Monitoring financial resilience – a snapshot

In July 2015 we consulted on the proposed financial monitoring framework.

We set out in that consultation that we intended to gather, analyse and report on information on the regulated companies which would give a clearer and broader view of their solvency, liquidity, risk management and longer-term financial viability in light of anticipated investment programmes.

We are now publishing this snapshot based on the financial information published by the water companies in the 2014-15 regulatory accounts.

! Throughout this document we provide links to further information. Look out for these pop ups

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Introduction and purpose of this report (1)

A company's management and investors are responsible for determining the company's capital and financing structure, and they, not customers, bear the risk associated with it.

This is an important feature of the water industry and, while encouraging investment by enabling a company to put in place a structure that works for it, provides an incentive to efficient management of risk.

The choices management and investors make can affect a service provider's resilience. The Water Act 2014 added to our primary duties a duty to further the resilience objective, highlighting the need for long-term resilience of water and wastewater systems and service provision when faced with increasing external stresses.

We consider resilience as the ability to cope with, and recover from, disruption, trends and variability in order to maintain services for people and protect the natural environment, now and in the future.

We have separately consulted on our role in resilience including financial and corporate resilience.

In July 2015 we also consulted on the proposed financial monitoring framework which, alongside our company monitoring framework and annual performance report, represents a key component in building trust and confidence in the sector.

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Introduction and purpose of this report (2)

In that consultation we set out our intention to gather, analyse and comment on information concerning regulated companies which would give us a clearer and broader view of solvency, liquidity, risk management and longer-term financial viability in light of anticipated investment programmes. This would better inform our proportionate and targeted approach to regulation.

The purpose of the financial monitoring framework is to:

- enhance visibility and transparency of financial and capital structures in the sector;
- assist Ofwat in monitoring the financial stability of the businesses that we regulate **and** enable other stakeholders to consider and challenge the sector in its identification and management of risk;
- identify financial, structural and systemic risk which may impact on service delivery over time and prove harmful to customers; and,
- help us in determining when we need to use the regulatory tools available to us to intervene to protect customers' interests.

As set out in the consultation document, we are now publishing a snapshot based on the financial information published by the water companies in the 2014-15 regulatory accounts. This snapshot covers a subset of the metrics that we are proposing to include in the full financial resilience commentary.

! Consultation on financial monitoring

Consistency and comparability (1)

We do not expect any one company to be identical to all other companies however we believe a company should be able to explain its relative position and understanding this will both improve awareness and management of risk.

We seek a meaningful comparison between companies, for both customers and investors, and it is therefore essential that information is presented on a consistent basis.

Where inconsistency occurs comparisons are limited. Even where useful conclusions can be made about changes in the financial resilience of an individual company as regulator we need to consider the sector as a whole.

As noted above a company's management is responsible for determining an appropriate capital and financing structure and we do not expect, for example, the level of gearing will be consistent across all companies. We will however monitor this information, partly to inform our own interventions and partly to ensure better transparency of information to allow challenge and scrutiny by others which in turn provides assurance that risks are being identified and well managed.

We also seek to identify both significant changes to the capital structure being chosen by individual companies and whether there are emerging industry trends which should influence the notional capital structure for future price controls.

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Consistency and comparability (2)

Our review and analysis has identified clear inconsistencies in the data published by companies which limits the ability to make comparisons across the sector.

We found occasions where numbers reported in one place differed from those reported elsewhere within the same company's financial results without explanation. An example is regulatory gearing which is reported as part of the net debt analysis in a company's regulatory accounts and as a reported key performance indicator ("KPI").

There may be legitimate reasons, for example the use of different accounting bases, for presenting statutory accounts (IFRS vs UK GAAP vs early adoption of new UK GAAP) or differing choices of accounting policies, why a company would want to present information differently in its regulatory accounts and elsewhere. However this results in inconsistencies across companies.

While we accept companies may present alternative calculations for specific metrics, uniform calculations should be utilised by all companies in their regulatory accounts. Should a company wish to present alternative calculations then the alternative should be reported separately with a clear explanation as to its purpose and why it differs from the standard calculation.

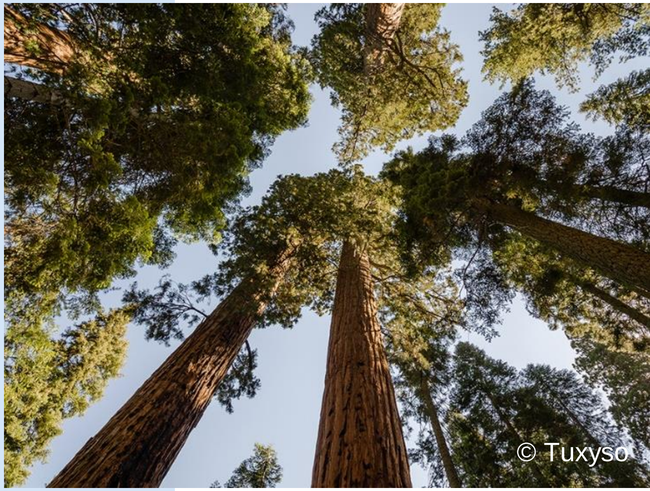
Financial resilience

We have considered the information that companies have published in their regulatory accounts for the 2014-15 financial year.

Based solely on the public information that was available to us we have not identified any specific areas where at this point in time we need to intervene to protect customers.

While we have not received any information from companies in respect of the period since 31 March 2015 we do monitor other sources concerning the financial position of companies.

Where necessary, we will intervene in a proportionate and targeted way to protect customers. In doing so, we will not undermine the responsibility of the companies and their investors for the identification and effective management of risks to financial resilience.



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We have reviewed the regulatory and statutory accounts published by each company for the year ended 31 March 2015 to enable us to assess the financial position of each company and to identify whether there are any companies which are significantly out of line with the rest of the sector and where it may be appropriate for Ofwat to investigate further.

Our review has identified areas where we consider that further guidance needs to be provided to companies to ensure that data presented in future allows comparisons to be made between companies to assist Ofwat in monitoring the financial stability of the businesses that we regulate and to enable other stakeholders to consider and challenge the sector as to its management of risk. This includes further clarification as to how financial metrics should be calculated for regulatory reporting

Presented below is a selection of the financial metrics that we have looked at as part of our pilot review.

Unless stated otherwise all charts and tables show the data for the WaSCs followed by the data for the WoCs.

