WATER COMPANIES' FINANCIAL PERFORMANCE 2017-18

POTENTIAL IMPLICATIONS FOR CUSTOMERS

Our analysis of the financial performance of water companies in England and Wales and the potential implications for customers.

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Abbreviations and acronyms

ANH	Anglian Water
APR	Annual Performance Report
AFW	Affinity Water
BWH	Bournemouth Water
BRL	Bristol Water
DVW	Dee Valley Water
E&W	England & Wales
ECA	Economic Consulting Associates
FD	Final Determination
NES	Northumbrian Water
ODI	Outcome Delivery Incentive
PR14	Price Review 2014
PRT	Portsmouth Water
RCV	Regulatory Capital Value
RoRE	Return on Regulatory Equity
RPI	Retail Price Index
SES	Sutton and East Surrey Water
SEW	South East Water
SRN	Southern Water
SSC	South Staffs Water
SUDS	Sustainable drainage systems
SVT	Severn Trent
SWT	South West Water
TMS	Thames Water
totex	Total expenditure
UU	United Utilities
WaCC	Weighted average cost of capital
WaSC	Water and Sewerage Company
WoC	Water Only Company
WRFIM	Wholesale Revenue Forecasting Incentive Mechanism
WSH	Dŵr Cymru Welsh Water
WSX	Wessex Water
YKY	Yorkshire Water

1. Introduction

This report presents our analysis of the 2017-18 financial performance of the water companies in England and Wales.

The purpose of the report is to highlight whether water companies' financial performance could have implications for customers through:

- Opportunities for sharing outperformance of regulatory assumptions (particularly those financial windfalls which have not been as a result of direct management action)
- Ofwat's 2019 price control review
- Financial risks

We have produced the report in conjunction with Economic Consulting Associates Limited (ECA) who produced the report for us last year.

Consumers' views on the legitimacy of the water sector can be undermined if companies are seen to be making substantial financial gains. This is especially so if they are not delivering tangible improvements to consumers in return, or customers cannot see the results of water company investment.

We have previously identified[1] that there are a number of customers with concern about the fairness and value for money provided by the sector, as well as a lack of trust. Greater financial transparency and sharing benefits of outperformance may help address this.

The report uses information collected from water companies' published Annual Performance Reports (APRs) in the period 2015-18.

2. Executive Summary

We have previously indicated that we think that companies' financial gains should be shared with customers as well as shareholders. To this end we played a major part in encouraging companies to share the financial gains they made following the 2009 Price Review[2].

We continue to think that companies should share their financial outperformance with their customers at the earliest opportunity. This is regardless of whether the outperformance stems from direct management action or is simply as a result of prevailing economic conditions. The combination of these measures can only improve the views that customers have of both their water company and the sector as a whole.

[1] https://www.ccwater.org.uk/wp-content/uploads/2018/05/Ofwats-consultation-on-financial-benefit-sharing-mechanisms-in-the-2019-price-review-methodology-May-2018.pdf
[2] https://www.ccwater.org.uk/wp-content/uploads/2016/06/CCWater-response-to-BIS-Call-for-Evidence-on-consumer-landscape.pdf

Based on our analysis in this report we have summarised, in Table 1, our key areas of interest in respect of each companies' financial performance. In arriving at this position we have taken into account areas of companies' performance where:

- there are no regulatory mechanisms to share outperformance with customers (e.g. cost of debt).
- mechanisms exist but this typically shares outperformance at the end of the five-year price control period (e.g. totex).
- we would like to better understand how companies' policies are in the customer interest (e.g. dividends and corporate structure).
- companies' financial gains can stem from over-generous regulatory assumptions rather than direct management action (e.g. cost of debt).

In short we will be challenging companies to share more of their outperformance with customers and to do so at the earliest opportunity. A particular focus will be to understand what companies are doing for their customers as a result of the financial gains they have made owing to Ofwat's cost of debt assumption.

A key feature of companies' 'outperformance' of the assumed cost of debt is the difference between Ofwat's assumed level of inflation relative to actual. This effectively gives companies a financial windfall. On the basis of companies' financial performance in 2015-18 we estimate companies' financial gain on the cost of debt to be in the region of £500m. Currently there is no regulatory mechanism which shares this financial gain with customers.

We will continue to monitor companies' financial performance through their interim and full year results and future APRs. We will update our areas of interest accordingly.

Table 1: Areas where we will challenge companies on their financial performance*

	Return on regulatory equity – financing – cost of debt	Return on regulatory equity – expenditure (totex and retail)	Dividend policy	Corporate structure - Gearing
AFW**	✓	✗	✓	✓
SSC	✓	✓	✓	✓
UU	✓	✗	✓	✗
NES	✓	✓	✓	✗
SVT	✓	✓	✓	✗
SWT***	✓	✓	✓	✗
TMS**	✓	✗	✓	✓
WSX	✓	✓	✓	✗
SRN**	✓	✗	✗	✓
ANH	✗	✓	✓	✓
YKY	✗	✗	✓	✓
SES	✗	✗	✓	✓
DVW	✗	✓	✓	✗
PRT	✗	✗	✓	✗
SEW	✗	✓	✗	✓
WSH	✗	✗	✗	✗

BRL	✕	✕	✕	✕

*A tick means we will challenge the company; a cross means we will not

*** While Affinity, Thames and Southern gain financially on the cost of debt they each underperform against overall RoRE

***NOTE – to date in the 2015-18 period, only South West Water has a formalised mechanism to share its cost and financial outperformance benefits with customers

Return on regulatory equity (RoRE)

RoRE is a key metric Ofwat introduced at PR14. It is intended to measure the returns available to shareholders over the course of a price control period by reference to notional regulated equity.

With the exception of Dŵr Cymru Welsh Water all seventeen companies improved their cumulative returns on regulatory equity in 2017-18 from those reported in 2016-17. Of these, nine companies reported outperformance against the base case regulatory assumption. These were: South West, Severn Trent, Dee Valley, Wessex, Northumbrian, South Staffs, Anglian, United Utilities and South East.

However, to date in the 2015-18 period, only South West Water has a formal mechanism to share its cost and financial outperformance benefits with customers.

Companies' returns can come from a number of areas. These are: expenditure (wholesale and retail), financial (cost of debt outperformance) and outcome delivery incentive rewards/penalties (for delivering against their performance commitments to customers). In 2017-18 three companies (Thames, Southern and Portsmouth) also identified the impact of exiting the non-household retail market on their RoRE.

Companies' reported RoRE showed that:

- Five companies outperformed on expenditure, financing and ODIs. These were: Northumbrian, Severn Trent, South West, Wessex and South Staffs
- Nine companies underperformed on at least two of the areas. With the exception of Bristol and South East, all of these companies reported underperformance on expenditure.
- Portsmouth Water was the only company to not report any outperformance on any of the three areas.

What we will do for customers
We will challenge companies outperforming RoRE assumptions on whether they should share any current or historic outperformance with customers. From Table 1, the companies are: 1. Financing outperformance (cost of debt): South West, South Staffs, United Utilities, Northumbrian, Severn Trent, Thames, Wessex, Affinity and Southern 2. Expenditure outperformance: Anglian, Northumbrian, Severn Trent, South West, Wessex, Bristol, Dee Valley, South East and South Staffs

Outcome Delivery Incentives (ODIs)

ODIs accounted for the smallest proportion of companies' RoRE outperformance in the period 2015-18.

Three companies (Anglian, South West and Severn Trent) reported in-period penalties/rewards for their delivery against performance commitments in 2017-18. This amounted to a net reward of £62m of which Severn Trent accounted for over 90 per cent.

Companies have accrued a £14m net penalty until the end of the period for their delivery against performance commitments in 2017-18 (benefits of £22m being offset by penalties of £36m). The most significant accrued penalty was Thames Water (£33m) and most significant accrued reward was from Yorkshire Water (£13m).

Companies have also forecast around £60m net ODI rewards by 2020[3] for their performance over the five-years 2015-20. This reflects the rewards/penalties for three years known performance 2015-18 and two years of forecast performance in 2018-19 and 2019-20. Nine companies are forecasting a net reward (+£194m) against six companies with a net penalty (-£134m). Yorkshire and Anglian account for around two thirds of the total net rewards[4]. Thames Water[5] accounted for over two thirds of the forecast net penalties in its own right.

What we will do for customers
We will examine the net ODI rewards and penalties at the end of this price control period to understand the customer impact on 2020-25 price controls. We will seek to ensure that future ODIs have evidence of customer support and reflect challenging targets for areas of service customers view as a priority

Dividend policy

Six companies have reported dividend covers[6] in 2017-18 that illustrate their dividends exceed distributable profits for that year. These are: Thames, Portsmouth, Affinity, Anglian, United Utilities and South Staffs. In some cases this is due to one off financial restructuring. We expect companies to be able to explain why their dividend policies are in the customer interest.

Nine companies reported a dividend yield higher than the 5 per cent Ofwat plans to use at the forthcoming price review to inform its initial assessment of companies' business plans for the period 2020-25. These companies were: Affinity, South Staffs, South West, Anglian, Northumbrian, Wessex, United Utilities, Severn Trent and Sutton & East Surrey. Where

[3] Neither Severn Trent nor Dee Valley reported forecast rewards/penalties to 2020 in their APRs
[4] Yorkshire Water's forecast rewards stem from performance on water supply interruptions, internal sewer flooding and category 3 pollution incidents. For Anglian Water the drivers are: water supply interruptions, category 3 pollution incidents and leakage.
[5] Drivers for Thames Water's forecast net penalty are: leakage, asset health (water) and security of supply
[6] Dividend cover measures how many times a company's net profit covers the dividend it pays. Ofwat requires (RAG 4.07) dividend cover and dividend yield to be reported excluding dividends paid to a holding company to enable it to pay interest on an intergroup loan

companies exceed this 5 per cent threshold Ofwat expects companies to explain why dividends at those levels are in the customer interest.

What we will do for customers
We will monitor companies' dividends. Where dividend yields and/or dividend covers appear at odds with companies with similar risk profiles we will challenge companies to explain how their dividend policies are in the customer interest The companies are: all companies except: Dŵr Cymru Welsh Water, Bristol, Southern and South East

<u>Gearing</u>

In 2017-18 six companies reported an increase in gearing. These were: United Utilities, Affinity, South Staffs, Severn Trent, Southern and Dŵr Cymru Welsh Water. Eleven companies reported a reduction.

United Utilities reported the biggest increase but expects its gearing to return to around Ofwat's notional level (62.5%) towards the latter part of the price control period. A number of companies, for example Thames, Anglian and Southern have specifically indicated in their APRs that they plan to reduce gearing in the coming years.

In last year's report ECA noted that companies may seek to refinance and/or reduce gearing to manage indicated changes at PR19. Ofwat has also explained that it expects companies to reduce gearing where the high level of debt is impacting on the financial resilience of the company. Ofwat has since suggested an outperformance sharing mechanism at PR19 for the most highly geared companies. This is intended to allow customers to share in the returns equity investors achieve from high gearing.

While the proposed introduction of a formal benefit sharing mechanism in relation to gearing is welcome[7], this does not address the historical gains companies have made. Analysts expect opportunities for outperformance to be far less in the future, and companies are already responding to some of the proposals (e.g. commitments to reduce gearing). This could lead to customers' share of any future outperformance being significantly lower than the benefits companies have gained in the past.

Ofwat has also since indicated[8] it has had written commitments from a number of highly geared companies to reduce their debt.

If Ofwat's planned outperformance mechanism on gearing[9] was currently in place three companies could be expected to share benefits with customers. These are: Thames,

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[7] More detail can be found in section 4.7. Ofwat's proposals on benefit sharing can be found here: https://www.ofwat.gov.uk/wp-content/uploads/2018/04/Benefit-sharing-decision-statement-FINAL-for-publishing.pdf

[8] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/environment-food-and-rural-affairs-committee/regulation-of-the-water-industry/oral/86811.html

[9] https://www.ofwat.gov.uk/wp-content/uploads/2018/04/Benefit-sharing-decision-statement-FINAL-for-publishing.pdf

Affinity and Anglian. However, these three companies do not currently have a formalised mechanism to share benefits with customers.

What we will do for customers
We will monitor companies' gearing levels and seek to understand from companies how they are in the public interest. We will challenge companies on whether they should introduce any gearing benefit share before any formalised mechanism is introduced by Ofwat to apply from 2020. We will also challenge companies where their public commitments to reduce gearing are not delivered. The companies are: 1. Gearing level – all companies but particularly the more highly geared of: Affinity, Anglian, South East, Southern, South Staffs, Sutton & East Surrey, Thames and Yorkshire 2. Public commitments (from APRs) – Anglian, Southern and Thames

Credit Ratings

Three companies reported in their APRs that credit rating agencies have placed them on negative outlook. These were: Thames, Northumbrian and Yorkshire.

Yorkshire Water is one notch above the investment grade (BBB-/Baa3) required of it under its licence. A number of companies have also been put on negative outlook by Moody's though this does not seem to be reflected in some companies' APRs. Around 60 per cent of the companies that Moody's rates are now on negative outlook.

A high credit rating signals good credit worthiness, typically with lower associated interest payments. Conversely a low credit rating would typically mean higher interest payments. Any deterioration in credit rating could reduce any benefit going to customers if a cost of debt sharing mechanism was in place.

What we will do for customers
We will monitor companies' credit ratings and seek explanations from companies should these change. The companies are: Affinity, Anglian, Dŵr Cymru Welsh Water, Northumbrian, Portsmouth, Severn Trent, Southern, Thames, Wessex and Yorkshire

Financial structures

Opaque financial structures and complex ownership models do not help build customers' trust in the sector.

Companies have taken steps to address this in 2017-18. For example, five companies (Anglian, Thames, Southern, Yorkshire and Affinity) have simplified or are in the process of simplifying their financial structures by getting rid of their Cayman subsidiaries. They have done this on public interest grounds to avoid the negative connotations customers may have of these types of arrangements (e.g. tax avoidance and complexity of financial arrangements). The companies' aims are to be more transparent and improve trust in the sector.

What we will do for customers
We will challenge companies to be more transparent about their financial structures and to explain how their financial structures, performance and policies are in the consumer interest. This applies to all companies

3. Financial gains

3.1 How companies can make financial gains

The regulatory model incentivises companies to drive outperformance which can lead to financial gains for the company. These financial gains can be through:

- direct management action e.g. innovation leading to doing things more cheaply or financial rewards for ODIs where companies do better than performance commitments.
- indirect e.g. through differences between prevailing market/economic conditions and regulatory assumptions made when Ofwat set price limits

There also needs to be an awareness of what truly is outperformance as the regulatory model can create perverse incentives to cut costs e.g. capital maintenance. While short-term cost cutting could go unnoticed, this could be unsustainable in the long-term.

