Monitoring financial resilience report

December 2020

Ofwat

Introduction and context

Introduction

Water companies are required to report performance information in their Annual Performance Reports ('APRs'). For each company this includes information about its financial returns and financial resilience both now and in the longer term. This report draws on information published by individual companies[1] in their APRs for the year ended 31 March 2020 and other publicly available information (e.g. statutory accounts published by individual companies or reports from the credit rating agencies).

This report is intended to enhance the transparency and accessibility of each company's financial performance and the financial structures in the sector by sharing key metrics, rather than drawing any conclusions on the financial performance of any individual company. This enables Ofwat and other stakeholders (including investors and potential investors, credit ratings agencies, analysts, government and customers) to monitor the businesses which we regulate and to challenge the sector in its identification and management of risk.

While this report does not draw any conclusions on the financial performance or resilience of any individual companies, in line with our strategic goal to transform water companies' performance, we continue to engage with companies directly where we have concerns about their financial or operational performance or where we see indicators of a risk to financial resilience. Further details of our strategic goals can be found in our document 'Time to act, together: Ofwat's Strategy'.

Context

The year ended 31 March 2020 is the final year of the 2015-20 price control period. As a result it includes outturn data for the whole of the 2015-20 period and this allows for comparison of actual company performance in delivery of their determinations, in contrast with prior years where this took account of forecast data. The returns for the period are shown in the sections on RoRE and Financial Flows.

We published the final determinations for PR19, the price review for the 2020-25 period, in December 2019 and the new period started on 1 April 2020. We have also issued updated Board leadership, transparency and governance principles which came into effect from 1 August 2019.

On 1 July 2018 variations were made to the Appointments of Severn Trent and Hafren Dyfrdwy (formerly Dee Valley Water; referred to as Hafren in this report for all years) so that activities within Wales are now undertaken by Hafren and activities within England are now undertaken by Severn Trent[2]. Hafren became a provider of wastewater services from 1 July 2018, however, this remains a small part of its overall business. Its position in the majority of the slides reflects that the company was a water only company at the start of the period.

Covid-19

Covid-19 has had a limited impact on the 2019-20 period as the UK did not go into lockdown until the last couple of weeks of the financial year. While companies have made some provisions for increased bad and doubtful debts in the period and there will be some impact on the timing of cash flows around the year end, the impact of Covid-19 will be seen more in the 2020-21 period and potentially beyond.

Contents

The metrics considered on the following pages are:

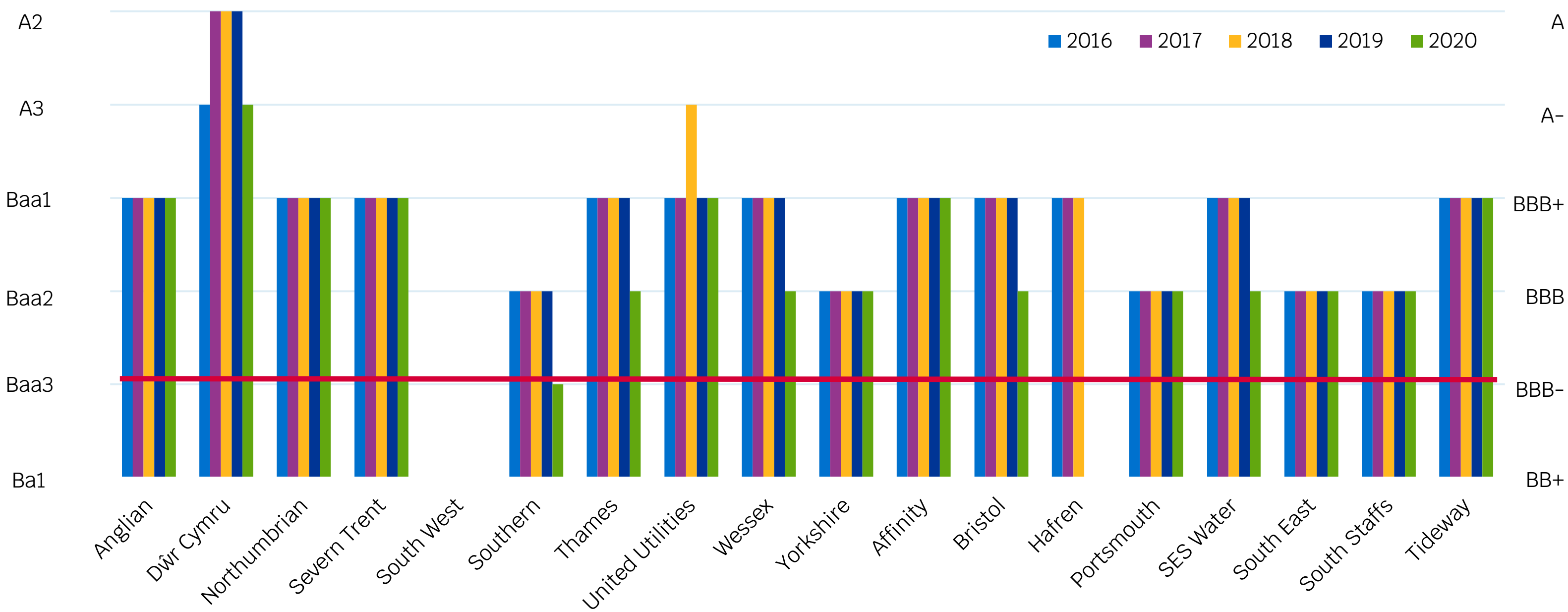
The report has the following supporting appendices:

Number references used throughout this report link through to further detail available in the end notes.

The delivery of the outcomes that were outlined in each company's final determination at PR14 are reviewed in more detail in our Service Delivery Report (being published on 3 December 2020).

The supporting data tables for the graphs included within this report have been published on our website.

Credit ratings

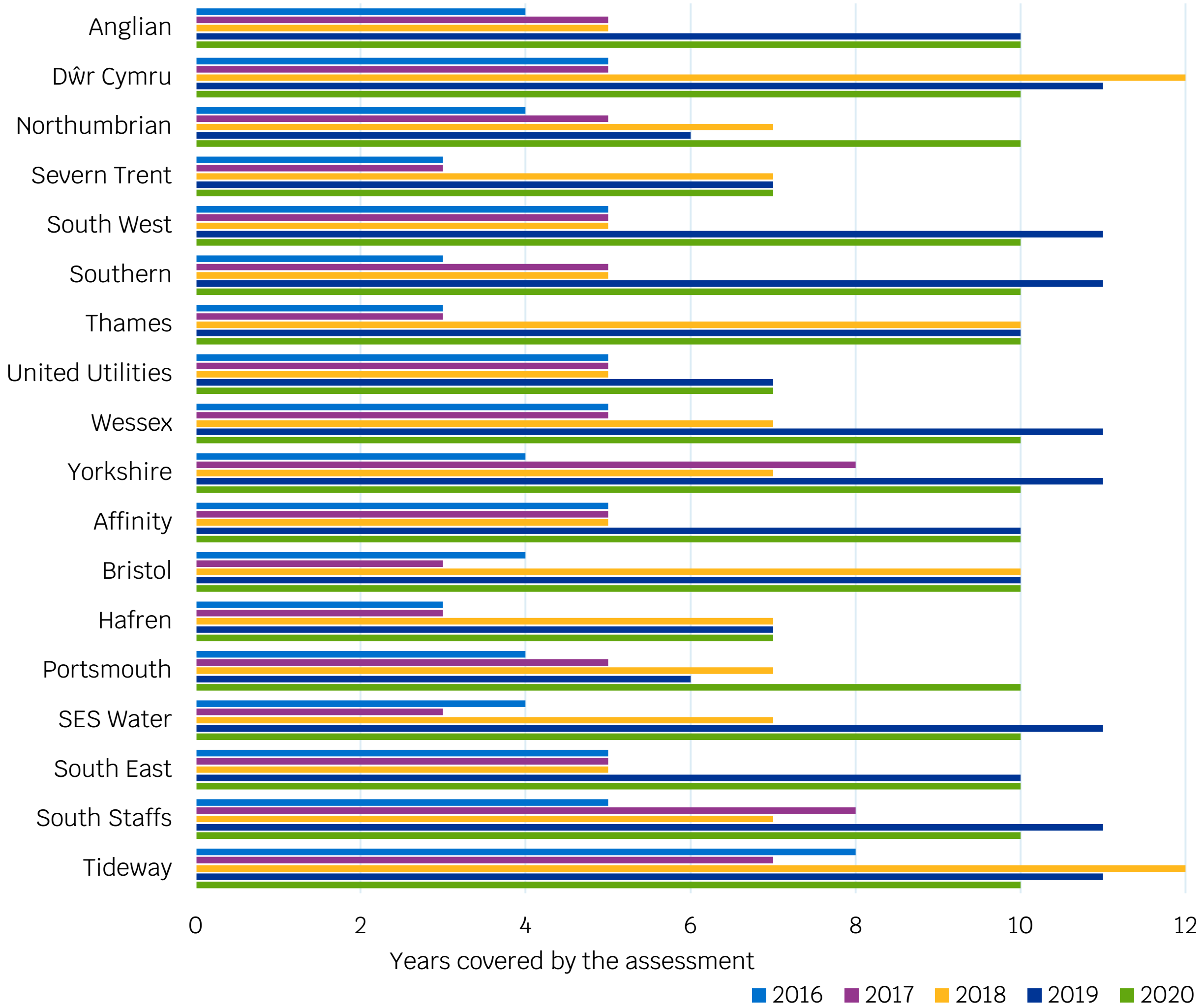


Most companies' licences include a requirement with respect to maintaining an investment grade credit rating[3]. The red line shows the level of the minimum investment grade level (BBB-/Baa3) that meets this requirement.

Typically, each company maintains a credit rating with one or more of Moody's, S&P and Fitch. The credit ratings shown in the chart reflect those reported in the Annual Performance Report, which requires the lowest rating to be reported where a company is rated by more than one agency. South West's and Hafren's licences do not require them to maintain a credit rating. However, their licences require the company's board to certify that each would be able to maintain an investment grade credit rating along with the main factors, including financial ratios, the board has taken into account to come to its conclusion.

As at 31 March 2020, six companies have their lowest rating on negative outlook (Anglian, Yorkshire, Affinity, Bristol, Portsmouth and SES Water), with Northumbrian having its Baa1 rating with Moody's under review for downgrade – this remains the case at the date of publication of this report. Southern has its lowest credit rating at the minimum investment grade (BBB-/Baa3).

Long-term viability statement (LTVS)



The LTVS is a public statement by the board of each company that they have assessed the viability of the business over the period shown in the chart and it sets out the approach they have taken in making that assessment.

All companies have provided a LTVS which looks ahead over a period of between 7 and 10 years and meets at least the minimum requirements set out in our published guidance. While many companies have provided clear and transparent statements setting out their detailed assessment of risk and how they have reached their conclusions we have identified areas where further improvements can be made. We will be following this up with companies directly.

Our Expectations for companies in issuing long term viability statements information notice, published in April 2019, detailed our expectations for companies in preparing its long term viability statements.

Gearing (1)

The period 2015-20 saw a slight reduction in the total debt to RCV in the industry. The average gearing for WoCs reduced from 77.1% at 31 March 2015 to 71.8% at 31 March 2020. Over the same period, gearing for WaSCs, saw only a small reduction, from 70.5% to 69.8%.This reduction has been aided by Southern, SES Water and South Staffs taking significant steps to reduce their gearing via equity injections, but this reduction in gearing has been offset by increases at other companies.

A number of companies have seen an increase in gearing in 2020 compared to 2019. In many cases this increase is due to companies incurring additional costs in 2019-20 (see slide 12) and/or experiencing reduced cash inflows near the year end due to Covid-19.

South West has indicated that it is targeting a higher gearing ratio of 62.5%, which is slightly higher than it has historically maintained but is not considered to be excessive or out of line with the rest of the industry.

Hafren's gearing had been falling over the period but increased at 31 March 2020 as a result of its costs being higher than the revenue it could recover in that year. Severn Trent has made a commitment to make an equity injection into Hafren post year end to reduce the company's gearing closer to the PR19 notional level of 60%.