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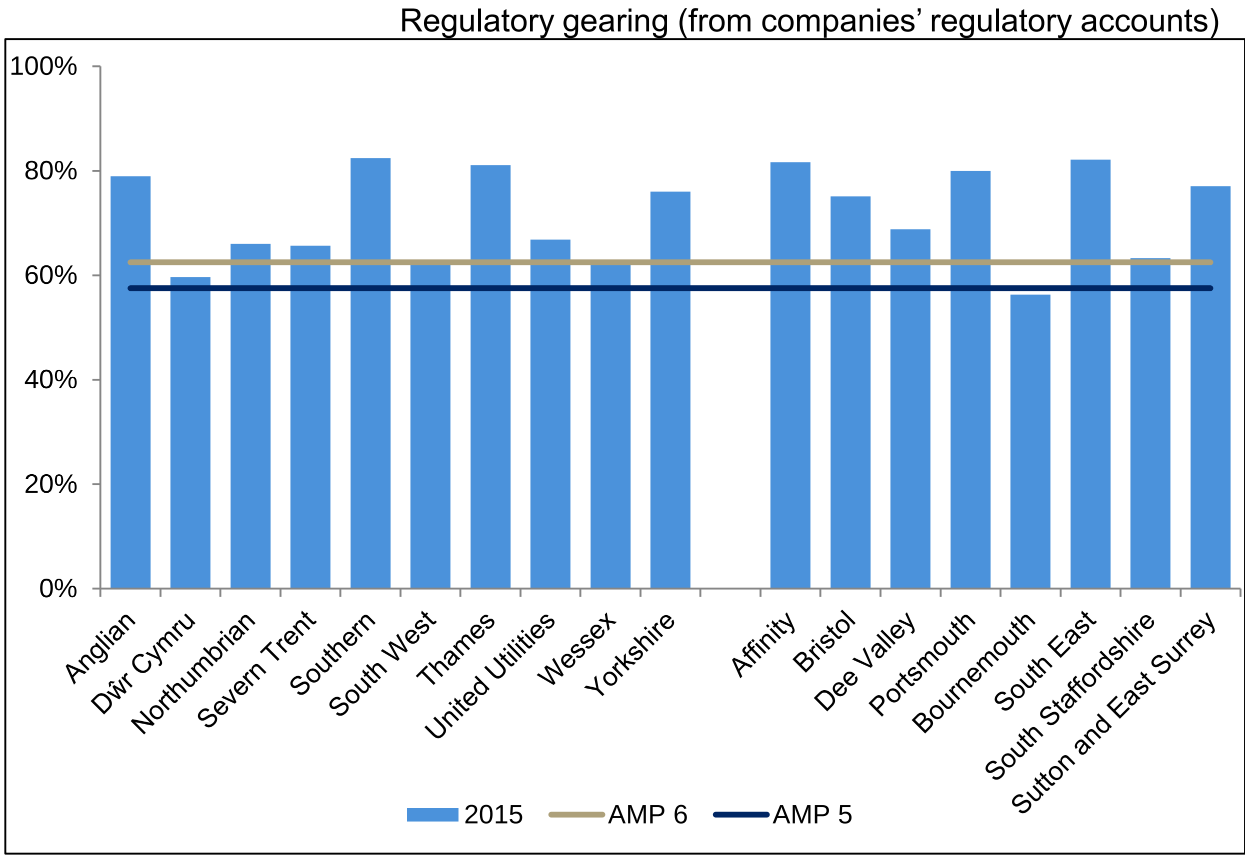
Regulatory gearing (1)

The chart presents the regulatory gearing figures extracted from each company's 2014-15 regulatory accounts.

Regulatory gearing for the industry ranged from 56% to 82%; in comparison in 2009-10 the range was 50% to 89%

For the purposes of the AMP6 (2015-2020) price control we assumed for a notional company a 62.5% regulatory gearing level, compared to 57.5% for the AMP5 (2010-2015) price control.

We continue to monitor changes in regulatory gearing and will consider changes in developing notional capital structures for future price controls.



Regulatory gearing is calculated as the net debt for the appointed business as a proportion of its regulatory capital value (RCV). Net debt excludes any pension deficit liability and mark-to-market accounting adjustments.

Up to company financial results

Regulatory gearing (2)

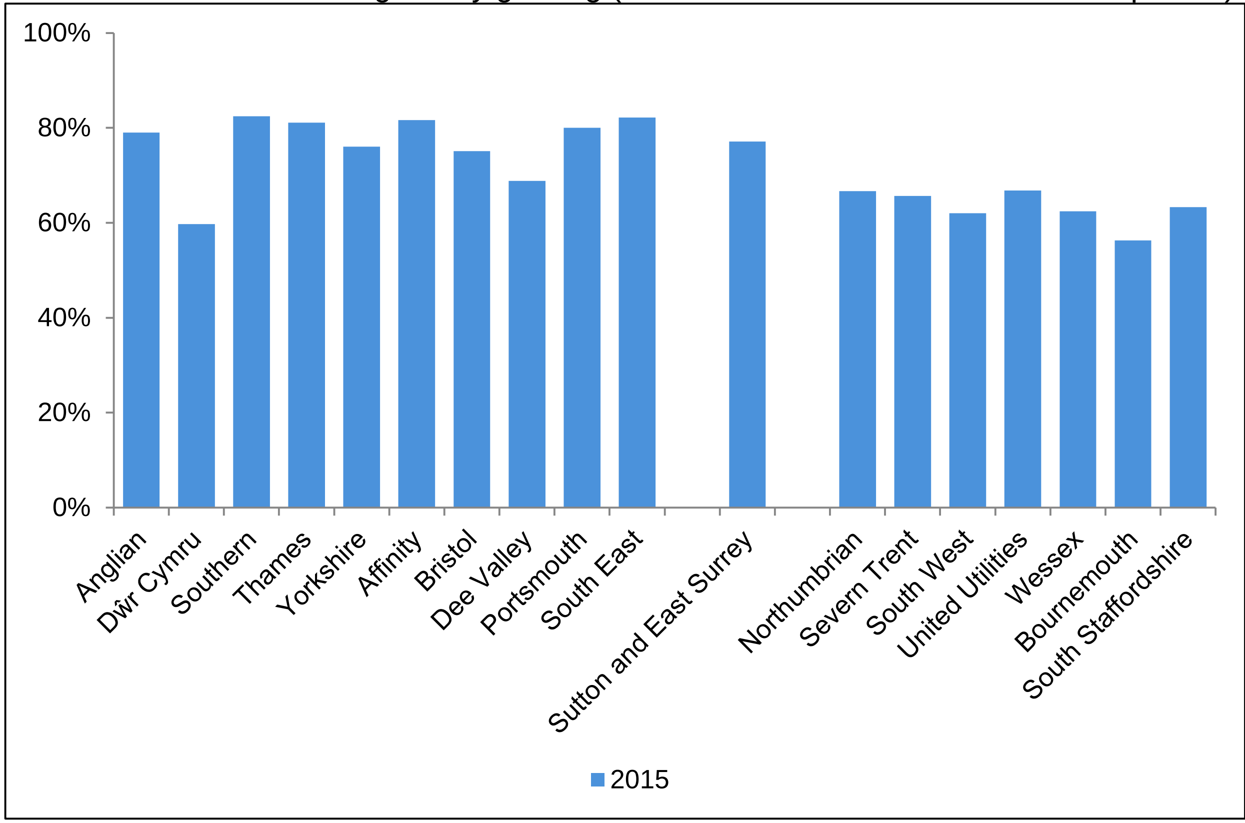
The chart compares the 2014-15 regulatory gearing for companies with securitised structures (LHS) against the companies which are not securitised (RHS).

The level of regulatory gearing for the companies with securitised structures (excluding Dŵr Cymru) ranges from 75% to 82% Dŵr Cymru's regulatory gearing was 60% (see footnote).

Sutton and East Surrey Water have a hybrid structure, having raised debt, which has the characteristics of securitised debt, but the company is not fully securitised

For the non securitised companies gearing ranges from 56% to 67%.

Regulatory gearing (securitised and non-securitised companies)



Dŵr Cymru Welsh Water is owned by Glas Cymru a single purpose not for profit Welsh company with no shareholders and is run solely for the benefit of customers. Under Glas Cymru's ownership, Dŵr Cymru's assets and capital investment are financed by bonds and retained financial surpluses.

Up to company financial results

Regulatory gearing | Dividend yield | Credit rating | Post-tax return on capital | Interest cover | Interest rates | Debt | Tax

Dividend yield (1)

The chart shows dividend yields calculated as dividends from the appointee as a percentage of regulated equity.

