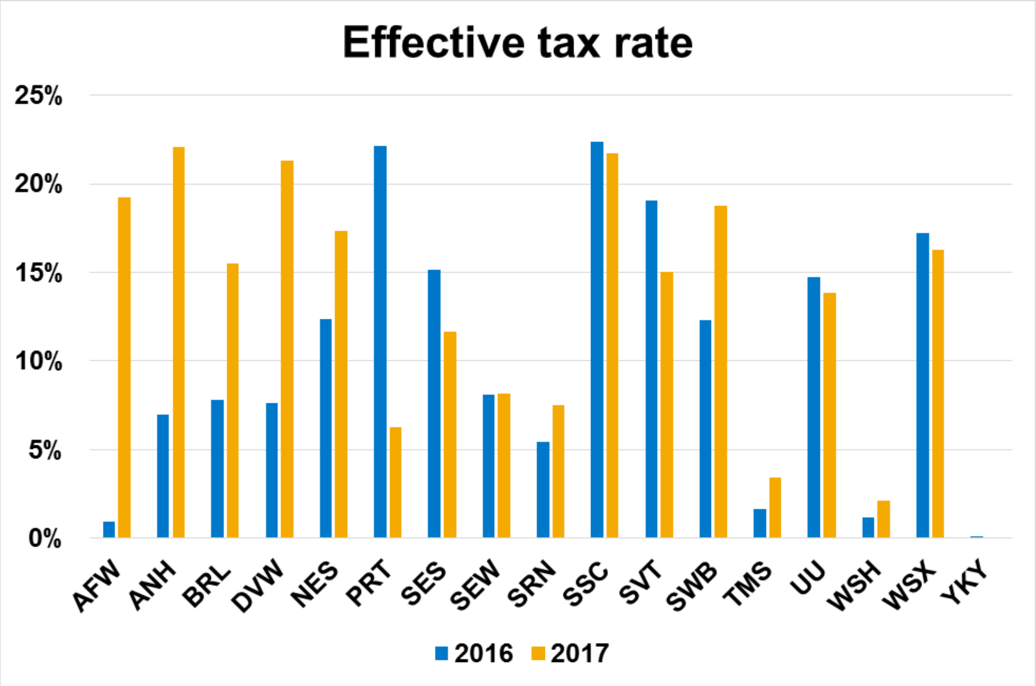


As with the household retail margins the non-household margin for Bournemouth Water is high as result of cost savings made following its acquisition by South West Water.

South Staffordshire Water has made significant retail cost savings which has boosted the margins that it has earned.

Portsmouth Water's margins have been negatively impacted by costs incurred in advance of the transfer of its non-household business to Castle Water from 1 April 2017.

Where companies' retail costs are below the levels anticipated at PR14, this will be taken into account when we set allowed revenue at PR19.



Companies paid a range of effective tax rates which varied between 0% and 22.1% (2015-16 0.2% and 23.5%) compared to the basic rate of corporation tax for each year of 20%.

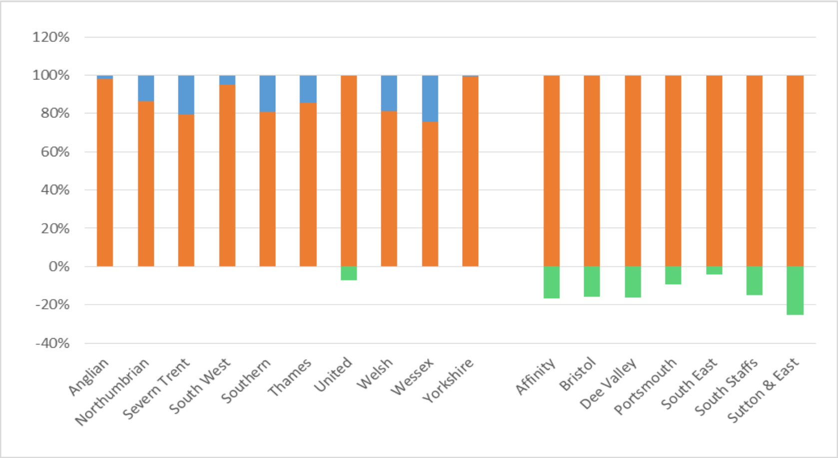
The effective rate of tax that companies pay is influenced by many factors including the level of capital expenditure over recent years, as a result of which they can claim capital allowances which defer taxation to future periods.

At PR14 we set tax allowances for each company based on their individual circumstances and proposed investment programmes. For many companies the allowance given to them was below 20%.