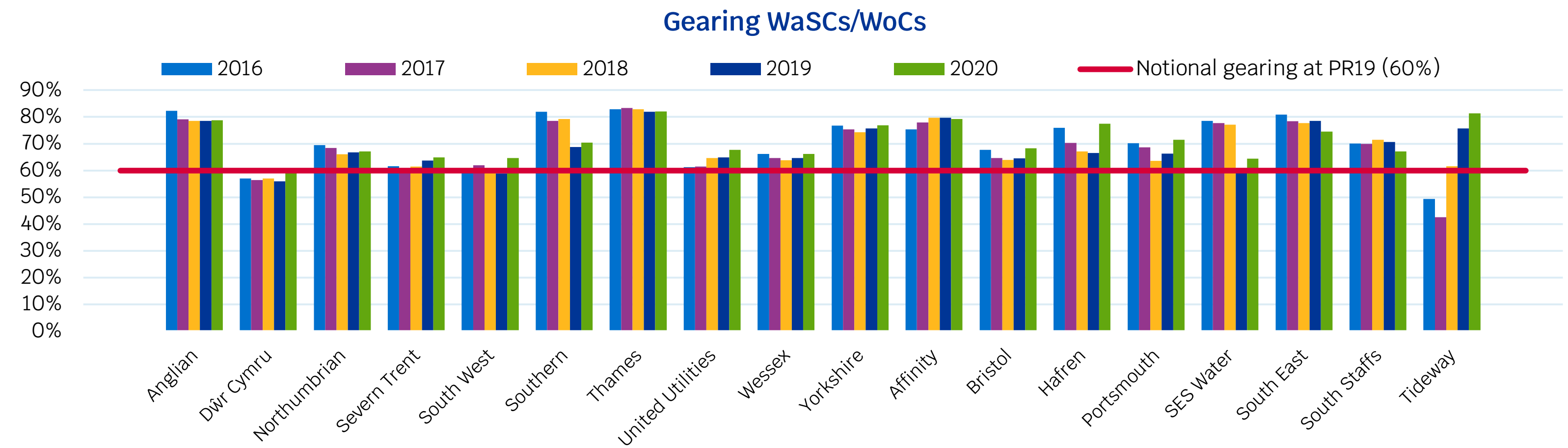
Slide 7 shows the year-end gearing ratios analysed by WoCs and WaSCs and by those with a securitised structure and those without. The existence of the common terms and security package means that a company with a securitised structure may support a higher level of gearing with limited impact on interest costs than a non-securitised company, while maintaining a similar investment grade credit rating[8].

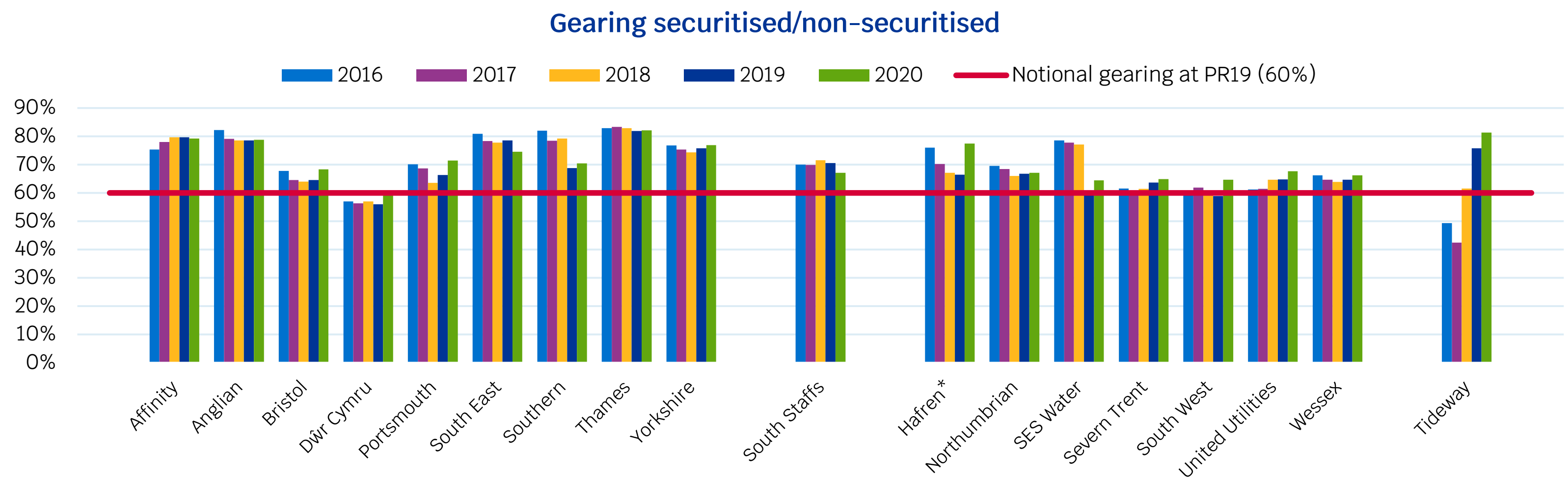
Regulatory gearing is the ratio of net debt for the appointed business to its regulatory capital value (RCV). Net debt includes preference share capital and shareholder loans, it excludes any pension deficit liability and mark-to-market accounting adjustments. For 2015-20 we have set notional gearing at 62.5% while for 2020-25 it is 60%.

A high level of gearing arguably reduces a company's resilience to cost shocks as it usually commits the company to paying higher overall interest costs due to the higher debt levels. Therefore, we encourage companies to consider whether high levels of gearing are sustainable and those companies with high gearing to consider options to de-gear.

Companies and their management are responsible for ensuring that they are financially resilient and have an appropriate capital structure. Since 2017 we have signalled that companies should be taking steps to improve their resilience particularly in the light of the wider market movements resulting in lower returns which were expected to apply from 2020.

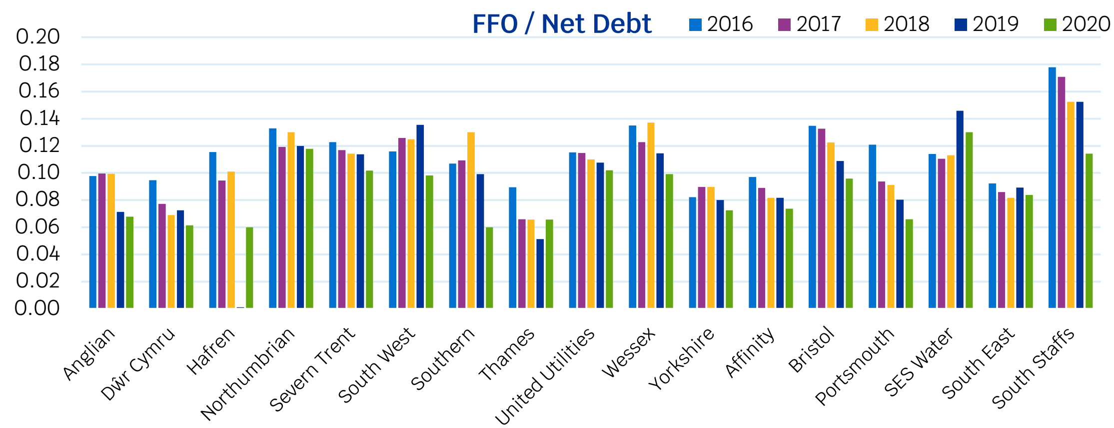
Gearing (2) – charts

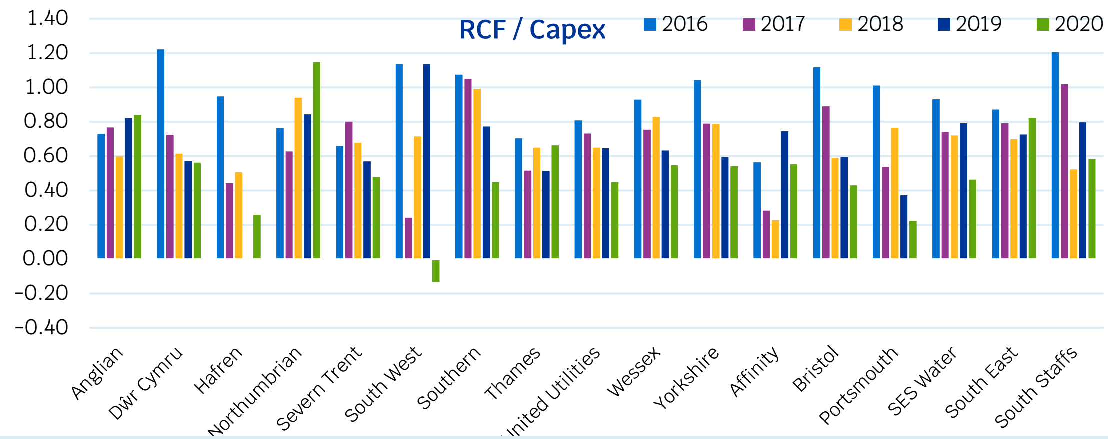




*Prior to its acquisition by Severn Trent, Hafren (formally Dee Valley Water) had a securitised structure.
The notional gearing level for the 2015-20 period was slightly higher than the PR19 notional gearing shown in the chart at 62.5%
South Staffs does not have a whole business securitisation arrangement but has a hybrid structure incorporating some securitised debt.
Tideway is different to the other companies in that it is developing new infrastructure rather than providing water and wastewater services. The increase in gearing reflects debt drawn down as the construction progresses. A portion of this debt is in the form of shareholder loans which are convertible into equity at a future date.

FFO/Net Debt and RCF/Capex





There has been a decrease in FFO / Net debt over the 2015-20 period. The cause of this is a reduction in FFO, which some companies have linked to an increase in social tariff uptake (see slide 21) along with an increase in operating expenditure. Fourteen companies have also had an increase in net debt as explained in the gearing slides.

South West reported a negative RCF / Capex. This is due to the company paying a higher than usual equity dividend reflecting outperformance in the 2015-20 period and targeting gearing of 62.5%.

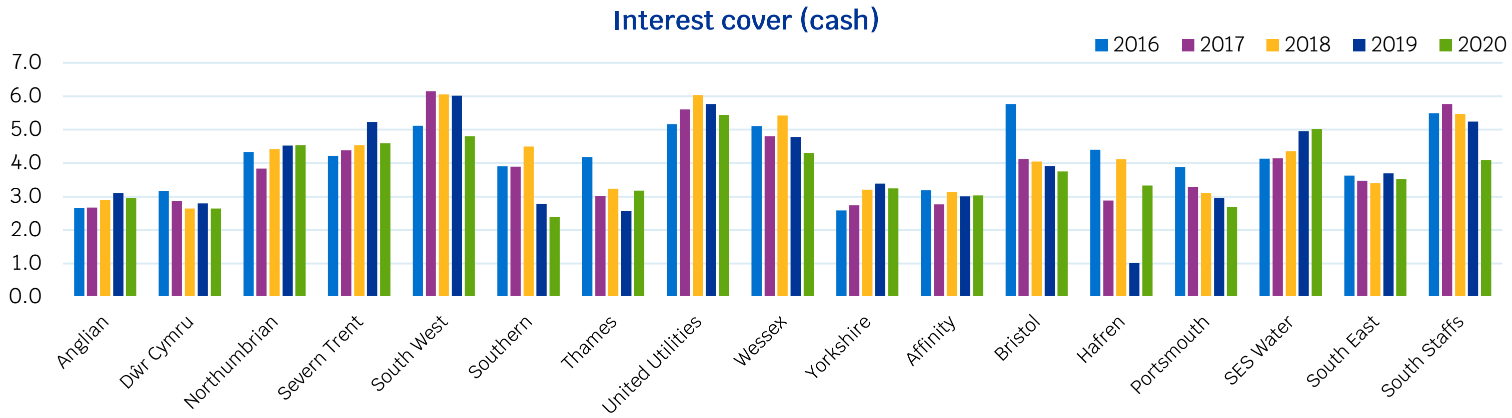
Northumbrian significantly reduced its dividends compared to the previous year, resulting in an increase in RCF/Capex.

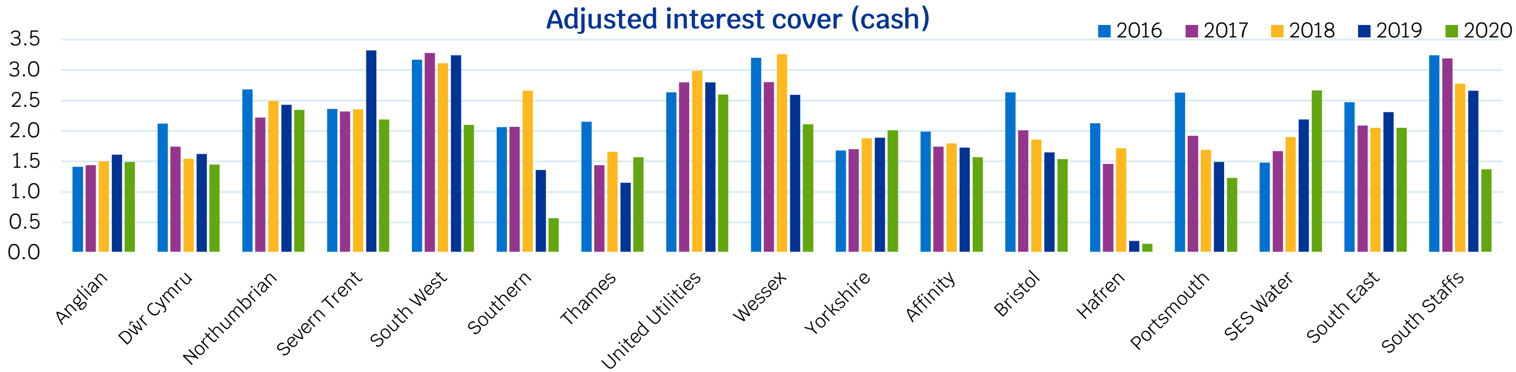
Funds from Operations (FFO)/Net Debt is calculated as FFO (cash generated from operating activities adjusted to remove changes in working capital, less net interest paid and tax paid) as a proportion of net debt. It indicates each company's ability to repay its debt. Variants of this metric are monitored by the credit rating agencies.