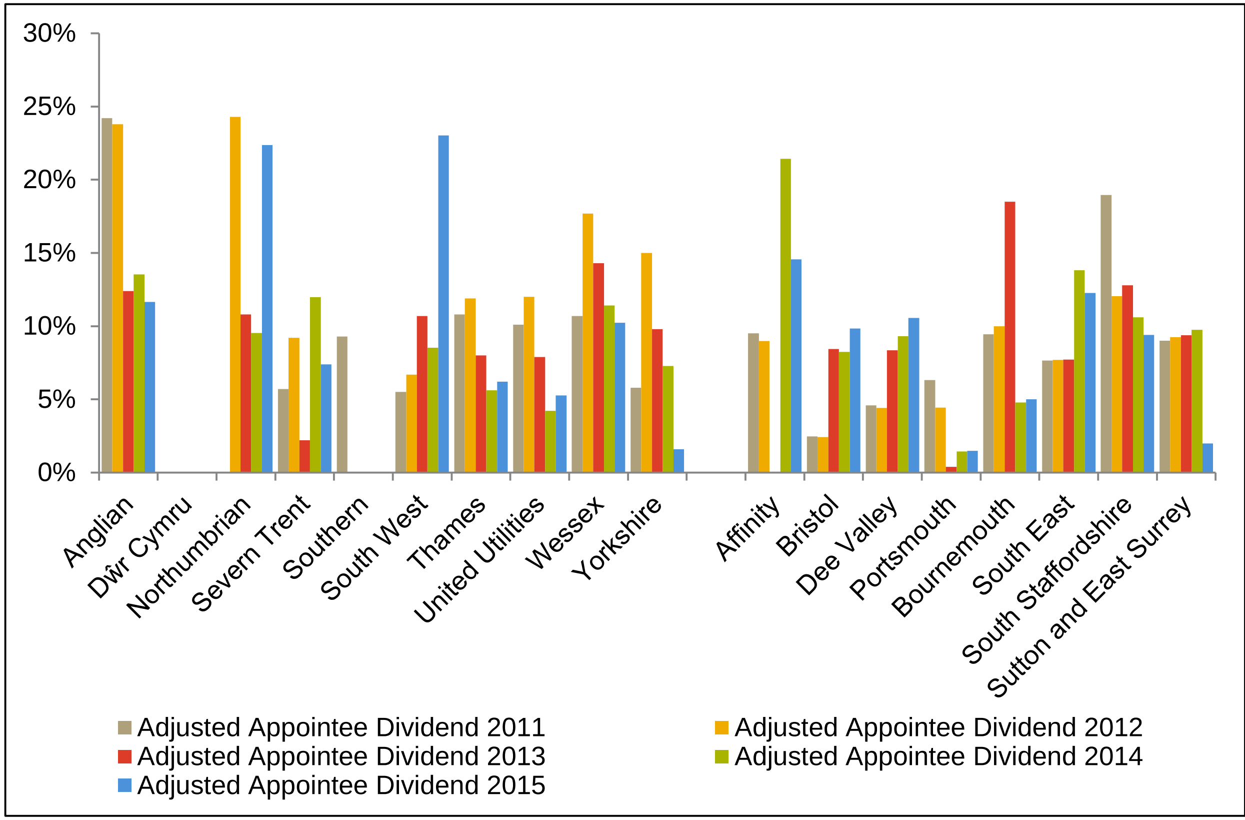
After adjusting for interest received Southern Water paid no dividends in 2014 and 2015 (see footnote).

Dŵr Cymru is a not-for-profit company and paid no dividends to investors in 2014 and 2015.

Average dividend yield in 2014-15 for WaSCs was 8.8% and for WoCs 8.1%.

2014-15 is the last year of the AMP5 price control and dividends may reflect the impact of AMP5 earned efficiencies and companies preparing to move into AMP6.

Dividend yields as a percentage of regulated equity



The dividend value used is as set out in each company's regulatory profit and loss account adjusted for any amounts which companies have paid to a parent company to enable that company to pay interest on a loan to that parent company from the appointee. Regulated equity is calculated as RCV less net debt for the appointee.

Up to company financial results

Dividend yield (2)

In 2011 Affinity Water paid an exceptional restructuring dividend which equated to a yield of 68%; as this is outside the normal range we have excluded it from the chart.

South West Water states that they have paid a special dividend to reflect their strong performance across AMP5.

Northumbrian Water's dividend reflects the company changing its accounting period to align the statutory accounting period to the regulatory accounting period. An additional dividend was paid in March 2015 rather than April 2015. Northumbrian Water has stated that similar amount will be paid in the 2015 calendar year compared to the dividends paid in the 2014 calendar year.

Up to company financial results

Credit rating

Except for two companies all companies have a licence condition that requires companies to maintain an investment grade credit rating.

As noted above a company's management and investors are responsible for determining a company's capital and financing structure, and is thereby also responsible for determining the level of credit rating headroom they consider appropriate. In respect of the recent AMP6 (2015-20) price control responsibility also rested with companies to assure us that their business plans and our final determination were financeable.

Credit ratings are 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 Standard & Poor's Rating Service and Fitch Ratings. Where a company has received an issuer or corporate family credit ratings from more than one agency, the lowest credit rating received has been used.

Severn Trent and South West Water do not currently have this requirement in their licence as their licences still contain the original terms included in "Condition F" that were issued to all companies at privatisation.

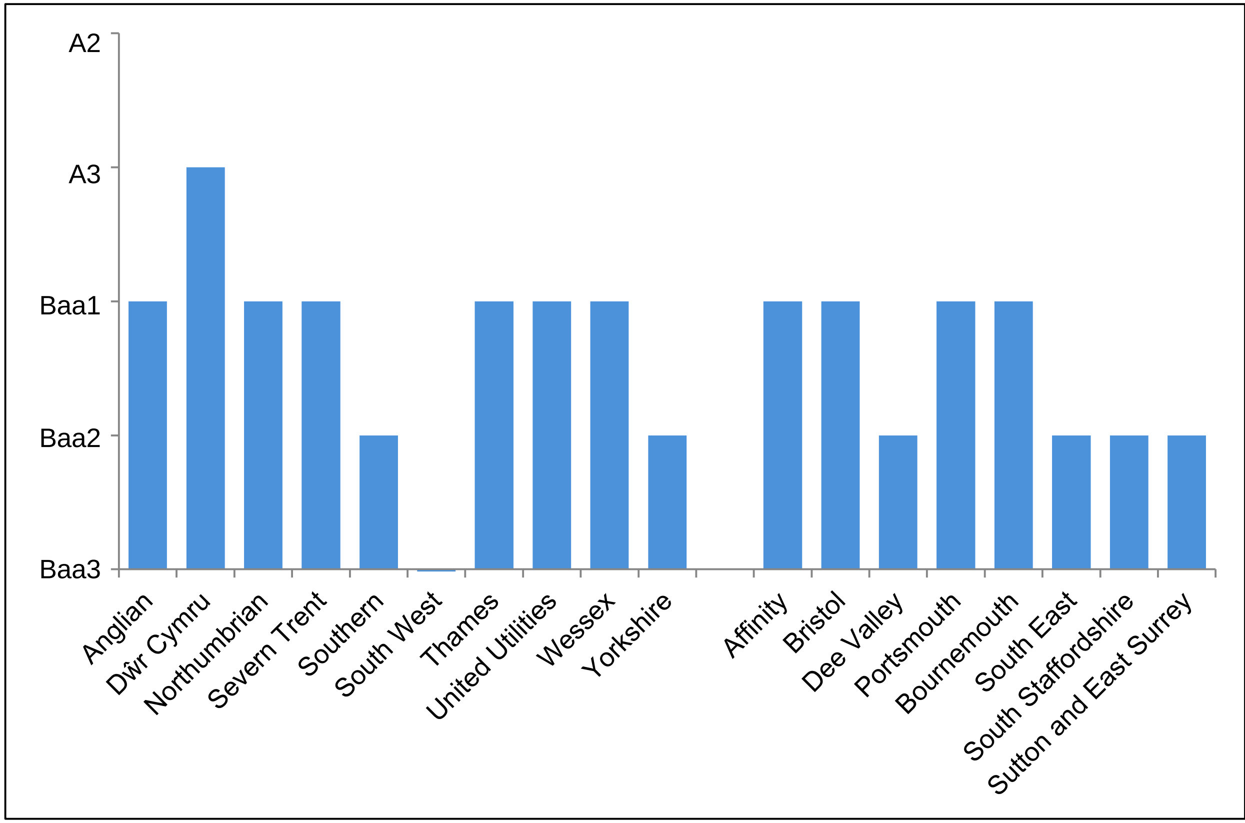
Credit rating (2)

The chart shows the lower of issuer and corporate family credit rating assigned by one of the three main credit rating providers (Moody's, Standard & Poor's and Fitch), **and** the resulting headroom above the minimum investment grade licence condition.