The disclosures made by companies also show that Anglian Water, Portsmouth Water, Southern Water, Thames Water, Wessex Water and Yorkshire Water were able to utilise group relief or consortium relief from connected companies which they did not pay for at the full tax value. This has enabled them to reduce the amount of tax paid and hence the effective tax reported is lower than the expected tax rate.

In the PR19 methodology consultation we have set out our proposal that companies should pay full value for any group relief that they receive and, if they do not, that we will claw back a proportion of the tax allowance they have received equivalent to that unpaid for group relief.

The effective corporation tax rate that companies paid in the year is calculated as current tax as a percentage of profit before tax and fair value adjustments. The effective tax rates shown here are slightly different to those included in table 4H of the APR. On reviewing the published data we identified an inconsistency in the basis of calculation of the effective tax rates, with some companies using profit before tax and fair value movements as a reference point and some companies using only profit before tax. We have therefore adjusted the data so that the calculations are made by reference to profit before tax and fair value movements and we have updated our APR guidance to reflect this clarification.



We have reviewed reported IAS 19 based exposures arising from companies' defined benefit pension schemes.

Overall the industry wide deficit at March 2017 equalled 8% of total pension liabilities. The overall increase in the year (£1.25bn) appears to result from further decreases in market based discount rates, along with a small increase in assumed inflation rates. Mortality assumptions remain generally steady.

While WoCs continue to report surpluses, only one WaSC, United Utilities, is reporting a surplus. All other WaSCs report deficits with Severn Trent's, as a percentage of RCV, being the largest at 7.3%. The chart below shows deficits as a percentage of total pension liabilities by company.

Each company determines the assumptions utilised, including discount and inflation rates, so comparability across companies is difficult. All WaSCs do however publish sensitivities which are useful in observing potential liability volatility. For example, a 50-basis point increase in discount rates could equate to a decrease in liabilities of circa £1.5bn.

Individual company exposures are kept under review and we are in discussions with companies with comparatively higher deficits to understand the steps being taken to manage their liabilities. These are companies with long term licences and a relatively high degree of stability and predictability over levels of activity which enables companies to have a reasonable level of certainty about future cash flows.

Cash contributions agreed by companies to repair deficits reflect actuarial valuations undertaken by independent scheme trustees and are reviewed by the Pensions Regulator. The results of actuarial triennial valuations may differ from accounting valuations as trustees are required to be prudent in setting assumptions. We expect companies to take account of their pensions position in their Long Term Viability Statements

Regulatory context

At the PR14 price review we set out our treatment of pension deficit repair costs for the 2015-20 price control period and beyond. We stated for each company the date at which customer contributions to deficit repairs will end; that no further allowances for deficit repair costs beyond the stated date will be allowed; and that we do not intend to allow companies to recover from customers any incremental deficit repair costs beyond those assumed at PR14 (which were based on PR09 valuations).

We continue to expect deficit repair costs, whether incremental or due after the dates specified, to be dealt with by management action or contributed by companies and their shareholders.

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ACICR	Adjusted Cash Interest Cover – An interest cover metric calculated as (FFO less regulatory deprecation)/cash interest paid
APR	Annual Performance Report – Annual report of performance published by the appointed companies
Dividend yield	Dividend paid as a % of regulated equity
FFO	Funds from operations – calculated as net cash generated from operating activities before changes in working capital
FD – Final determination	The final determination of allowed costs, revenues and prices by Ofwat
Gearing	Net debt / RCV
Net Debt	Net debt is calculated as all borrowings of the company less cash. It excludes any pension deficit liability and mark-to-market accounting adjustments.
Nominal	Interest rates, prices and costs are said to be in nominal terms if they include the impact of inflation
Notional	Ofwat "notional" capital structure for setting prices. For the current period the notional gearing is 62.5%
PR14 (PR19)	The Price Review which covers the period 2015-2020 (2020-2025)
RAGs	Regulatory Accounting Guidelines
Real	Interest rates, prices and costs are said to be in real terms if they exclude the impact of inflation
Regulatory deprecation	The amount by which the RCV is depreciated
RCF	Retained Cash Flow – the cash generated by the business after payment of dividends, but before capital expenditure
RCV	Regulatory capital value – This is the regulatory value of the investment that has been made in the company
Regulated Equity	RCV less net debt. This can be in actual or notional terms
RORE	Return on Regulated Equity – A return metric calculated using the notional level of net debt
Securitisation	Securitisation enables a company to raise debt by granting a mortgage (charge) over an identifiable stream of future cashflows
Totex	Total expenditure which includes both operational expenditure (opex) and capital expenditure (capex)
WaSC	Water and wastewater companies
WoC	Water only companies

Company acronyms

AFW	Affinity Water
ANH	Anglian Water
BRL	Bristol Water
BWH	Bournemouth Water
DVW	Dee Valley Water
NES	Northumbrian Water
PRT	Portsmouth Water
SES	SES Water
SEW	South East Water
SRN	Southern Water
SSC	South Staffordshire Water
SVT	Severn Trent Water
SWB	South West Water (including Bournemouth Water)
SWT	South West Water
TMS	Thames Water
TTT	Bazelgette Tunnel (Thames Tideway)
UU	United Utilities
WSH	Dŵr Cymru Welsh Water
WSX	Wessex Water
YKY	Yorkshire Water

Appendix 2: Comparability of data

To enable us to make meaningful comparisons between companies it is essential that the information about each company is compiled on a consistent basis.