Retained Cash Flow (RCF)/Capex is the ratio of retained cash flow (FFO less total equity dividend paid) as a proportion of gross cash paid in relation to fixed assets. It relates to a company's ability to meet its capital expenditure requirements. It is also a financial ratio that is monitored by credit rating agencies.

Anglian presented its financial metrics up to 2018 excluding certain internal transactions[5]. The company's metrics are shown in the charts above excluding these transactions, as presented by the company.

Interest cover



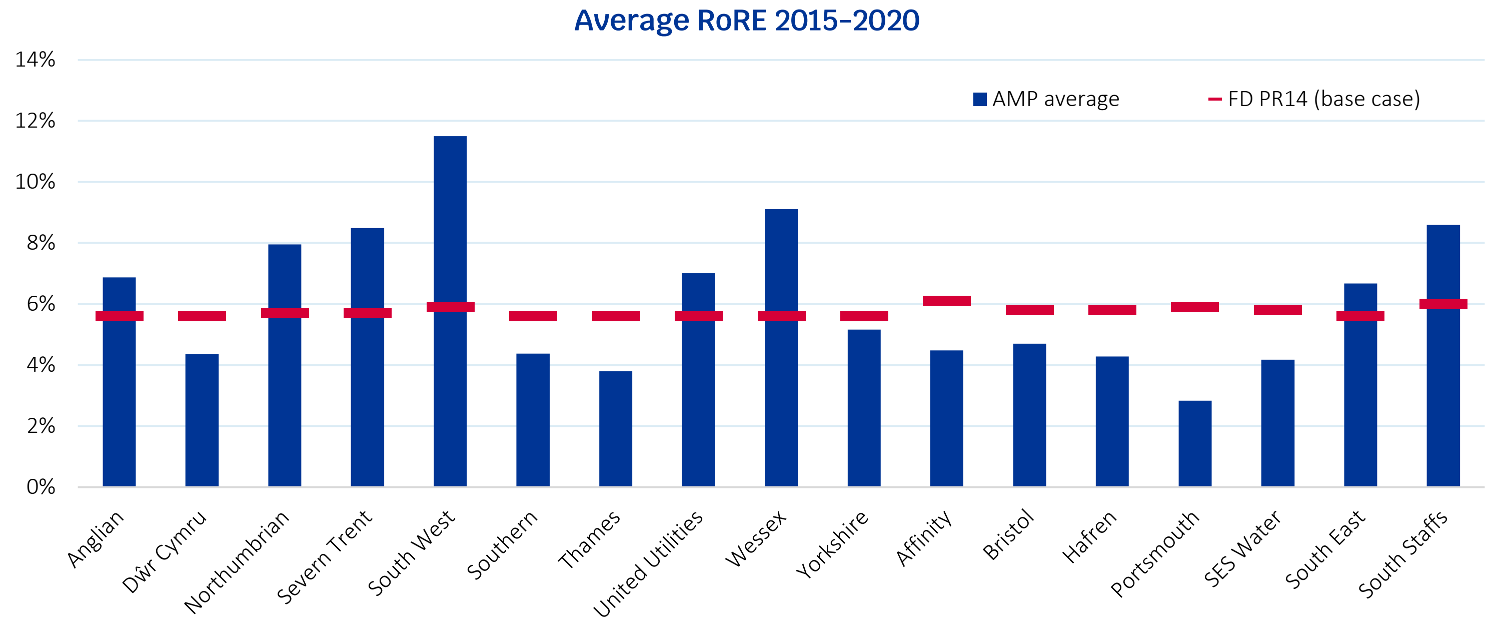


Interest cover ratios illustrate a company's ability to pay interest on its debt. Companies have provided two interest cover ratios in their APRs and these metrics are also used in Ofwat's assessment of financeability during price reviews. Interest cover ratios are an indicator of the relative financial strength of a company. Interest cover is impacted directly by factors such as each company's actual debt costs and operational performance.

The interest cover ratio looks at the ratio of funds from operations (FFO) before the payment of interest to cash interest paid. In the adjusted interest cover metric, the numerator is adjusted to subtract regulatory depreciation which is an approximation of the capital cost that would be incurred if companies were to maintain the RCV at a constant level.

Anglian presented its financial metrics up to 2018 excluding certain internal transactions[5]. The company's metrics are shown in the charts above excluding these transactions, as presented by the company.

Return on Regulatory Equity (RoRE) (1)



The base RoRE for each company at PR14 (shown by the red line in the chart) represents the return a company would earn if its performance was in line with our determinations and assuming that companies are geared in line with the notional capital structure.

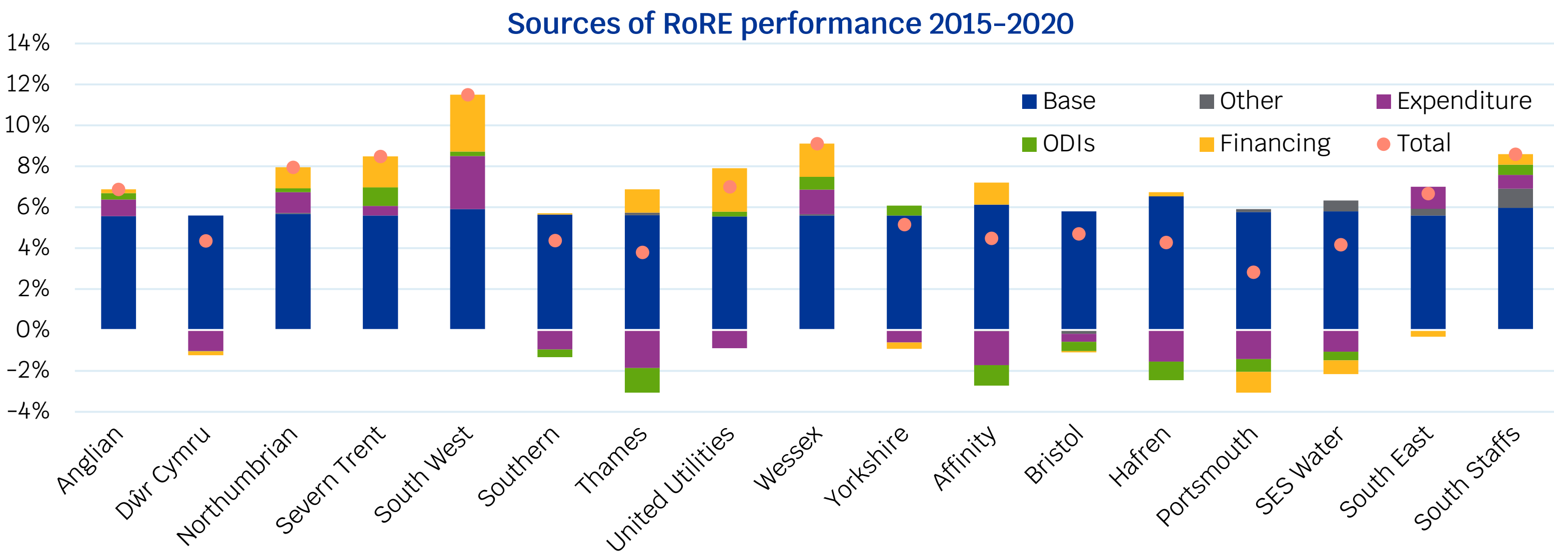
Variances against base case RoRE are driven by accrued operational and financial out and under performance. Further analysis of the individual components of this performance is shown on the next page. Over the 2015-20 period, 8 companies outperformed their base RoRE with 9 underperforming their base RoRE.

Slide 11 provides a breakdown of RoRE into its individual components while slide 12 shows this for the final year of the period.

Return on Regulatory Equity (RoRE) measures the returns (after tax and interest) that companies have earned by reference to notional regulatory equity, where regulatory equity is equal to 37.5% of the RCV. The calculations presented are the responsibility of company management and have not been verified by Ofwat.

The calculations of RoRE in the first four years of each price control period require an element of judgement by company management in relation to timing of expenditure. Companies have to determine whether any over or underspend in each year amounts to genuine additional costs or cost savings or is simply due to re-profiling of expenditure within the current price control period.

Return on Regulatory Equity (RoRE) (2)

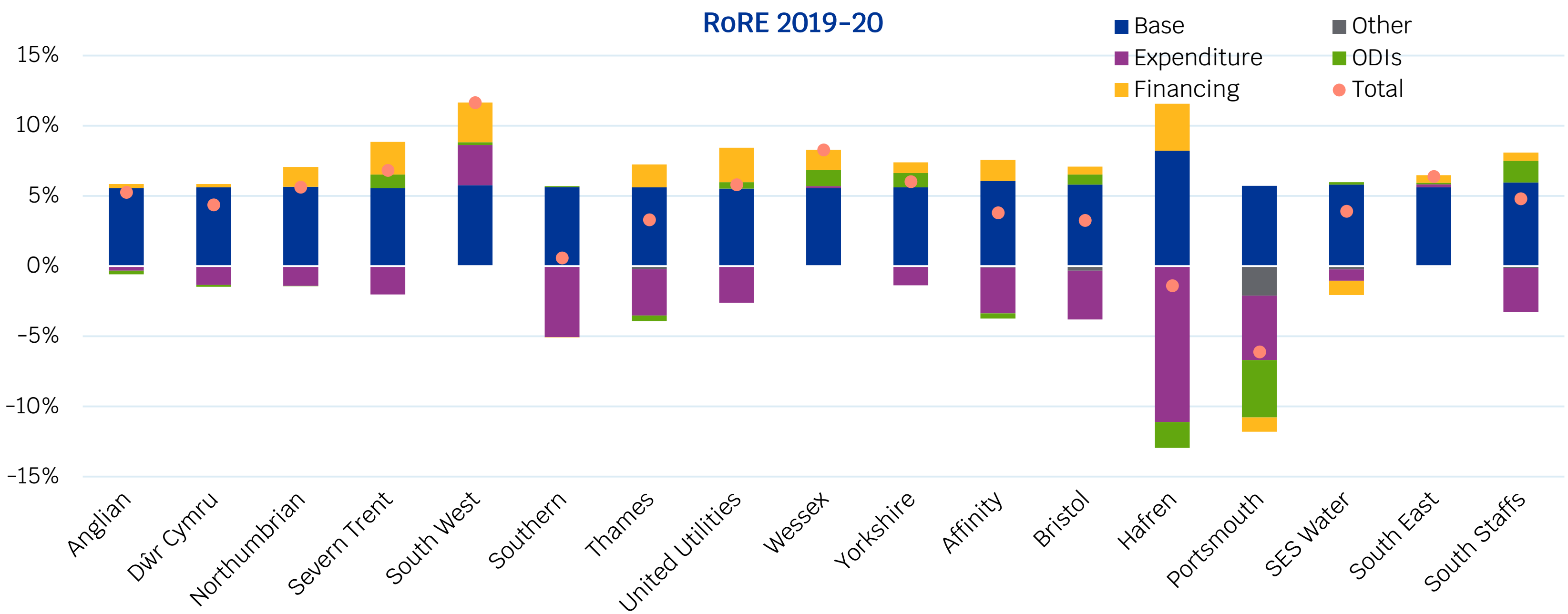


Source of RoRE variance	Low	High	Simple average
Expenditure	-1.86%	2.60%	-0.21%
Financing	-1.02%	2.78%	0.57%
Service incentives (ODI)	-1.21%	0.90%	-0.09%
Other	-0.19%	0.93%	0.11%

Outturn RoRE performance is impacted primarily by:

- Base RoRE – this is the base return as set out in the company's final determination.
- Financing – where companies out or under perform the cost of debt assumed in price determinations.
- Outcome Delivery Incentives (ODIs) – these are financial incentives that incentivise companies to provide stretching levels of service to customers. ODIs are underpinned by performance commitments against which outperformance and underperformance adjustments are made. At the performance commitment level, the ODI impact to RoRE will be 0%.
- Expenditure (Cost out or under performance) – companies are incentivised to deliver wholesale and retail services at efficient cost by retaining some of the financial benefits of outperformance and bearing a share of underperformance. For retail services the full financial benefits of outperformance are kept by the company, but for the wholesale services a portion of the financial benefits are shared with customers.
- Other – 'Other' contains adjustments that do not fit into the main categories but still have an impact on RoRE. This includes the impact from a company's exit from the non-household market.