Where a company outperforms on performance commitments this can benefit all customers (not just those of the specific company) because it could push performance boundaries that Ofwat uses to assess relative company performance.

Outperformance of regulatory assumptions may give rise to financial gains through an additional return on regulatory equity (e.g. totex, financing costs (cost of debt) and ODIs). Other areas of outperformance, such as revenue, would not.

Revenue variances are not retained as financial gains or losses. Ofwat expects companies to use best endeavours to correct for over recovery of wholesale revenues within the price control period. Ofwat will take account of any over/under recovery at subsequent price review. At PR14 Ofwat's introduction of the wholesale revenue forecast incentive mechanism incentivised accurate revenue forecasts (Ofwat penalises companies for any under/over recovery outside a threshold).

Companies could also outperform owing to inflationary pressures where this increases revenue in line with inflation (RPI) but costs increase at a lower rate. In the past this has led to windfalls for companies.

At PR14 companies could also achieve further benefits by having what Ofwat viewed as an 'enhanced' business plan. This gave South West Water and Affinity Water a financial reward and access to a slightly higher WaCC. The RoRE performance in this report is relative to the higher regulatory assumption about RoRE that this enhanced status brings.

Typically, customers benefit from company outperformance when Ofwat takes account of any lower costs, for example, at the subsequent price review.

3.2 What companies can do with financial gains

Where companies outperform regulatory assumptions, they have a number of options. They could:

- Share benefits with customers
- Pay dividends to shareholders
- Retain money in the business

Sharing benefits with customers

Companies have a number of options to share outperformance benefits with customers. The most transparent of these is to reduce bills in the price control period. Alternatives could include additional investment (outside of the RCV), contributions to social tariffs and other forms of assistance. At the very least we would expect companies to reflect any lower costs incurred in their business plans for the next price review[10].

In the current price control period there is no requirement for companies' delivery against performance commitments to result in in-period ODI rewards/penalties. But at PR14 Ofwat agreed that three companies (Severn Trent, Anglian and South West) could apply ODI rewards or penalties in bills from 2017-18 onwards. During the 2015-20 price control period, all other companies will aggregate their ODI rewards and penalties at the end of the five years.

South West Water established its WaterShare scheme which has already shared some of its outperformance with customers. £5.5m are being passed back to customers either through reinvestment to improve services or through bill reductions (the company's performance in 2015-16 resulted in £3.1m being reinvested in 2016-17; in 2016-17 South West used £2.1m of the benefit to reduce bills in 2018-19 by around £3; 2017-18 performance resulted in £0.3m – the in-period ODI benefit - being passed back to customers through reduced bills in 2018-19. A further £9m remains in the company's WaterShare mechanism which is being deferred so it can be used to smooth the profile of future bills).

For the next price control period 2020-25 Ofwat has proposed to require sharing outperformance of higher gearing and to encourage sharing benefits of a lower cost of debt than Ofwat assumed when it set price limits. There is nothing that precludes companies sharing outperformance now, be that driven by choice of gearing, cost of debt or anything else.

Paying dividends to shareholders

[10] Companies submitted their Business Plans to Ofwat on 3 September 2018

We have previously identified that companies' returns to shareholders have significantly exceeded FTSE returns despite the much lower risk associated with the water sector[11].

Companies' dividend policies have also recently come under scrutiny. For example, in the debate about nationalisation of the water companies, it has been reported that dividends have often exceeded pre-tax profit with 2016-17 dividends up around 24 per cent on the prior year.

At the EFRA committee meeting on 11 July 2018[12] it was indicated that over £18.1 billion was paid out to shareholders of the nine largest English regional water and sewerage companies over the decade between 2007 and 2016; 95% of the profits went in dividends to shareholders.

To increase trust in the sector Ofwat has required[13] companies to explain their dividend policies, and how they relate to performance, in the Business Plans that they submitted to Ofwat in September 2018. Ofwat's guidance explained that:

> 'Where companies propose base dividend yields that are higher than 5% in their business plans, they should explain, transparently for customers and wider society, why such higher dividends are in customers' interests'.[14]

We think dividends should be aligned to the low risk associated with the sector and the service performance of the company. We think companies should show restraint on dividend levels given their privileged position as monopoly provider in a low risk sector.

<u>Retaining money in the business</u>

Where companies do not distribute the entirety of profit as dividends it retains this cash in the business. All things equal this would reduce the companies' gearing, increase its liquidity and provide some headroom for any unforeseen cost shocks without the need to borrow. This could have the effect of lowering the financial risk of the company and improve consumers' perception of the legitimacy of the sector.

4. Performance against regulatory allowances/assumptions

4.1 Overview

In this section we have compared the financial performance of water companies both between themselves and against the regulatory assumptions Ofwat made when it set price limits for the 2015-20 period. We have considered:

- Return on regulatory equity

[11] https://www.ccwater.org.uk/wp-content/uploads/2016/06/CCWater-response-to-BIS-Call-for-Evidence-on-consumer-landscape.pdf
[12] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/environment-food-and-rural-affairs-committee/regulation-of-the-water-industry/oral/86811.html
[13] https://www.ofwat.gov.uk/wp-content/uploads/2018/07/Benefit-sharing-decision-statement-FINAL-for-publishing.pdf
[14] The 5 per cent is neither an Ofwat target nor control. Ofwat expects companies to explain why dividend yields in excess of 5 per cent reflect performance delivery to customers and are in the customer interest

- Gearing
- Cost of debt
- Totex
- ODIs
- Revenue

We go on to consider indicative outperformance shares for customers if the proposed benefit sharing mechanisms that Ofwat proposes to implement in the 2020-25 period were introduced now.

4.2 Return on regulatory equity

The return on regulatory equity is a key metric Ofwat introduced at PR14. It is intended to measure the returns available to shareholders over the course of a price control period. However, it is based on Ofwat's assumed notional capital structure (62.5 per cent gearing at PR14) rather than companies' actual capital structures. As a result, RoRE may not be equivalent to actual returns.

In their APRs companies have reported how a number of factors have contributed to their out- or underperformance of RoRE relative to the regulator's assumptions. These are outlined in table 2. However, in 2017-18 three companies (Thames, Southern and Portsmouth) also identified the impact of exiting the non-household retail market on their RoRE:

Table 2: Areas where companies can outperform regulatory assumptions

Expenditure	• The company's share of totex out- or under-performance (excluding any differences arising from the re-profiling of totex within the period) • The company's share of out- or under-performance against retail costs • The impact on RCV run-off (i.e. slow money) of any totex out- or under-performance
ODI	• The impact of ODI or Service Incentive Mechanism rewards or penalties
Financing	• The difference between the actual average interest rate paid on debt and the allowed interest rate (both in real terms).[15]

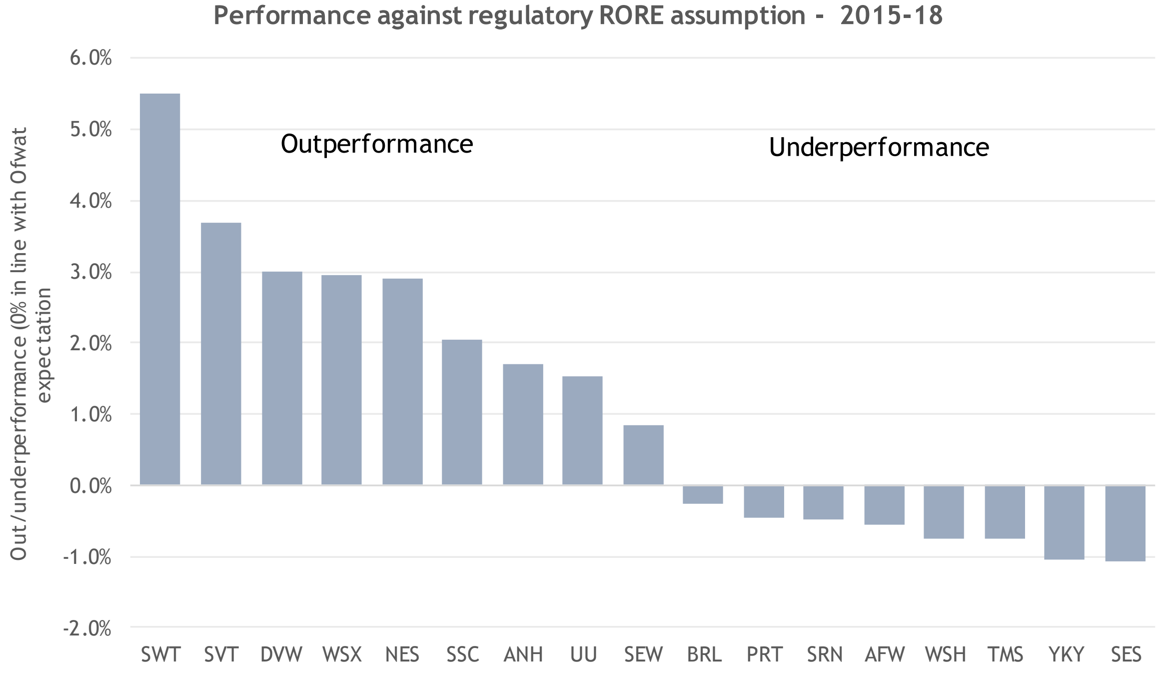
With the exception of Dŵr Cymru Welsh Water all companies have improved their cumulative return on regulatory equity that they reported last year. Figure 1 shows that nine companies have reported outperformance of the regulator's RoRE assumption. South West Water reported the highest RoRE which was over 5 per cent higher than the regulator's assumption.

Sutton and East Surrey reported the biggest underperformance against regulatory assumptions.

[15] https://www.ofwat.gov.uk/wp-content/uploads/2016/08/prs_web20160817regrep406.pdf

That mix of out- and underperformance in the 2015-18 period may be indicative of fairer regulatory assumptions at PR14. However, it is apparent that the scale of outperformance is significantly higher than companies' underperformance.

Figure 1: Return on Regulatory Equity (RoRE) cumulative performance 2015-18



In terms of the key contributors to RoRE:

- Only one company (Portsmouth) reported no outperformance from either, expenditure, financing or ODI
- Five companies reported outperformance on all three measures. These were: Northumbrian, Severn Trent, South West, Wessex and South Staffs
- Ten companies reported ODI outperformance
- Five companies reported outperformance on both financing and expenditure
- As in 2016-17, nine companies reported overall RoRE outperformance; 8 underperformance. With the exception of Dŵr Cymru Welsh Water all companies' cumulative RoRE improved in 2017-18. Dŵr Cymru Welsh Water's marginal decline of -0.3 per cent resulted from gains made on financing being outstripped by deterioration in expenditure and ODI performance
- In 2016-17 12 companies were underperforming on finance. Ofwat noted that with rising inflation it expected fewer companies to underperform on financing costs in 2017-18. While all companies improved the finance contribution to cumulative RoRE in 2017-18, seven companies have remained underperforming on finance.

South West Water, through its WaterShare scheme[16], has already shared some of its cost and financing outperformance with customers. In 2015-16 it reported a benefit of £3.1m which it attributed to lower than anticipated financing costs.

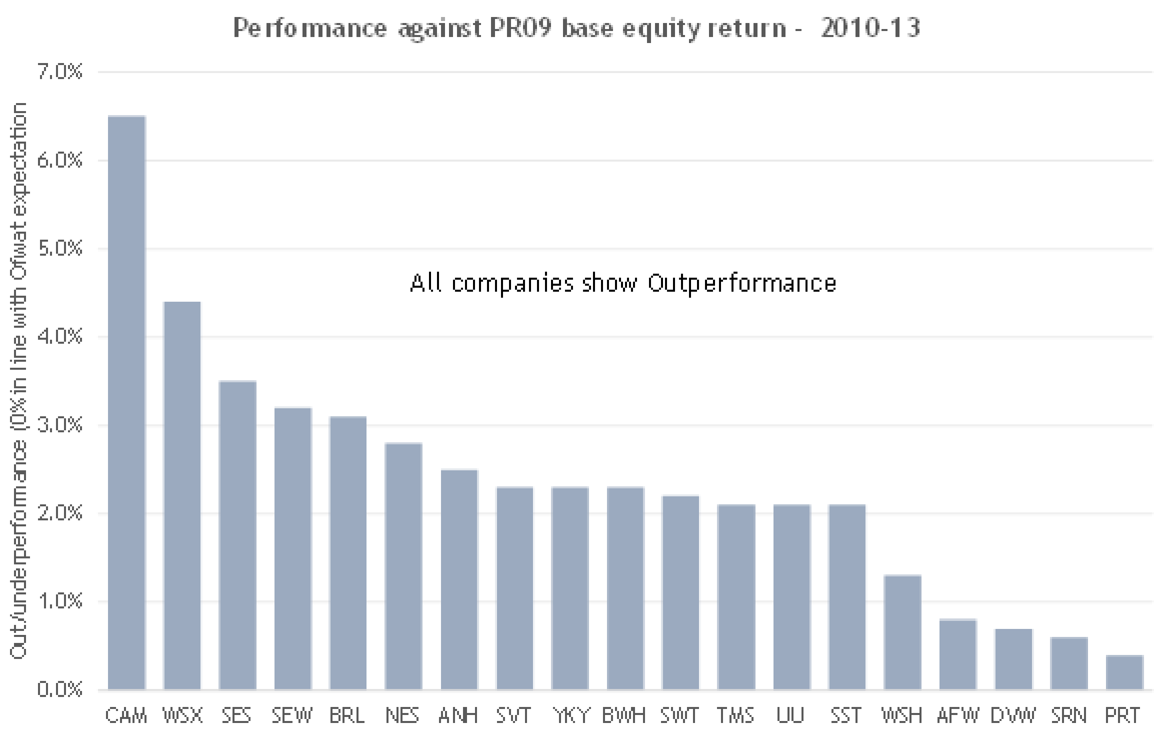
In last year's report ECA referred to the financial analysis it had done at a comparable point at the last periodic review. In its 2013 report ECA found that all companies experienced returns in excess of their base equity return across the first two years 2010-12 (outperformance ranged from +0.2 per cent to +8.4 per cent). ECA expected that better performing companies would outperform while the poorer performers would have a return lower than the base level. ECA concluded that:

> 'Combined with the experience from previous price control periods it reinforces the view that Ofwat's processes for challenging companies' business plans do not fully compensate for bias (systematic or unintentional) in company estimates'.