While its licence does not currently contain a minimum credit rating requirement Severn Trent maintains credit ratings above minimum investment grade.

South West Water's licence currently does not contain a credit rating requirement, and no credit rating has been assigned.

Headroom above minimum investment grade



Affinity Water have disclosed the credit rating on their Class A debt in their KPI report. Their corporate family rating which is used for their licence requirement is Baa1. Portsmouth Water and Dee Valley Water failed to disclose their credit ratings in their KPI reports. Portsmouth Water's credit rating is Baa1 while Dee Valley is BBB. Bournemouth Water has stated only that their rating is investment grade in their KPI Report. Their actual rating is BBB+

Up to company financial results

Regulatory gearing | Dividend yield | Credit rating | Post-tax return on capital | Interest cover | Interest rates | Debt | Tax

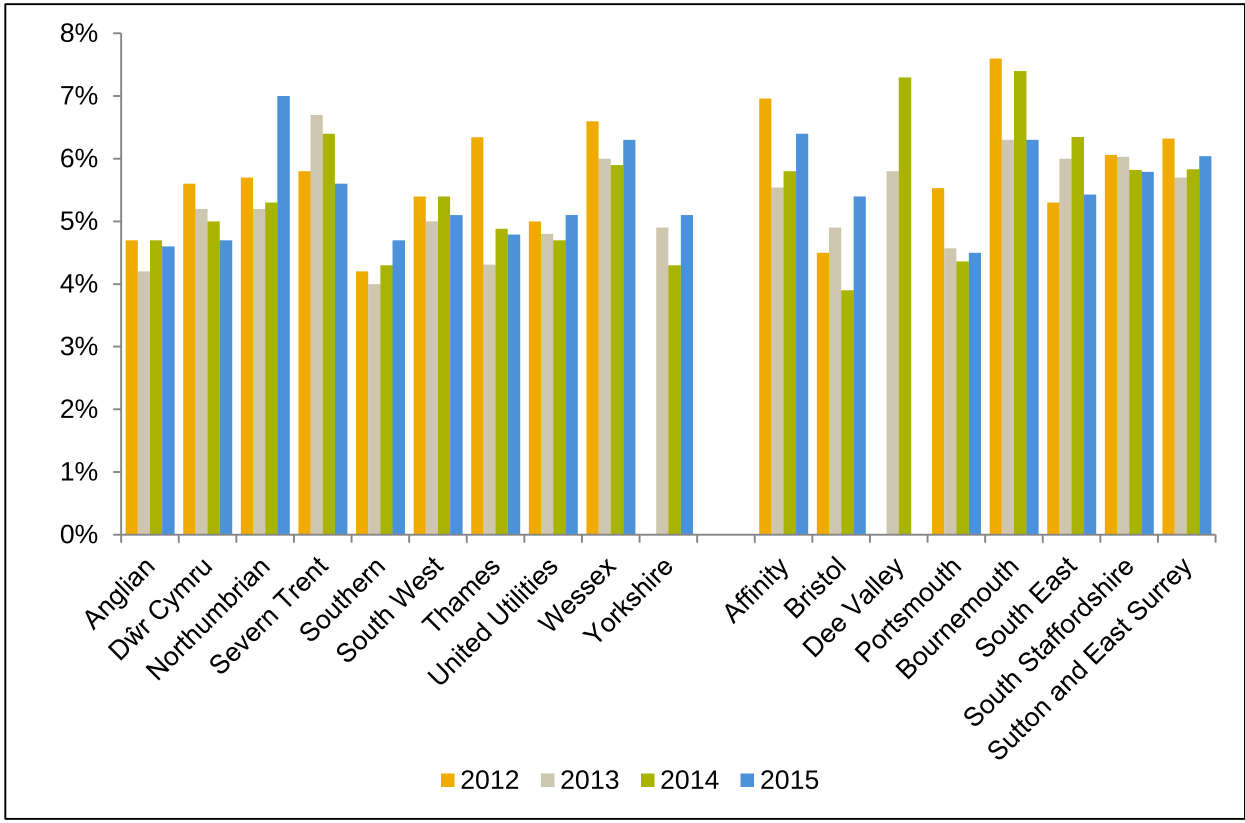
Post-tax return on capital

The chart shows post-tax returns on capital reported by companies in their regulatory KPI statements.

The reported returns for 2015 range from 4.5% to 7.0%. With an average of 5.3% for the WaSCs and 5.7% for the WoCs who reported this data.

No figures for 2015 were reported by Dee Valley Water in its regulatory KPI report.

Post-tax return



This indicator is defined as current cost operating profit less tax as a return on regulatory capital value

For 2014-15 Ofwat allowed a weighted average cost of capital of 5.1% for the WaSCs, 5.3% for South East Water and Veolia Central (now part of Affinity Water) and 5.5% for the other WoCs excluding Bristol Water. The Completion Commission allowed 5.0% for Bristol Water.

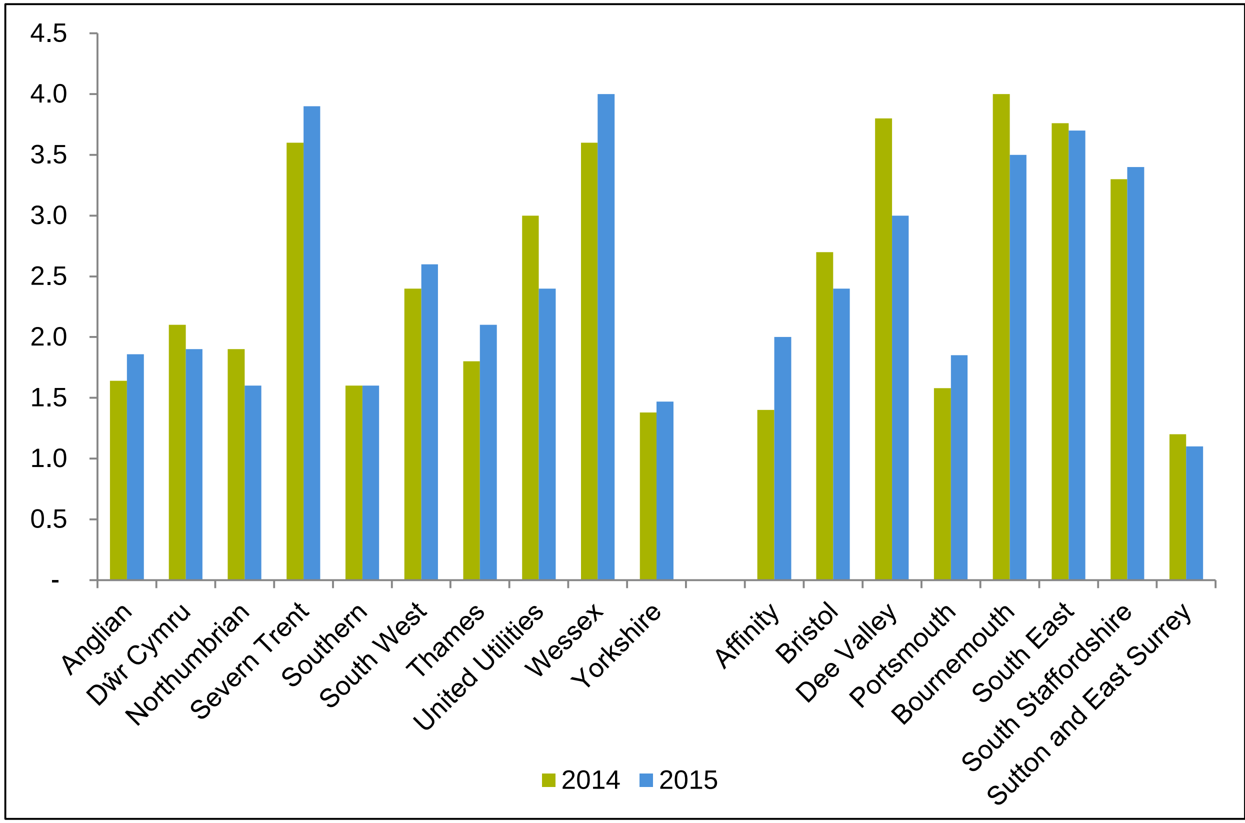
Up to company financial results

Regulatory gearing | Dividend yield | Credit rating | Post-tax return on capital | Interest cover | Interest rates | Debt | Tax

Interest cover ratios illustrate how easily a company can pay interest on its outstanding debt. Companies are required to present a cash interest cover ratio within their regulatory KPIs. The ratios reported for 2014 and 2015 are shown in the chart.