Return on Regulatory Equity (RoRE) (3)

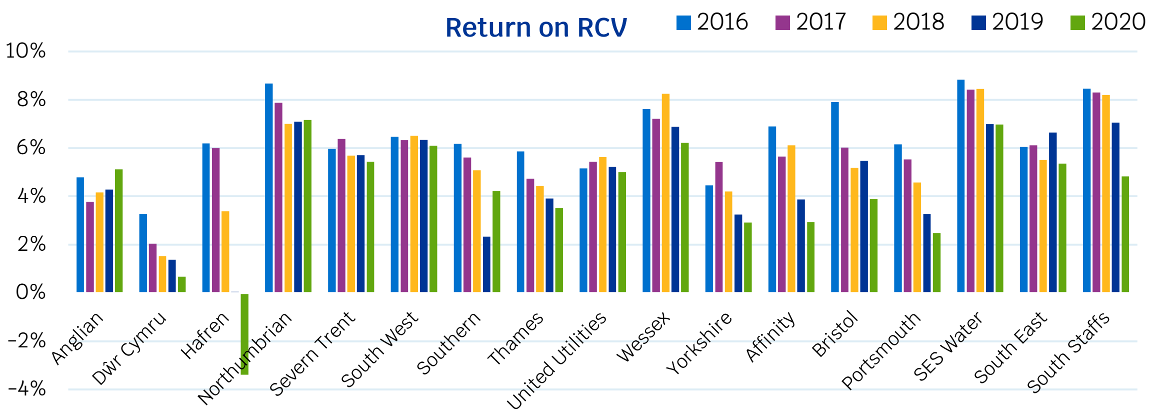


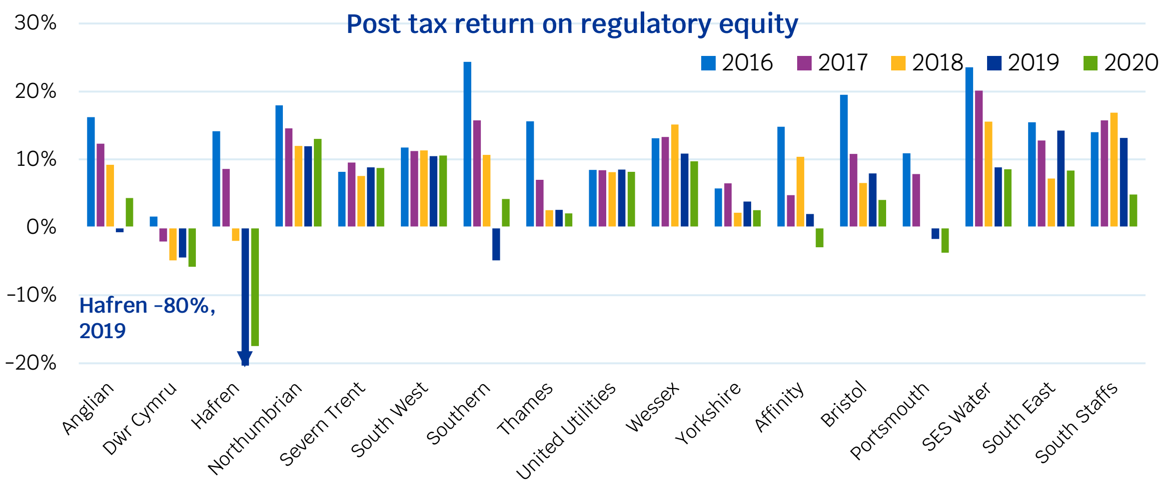
Source of RoRE Variance	Low	High	Simple average
Expenditure	-11.11%	2.87%	-2.39%
Financing	-1.03%	3.36%	1.05%
Service incentives (ODI)	-4.07%	1.54%	-0.04%
Other	-2.12%	0.00%	-0.19%

2019-20 saw a number of companies significantly overspend and therefore report significant underperformance in respect of expenditure. Some companies have attributed the overspend to expenditure having been delayed from earlier in the 2015-20 period or additional expenditure to ensure performance targets are met, while others have attributed this to additional investment in preparation for the 2020-25 period.

Performance on expenditure may also be impacted by any increased provisions for bad debt as a result of Covid-19. For household activity this will form part of increased retail costs while for those companies that have exited the non-household market these additional costs will be included in totex. Portsmouth has chosen to report this in the 'other' portion of RoRE due to the exceptional nature of the impact.

Return on RCV and post tax return on actual regulatory equity





Return on RCV is calculated as profit for the year before interest less current tax, divided by the average RCV for the year.

Post tax return on regulatory equity is calculated as profit after interest but before fair value movements, less current tax, taken as a percentage of average regulatory equity. In this metric regulatory equity is RCV less actual net debt.

Companies with a higher level of gearing will have a lower level of regulatory equity. This will cause the post-tax return on actual regulatory equity to be more volatile year on year.

We comment on material year on year movements below.

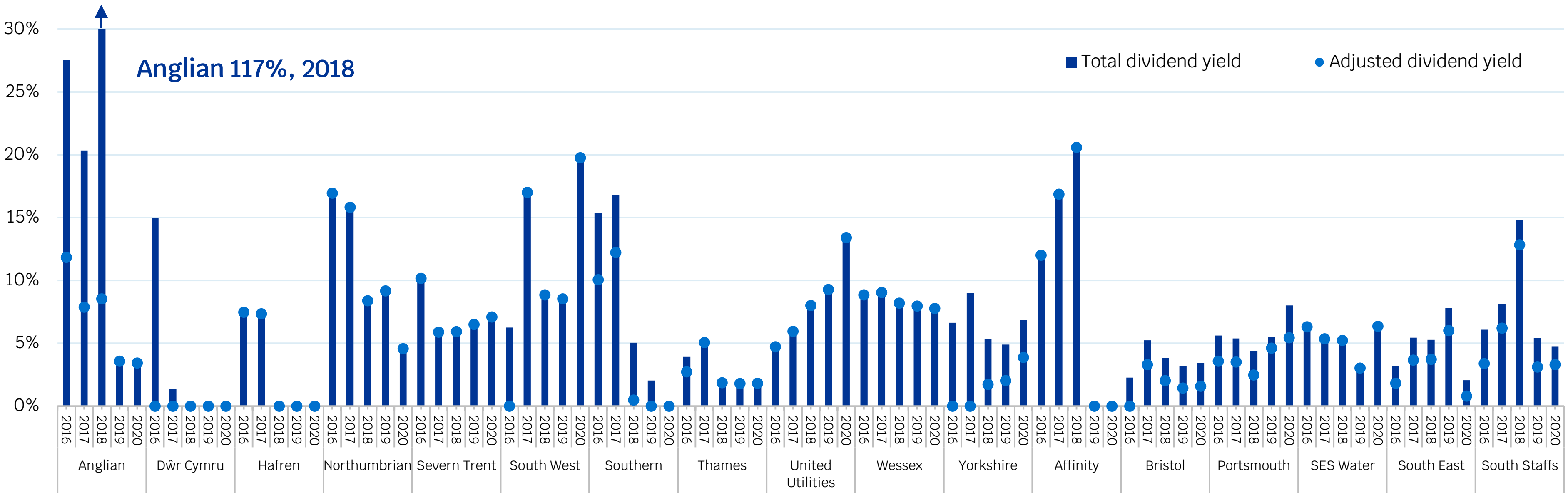
South Staffs had a significant reduction in Return on RCV and post-tax return on regulatory equity for 2020. This decrease is partly because of an increase in bad debt provision of £10.2 million caused by delays to the implementation of a new debt recovery system.

The reduction in Southern's return on RCV in 2019 was due to a £138.5 million provision for an enforcement package constituting an undertaking to return money to customers and a penalty[7].

Hafren made a loss after taxation and so has made negative return on RCV and post-tax return on regulatory equity for 2020. Hafren has experienced higher costs of operating and maintaining the network following the boundary changes after the merger with Severn Trent[2].

In 2019 Hafren also experienced an exceptional financing cost linked to changes to its debt portfolio. This was a one off cost and resulted in a significant negative post tax return on regulatory equity in that year.

Dividends



The average total dividend yield in 2020 across the sector increased to 5.3% from 4.6% in 2019.

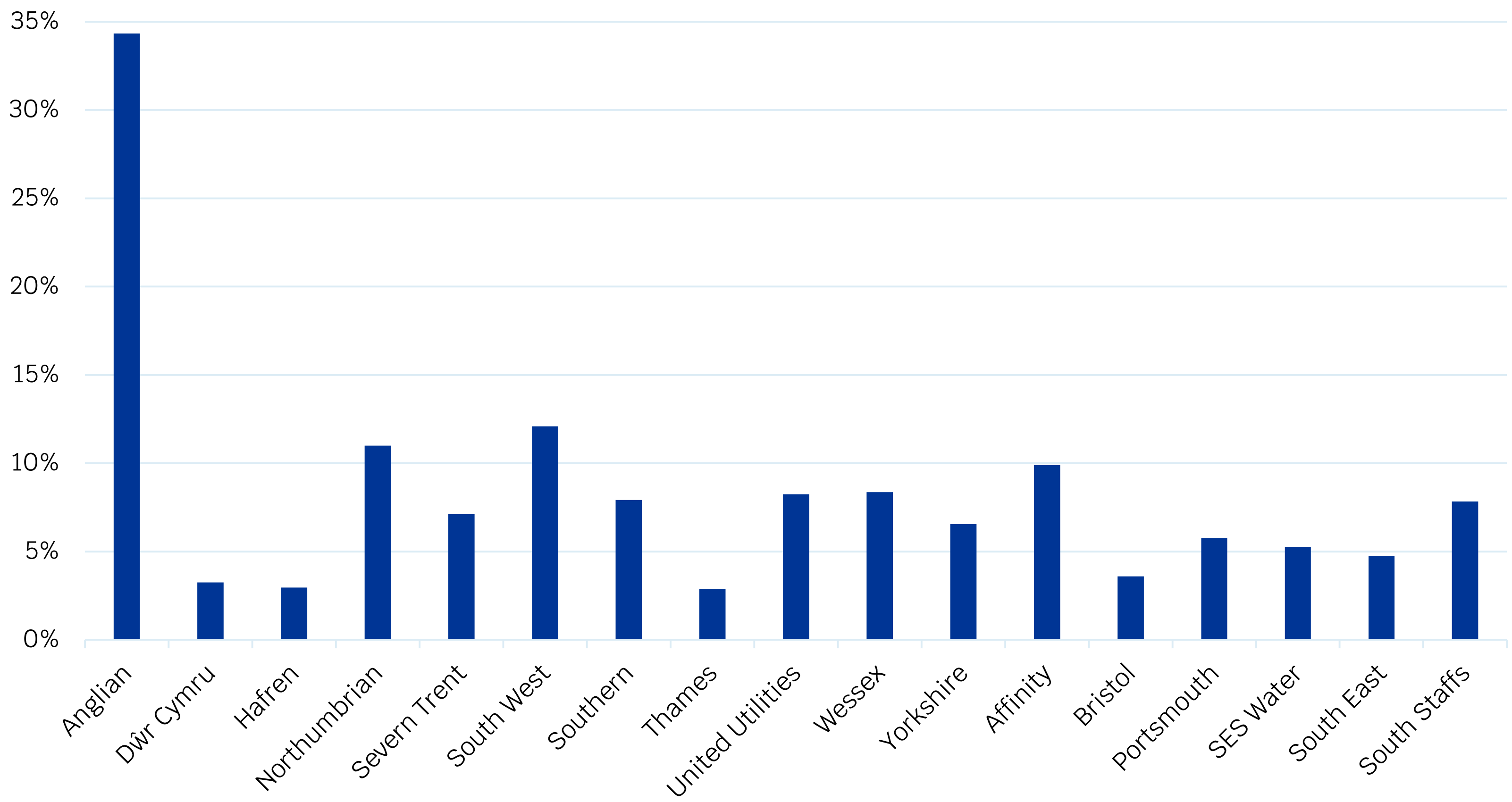
We expect equity investors to earn a return on their investment. Returns earned and dividends paid should reflect performance in delivering an essential service to customers. When companies make decisions about declaring and paying dividends we expect them to take account of a number of factors including the need to maintain financial resilience, the delivery of companies' obligations and commitments to customers and other stakeholders, and the company's future financing needs. We set out our expectation on company disclosures and company commitments on dividends for 2020-25 in our PR19 final determinations – Aligning risk and return technical appendix.

Some companies report adjusted dividends yields – these excludes dividends paid, which are then paid back to the company as interest on loans which have been from the company to other group companies. In all instances, we consider the total, gross dividend yield to be the most relevant and informative measure by which investor returns should be assessed over time.