ECA's analysis over the first three years of the 2010-15 price control period showed companies' outperformed the base equity return on average by 2.2 per cent (range 0.6 per cent to 6.5 per cent). This is shown in figure 2.

In ECA's more recent work on the WaCC[17] ECA noted that "It is unclear whether this reversal in the tendency for water companies to outperform the market will persist; it may reflect the indications from Ofwat of a lower WACC and tougher settlement in PR19".

Figure 2: Performance against PR09 base equity return - 2010-13



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[16] https://www.southwestwater.co.uk/about-us/watershare/

[17] https://www.ccwater.org.uk/wp-content/uploads/2017/12/Recommendations-for-the-Weighted-Average-Cost-of-Capital-2020-2025.pdf

In the energy sector Ofgem reported[18] that none of the electricity and gas transmission and distribution companies reported a forecast return on regulatory equity lower than the regulatory cost of equity assumption in their current price control periods. Some of these companies have voluntarily returned some of their outperformance benefits to customers[19].

4.3 Gearing

Gearing measures the extent to which companies are funded by equity or debt. The more highly geared companies are riskier. This is because they have less discretion in the event of cost shocks. While interest payments on debt must be paid regardless of cash flow, companies have discretion over whether to pay a dividend to shareholders and at what level that dividend should be.

Ofwat says financial structure is a choice for companies – but sets prices based on a notional capital structure (at PR14 this was 62.5 per cent). Figure 3 shows the variability in the capital structures companies have adopted and have reported in their APRs.

At the Efra committee hearing in June 2018 Rachel Fletcher of Ofwat explained that it expects companies to reduce gearing where the high level of debt is impacting on the financial resilience of the company. Ofwat has had written commitments from a number of highly geared companies to reduce their debt.

The range in gearing reported in 2017-18 was 57.1 per cent (Dŵr Cymru Welsh Water) to 82.9 per cent (Thames Water).

In 2017-18 six companies reported higher gearing than in 2016-17. United Utilities reported increased gearing in 2018 of 3 per cent[20]. This was as a result of the net debt increase (of around £500m) exceeding the growth in the RCV. UUW attributes the increase in debt to acceleration of totex spend in the earlier part of the price control period which is not yet reflected in the RCV. United Utilities expects that gearing will reduce to around Ofwat's notional level in the latter part of the price control period as timing differences unwind.

Affinity Water reported an increase in gearing of 1.7 per cent. This was largely attributable to an increase in net debt from a bond issue in November 2017 partially offset by higher year end cash in hand. The company's reported gearing of 79.7 per cent is marginally lower than its internal threshold of 80 per cent giving some headroom within its financial covenants (which are triggered at 90 per cent).

Thames Water reported the highest gearing in the sector at over 80 per cent. However, the company has indicated in its APR that the "Board and our shareholders are all committed to bringing the gearing down over time, and I expect this will start to be

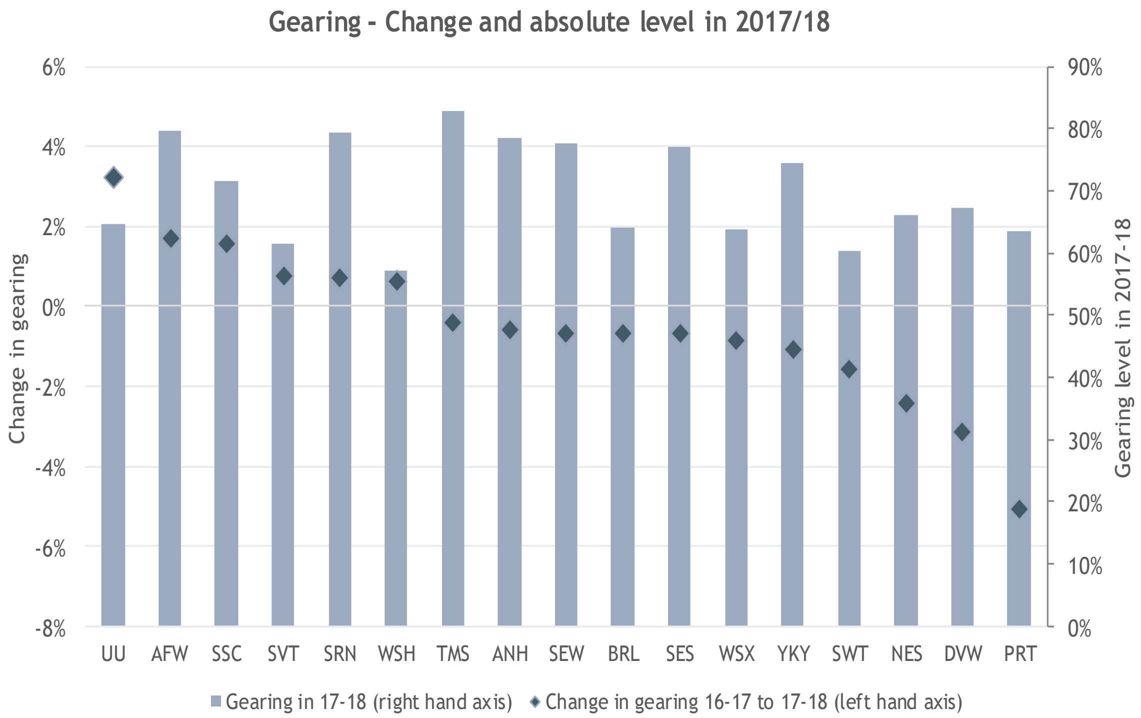
[18] https://www.ofgem.gov.uk/publications-and-updates/ofgem-publishes-latest-annual-reports-energy-network-price-controls
[19] https://www.ofgem.gov.uk/publications-and-updates/ofgem-welcomes-sgn-s-contribution-consumers
[20] UUW excluded preference shares of £130m from 2016-17 net debt so reports a true like for like increase 2 per cent

noticed over the next few years". In its Business Plan to Ofwat it sets out its plans to reduce gearing by 5 per cent by 2024-25.

In its APR Anglian Water reported a reduction in gearing and signalled on 15 March 2018[21] that it will reduce future dividends and borrowings through to 2025 which will result in both lower debt and gearing.

Southern Water indicated in its annual report that its financing plan includes a reduction in gearing and interest costs.

Figure 3: Gearing: Change 2016-17 to 2017-18 and absolute level



4.4 Cost of debt

We have previously raised with Ofwat our concerns about high gearing. We have also raised concerns that companies have been consistently able to outperform the regulator's cost of capital assumptions.

Ofwat commissioned PWC at the 2014 Periodic Review to consider the weighted average cost of capital (WaCC)[22]. On the cost of debt PWC reported that:

> Looking back at previous price controls, Ofwat's record in setting the cost of debt has been generous ex-post. Whereas the cost of debt assumption in PR94 was set at a level close to the outturn figures, the cost of debt

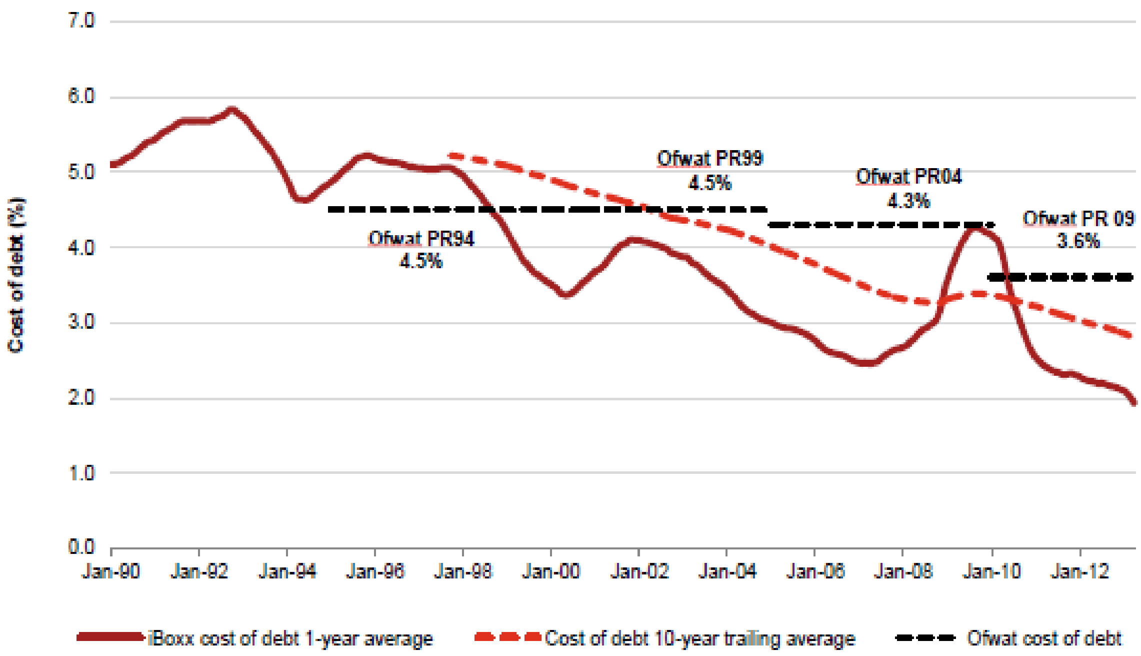
[21] https://media.anglianwater.co.uk/anglian-water-announces-commitments/
[22] https://www.ofwat.gov.uk/wpcontent/uploads/2016/01/rpt_com201307pwccofc.pdf

subsequently fell below the PR99 cost of debt ex-ante assumption. This pattern continued into PR04 and PR09. However, this pattern is understandable, as the past 20 years has been characterised by a long-term reduction in interest rates with the price setting process always lagging the market movements, reflecting that this decline was not anticipated in advance.

Source: **PWC report -** ***Cost of capital for PR14: Methodological considerations July 2013***

Figure 4, which has been copied from PWC's report, shows a graphical representation of how Ofwat's historical cost of debt assumptions have been consistently outperformed

Figure 4: Ofwat's cost of debt assumptions



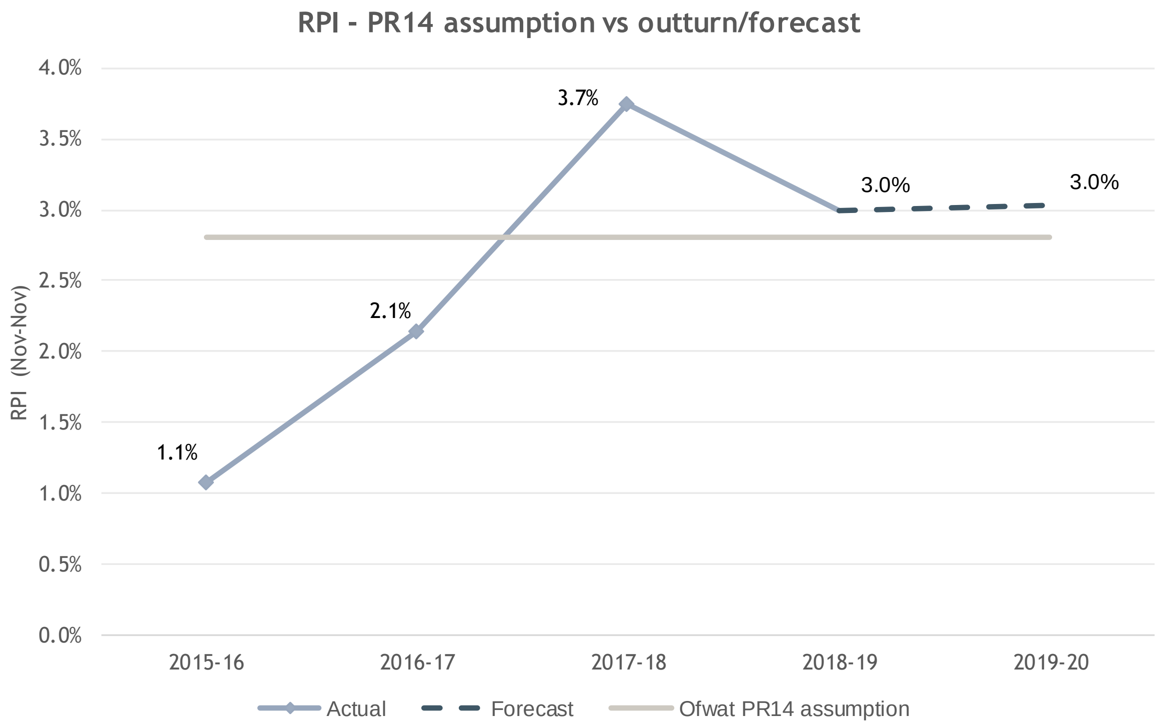
Source: PwC analysis, DataStream, Bank of England, Capital IQ, Ofwat

Figure 5 shows actual and forecast inflation[23] relative to Ofwat's 2.8 per cent RPI assumption it used in estimating the real cost of debt at PR14. It shows that inflation has been higher in 2017-18 than Ofwat assumed. This gives scope for companies who have a relatively low proportion of RPI-indexed debt to outperform Ofwat's real cost of debt. This scope was not as big in 2015-16 where inflation was low.

For the remainder of the price control period to 2020 RPI is forecast to be higher than Ofwat's assumption. The effect is to overestimate the real cost of debt for the proportion of debt not index linked.

[23] Forecast inflation for 2018-19 and 2019-20 based on projections from Office for Budget Responsibility http://obr.uk/forecasts-in-depth/the-economy-forecast/inflation/

Figure 5: RPI: PR14 assumption vs outturn/forecast



The effect of inflation can be seen in a comparison of actual interest costs with Ofwat's PR14 assumption. Figures 6 and 7 show this on a nominal and real basis respectively. In 2017-18 all companies' interest costs are lower than Ofwat's PR14 assumption. Where companies' financial outperformance does not stem directly from companies' management action i.e. it is because of prevailing market/economic conditions and regulatory assumptions, there is a case for sharing these benefits with customers.