Significant variances exist between companies. While these variances may in part result from each company's debt funding arrangements, the variances appears to be too large for this to fully explain the differences.

Interest cover ratios



The current guidance to companies is that "for traditionally financed companies, adjusted interest cover and FFO/interest or, for structured companies, adjusted interest cover or PMICR as required within the financial covenants. For reporting purposes, a company is required to report the lower of the interest cover ratios."

The current reporting of interest cover ratios is clearly not on a consistent basis, thus, while providing a useful year-on-year comparison for individual companies, it does not allow effective comparisons to be drawn between companies.

Up to company financial results

Interest rates

In the notes to the regulatory accounts, each company is required to provide details of their average interest rates for the year on its debt.

These rates are shown in the next four figures, and demonstrate the range of interest rates that are reported as being paid.

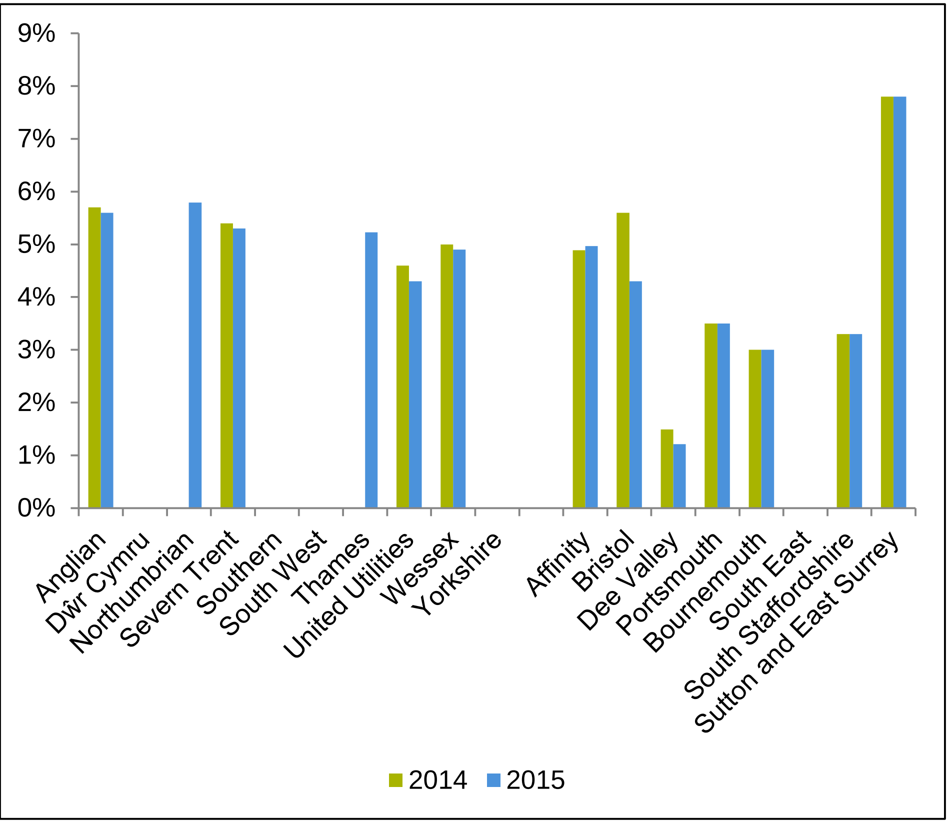
These charts also highlight that a number of companies have not published the required information.

Interest rates: fixed rate debt (1)

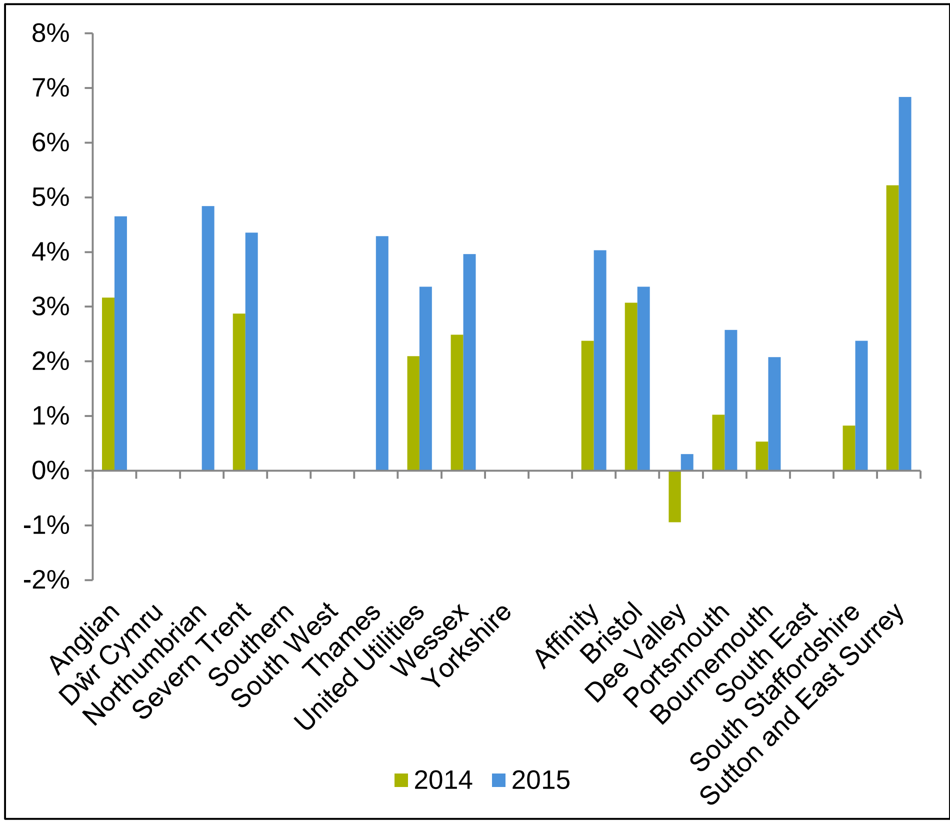
The average nominal fixed interest rates reported for 2015 ranged between 1.2% and 7.8% (industry average 4.6% for both 2014 and 2015). The average for WaSCs was 5.2% in both 2014 and 2015. For WoCs the average was 4.2% in 2014 reducing to 4.0% in 2015.

In our PR09 determinations for the AMP5 (2010-15) price control we allowed WaSCs a real cost of debt of 3.6%, South East Water and Veolia Central (now part of Affinity Water) a real cost of debt of 3.7% and the other WoCs a real cost of debt of 4.0%. Following an appeal the Competition Commission (now the Competition and Markets Authority) allowed Bristol Water a real cost of debt of 3.9%.

Fixed nominal interest rates



Fixed real interest rates



The figure on the left shows published nominal interest rates and the figure on the right adjusted interest rates removing the impact of inflation as measured by average year-on-year RPI to show the real fixed interest rates over the same period.