United Utilities and South West's increase in dividend yield for 2020 is due to dividends paid to shareholders following outperformance in the 2015-20 period. Anglian's higher total dividend yield in 2018 reflects that its total Appointee dividend in that year included £1,602.6 million which was paid to its holding company and subsequently returned to Anglian as a repayment of an intercompany loan.

Total dividend yield is calculated as dividend paid as a percentage of actual regulated equity. Adjusted dividend yield is the appointee dividend less dividends paid to a holding company to enable that company to pay interest on and/or make a repayment on an intra-group loan from the Appointee as a percentage of actual regulated equity. Due to Dŵr Cymru's ultimate parent undertaking being limited by guarantee and therefore having no shareholders[6], its adjusted Appointee dividend yield is deemed to be nil.

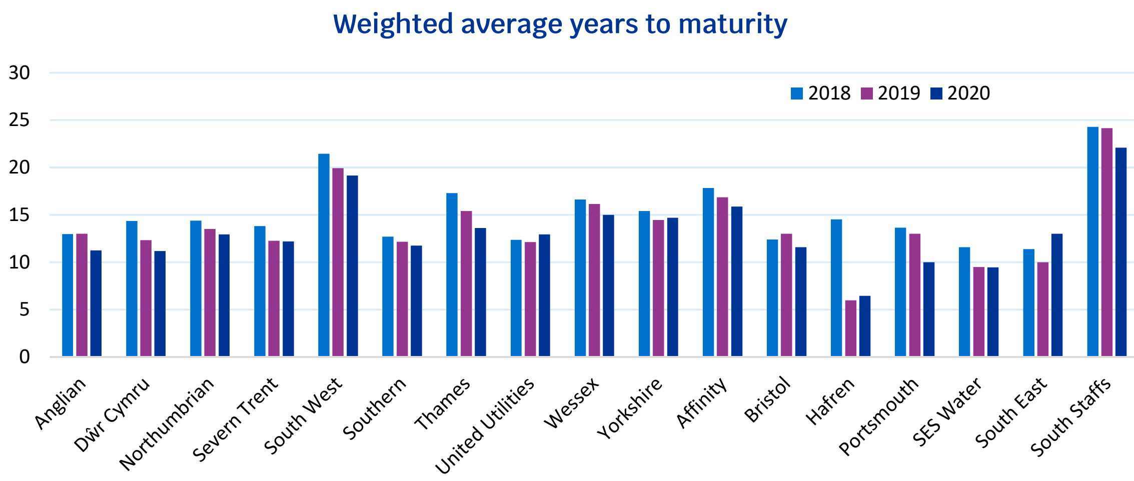
Average dividend yield 2015-20



Anglian's total appointee dividend for 2017-18 included a £1,602.6m special dividend paid to its holding company to enable that company to repay an intercompany loan from Anglian.

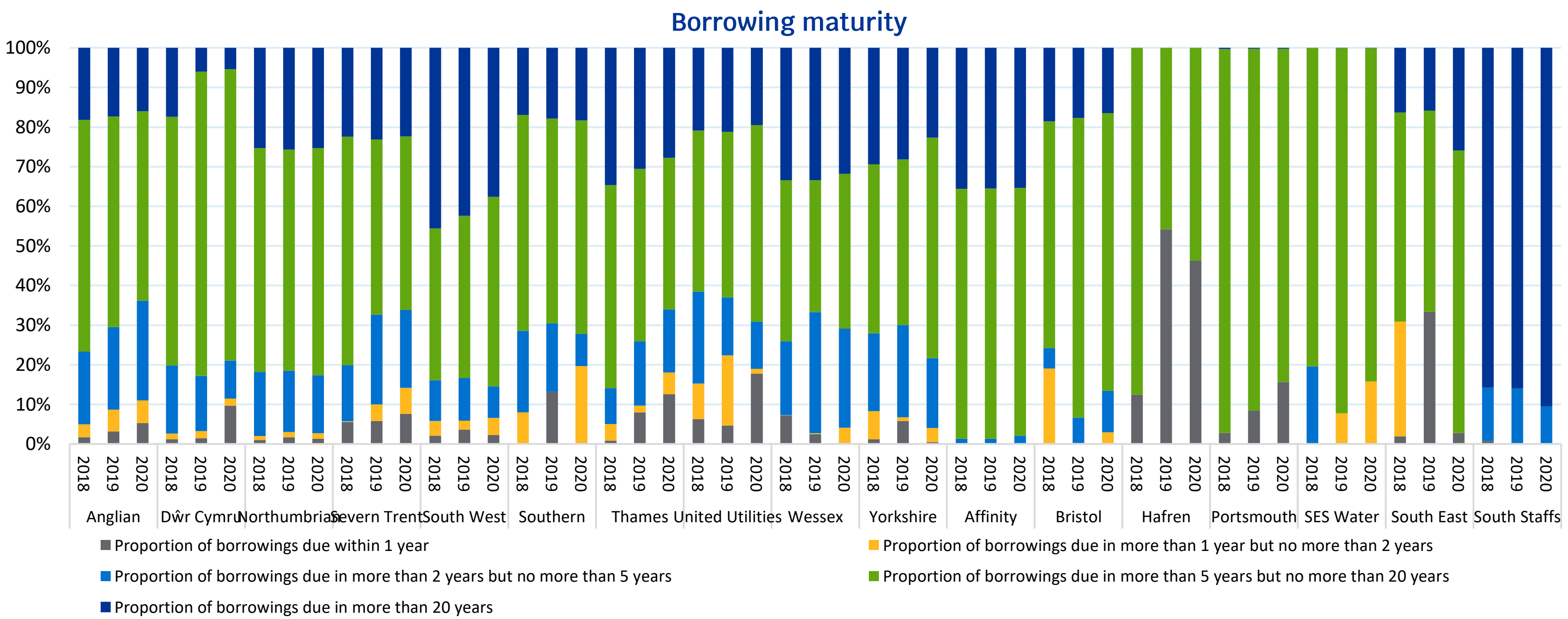
If this special dividend is excluded from the calculations Anglian still report the highest average dividend yield in the sector for the period 2015-20 at 13.72%.

Maturity of company debt

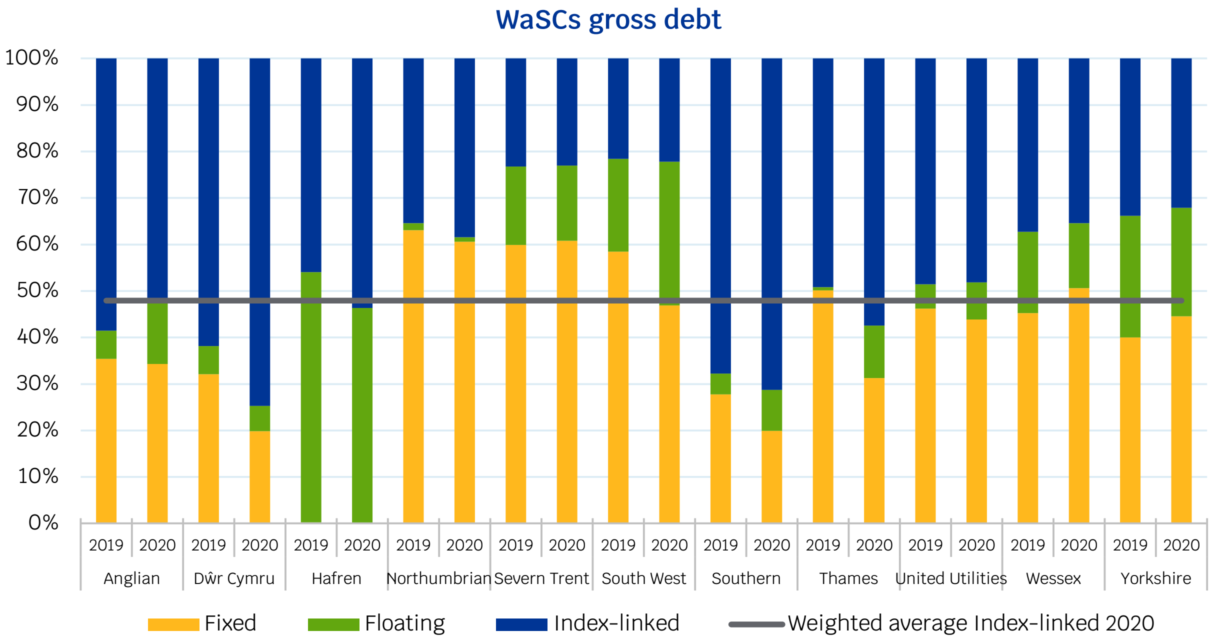


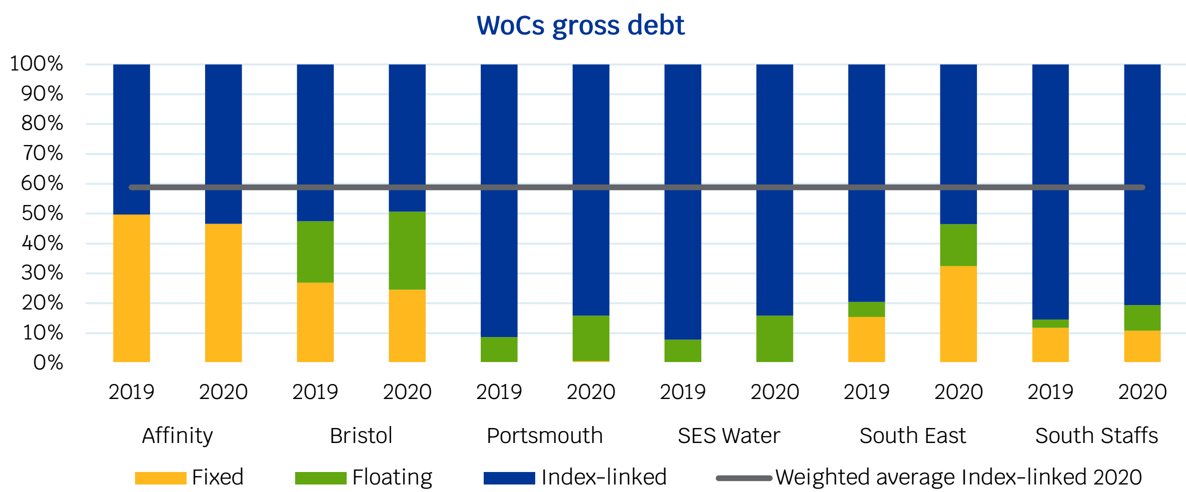
Companies use a portfolio of both long and short term debt to finance their business. The average debt term across the sector at 31 March 2020 has reduced slightly to 13.1 years compared to 13.8 years in 2019 and 15.1 years in 2018.

Hafren's weighted average years to maturity and the composition of its debt has been impacted by restructuring of its debt finance in the 2018-19 financial year.



Composition of company borrowings





Companies typically use index-linked debt and other index lined instruments to manage their exposure to inflation risk.

The use of index-linked debt impacts the cash interest payments required each year. This can improve short term financeability but does not impact companies' overall levels of debt.

At PR14 we assumed that for a notional company 33% of companies' net debt was index-linked (linked to RPI).