Figure 6: Companies nominal cost of debt relative to Ofwat's PR14 assumption

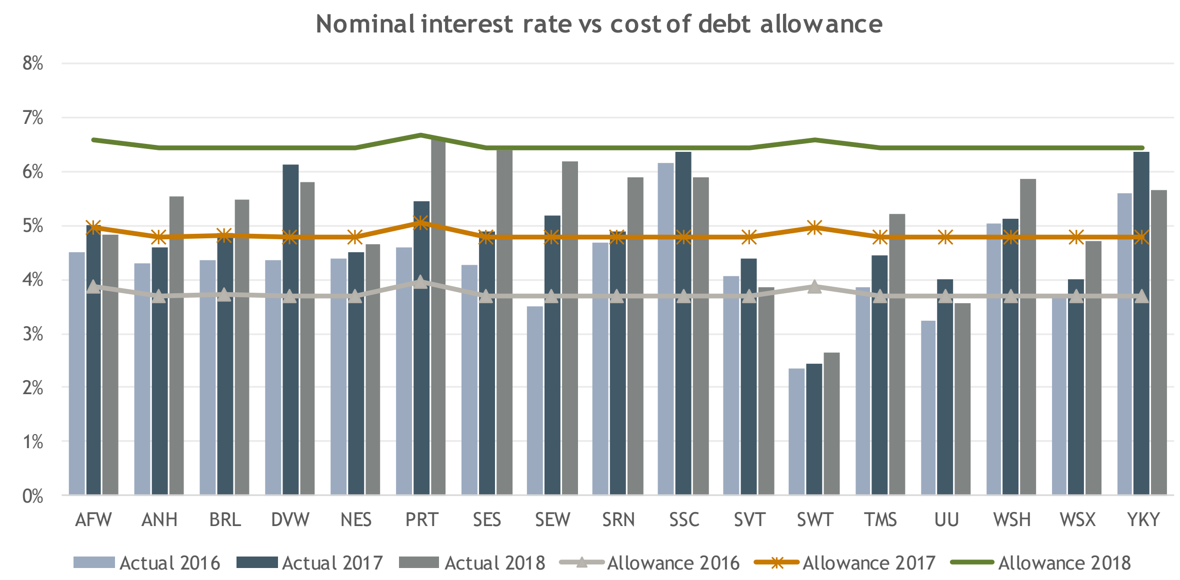
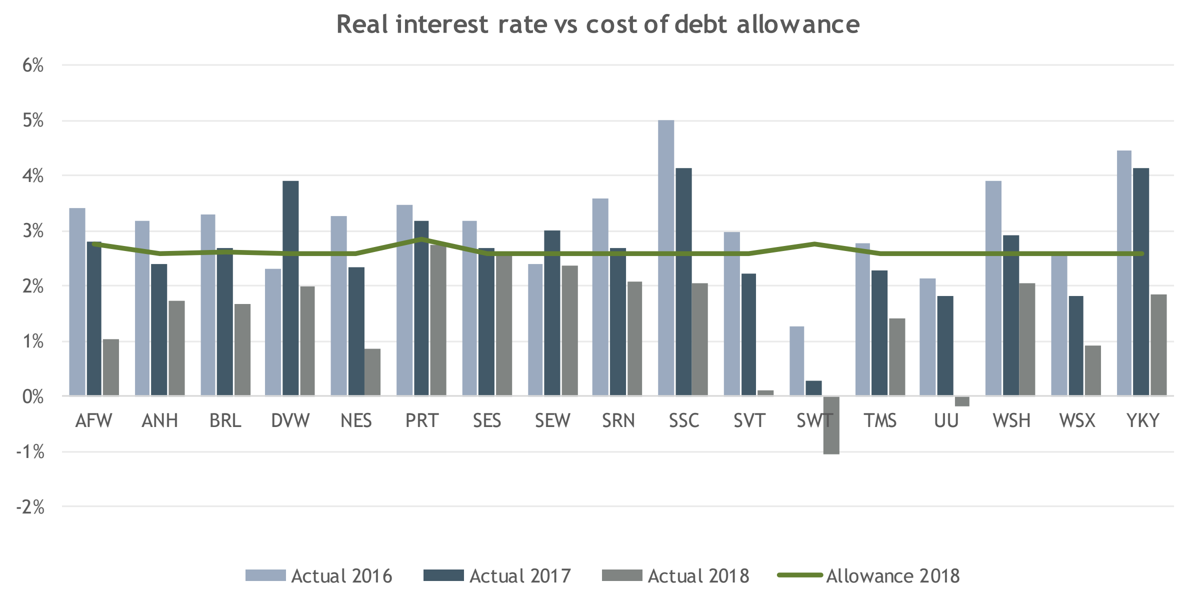


Figure 7: Companies real cost of debt relative to Ofwat's PR14 assumption



4.5 Totex

In PR14 Ofwat adopted a total expenditure (totex) based approach to assessing efficient expenditure for the wholesale price controls. This approach was intended to remove the perceived bias towards capital intensive solutions that might arise from the separate assessment of operating and capital expenditure.

Ofwat introduced menu regulation for capital expenditure in PR09 and extended this to totex at PR14. Menu regulation is intended to incentivise companies to accurately forecast spend. It also gives companies flexibility in how they will share outperformance with customers. Any benefit sharing of outperformance are determined at the outset. If a company delivers its commitments at a lower cost than was included in price limits then this saving is shared between customers and the company. Conversely, where the company spends more, then both the company and customers contribute towards the additional expenditure. These variances are taken into account at the next price review.

Variance to the regulatory assumption can occur for a number of reasons including, for example, efficiencies (delivering the same scope but at a lower price) or profiling change (the phasing of spend differs to the regulatory assumption). Companies' should take account of these timing differences when calculating RoRE as reported in section 4.2.

The cumulative totex position 2015-18 is shown in figure 8. This shows that only three companies reported an overspend relative to Ofwat's PR14 assumption. These were United Utilities, Thames Water and Dŵr Cymru Welsh Water.

United Utilities has spent around 10 per cent more than Ofwat's PR14 assumption. United Utilities explained that it accelerated spend (brought it forward) so that it could better target service levels, improve performance against outcomes and drive future sustainable efficiency savings. However, United Utilities' RoRE analysis, which should take account of differences between forecast and actual timing of spend, shows expenditure underperformance.

Despite this, over the course of the 2015-20 period United Utilities expects to make savings of around £100m relative to the Ofwat assumption.

Thames Water reported totex around £300m higher than allowed. This was primarily driven by increased spend on its water service (£230m) which the company attributes to reflecting the need to improve leakage and resilience. Over a third of these costs related to inefficient leakage costs. While Thames could get customers to pay for an element of this through the totex sharing mechanism, shareholders have committed to fully bearing this cost. Thames Water's RoRE analysis shows expenditure above allowances.

Fourteen companies reported lower totex than the regulator assumed. These ranged from 0.4 per cent lower (South Staffs) to nearly one fifth lower (South West Water).

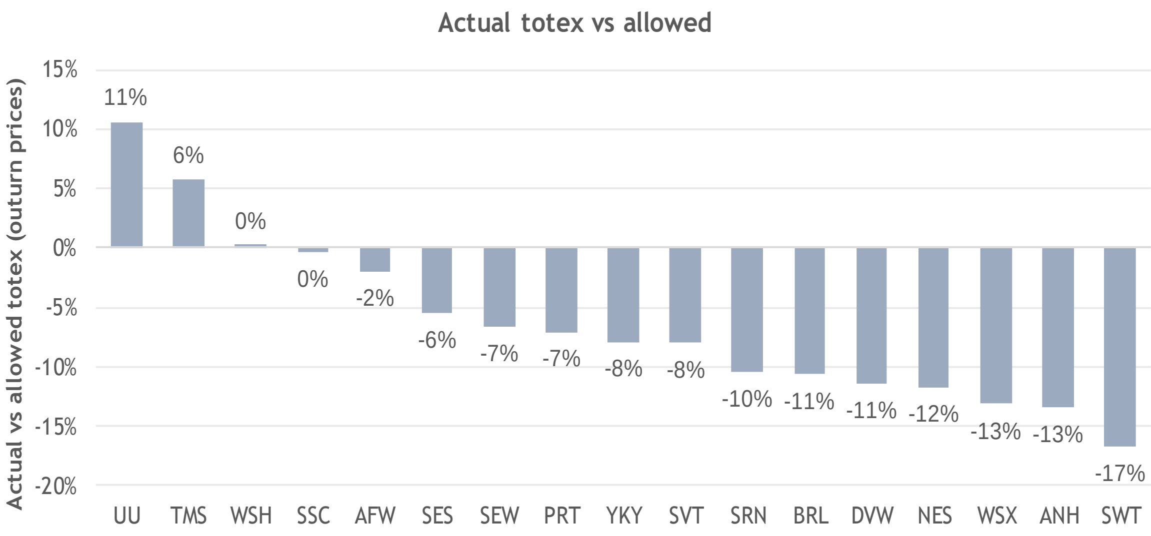
South West Water reported totex around £200m lower than allowed. South West Water attributes pretty much all of this net reduction to efficiencies. The company has front end loaded its efficiencies and savings so that it allows earlier and more certain outperformance.

Northumbrian Water reported totex 12 per cent lower than Ofwat assumed. The majority of this underspend was on the company's waste water programme. The company explained in its APR that its strong efficiency was due to a new capital investment delivery model and investment in renewable energy and SUDS.

Five companies that reported underspend relative to the Ofwat assumption did not include any expenditure related outperformance in their RoRE calculations. These are: Affinity, Portsmouth, Sutton & East Surrey, Southern and Yorkshire. In these companies the underspend could be attributable to timing.

We expect companies to have reflected claimed efficiencies in their business plans for PR19.

Figure 8: Companies actual totex relative to Ofwat's PR14 assumption (cumulative 2015-18)



4.6 Outcome delivery incentives

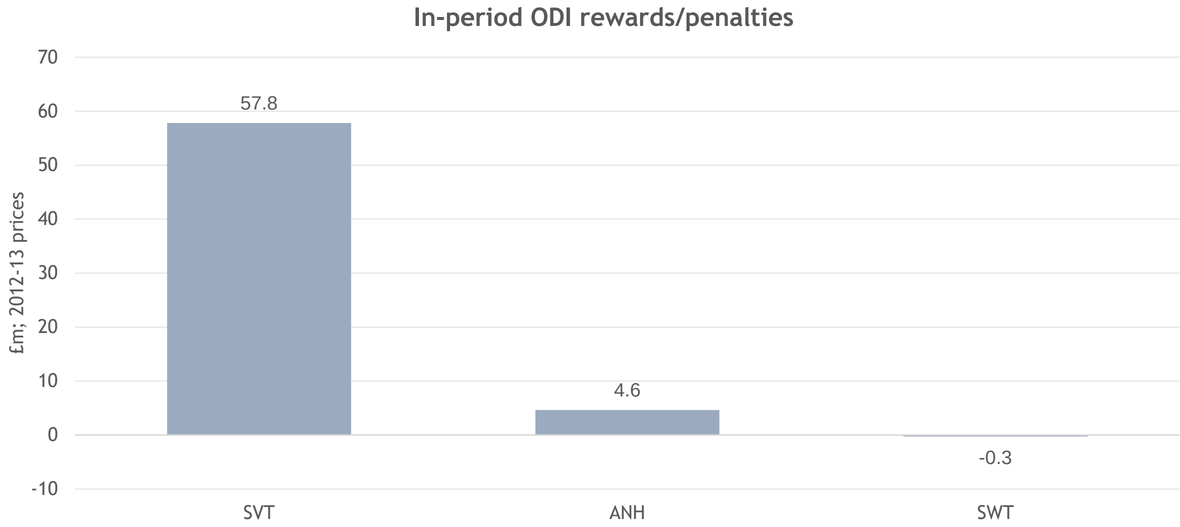
At PR14 water companies identified the outcomes their customers expect and report on delivery against these annually. This includes the outcome delivery incentives (ODIs) attached to these performance commitments.

Companies' failure to meet targets can result in financial penalties; performing better than target can lead to rewards. We challenge those underperforming companies, especially where performance commitments reflect customer priorities, to improve.

For most companies Ofwat will take account of these penalties/rewards at the next periodic review of price limits by adjusting revenue or companies' regulatory capital values. This means that their customers will therefore not be financially impacted by 2017-18 performance against ODIs in the 2015-20 price control period. But for three companies (Severn Trent, Anglian and South West) Ofwat agreed at PR14 that these rewards or penalties could apply in bills from 2017-18 onwards.

Figure 9 shows that Severn Trent Water had the most significant in-period ODI benefit in 2017-18 of £58m. This was largely attributable to an £84m benefit owing to the company's performance on sewer flooding being partially offset by a £24m penalty arising from interruptions to supply greater than three hours.

Figure 9: In period ODI rewards/(penalties)



Companies also reported on the 2017-18 ODI rewards/penalties that they have accrued to the end of the current price control period. Yorkshire Water accrued the largest reward of nearly £13m. This was largely due to rewards of £10m and £7m for water supply interruptions and internal sewer flooding respectively. This was offset by a £7m penalty for drinking water contacts.

Thames Water accrued the largest net penalty in 2017-18 of around £30m. This will be taken into account at the end of the 2015-20 price control period. This resulted from underperformance on: leakage (£13m); supply interruptions over four hours (£11m), security of supply (£7m) and water infrastructure asset health (£5m).

In view of its leakage performance Thames Water will return around £120m to customers by way of reduced bills in 2019-20, 2020-21 and 2021-22. The £120m comes as a result of an Ofwat investigation into Thames' leakage performance. It consists of a £55m[24] automatic penalty for failing to meet its performance commitment on leakage through the ODI mechanism and an additional £65m to compensate customers for its performance. Ordinarily this would be taken into account at the next Periodic Review but it has been brought forward so customers benefit earlier.

[24] This is expressed in 2018-19 prices and reflects the automatic ODI penalties for leakage and security of supply performance (actuals in 2016-17 and 2017-18 and forecasts for 2018-19 and 2019-20). It includes the £20m penalty in 2017-18 (2012-13 prices) which is £23m in 2018-19 prices

Companies have also forecast net rewards/penalties covering the entire 2015-20 price control period. This covers actual performance in the first three years and forecast performance for the last two years. There is significant variation between the companies. For example, Yorkshire Water forecasts a £68m benefit (2012-13 prices) whilst Thames Water forecasts a £93m penalty.

Yorkshire Water's forecast net reward is driven by performance on: water supply interruptions (+£36m); internal sewer flooding (+£24m) and category 3 pollution incidents (+£19m). This was partially offset by a penalty of -£14m for drinking water contacts (e.g. discolouration/odour).