Up to company financial results

Regulatory gearing | Dividend yield | Credit rating | Post-tax return on capital | Interest cover | Interest rates | Debt | Tax

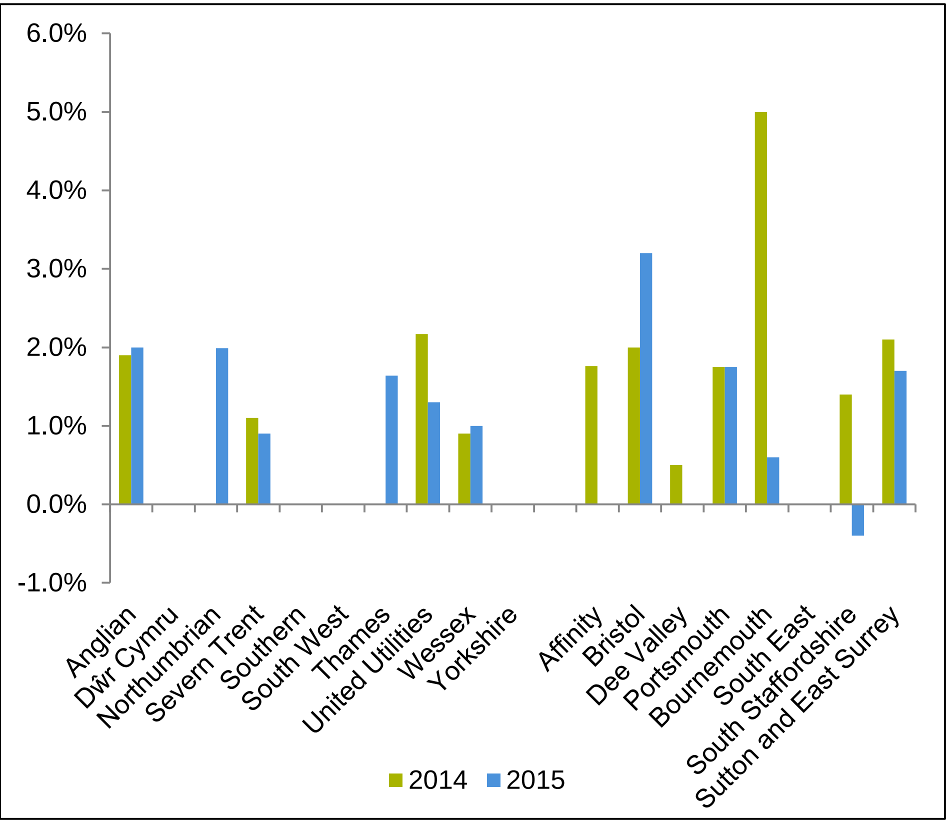
Interest rates: floating rate debt (1)

The average nominal floating interest rates reported for 2015 ranged between -0.4% and 3.2%. The industry average was 3.2% for 2015 and 1.9% for 2014. The average reported rate for WaSCs in both 2014 and 2015 was 1.5% while for WoCs 2.1% in 2014 falling to 1% in 2015.

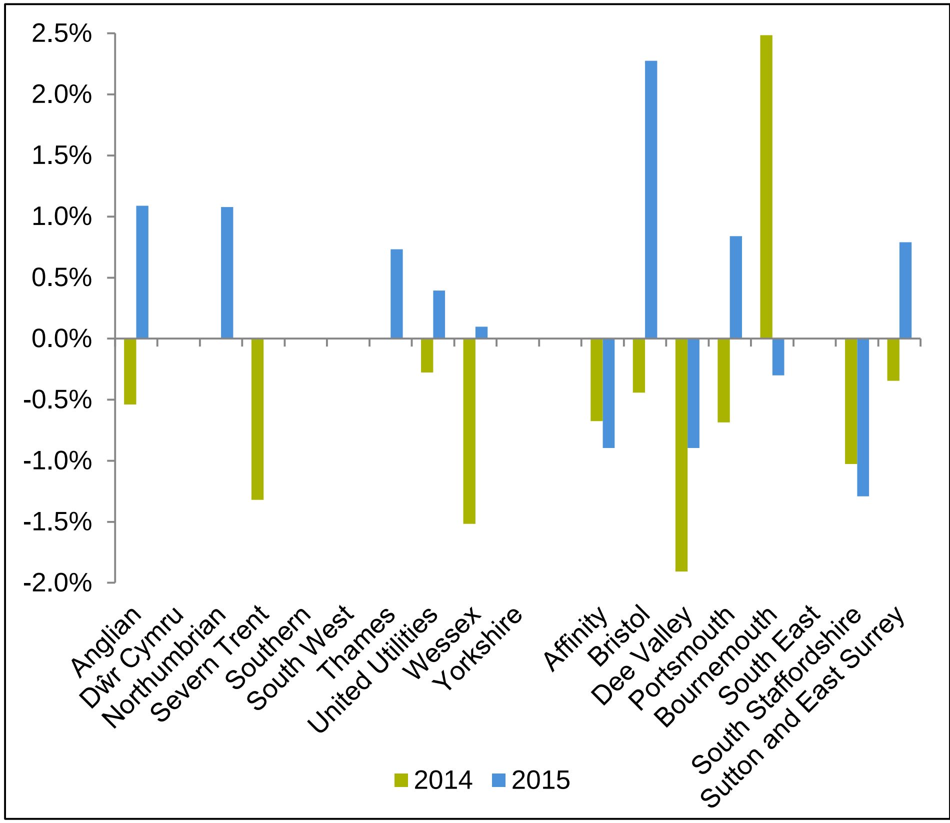
After removing the impact of inflation as measured by average year-on-year RPI it is clear that a number of companies have benefited from negative real interest rates on their floating rate debt

Interest rates: floating rate debt (2)