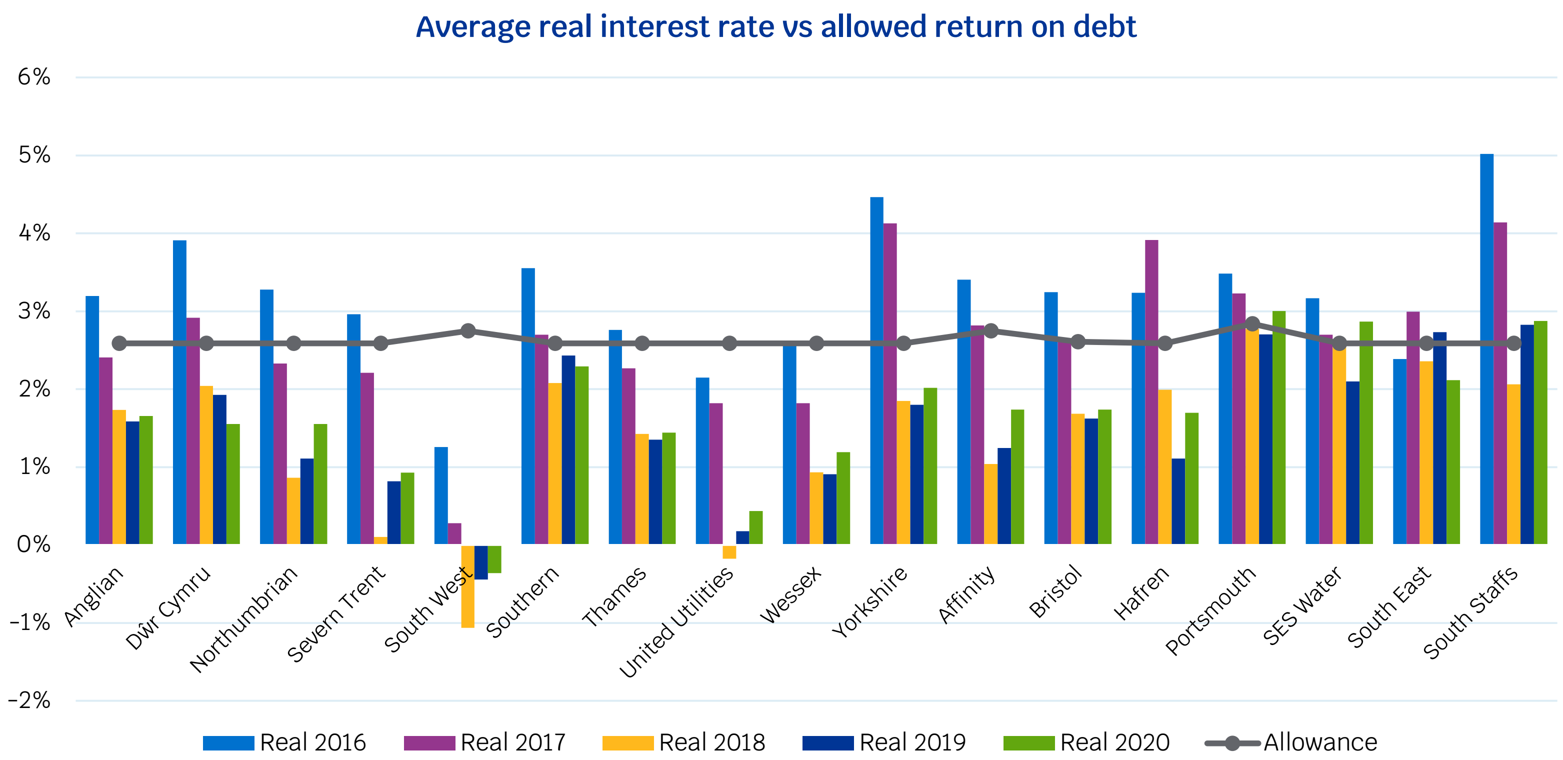
For WaSCs, in 2020 an average of 46% of debt was index-linked, compared to 44% in 2019. For WoCs, in 2020 an average of 68% of debt was index-linked, compared to 75% in 2019.

Historically, index-linked instruments have been linked to RPI. However, with price controls transitioning from RPI to CPIH from 2020, some companies have issued CPI-linked debt.

The charts show the gross debt of each company. Net debt (gross debt less cash) is used when calculating companies' regulatory gearing.

The data is reported after the impact of any relevant swaps.

Cost of debt

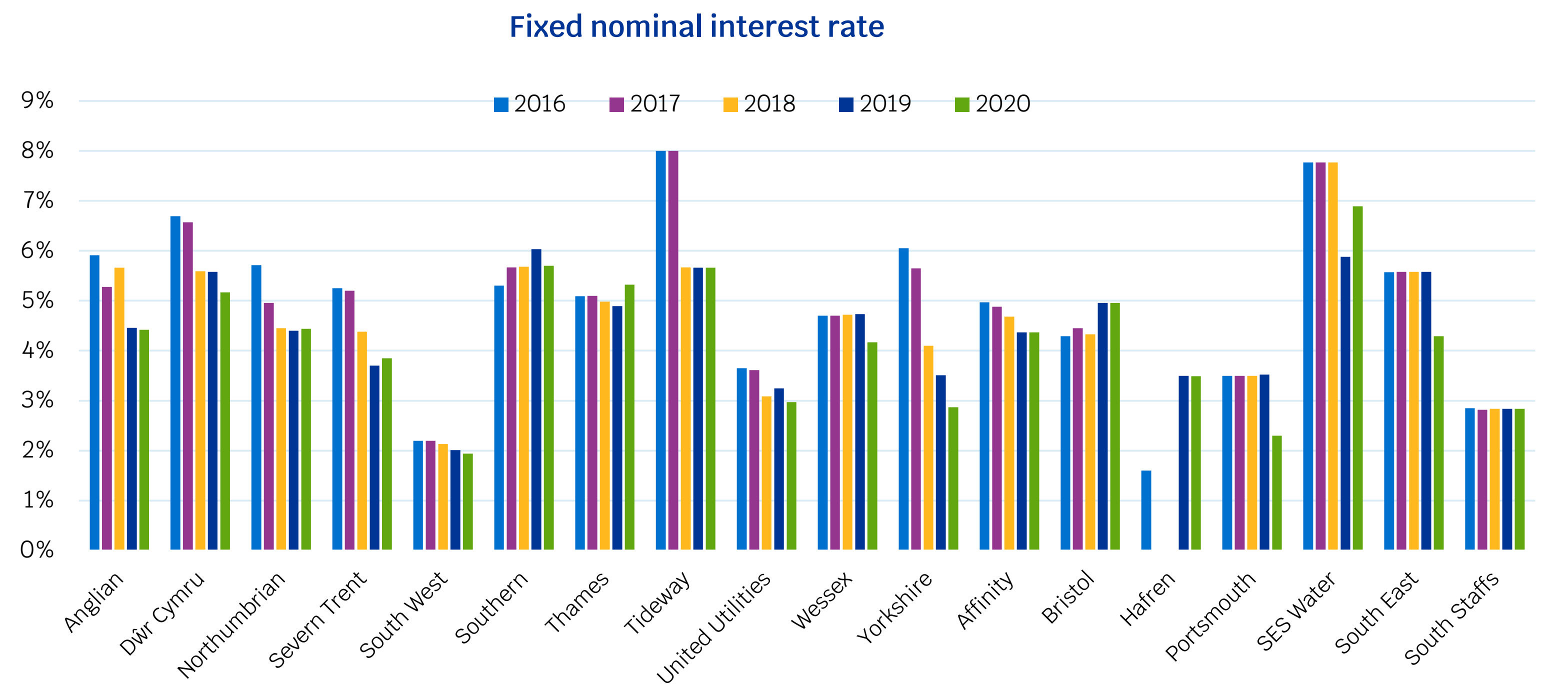


This chart presents reported interest rates in real terms. Where companies pay interest rates in nominal terms, changes in inflation levels will impact on the real interest rate that they incur.

For the 2015-20 period the allowed return on debt was set in real terms.

In order to allow comparison against the PR14 cost of debt allowance we have presented companies' average nominal interest rates in real terms. To calculate this we have deflated the average nominal interest rates reported by companies by outturn average RPI, and presented these average real interest rates in the chart above alongside the PR14 cost of debt allowance.

Reported interest rates (1)

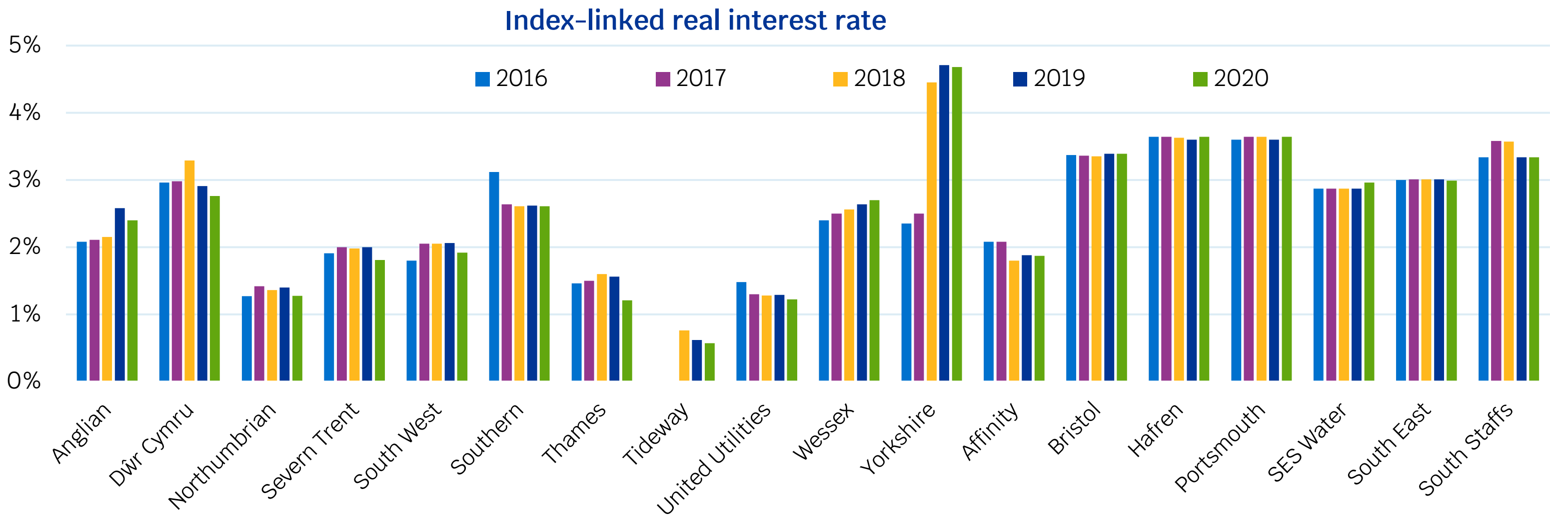


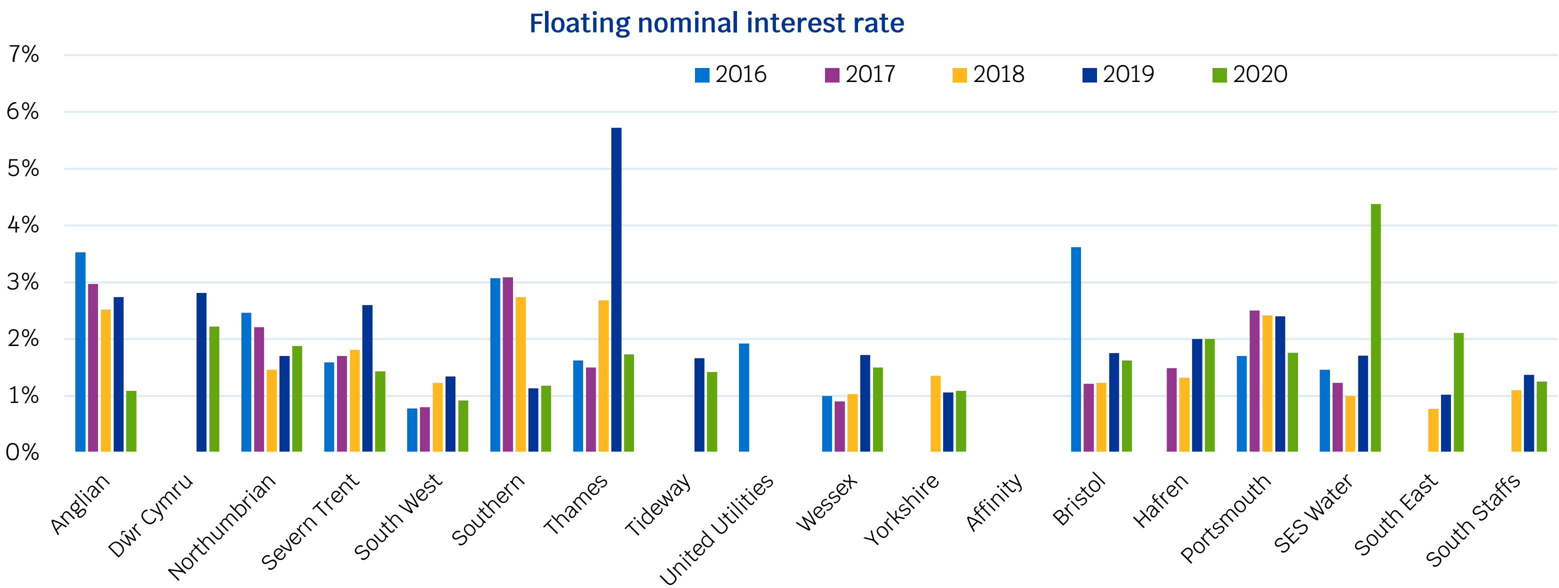
Companies have published details of the interest rates paid in respect of their fixed, floating and index-linked debt in the year.

This chart presents the average reported nominal interest rates paid in respect of fixed rate debt. The nominal interest rates paid in respect of floating rate debt and the average real interest paid in respect of index-linked debt are presented on the following slide.