Thames Water's forecast net penalty is driven by performance on: leakage (-£49m); asset heath – water (-£23m) and security of supply (-£9m).

Figure 10 shows those companies with forecast rewards/penalties over £10m. All of these companies are WaSCs.

Figure 10: Forecast 2015-20 ODI rewards/(penalties) - Greater than £10m

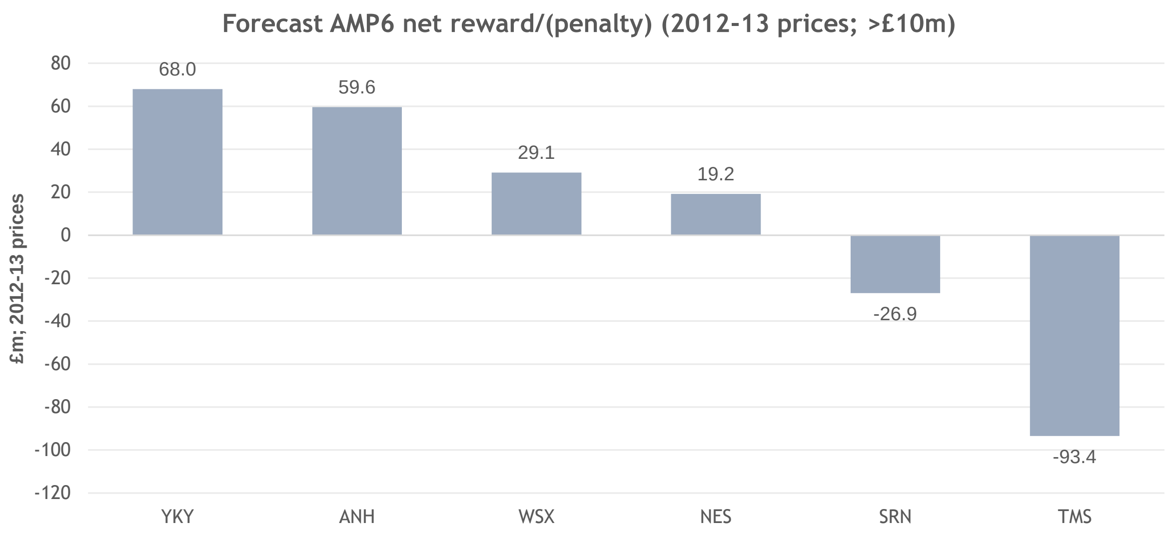
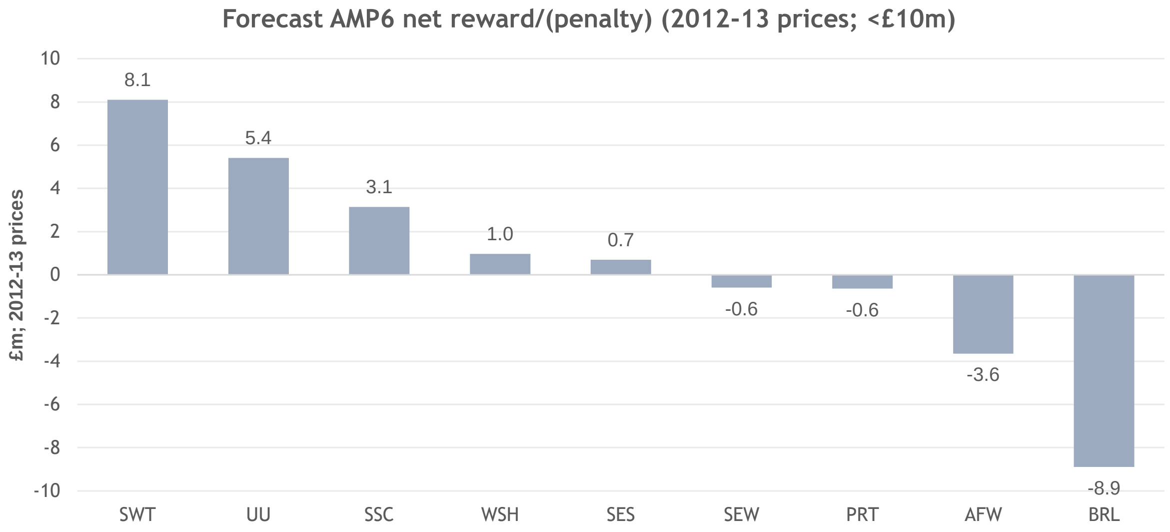


Figure 11 shows companies whose forecast net rewards/penalties for the entire price control 2015-20 period are lower than £10m. With the exception of United Utilities and Dŵr Cymru Welsh Water all these companies are WoCs. Overall six companies are forecasting ODI penalties whilst nine companies forecast rewards[25].

Figure 11: Forecast 2015-20 ODI rewards/(penalties) - Less than £10m

[25] Note: Neither Severn Trent Water nor Dee Valley Water forecast net ODI rewards in Table 3A of their APRs



4.7 *Indicative outperformance calculations*

4.7.1 *Gearing benefit share*

Ofwat announced on 3 July 2018 its proposed approach to benefit sharing for the next price control period 2020-25.

Companies with gearing over 70 per cent will be required to share financial outperformance between customers and investors.

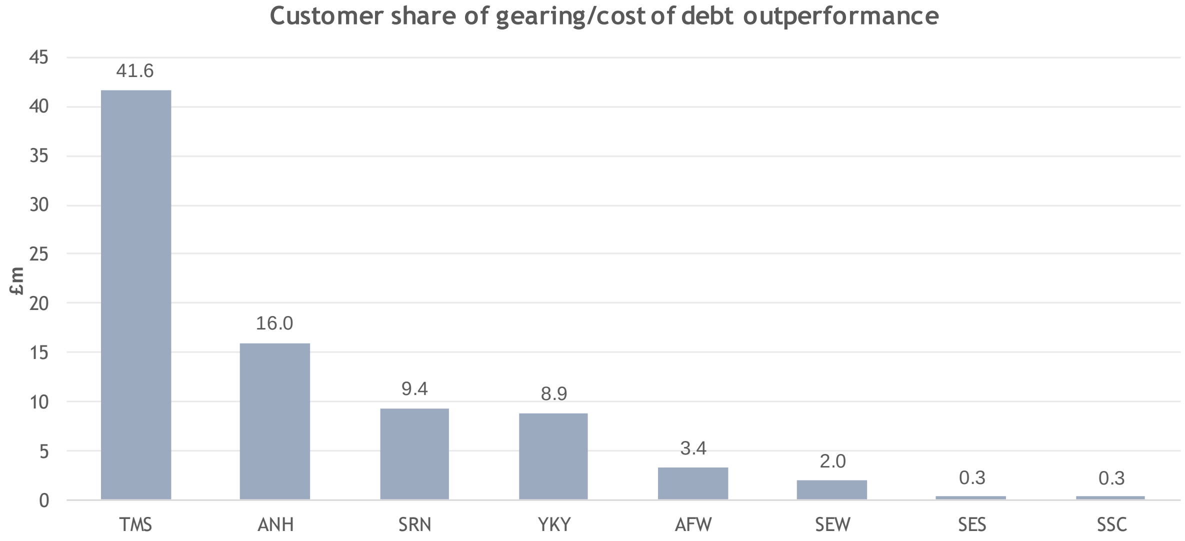
Based on Ofwat's proposed methodology we have calculated that eight companies could be required to share benefits with customers if this mechanism had been used in the 2015-20 period. We estimate that the overall value of this to customers could be around £82m[26]. This is shown in Figure 12.

Benefit sharing occurs if two conditions are met. First that the company's gearing exceeds 70 per cent and secondly that its actual, nominal cost of debt is lower than the nominal cost of equity Ofwat assumed when it sets price limits for the 2015-20 period.

If Ofwat changed the 70 per cent threshold to 65 per cent Dee Valley Water would also have to share outperformance. Our calculations suggest the customer share would be around £0.03m.

Figure 12: Customer share of cost of debt outperformance (indicative)

[26] Consumer share of the benefit is 50 per cent. Benefit is calculated on the level of gearing (%) above 65 per cent applied to the RCV (net debt and regulated equity from table 4H of companies' APRs). Nominal actual cost of debt versus nominal assumed cost of equity derived from PR14 real cost of equity of 5.65 per cent and 2.8 per cent inflation assumption.



We indicated in our response to Ofwat's consultation[27] on financial benefit sharing mechanisms that consumers' trust and confidence in the water sector can be undermined if companies are seen to be making substantial financial gains. This is especially so if they are not delivering tangible improvements to consumers in return.

We have identified that customers are concerned about the fairness and value for money provided by the sector, as well as a lack of trust. While Ofwat's approach will address the risk of significant gains occurring in the future, high investor returns achieved from higher gearing and lower cost debt financing have occurred in the past.

In addition, Moody's recently indicated[28] that companies have more limited scope for financial outperformance post PR19 than they have had in the past. While any sharing with customers is welcome it could be considered a missed opportunity that customers have not benefited from significant historical gains in a similar manner.

Increased financial transparency and a share of the benefits when companies make gains from debt financing and higher gearing may help address trust issues in the sector. However, this is not as strong as it might have been if this was introduced earlier or covered historical outperformance.

[27] https://www.ccwater.org.uk/wp-content/uploads/2018/05/Ofwats-consultation-on-financial-benefit-sharing-mechanisms-in-the-2019-price-review-methodology-May-2018.pdf
[28] https://www.waterbriefing.org/home/regulation-and-legislation/item/15136-moody%E2%80%99s-warns-ofwat-plans-will-undermine-stability-and-confidence-in-water-sector

4.7.2 *Cost of debt outperformance*

We have also estimated from companies' APRs that the value to companies of their cost of debt outperformance over the 2015-18 period is in the region of £500m. We have calculated this based on companies reported notional regulatory equity and the breakdown of their cumulative RoRE performance. Table 3 shows the breakdown of this outperformance. Six companies have reported financing outperformance and that their overall RoRE is higher than the regulatory base assumption. A further three companies have reported financing outperformance but their overall RoRE is lower than the regulatory base assumption.

Table 3 - Quantification of cost of debt outperformance

	Number of companies	Financing outperformance
Financing and overall RoRE outperformance	6	£446m
Financing outperformance but overall RoRE underperformance	3	£124m
TOTAL	9	£570m

4.8 *Revenue*

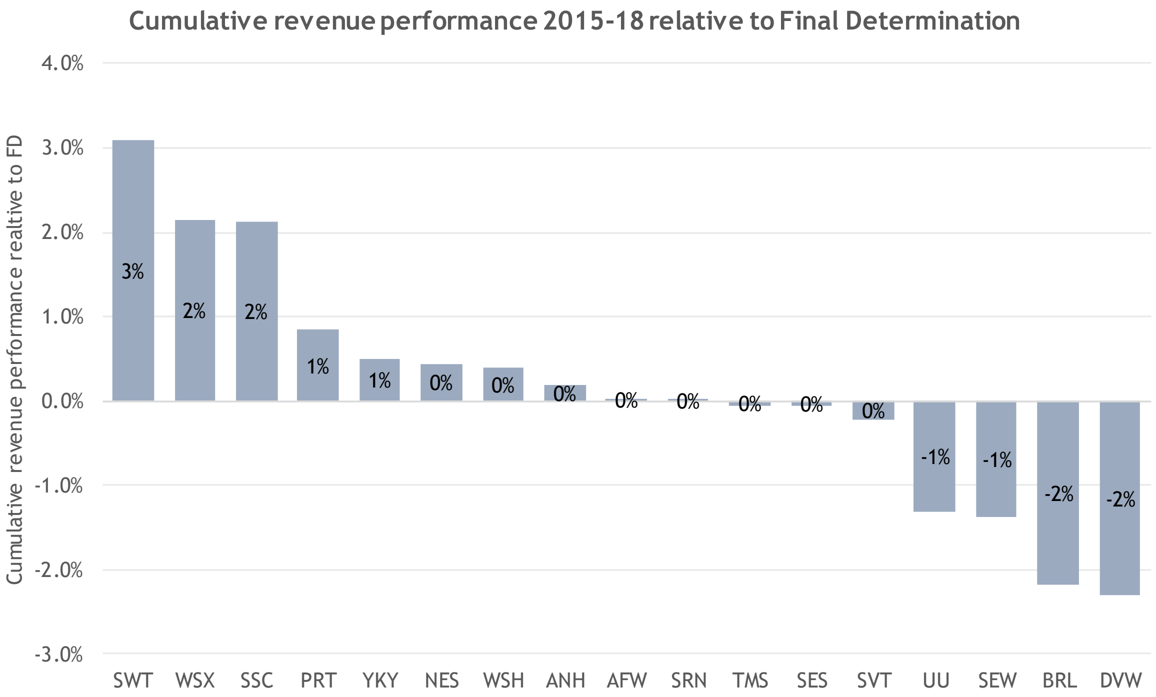
As explained in section 3.1, revenue variances are not retained as financial gains or losses. Ofwat expects companies to make in-period adjustments or will itself take account of revenue performance at a subsequent price review.

Figure 13 shows that most companies' revenue (cumulative between 2015-18) did not vary significantly from the Final Determination. Twelve companies reported revenue within 2 per cent of Ofwat's assumption. The most significant variance was for South West Water[29] whose cumulative revenue exceeded the Final Determination by 3 per cent.

Companies could get a financial benefit if revenues increased in line with inflation but costs increased at a lower rate. However, companies' APRs currently show totex between 2015-18 increased at a higher rate than the revenue change over the same period. This is likely to be distorted by companies' decisions on the phasing of their investment where companies have front-end loaded this into the earlier part of the 2015-20 price control period.

[29] NOTE: South West Water's cumulative revenue performance includes Bournemouth Water revenue

Figure 13: Cumulative revenue performance 2015-18



5. Risk

This section focusses on areas of companies' financial performance and structure that could have implications for customers. These implications could be through the perceptions customers get of companies through their financial performance and/or implications of companies' financial position at the next periodic review of prices.