Nominal floating interest rate



Real floating interest rate



Up to company financial results

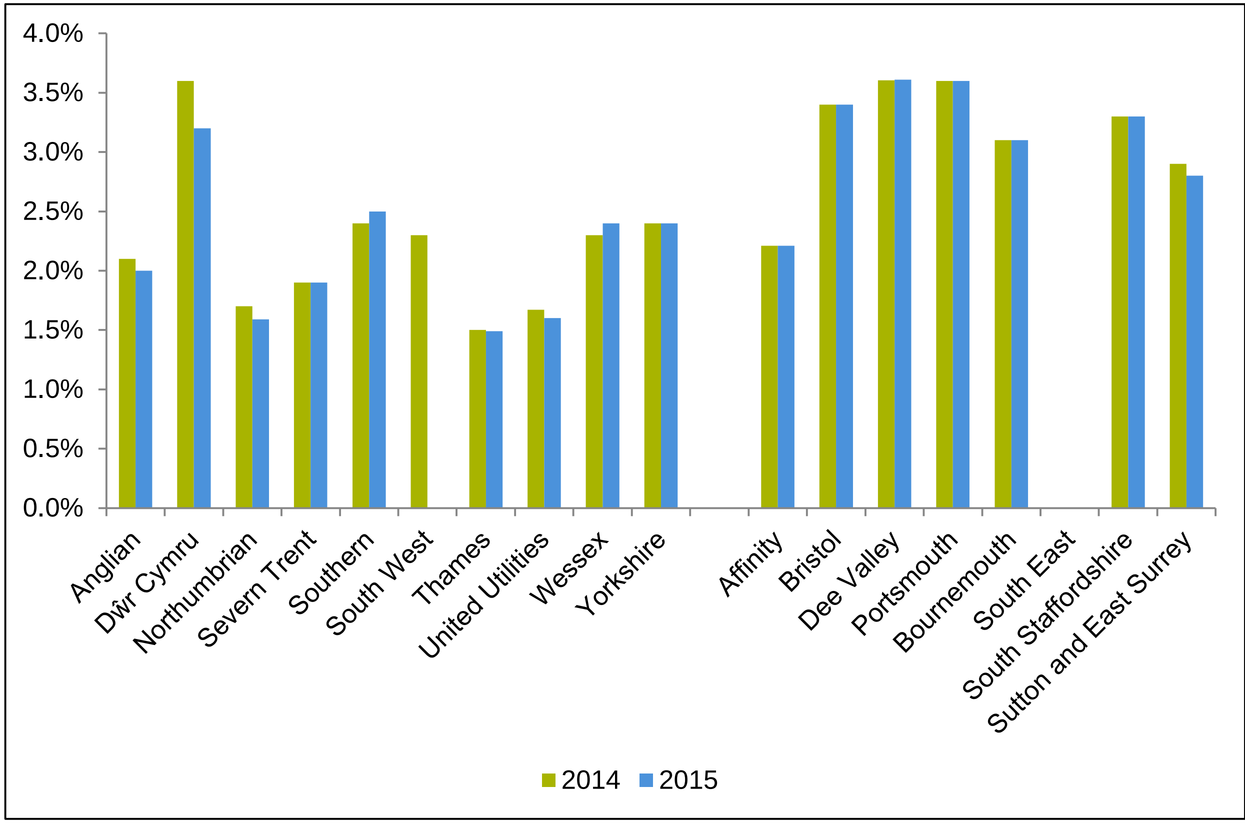
Debt: index linked

The chart on the right shows the reported interest rates on index-linked debt

For 2015 the real interest rate ranged between 1.5% and 3.6%, and the average across the industry was 2.6% for both 2014 and 2015.

For the WaSCs, excluding Dŵr Cymru, the average rate was 2.0% for 2014 and 2015, for Dŵr Cymru the average rate was 3.6% and 3.2% for 2014 and 2015 respectively. For the WoCs the average was 3.2% and 3.1% for 2014 and 2015 respectively.

Interest rates on index-linked debt



All rates are presented in real terms, i.e. excluding the impact of inflation as measured by average year-on-year RPI.

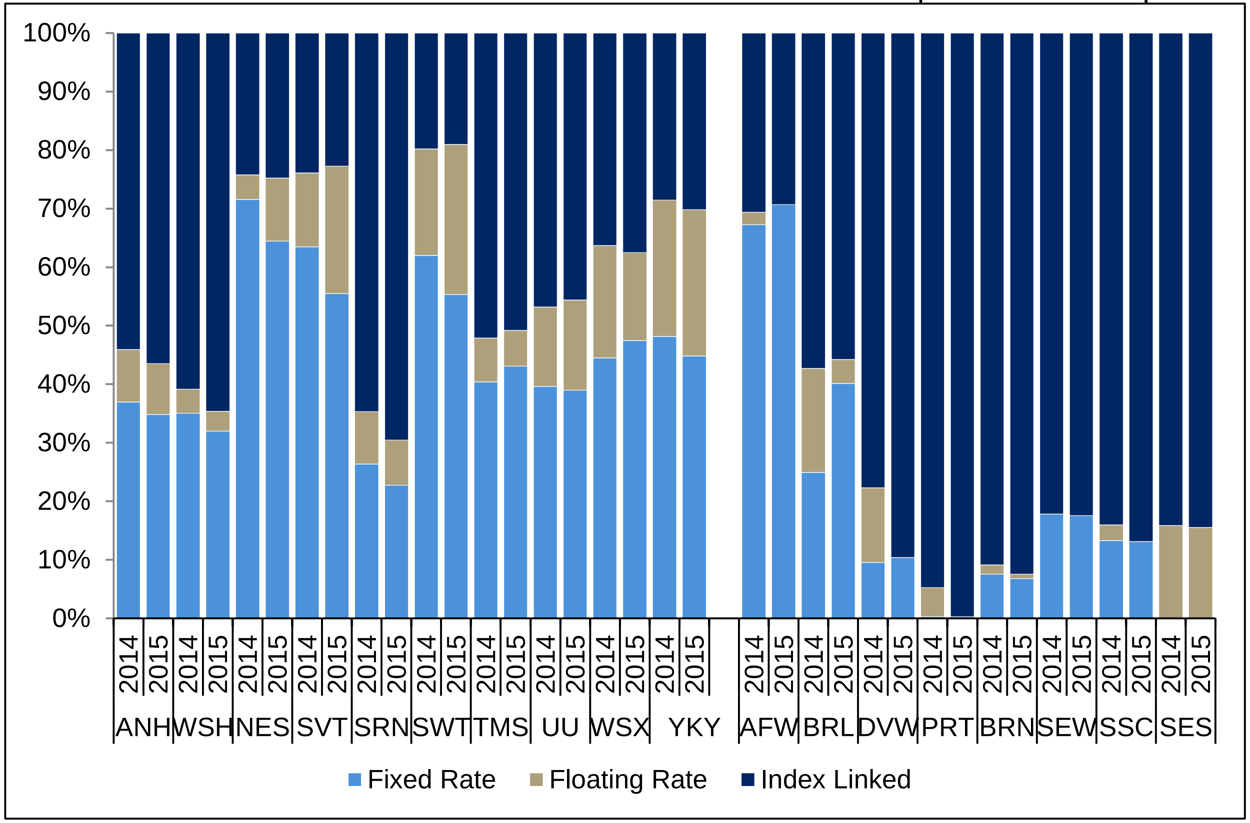
The chart on the right illustrates the composition of each company's debt portfolio in 2014 and 2015, analysed between fixed rate, floating rate and index linked.

The data shows that companies are using a significant amount of index linked debt to reduce their exposure to inflation risk.

The average amount of index-linked debt as a percentage of total debt entered into by WaSCs has increased from 41.1% in 2014 to 42.1% in 2015; for the WoCs the average increased from 75.2% to 77.6%.

As previously noted a company is responsible for determining its financing structure, including the mix of debt which it considers appropriate.

Composition of debt portfolio



As reported in net debt notes included in each company's regulatory accounts.

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Debt: maturity (1)

Each company is required to disclose the average length of time over which their debt is to be repaid.

Companies use a portfolio of both long and short term debt to finance their business with each company deciding on an appropriate mix.

Covenants agreed with lenders may restrict a company's flexibility as to the mix of maturities so as to reduce a company's exposure to refinancing risk.

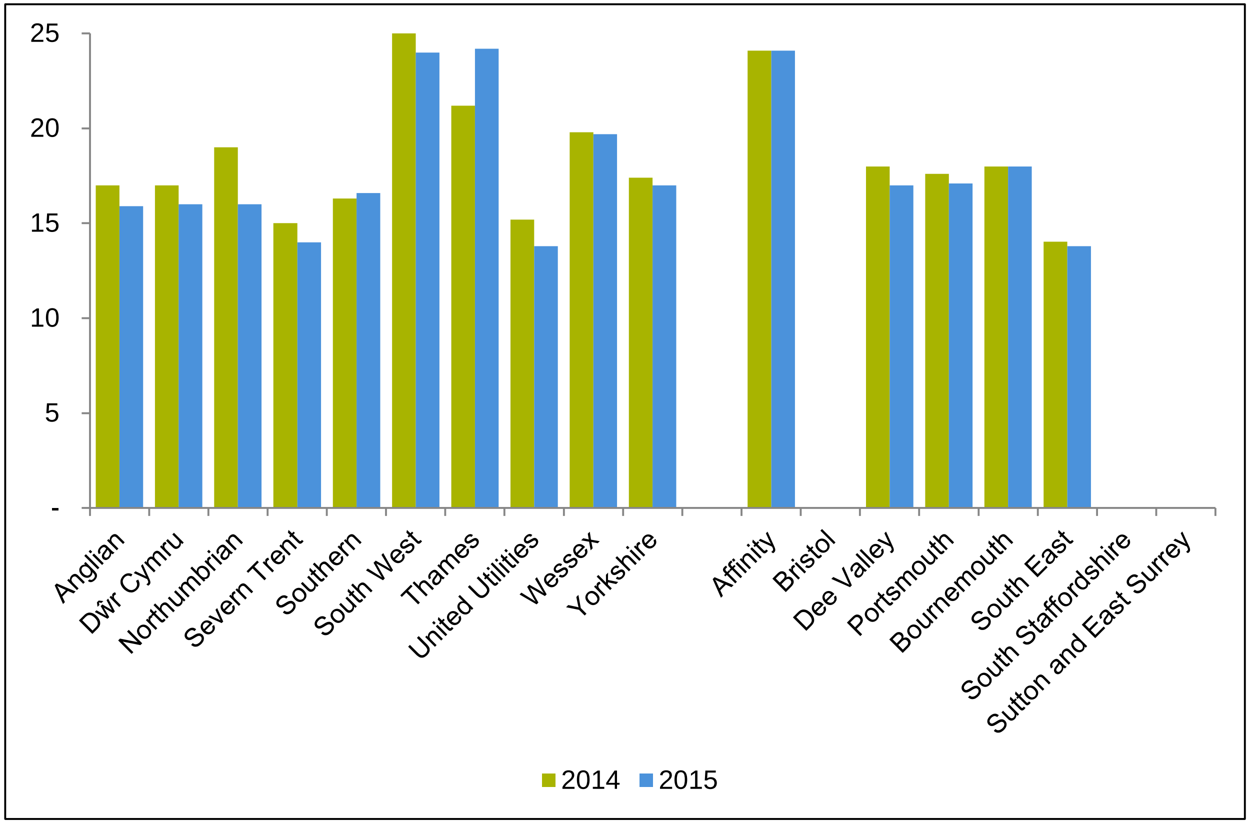
Debt: maturity (2)