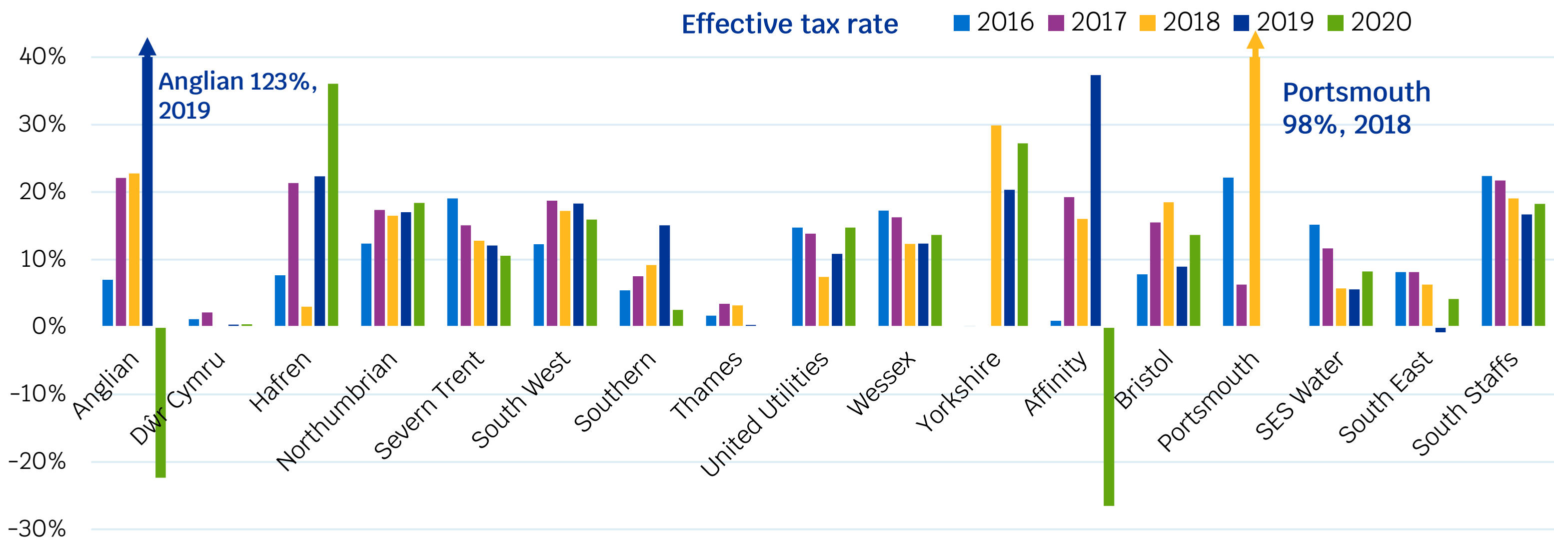
As seen within the composition of company borrowings, floating rate debt makes up a relatively small proportion of most companies' gross debt.

Reported interest rates (2)





Tax



The standard rate of corporation tax for 2016 was 20%; it reduced to 19% for 2017 to 2020.

The effective rate of tax that companies pay is influenced by the various tax reliefs that are available to them – for example capital allowances on capital expenditure. It is also influenced by any expenditure which is not allowable for tax purposes and differences in the timing of when certain items are recorded in the profit and loss account and when they become taxable.

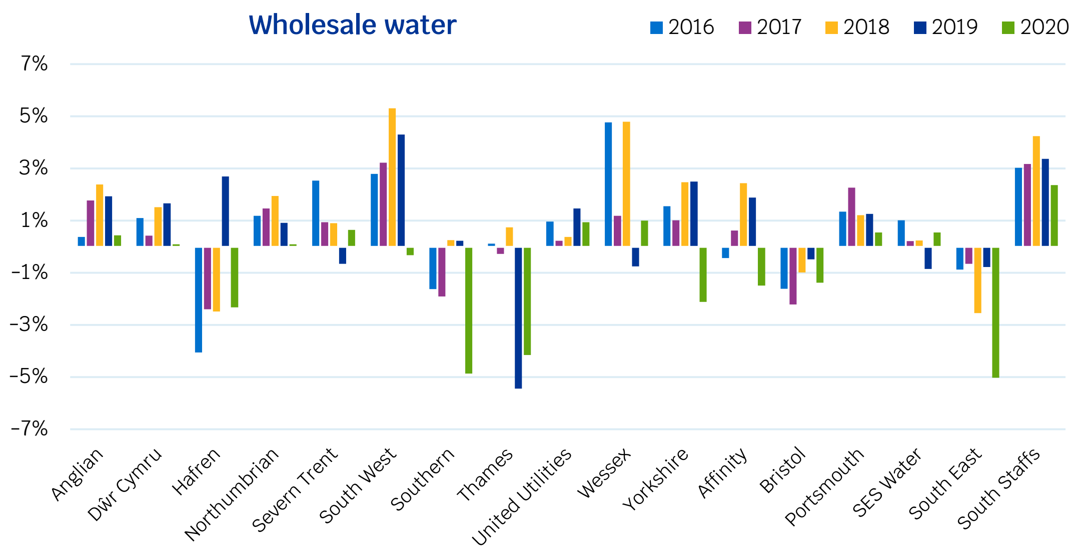
In 2020, Anglian's tax charge has been influenced by short term timing differences and capital allowances while Affinity's charge is influenced by both timing differences and disclaimed capital allowances.

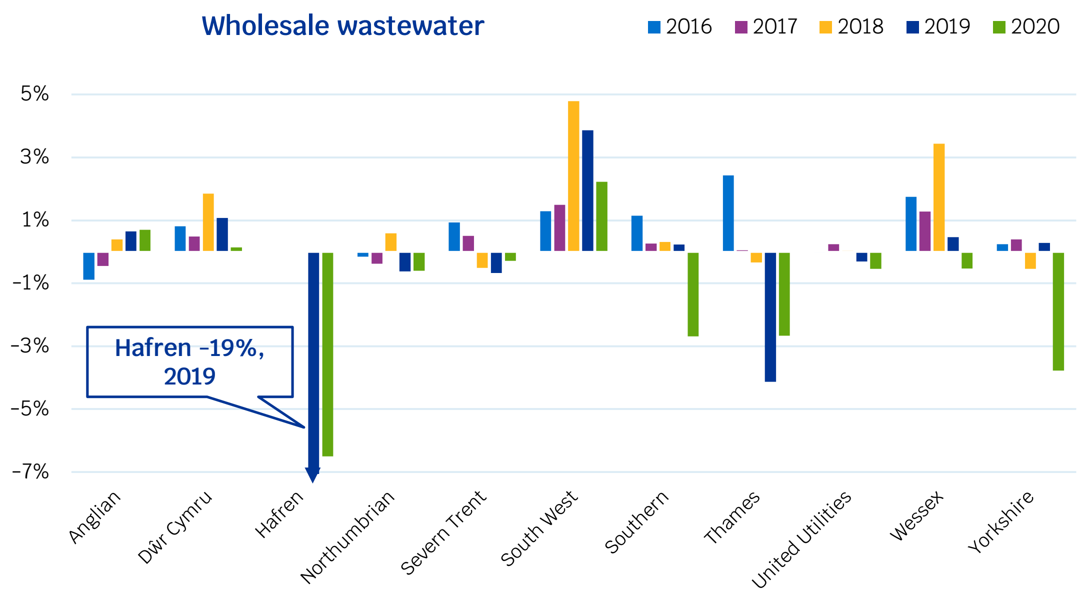
Anglian's effective tax rate of 123% in 2019 was due to the impact of an adjustment required as a result of its transition to IFRS, while in 2018 Portsmouth incurred tax liabilities linked to the removal of its Employee Benefit Trust.

The disclosures made by Southern for 2020 show that they utilised group relief which they did not pay for, enabling them to reduce its tax bill. In future, companies will be required to pay full value for any group relief that they receive and, if they do not, we will claw back a proportion of the tax allowance they have received equivalent to unpaid for group relief, at a future price review.

The effective corporation tax rate that companies paid in the year is calculated as the current tax charge for the appointed business as a percentage of profit before tax and fair value adjustments for the appointed business.

Wholesale revenue (under/over recovery)





We set binding, separate revenue controls for water and wastewater.

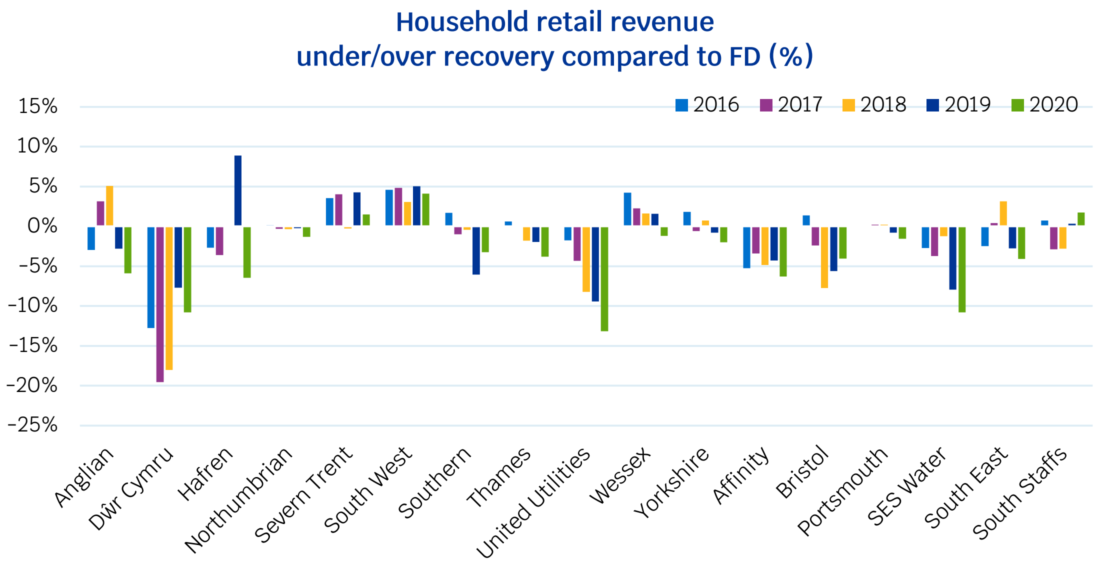
These charts compare revenue collected with revenue allowances. Companies are incentivised to accurately forecast revenue recovery under the wholesale revenue forecasting incentive mechanism (WRFIM), which allows reconciliation for over or under recovered revenue, subject to a penalty mechanism for material variances.

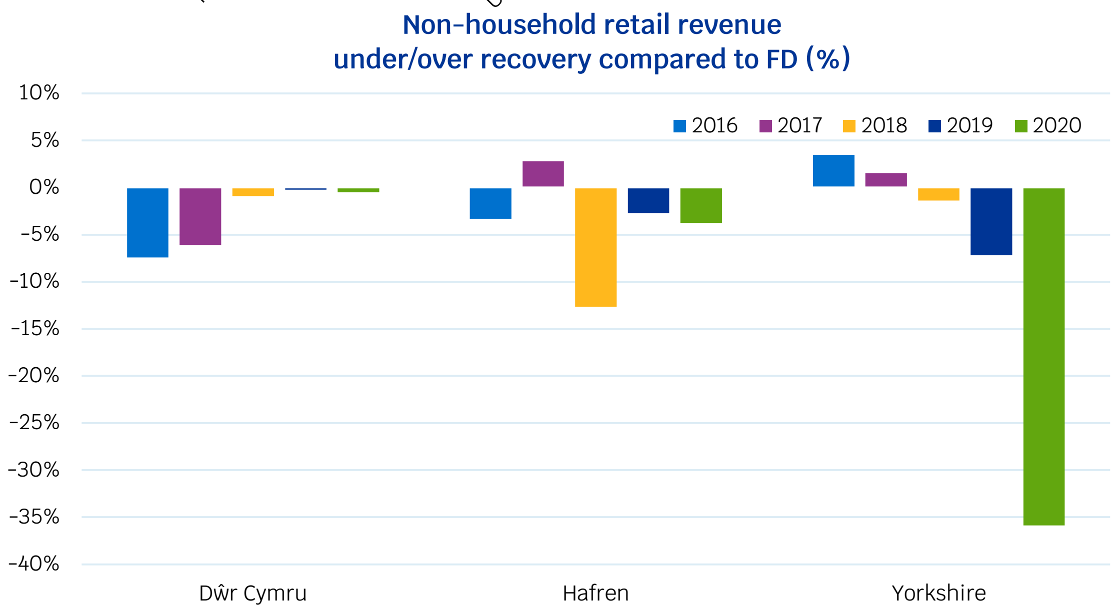
Thames' wholesale water revenue for 2020 was lower than the FD, largely due to prices being set at a level lower than the FD to reflect ODI underperformance payments being passed back to customers on leakage. Southern's performance has also been impacted by amounts returned to customers.

Hafren started to provide wholesale wastewater services for a small number of customers from the year ending 2019. To ensure customer bills remained manageable, the company intentionally under-recovered from its allowances for the wholesale wastewater control.

Yorkshire stated that it made an error when completing its PR14 business plan for connection charges and as a result its forecasts for connection charges were not included in its allowed wholesale water revenue at PR14, leading to a lower wholesale water allowed revenue as a consequence.