5.1 Composition of companies' debt

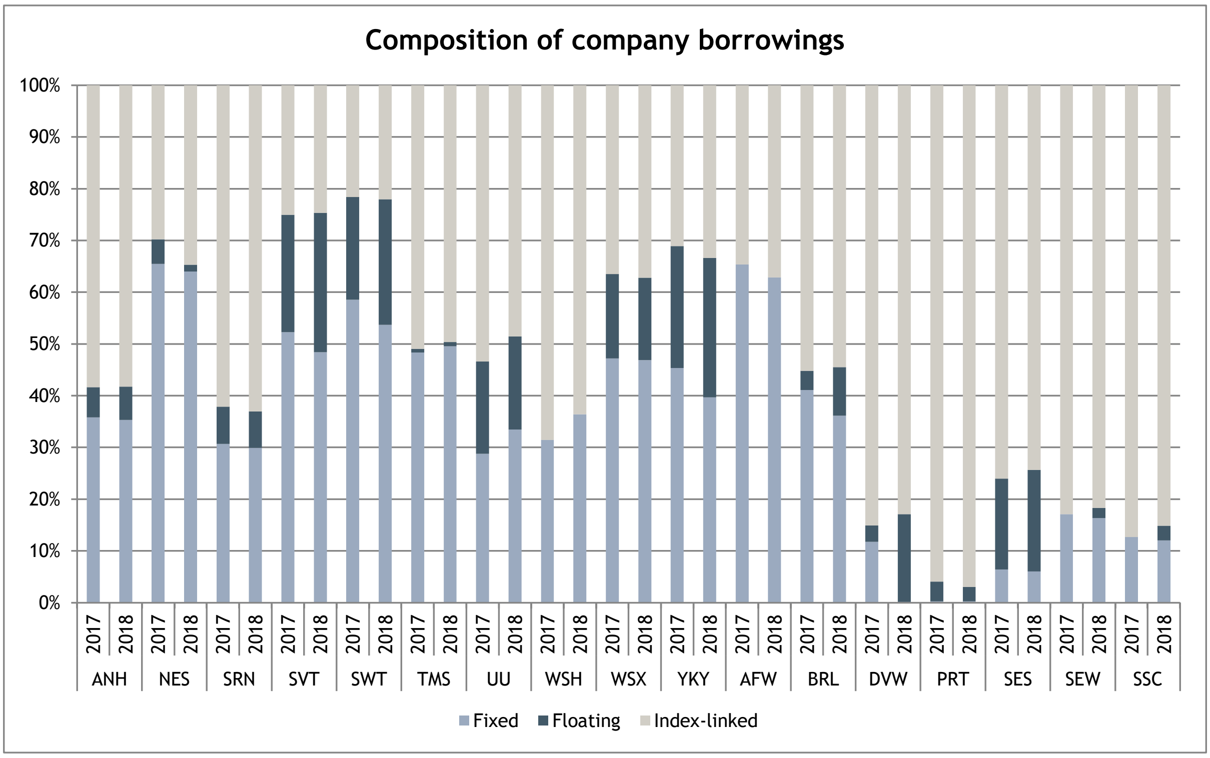
Figure 14 shows the proportions of the different types of debt held by the companies (i.e. fixed rate, floating rate, or index-linked). In 2017-18, 14 companies reported a reduction in the proportion of debt that was fixed rate. The biggest reduction was Dee Valley Water which reduced its proportion of fixed rate debt to virtually nothing (0.16 per cent). This was off-set by an increase in floating rate debt.

Ten companies reported a reduction in the proportion of their debt that was index-linked. The biggest reduction was reported by Dŵr Cymru Welsh Water (5 per cent) which moved to fixed rate debt.

As ECA noted in last year's report, WoCs typically have a higher proportion of index-linked debt which means they are less exposed to inflation variance.

In periods of higher inflation those companies with a higher proportion of index-linked debt will have more limited opportunity to outperform regulatory assumptions about the cost of debt.

Figure 14: Composition of company debt



5.2 *Credit ratings*

Credit ratings are a measure of the relative risk of a company. A high credit rating signals good credit worthiness, with typically lower associated interest payments. Conversely a low credit rating would typically mean higher interest payments.

In 2017-18 all companies reported in their APRs that, with the exception of United Utilities[30], their credit ratings were unchanged.

Most companies' licences require them to have an investment grade credit rating[31]. All the companies with this requirement currently have credit ratings which are at least one notch above the minimum investment grade level. However, credit rating agencies have placed some companies on negative outlook which signals a potential lowering of that rating in the near term (typically six months to two years).

On the back of Ofwat's Back in balance proposals[32] Moody's reconsidered its credit ratings as it felt that Ofwat's proposals would give Ofwat more influence over companies' capital structures and dividends. As a result, it added four companies to its list of companies on negative outlook: Thames Water, Anglian Water, Wessex Water and Affinity Water. Given

[30] United Utilities reported a higher credit rating in 2017-18

[31] The minimum investment grade credit ratings are Baa3 (Moody's Investor Services) and BBB- for both S&P Global and Fitch Ratings

[32] https://www.moodys.com/research/Moodys-changes-outlook-to-negative-on-ratings-of-4-UK--PR_383966

those which already have negative outlook[33] around 60 per cent of the water companies that Moody's rates have now been placed on negative outlook.

However, only three companies reported the move to negative outlook in their APRs and these are set out in table 3.

One of these companies, Yorkshire Water, is one notch above investment grade and has been placed on negative outlook.

Table 4: Credit ratings with negative outlook

Company	Reason for negative outlook
Thames Water	Driven by a change in assessment of the stability and predictability of the UK water regulatory regime rather than a reflection of our operational performance.
Northumbrian	No reason provided in APR
Yorkshire Water	Reflected the expected decline in allowed returns on RCV after 2020, while Yorkshire Water's own cost of debt remains high. While management's financial strategy towards strengthening the balance sheet has created some headroom, the Company will have to continue to work on additional measures to maintain financial resilience. However, the current financial policy evidences a commitment towards maintaining credit quality".

Moody's press release went further, indicating that the risk that lower returns and increasing cash flow volatility will jeopardise the sector's credit quality unless shareholders are willing to support de-gearing.

Under Ofwat's notional gearing approach, risks with capital structure are borne by the shareholders, not consumers. Following publication of the PR19 methodology (and, in particular, the indication of a notably lower cost of capital), more action by companies to manage this expected change may become evident (e.g. refinancing and gearing reductions).

We will continue to monitor companies' credit ratings to understand the sustainability of companies and how they are operating in the consumer interest.

5.3 Long-term viability statements

In 2017 Ofwat identified inconsistencies in the level of detail provided by the companies in their long-term viability statements. Ofwat therefore clarified its expectations about companies' long-term viability statements in an information note[34] in 2018, identifying that:

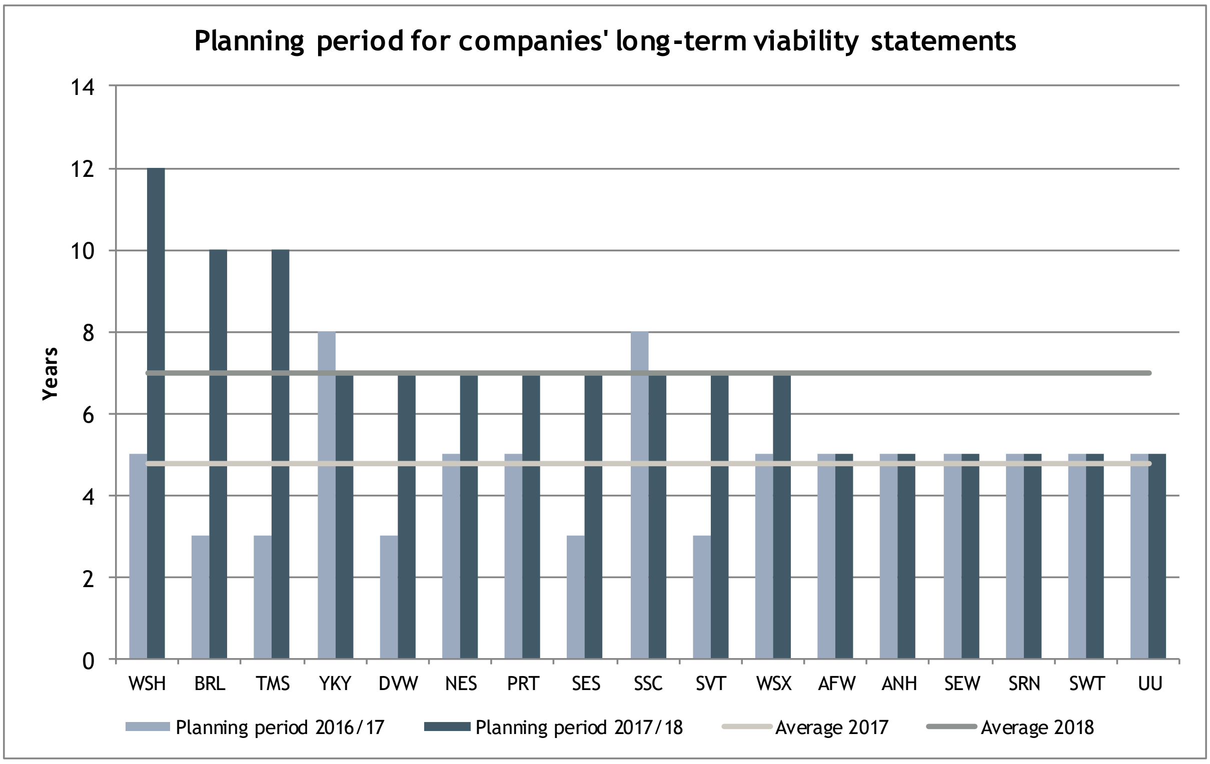
[33] Northumbrian, Portsmouth, Severn Trent, Southern, Yorkshire
[34] https://www.ofwat.gov.uk/publication/18-04-expectations-companies-issuing-long-term-viability-statements/

- companies should not be constrained by the end of the current price control period
- there should be a minimum 5-year forward look
- companies should stress-test to reflect their business risks, to include but not be limited to:
    - inflation
    - revenue
    - totex
    - impact of ODIs
    - unfunded costs
    - debt service requirements
    - unfunded pension liabilities
    - exceptional items (e.g. regulatory fines and legal claims)

Figure 15 shows that all companies satisfy Ofwat's expectation that the forward plan should be for at least five years (six companies reporting a five year forward look). A number of companies' viability statements consider the period to the end of the price control period in 2025. Seven companies left their planning periods unchanged from last year while eight companies extended their planning periods. One company, South Staffordshire Water, reduced its planning period owing to this being linked to the end of the next price review period in 2025.

All companies declared that they had a reasonable expectation that they will be able to continue in operation and meet their liabilities as they fall due over the periods that they have assessed.

Figure 15: Period considered in long-term viability statements



5.4 Dividends

Ofwat explains that it has no formal powers to control dividends. However, companies are required (through their licences) to declare or pay dividends only in accordance with a dividend policy which has been approved by its Board. This dividend policy also has to comply with both of the following principles:

- The dividends declared or paid will not impair the ability of the company to finance the regulated water and sewerage business.
- Under a system of incentive regulation, dividends are intended to reward efficiency and the management of economic risk.

Ofwat requires the regulated companies to report any dividend paid to their parent company in their regulatory accounts. They must also explain the basis of the dividend.

We will encourage the companies to explain to their customers, and to the public generally, what returns they have made in the regulated business and what they intend to do with them.

Companies' dividend policies have recently come under scrutiny. For example, in the debate about nationalisation of the water companies, it has been reported that dividends have often exceeded pre-tax profit with 2017 dividends up 24 per cent on 2016 dividends.

At the EFRA committee meeting on 11 July 2018[35] it was indicated that over £18.1 billion was paid out to shareholders of the nine largest English regional water and sewerage companies over the decade between 2007 and 2016; 95% of the profits went in dividends to shareholders

To increase trust in the sector Ofwat has required[36] companies to explain their dividend policies, and how they relate to performance, in the Business Plans that they submitted to Ofwat in September 2018. Ofwat's guidance explained that:

> 'Where companies propose base dividend yields that are higher than 5% in their business plans, they should explain, transparently for customers and wider society, why such higher dividends are in customers' interests'.[37]

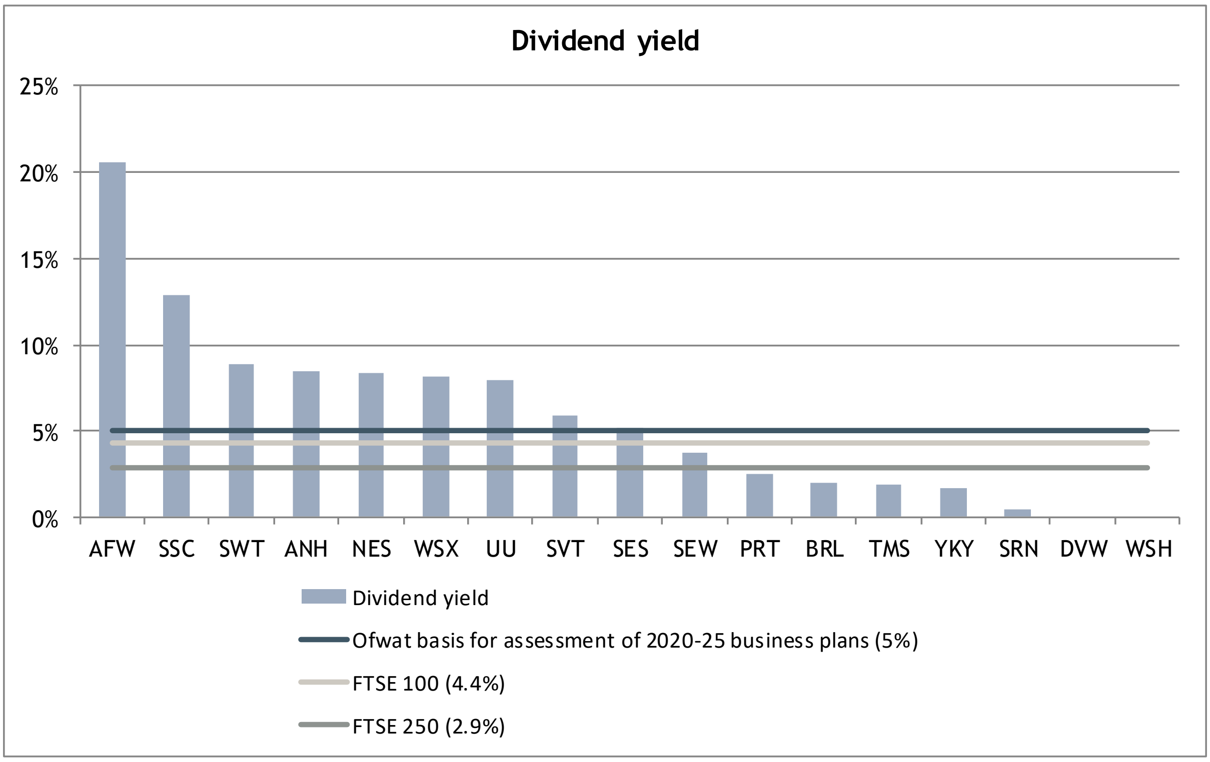
5.4.1 Dividend yield

Nine companies reported a dividend yield[38] in 2017-18 higher than the 5 per cent Ofwat regards as a reasonable return against which to assess companies' 2020-25 business plans. This is shown in figure 17. The same nine companies have a dividend yield that exceeds the average dividend (4.35 per cent) for FTSE 100 companies. Ten companies have a dividend yield that exceeds the average of the FTSE 250 companies (2.85 per cent)[39].