We have been working with companies to ensure that all companies are reporting data that is clear and transparent and that they are reporting in line with guidance that we have issued.

Following the publication of the 2016 report we became aware that some companies had interpreted our guidance in relation to the calculation of RORE in different ways. This resulted in figures being published which were not calculated on a consistent basis across the industry.

As a result we have issued further guidance to companies to improve consistency of reporting and a number of companies have revised the RORE figures that they reported in 2016. These revised RORE figures for 2015-16 have been reflected in the annual average RORE figures reported for the AMP to date in this report.

We have also identified an inconsistency in relation to the reporting of effective tax rates and have adjusted the figures reported to remove this. We have updated our guidance in this area to improve consistency.

We are continuing to keep our reporting guidance under review and continue to highlight examples of good practice in reporting. We will also issue further guidance and clarification where we consider it necessary and will look to incorporate this into the Regulatory Accounting Guidelines (RAGs).

We also recognise that there may be good reasons why companies may wish to present alternative versions of specific metrics which we have asked them to publish. In this case we have asked companies to make it clear that they are using an alternative approach and to clearly state how their alternative calculations differ from the approach specified for the APR.

We do not expect any one company to be identical to all other companies. However we believe that, where appropriate, a company should be able to explain its relative position compared to its peers.

Where appropriate we have included the financial results of Bazalgette Tunnel Limited (Tideway or TTT) which is currently constructing the Thames Tideway Tunnel. While Tideway is a regulated business, its activities are significantly different to those of the other regulated water and wastewater companies and as a result we do not expect its financial performance to be directly comparable with that of the other regulated companies.

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1. While we have undertaken a high level review of the information published by companies and included in this report to ensure consistency, the responsibility for the accuracy of the information that each company publishes and which we have used when compiling the report remains with each of the appointed companies. Where companies have made changes to their data since publishing their APRs as a result of queries raised by Ofwat, we expect companies to republish those APRs to include the corrected data.

It should be noted that Bournemouth Water became part of South West Water with effect from 1 April 2016. Therefore for 2016-17 the results of the South West Water (now referred to as SWB) business include the combined results of both Bournemouth Water (BWH) and the original South West Water business (SWT). Due to the relative size of the two businesses, we have not restated the comparative figures for 2015-16 and previous years.

From 1 April 2017 the non-household retail market in England has been opened further to competition for eligible customers. A number of the appointed companies have already exited this market, and the retail only businesses are being regulated in a different way. For these reasons, this activity will not be covered by this report in future years.

2. Most companies' licences include a requirement with respect to maintaining an investment grade credit rating. The licence for South West Water (incorporating Bournemouth Water from 1 April 2016) also has a requirement to maintain an investment grade credit rating but in its current specific circumstances an exemption applies. This is because neither South West Water nor its parent company Pennon raise finance on the bond market, and as a result it does not have credit ratings. This is why no rating is shown in the table on slide 7. However, South West Water's licence does require it to maintain financial metrics appropriate to an investment grade credit rating regardless of this.

Credit ratings are usually provided by one of the three main credit rating agencies. The minimum investment grade credit ratings are Baa3 for Moody's Investors Service and BBB- for both S&P Global and Fitch Ratings as shown by the red line. Where a company has received an issuer or corporate family credit rating from more than one agency, the lowest credit rating received has been recorded.

Since the publication of companies' APRs, S&P downgraded the ratings on Thames Water's class A (senior) and class B (subordinated) debt and upgraded the long-term corporate credit and senior unsecured debt ratings for United Utilities. Moody's have also reaffirmed ratings for Severn Trent as stable and withdrawn the separate corporate family rating for Dee Valley Water following its acquisition by Severn Trent and have assigned an A3 long-term issuer rating to Dee Valley Water.

3. In line with changes to the UK Corporate Code in 2016, we introduced a requirement for companies to include a long term viability statement in their accounts. We set out our expectations on what companies should include in their statements in our Information Notice IN 16/03 March 2016.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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