The chart on the right shows that at year end 2015 the average term of outstanding debt by a company ranged between 14 and 24 years, with an industry average of 17.8 years.

The 2015 average has fallen slightly compared to the previous year when the company range was between 14 and 25 years with an industry average 18.3 years.

Where no data is included in the chart the information has not been published by the company

Average term of outstanding debt



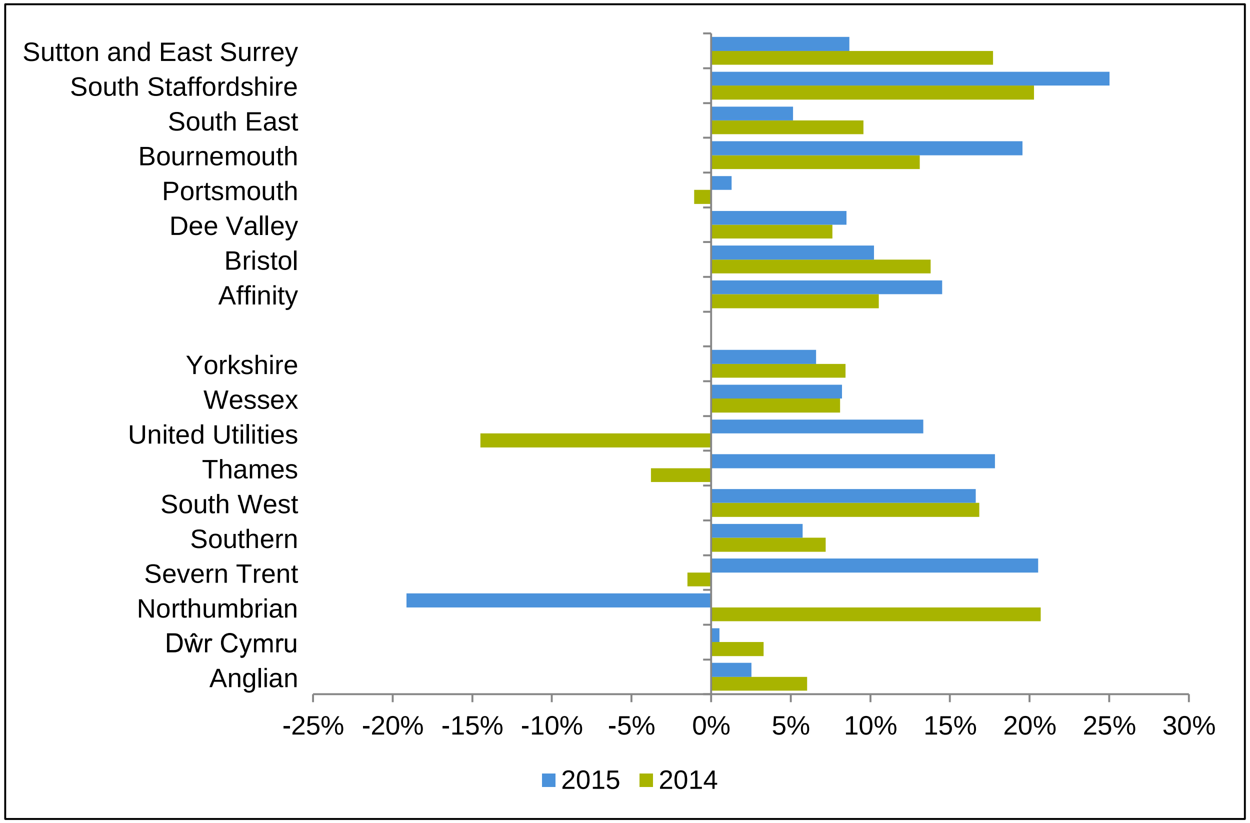
Up to company financial results

Effective tax rate

The chart shows the effective tax rate paid by each company for 2014 and 2015 calculated as the appointee's current tax charge as stated in the regulatory accounts as a percentage of the regulatory profit before tax.

The standard corporation tax rate for 2013-14 was 23%, falling to 21% for 2014-15.

Negative values indicate that the company has received a refund of tax in the period.



Tax policy is a matter for the UK government and collection of tax the responsibility of HMRC. The effective tax rate a company pays reflects the impact of tax reliefs generally available to UK companies in respect of, for example, capital allowances and pension scheme contributions, along with the availability of group loss relief or other timing differences.

Northumbrian Water has confirmed that the refund in 2015 was due to the agreement of capital allowance claims in respect of prior periods with HMRC.

In 2014 UU received a refund from HMRC in respect of an industry wide settlement relating to the abolition of industrial building allowances. UU have shared this saving with customers.

Future developments (1)

We have considered the responses received to the initial consultation and will be publishing a response document shortly.

Meetings with companies and other relevant parties will also be held to discuss and confirm the basis on which certain metrics will be calculated in the future and we will issue written guidance before the end of 2015

A full suite of financial metrics has not been included as either there is currently insufficient public data available to allow a meaningful comparison to be made at this point in time or the necessary information was not separately reported in the regulatory accounts for 2014-15, for example retail profit margins.

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Future developments (2)

This snapshot includes information on the regulated companies only.

Further consideration is being given as to the extent to which in fulfilling our statutory duties, in particular our resilience duty, we will look outside the regulatory ring fence at holding companies and group structures.

In addition, we are giving further consideration to the stress testing by companies of financial projections pursuant to the long-term viability statement requirement under the 2014 UK Corporate Governance Code.

Further information will be given as to the extent that such information will be included in a future financial monitoring commentary.

The first full financial resilience commentary will be published following the receipt of the 2015-16 regulatory accounts.

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Appendix: Company financing and capital structures

A number of privately owned companies have established “securitised” debt structures and often have a higher gearing than non-securitised companies.

Similar to a household mortgage, securitisation enables a company to raise debt by granting a mortgage over an identifiable stream of future cash flows generated by the business, rather than through a mortgage on the asset.

In order to protect the quality of future cash flows, a securitised borrower agrees or "covenants" with its lenders, under a common set of terms and conditions, to maintain the assets to a certain standard and not to sell the assets without consent.

In addition, the company normally agrees, after paying its operating expenses, to use cash generated by the business to pay interest and debt repayment obligations when due, before making any distributions to shareholders.

The way that water companies are regulated means that cashflow is relatively stable and predictable and this type of financing structure has been attractive to investors.

The existence of the common terms and security package means that a company with a securitised structure can support a higher level of gearing with limited impact on interest costs than a non-securitised company while maintaining a similar investment grade credit rating.

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