At PR14 Ofwat's populated financial models[40] included a dividend yield assumption of 4 per cent and real dividend growth of 1.65 per cent per annum. Based on our calculations of dividends going to the ultimate shareholder six companies exceeded the nominal dividend growth[41] Ofwat envisaged when it set price limits. These were: Anglian, United Utilities, Affinity, South East, South Staffs and Sutton & East Surrey.

[35] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/environment-food-and-rural-affairs-committee/regulation-of-the-water-industry/oral/86811.html
[36] https://www.ofwat.gov.uk/wp-content/uploads/2018/07/Benefit-sharing-decision-statement-FINAL-for-publishing.pdf
[37] The 5 per cent is neither an Ofwat target nor control. Ofwat expects companies to explain why dividend yields in excess of 5 per cent reflect performance delivery to customers and are in the customer interest
[38] Dividends in companies' APRs exclude any dividend to holding companies to pay interest on inter-company loans
[39] FTSE 100 and 250 dividend yields as at 17 April 2019 https://www.dividenddata.co.uk/dividendyield.py?market=ftse250
[40] https://www.ofwat.gov.uk/publications/companies-populated-pr14-financial-models/
[41] Based on 1.65 per cent real dividend growth and Ofwat's financial year end inflation forecast

Figure 16: Companies' reported dividend yields



5.4.2 Dividend cover

Dividend cover is the ratio of distributable profits to dividends. Dividend cover ratios can be categorised as:

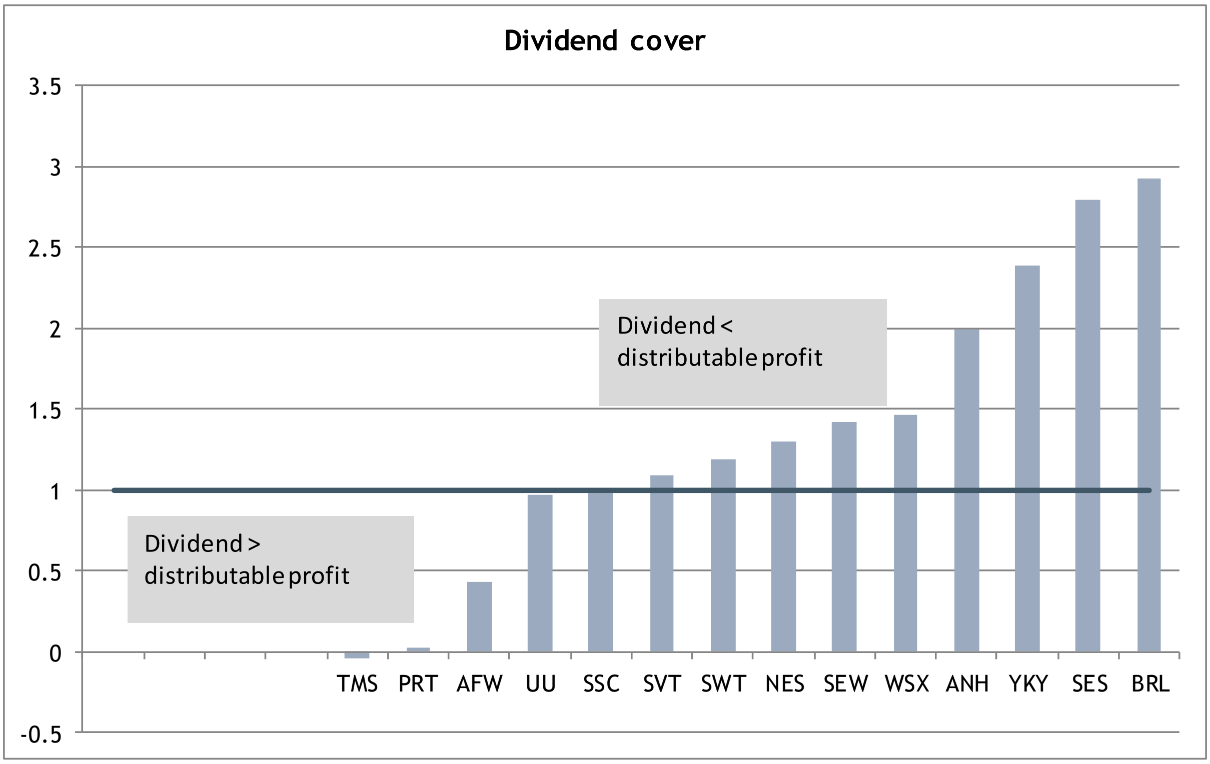
Table 5: Dividend cover - what it means

Dividend cover	What this means
>1	Some profit is retained in the business which could reduce the level of gearing
=1	All distributable profit is paid to shareholders
<1	The dividend paid to shareholders exceeds the distributable profit generated in the financial year. This will reduce the cash in the business and all things equal result in increased gearing

Figure 17 shows that in 2017-18 five companies had a dividend cover lower than 1 which means the amount they paid in dividends exceeded the amount they had in distributable profits for the year. Of these, South Staffordshire and United Utilities paid dividends marginally in excess of distributable profits. Thames Water reported a relatively small loss (£2m) after profit and tax which accounts for its negative dividend cover. Notwithstanding this figure 3 shows that Thames reduced gearing in 2017-18.

Affinity Water indicated that its policy is to distribute earnings equal to the amount necessary to maintain net debt to RCV at or below its target. The company attributes its dividend increase to the increase in RPI on the RCV and proceeds from the disposal of the company's non-household retail business.

Figure 17: Relationship between dividends and distributable profit



5.5 *Company structures*

Five companies have noted changes, or planned changes, in their group structures in the period. For example, Anglian, Thames, Southern, Yorkshire and Affinity have closed, or are in the process of closing down, their Cayman Island subsidiaries, typically on public interest grounds.

In each case the companies have explained the legitimacy of setting up these companies and that having these subsidiaries offered no tax advantage.

Anglian Water was the first company to do so. It explained that its subsidiary was effectively dormant having never been used to raise debt or not having benefitted from any tax advantage.

Anglian Water also reported that £1.6bn of its declared dividend of £1.9bn in 2017-18 was a one-off restructuring dividend that is aimed at simplifying and enhancing transparency of the company's corporate structure. In turn this money was used to pay off an inter-company loan.

Thames Water reported that negative connotations of tax avoidance and complex financial arrangements drove its decision to close the subsidiary. The company has received approvals from investors holding debt issued by the Cayman subsidiary to close it down and expects this to happen in the 2018-19 financial year. Thames put the subsidiary into liquidation at the end of September 2018 and they will be formally dissolved by the end of March 2019[42].

Thames Water indicates that neither it nor the company gained any tax advantage from this structure. Rather the structure was put in place to in order to raise debt finance to buy its own shares which Thames Water could not do as a UK publicly listed company.

Affinity Water's APR indicates that its Cayman subsidiary was resident in the UK for tax purposes. It plans to substitute a UK entity for this subsidiary and has appointed advisors to progress this.

Yorkshire Water's APR indicates that while its Cayman subsidiary was legitimate and did not give any tax benefit, it was opaque and caused customers to be suspicious. Yorkshire will remove the subsidiary by the end of 2018.

Southern Water's annual report[43] indicates its plans to close its Cayman islands subsidiary as it could lead to misconceptions about business practices.

6. Conclusion

From the outperformance companies have reported in their APRs it appears that there is scope for companies to do more for their customers, particularly in-period, where they outperform.

Some companies already have formalised benefit sharing mechanisms in place e.g. South West Water. We think that customers of other companies that are outperforming regulatory assumptions would similarly welcome some share of the benefits that companies are making.

It is apparent that some companies are responding to the challenge of trust in the sector and have sought to simplify financial structure and remove subsidiary companies that can illicit negative connotations e.g. Thames and Anglian. However, we think that there is more to do.

For our part we will continue to monitor companies' financial performance each year to understand the consumer implications of that performance. We will continue to publish, annually, a monitoring financial performance report that brings together companies' performance and these consumer implications.

We will continue to advocate the consumer interest that comes out of our analysis. This could be to press companies to share outperformance with customers; to ensure Ofwat is aware and takes account of performance at price reviews; or to press companies to

[42] https://corporate.thameswater.co.uk/sitecore/content/Corporate-Responsibility/Corporate-Responsibility/How-we-do-business/Sustainable-finance

[43] https://annualreport.southernwater.co.uk/media/1792/annualreport_2017_18.pdf

explain why their financial structures, performance and policies are in the consumer interest.

From our analysis of 2017-18 APRs we plan to:

- challenge those companies outperforming RoRE assumptions, particularly on the cost of debt, on whether they have considered sharing any current or historic outperformance with customers
- challenge those companies with dividend yields and/or dividend covers at odds with companies with similar risk profiles to explain how their dividend policies are in the customer interest
- monitor companies gearing levels to ensure changes are in line with public commitments and to challenge where they are not
- press Ofwat to take account of companies' outperformance of cost of debt, now and historically, in its consideration of the cost of capital for PR19

We also expect Ofwat to take account of companies' financial performance in their review of price limits for the 2020-25 in terms rebaselining revenues/costs.

Appendix 1 – Data Tables

This annex contains data underlying the Figures presented in the main body of the report. All data are for 2017-18, unless otherwise stated.

Table A - Return on regulatory equity (RoRE) - cumulative 2015-18

All figures %	Base Case RoRE	Expenditure	Finance	ODIs	Non-household disposal	Total
Anglian	5.60	1.40	0.00	0.30	0.00	7.27
Dŵr Cymru Welsh Water	5.60%	-0.38	-0.38	0.01	0.00	4.85
Northumbrian	5.70%	2.10	0.60	0.20	0.00	8.59
Severn Trent	5.60%	1.30	0.90	1.50	0.00	9.30
South West	6.00%	2.60	2.60	0.30	0.00	11.54
Southern	5.63%	-0.15	0.10	-0.42	0.19	5.35
Thames	5.62%	-1.54	0.78	-0.38	0.39	4.86
United Utilities	5.56%	-0.18	1.68	0.02	0.00	7.08
Wessex	5.60%	1.17	1.20	0.58	0.00	8.55
Yorkshire	5.65%	-0.23	-1.16	0.35	0.00	4.61
Affinity	6.17%	-1.19	0.89	-0.26	0.00	5.61
Bristol	5.80%	0.58	-0.31	-0.54	0.00	5.53
Dee Valley	5.80%	3.30	-0.30	0.00	0.00	8.80
Portsmouth	5.82%	-0.36	-1.01	-0.01	0.95	5.37
South East	5.60%	1.51	-0.60	-0.07	0.00	6.42
South Staffs	5.98%	1.65	0.11	0.26	0.00	8.01
Sutton & East Surrey	5.80%	-0.90	-0.57	0.40	0.00	4.73

Source: APRs

Table B: Gearing

All figures %	Actual gearing			
	2016-17	2017-18	Change	Ofwat notional gearing
Anglian	79.1	78.5	-0.6	62.5
Dŵr Cymru Welsh Water	56.4	57.1	0.7	
Northumbrian	68.4	66.0	-2.4	
Severn Trent	60.7	61.5	0.8	
South West	61.9	60.4	-1.6	
Southern	78.5	79.2	0.7	
Thames	83.3	82.9	-0.4	
United Utilities	61.4	64.7	3.3	
Wessex	64.7	63.9	-0.8	
Yorkshire	75.4	74.3	-1.0	
Affinity	78.0	79.7	1.7	
Bristol	64.6	64.0	-0.7	
Dee Valley	70.2	67.2	-3.1	
Portsmouth	68.6	63.6	-5.1	
South East	78.4	77.7	-0.6	
South Staffs	69.4	71.5	2.1	
Sutton & East Surrey	77.7	77.1	-0.7	

Source: APRs, ECA calculations

Table C - Cost of debt

All figures %	Allowed cost of debt (real)	Actual cost of debt (real)
Anglian	2.6	1.73
Dŵr Cymru Welsh Water	2.6	2.04
Northumbrian	2.6	0.87
Severn Trent	2.6	0.1
South West	2.8	-1.06
Southern	2.6	2.08
Thames	2.6	1.42
United Utilities	2.6	-0.18
Wessex	2.6	0.92
Yorkshire	2.6	1.85
Affinity	2.8	1.04
Bristol	2.6	1.68
Dee Valley	2.6	1.99
Portsmouth	2.8	2.75
South East	2.6	2.36
South Staffs	2.6	2.06
Sutton & East Surrey	2.6	2.56

Source: APRs, Final Determinations, ECA calculations

Table D: Debt composition

All figures %	Fixed rate debt	Floating rate debt	Index-linked debt
Anglian	35	6	58
Dŵr Cymru Welsh Water	36	0	64
Northumbrian	64	1	35
Severn Trent	48	27	25
South West	54	24	22
Southern	30	7	63
Thames	50	1	50
United Utilities	33	18	49
Wessex	47	16	36
Yorkshire	40	27	33
Affinity	63	0	37
Bristol	36	9	54
Dee Valley	0	17	83
Portsmouth	0	3	97
South East	16	2	82
South Staffs	12	3	85
Sutton & East Surrey	6	20	74

Source: APRs

Table E: Debt maturity

	<1 yr (%)	1 - 2 yr (%)	2 - 5 yr (%)	5 - 20 yr (%)	> 20 yr (%)	Average (yrs)
Anglian	2	3	18	59	18	12.96
Dŵr Cymru Welsh Water	1	1	17	63	17	14.37
Northumbrian	1	1	16	56	25	14.38
Severn Trent	6	0	14	58	22	13.82
South West	2	4	10	38	46	21.46
Southern	0	8	21	55	17	12.71
Thames	1	4	9	51	35	17.30
United Utilities	6	9	23	41	21	12.35
Wessex	7	0	19	41	33	16.61
Yorkshire	1	7	20	43	29	15.40
Affinity	0	0	1	63	36	17.84
Bristol	0	19	5	57	19	12.41
Dee Valley	13	0	0	87	0	14.51
Portsmouth	3	0	0	97	0	13.66
South East	2	29	0	53	16	11.40
South Staffs	1	0	13	0	86	24.28
Sutton & East Surrey	0	0	20	80	0	11.59

Source: APRs

Table F: Dividends

	Dividends (£m)			Change in dividends (£m)	
	2015-16	2016-17	2017-18	2015-16 to 2016-17	2016-17 to 2017-18
Anglian	145.2	121.9	140.9	-23.2	+18.9
Dŵr Cymru Welsh Water	-	30.2	-	+30.2	-30.2
Northumbrian	200.0	200.8	119.4	+0.8	-81.4
Severn Trent	306.0	190.4	199.7	-115.6	+9.3
South West	74.9	213.1	120.3	+138.2	-92.8
Southern	79.6	121.5	4.9	+41.9	-116.7
Thames	57.6	109.1	43.5	+51.5	-65.6
United Utilities	180.4	242.7	311.1	+62.3	+68.4
Wessex	84.0	94.0	92.1	+10.0	-2.0
Yorkshire	-	45.4	28.6	+45.4	-16.8
WASC sub-totals	***1,127.6***	***1,369.2***	**1,060.4**	***+241.5***	**-308.7**
Affinity	32.0	43.0	50.5	+11.0	+7.6
Bristol	-	5.5	3.7	+5.5	-1.8
Dee Valley	1.4	1.9	-	+0.6	-1.9
Portsmouth	1.4	1.5	1.3	+0.1	-0.2
South East	4.1	9.8	10.8	+5.7	+1.1
South Staffs	3.4	6.5	13.3	+3.1	+6.9
Sutton & East Surrey	3.0	2.8	3.0	-0.2	+0.2
WOC sub-totals	*44.1*	*71.0*	82.7	*+25.8*	+11.7
Industry totals	**1,176.8**	**1,440.1**	**1,143.1**	**267.3**	**-297.0**

Source: APRs. Dividends paid to external shareholders.

Table G: Wholesale totex

All figures £m	2015-16			2016-17			2017-18		
	Allowed	Actual	Difference	Allowed	Actual	Difference	Allowed	Actual	Difference
Anglian	852.9	724.9	128.0	1,055.7	830.7	225.0	960.3	928.4	31.9
Dŵr Cymru Welsh Water	568.6	469.0	99.7	574.0	601.4	-27.3	585.9	662.4	-76.5
Northumbrian	505.7	457.0	48.7	533.8	446.0	87.8	570.8	518.8	52.0
Severn Trent	1,064.6	1,030.3	34.3	1,236.7	1,088.0	148.7	1,344.0	1,235.0	109.0
South West	363.3	288.9	74.4	410.1	350.5	59.7	406.5	343.8	62.7
Southern	563.1	453.6	109.5	627.3	533.1	94.2	639.4	651.8	-12.4
Thames	1,590.4	1,644.2	-53.8	1,602.8	1,736.7	-133.9	1,689.4	1,783.6	-94.2
United Utilities	1,080.9	1,248.0	-167.1	1,149.0	1,293.7	-144.7	1,254.5	1,313.1	-58.6
Wessex	362.7	325.5	37.2	391.2	341.9	49.3	428.4	359.3	69.1
Yorkshire	789.4	600.7	188.7	768.3	746.5	21.8	766.3	793.5	-27.2
WASC sub-total	*7,741.6*	*7,242.0*	*499.6*	*8,349.0*	*7,968.4*	*380.7*	8,645.5	8,589.7	55.8
Affinity	259.5	229.4	30.1	267.6	268.7	-1.1	241.7	255.6	-13.9
Bournemouth	30.2	25.0	5.3	n.a	n.a	n.a	n.a	n.a	n.a
Bristol	93.4	69.8	23.6	94.9	82.9	12.0	99.1	104.0	-4.9
Dee Valley	22.4	16.3	6.1	27.2	21.4	5.7	24.5	27.9	-3.4
Portsmouth	28.8	27.5	1.4	31.8	31.7	0.2	33.0	28.0	5.0
South East	159.9	155.8	4.1	171.9	158.4	13.5	189.1	172.1	17.0
South Staffs	84.6	80.7	3.9	87.2	85.6	1.6	90.8	95.3	-4.5
Sutton & East Surrey	45.1	43.1	1.9	50.6	48.1	2.5	55.1	51.2	3.8
WOC sub-total	*723.9*	*647.4*	*76.4*	*731.2*	*696.8*	*34.4*	733.2	734.2	-0.9
Industry totals	**8,465.5**	**7,889.5**	**576.0**	**9,080.2**	**8,665.2**	**415.0**	**9,378.7**	**9,323.9**	**54.9**

Source: APRs, ECA calculations

Table H: Retail

(£m, nominal terms)	2015-16			2016-17			2017-18		
	Allowed	Actual	Difference	Allowed	Actual	Difference	Allowed	Actual	Difference
Anglian	79.3	81.2	-1.9	82.1	81.5	0.6	83.7	76.1	7.6
Dŵr Cymru Welsh Water	58.6	68.8	-10.2	57.1	63.2	-6.1	55.4	64.8	-9.5
Northumbrian	56.1	51.0	5.1	56.8	52.8	4.0	57.5	50.2	7.3
Severn Trent	119.1	103.8	15.3	124.9	92.3	32.6	130.8	99.2	31.6
South West	30.3	33.3	-3.0	36.2	36.7	-0.5	36.9	31.1	5.9
Southern	62.9	86.9	-24.0	62.0	92.5	-30.5	57.6	71.9	-14.4
Thames	168.1	190.0	-21.9	167.6	201.3	-33.7	168.6	177.9	-9.3
United Utilities	142.2	156.2	-13.9	138.4	123.0	15.4	131.0	107.8	23.3
Wessex	32.8	30.3	2.5	33.5	30.5	3.0	34.5	30.3	4.2
Yorkshire	56.9	62.1	-5.2	58.5	63.0	-4.5	60.6	70.7	-10.2
WASC sub-total	806.4	863.6	-57.2	817.3	836.9	-19.6	816.5	780.0	36.5
Affinity	29.8	34.5	-4.7	29.3	35.9	-6.6	28.7	31.7	-3.0
Bournemouth	4.8	5.3	-0.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bristol	10.4	9.9	0.5	10.8	10.3	0.5	11.1	10.0	1.1
Dee Valley	2.6	3.0	-0.3	2.7	2.7	0.0	2.7	2.5	0.2
Portsmouth	4.5	5.2	-0.7	4.6	5.4	-0.8	4.7	4.9	-0.2
South East	21.1	19.7	1.4	21.6	18.3	3.2	22.1	18.5	3.6
South Staffs	16.0	14.5	1.5	16.2	14.2	2.0	16.8	12.7	4.1
Sutton & East Surrey	5.8	6.8	-1.0	5.8	6.9	-1.1	6.0	7.2	-1.2
WOC sub-total	95.0	98.9	-3.9	91.0	93.8	-2.8	92.1	87.5	4.6
Industry totals	**901.4**	**962.5**	**-61.1**	**908.2**	**930.6**	**-22.4**	**908.6**	**867.5**	**41.1**

Source: APRs, ECA calculations

Table I: Net ODI rewards

	2015-16		2016-17		2017-18	
(£m 2012-13 prices)	In period	End of period	In period	End of period	In period	End of period
Anglian	0.5	10.6	2.6	2.5	4.6	8.7
Dŵr Cymru Welsh Water	0.0	1.0	0.0	2.8	0.0	-3.4
Northumbrian	0.0	4.5	0.0	5.0	0.0	3.8
Severn Trent	18.7	0	40.3	0.0	57.8	0.0
South West	-1.7	3.6	-0.3	3.9	-0.3	2.9
Southern	0.0	-1.5	0.0	0.0	0.0	-0.3
Thames	0.0	-13.3	0.0	-15.0	0.0	-33.9
United Utilities	0.0	2.4	0.0	6.7	0.0	-7.0
Wessex	0.0	5.1	0.0	5.5	0.0	6.6
Yorkshire	0.0	5.7	0.0	8.8	0.0	12.7
WASC sub-total	*17.5*	*18.2*	*42.6*	*20.1*	*62.2*	*-9.9*
Affinity	0	-1.6	0.0	-1.6	0.0	-0.4
Bristol	0.0	0.0	0.0	0.0	0.0	-2.3
Dee Valley	0.0	-1.1	0.0	-0.2	0.0	0.0
Portsmouth	0.0	0.0	0.0	0.0	0.0	-0.4
South East	0.0	-0.3	0.0	0.0	0.0	-1.5
South Staffs	0.0	-0.1	0.0	0.4	0.0	-0.2
Sutton & East Surrey	0.0	0.5	0.0	0.8	0.0	0.3
WOC sub-total	*0.0*	*-2.4*	*0.0*	*-0.4*	0.0	-4.5
Industry totals	**17.5**	**15.8**	**42.6**	**19.7**	**62.2**	**-14.4**

Source: APRs, ECA calculations

Table J: Revenue

(£m, nominal terms)	2015-16			2016-17			2017-18		
	Allowed	Actual	Difference	Allowed	Actual	Difference	Allowed	Actual	Difference
Anglian	1,187.3	1,181.8	-0.5%	1,213.8	1,222.3	0.7%	1,247.1	1,251.1	0.3%
Dŵr Cymru Welsh Water	731.1	729.7	-0.2%	738.6	747.2	1.2%	743.5	745.0	0.2%
Northumbrian	775.1	779.2	0.5%	789.7	793.7	0.5%	804.2	806.6	0.3%
Severn Trent	1,519.4	1,545.6	1.7%	1,549.9	1,541.1	-0.6%	1,591.1	1,563.6	-1.7%
South West	496.2	506.0	2.0%	544.2	553.8	1.8%	544.4	574.4	5.5%
Southern	793.3	798.5	0.7%	806.9	806.2	-0.1%	817.6	813.1	-0.5%
Thames	2,011.7	2,035.7	1.2%	2,037.7	2,038.0	0.0%	2,047.7	2,020.5	-1.3%
United Utilities	1,705.0	1,712.5	0.4%	1,742.9	1,710.4	-1.9%	1,774.2	1,730.9	-2.4%
Wessex	507.2	519.5	2.4%	517.1	524.1	1.4%	521.9	535.9	2.7%
Yorkshire	965.0	980.9	1.6%	989.2	979.8	-0.9%	1,013.4	1,021.9	0.8%
WASC sub-total	*10,691.3*	*10,789.4*	*0.9%*	*10,930.0*	*10,916.6*	*-0.1%*	11,105.0	11,062.9	-0.4%
Affinity	307.0	304.8	-0.7%	310.6	311.8	0.4%	310.3	311.6	0.4%
Bournemouth	39.6	40.5	2.1%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bristol	114.0	111.8	-1.9%	113.6	111.5	-1.9%	118.5	115.3	-2.7%
Dee Valley	24.7	23.9	-3.4%	25.6	25.2	-1.5%	26.4	25.8	-2.0%
Portsmouth	38.4	38.8	1.1%	39.1	39.8	1.9%	39.8	39.6	-0.4%
South East	221.1	219.1	-0.9%	226.4	224.5	-0.8%	235.0	229.5	-2.3%
South Staffs	119.6	123.0	2.9%	119.9	123.0	2.6%	122.2	123.4	1.0%
Sutton & East Surrey	59.9	60.5	0.8%	61.1	61.2	0.1%	62.4	61.8	-1.1%
WOC sub-total	*924.4*	*922.3*	*-0.2%*	*896.4*	*897.1*	*0.1%*	914.6	907.0	-0.8%
Industry totals	**11,615.7**	**11,711.7**	**0.8%**	**11,826.4**	**11,813.7**	**-0.1%**	12,019.6	11,969.9	-0.4%

Source: APRs, ECA calculations

Table K: Profits and margins

	2015-16				2016-17				2017-18			
	Operating		Post-tax		Operating		Post-tax		Operating		Post-tax	
	£m	Margin (%)	£m	Margin (%)	£m	Margin (%)	£m	Margin (%)	£m	Margin (%)	£m	Margin (%)
Anglian	340	29.1	325	27.9	355	29.4	194	16.0	337	27.4	282	23.0
Dŵr Cymru Welsh Water	161	21.8	54	7.3	98	13.3	-53	-7.1	66	8.8	-52	-7.0
Northumbrian	362	46.9	241	31.1	340	43.3	186	23.7	322	40.4	150	18.9
Severn Trent	515	33.6	319	20.8	517	33.8	309	20.2	496	32.0	218	14.1
South West	207	41.1	157	31.1	233	41.8	147	26.3	245	43.3	143	25.3
Southern	286	35.6	117	14.6	248	31.2	-180	-22.7	235	29.3	142	17.8
Thames	721	35.2	440	21.5	525	25.7	17	0.9	524	25.9	-2	-0.1
United Utilities	568	33.3	365	21.4	580	34.4	364	21.6	603	35.2	302	17.7
Wessex	238	46.4	152	29.6	230	44.6	142	27.5	264	50.1	135	25.6
Yorkshire	254	26.3	230	23.9	314	31.9	-267	-27.1	268	26.8	68	6.8
WASC sub-total	3,651	34.0	2,400	22.3	3,440	31.7	859	7.9	3,358	30.7	1,387	12.7
Affinity	70	23.5	52	17.3	56	18.5	23	7.7	51	17.1	22	7.2
Bournemouth	10	25.3	7	16.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bristol	35	32.3	28	25.4	29	26.2	19	17.6	26	22.9	11	9.5
Dee Valley	5	19.9	3	13.6	4	17.7	2	6.3	4	17.4	0	1.0
Portsmouth	9	21.6	5	11.3	6	15.3	3	7.4	6	16.4	0	0.1
South East	72	33.4	42	19.5	76	34.2	22	10.2	63	28.7	11	5.1
South Staffs	32	26.7	21	17.2	29	24.6	16	13.5	19	16.2	13	11.0
Sutton & East Surrey	19	31.6	14	23.4	18	29.6	11	18.7	16	27.2	8	13.9
WOC sub-total	252	27.8	170	18.8	218	24.9	97	11.1	187	21.3	65	7.4
Industry totals	3,903	33.5	2,570	22.1	3,658	31.2	956	8.2	3,545	30.0	1,453	12.3