Retail revenue (under/over recovery)





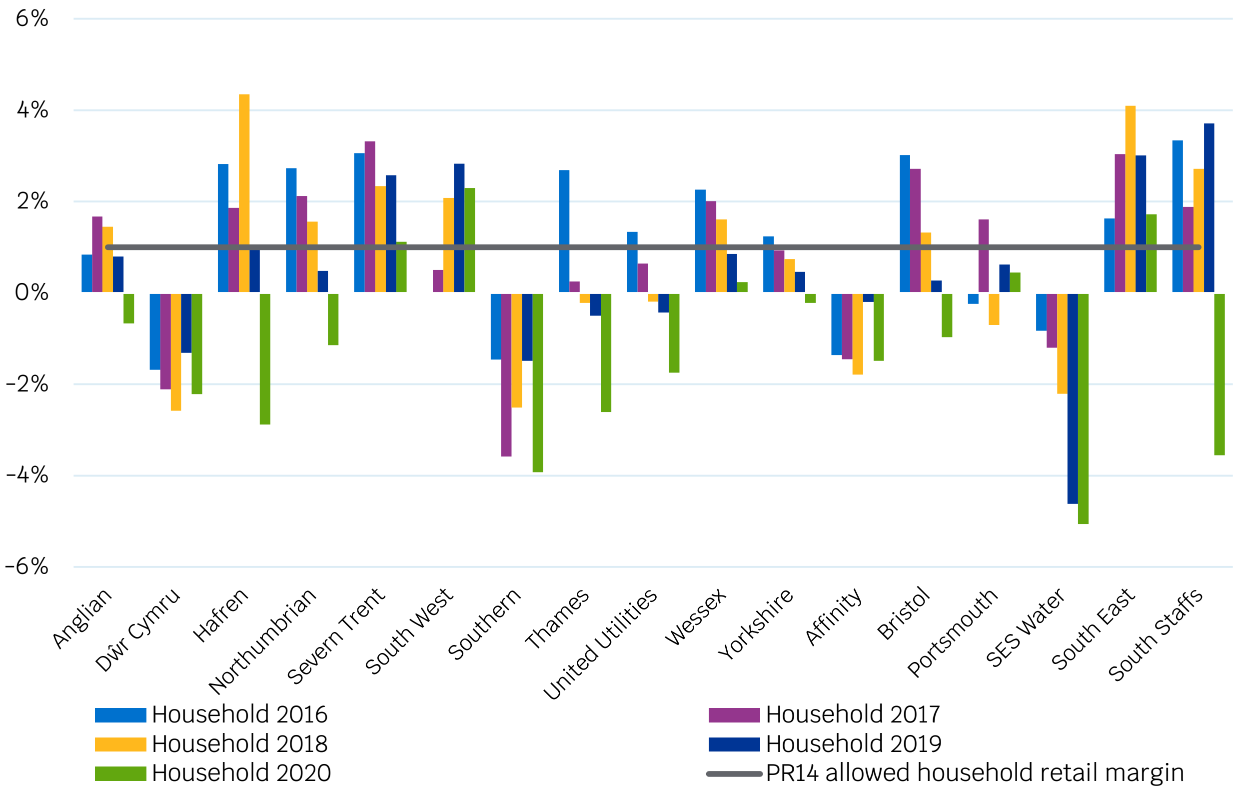
These charts show the household retail component of revenue and non-household retail component of revenue compared to the amounts forecast at the PR14 final determination. The household and non-household controls are separate.

Dŵr Cymru, SES Water and United Utilities show under recovery for 2020 household retail revenue due to a greater number of customers receiving social and support tariff discounts than budgeted for in their Business Plans.

Yorkshire's under recovery of non-household retail revenue in 2020 reflects the company formally exiting the non-household retail market on 1 October 2019.

Companies not shown in the non-household retail revenue chart which have reported income and costs within this business area are South East, Southern, Severn Trent, Thames and United Utilities. Despite exiting the market these companies recognise legacy bad debts and retail income for activities such as developer services in accordance with [RAG consultation questions and responses 2017-18](). Companies will not be recognising retail activities such as developer services within the non-household control for the next control period.

Household retail profit margins



Our PR14 determinations assumed a household retail margin of 1%.

All companies had a reduction in household retail profit margins in 2020.

This is in part due to a significant increase in doubtful debts, partly due to the impact of Covid-19.

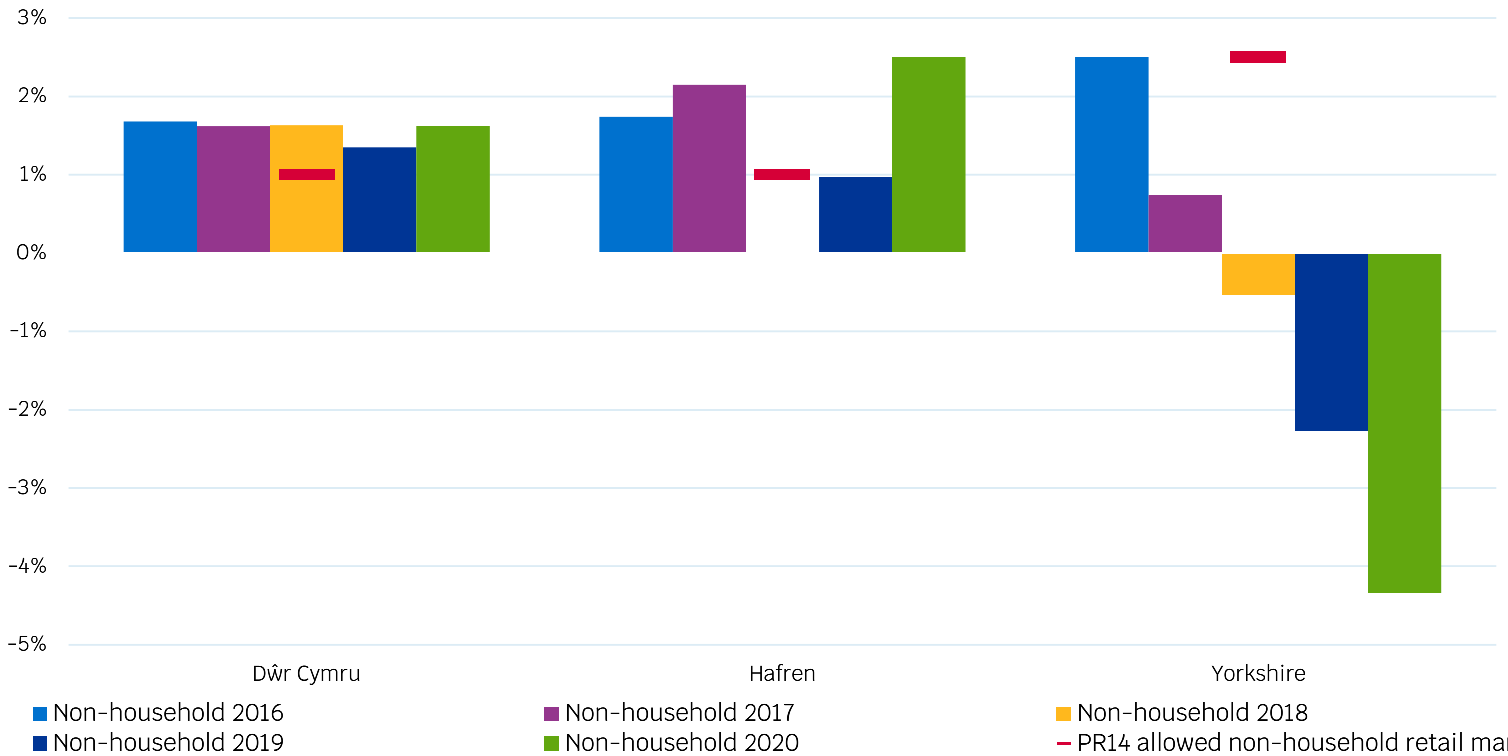
Southern, South East, South Staffs and SES Water are companies which more than doubled its level of provision for doubtful debts compared to 2019.

Allowed margins were calculated by reference to the allowed costs at the FD. A company's actual margin earned can vary from the amount allowed in the final determination if its retail costs differ from the average cost to serve that we include in the FD. A company can earn a household margin above the 1% allowed, by reducing costs below the levels allowed in the FD and by managing bad debts, but must bear the costs if its costs rise above the allowance.

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

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

Non-household retail profit margins

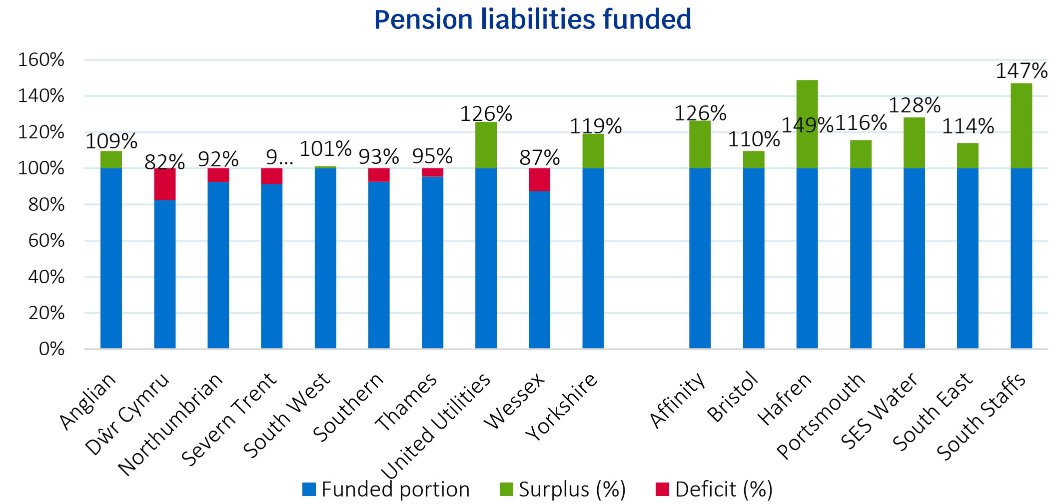


The chart above shows the non-household retail profit margins for all three of the major water and wastewater companies that participated in the market this year. Yorkshire formally exited on 1 October 2019.

Yorkshire's further decrease in non-household retail profit margin is due to an increase in operating costs of £1.6 million compared with 2018-19. The majority of this increase relates to one-off costs associated with potential bad debts arising as a result of Covid-19.

From 1 April 2017 the non-household retail market in England has been open to competition for eligible customers. This report only deals with the main providers of water and sewerage services, so does not report on any of the other retail market participants. As of October 2019, only the two companies operating wholly or mainly in Wales , Dŵr Cymru and Hafren, have a non-household retail component to their business.

Pension liabilities



Pension Deficits (red)/ surpluses (green) are shown as a proportion of the total pension liability reported in the 2019-20 statutory accounts.

At 31 March 2020, the industry wide pension surplus averaged 3.8% which is an improvement on 31 March 2019 when the average was a deficit of 3.4%. This improvement (equivalent to £1.1 billion) is largely as a result of movements in the financial markets and changes in the assumptions used by companies in valuing their pension liabilities.

At 31 March 2020 there was significant financial market volatility as a result of the Covid-19 pandemic therefore asset valuations at that date are subject to significant uncertainty. The gains reported at 31 March 2020 and the surplus when calculated on an accounting basis may subsequently reverse.

Each company determines its own assumptions when valuing its pension assets and liabilities, such as discount and inflation rates. All water and sewerage companies publish sensitivities which are useful in observing potential volatility to the liability. For example, a 0.5% decrease in discount rates could equate to increased liabilities of circa £1.2 billion for the sector. As such, companies should not use accounting gains in the year to March 2020 as a reason to reduce or defer pension deficit repair payment plans and should continue to focus on reducing the liabilities over an appropriate time period.

Companies agree deficit repair contributions with the independent scheme trustees reflecting triennial actuarial valuations. These may differ from accounting valuations as trustees are required to be prudent in setting assumptions. The level of contributions and deficit recovery period are subject to review and may be challenged by the Pensions Regulator.

At the PR14 price review we set out our treatment of pension deficit repair costs for the 2015-20 price control period and beyond. For each company, we stated the date at which customer contributions to repair deficits will end, with all subsequent deficits funded by shareholders. The PR19 price control allowances do not include incremental deficit repair costs beyond those assumed at PR14 (which were based on PR09 valuations). Furthermore, we do not expect the PR19 price determinations to have an impact on the rate of recovery of pensions schemes, in particular the gearing sharing mechanism should not constrain the level of deficit repair contributions.

We expect pension deficits to be addressed by a company's management over an appropriate period. We also expect companies to take account of their pensions position in their Long Term Viability Statements, and when determining their dividend policy, taking fair account of employee interests including pension deficits.

Overview of financial flows

For the second year, our Regulatory Accounting Guidelines required companies to formally report information on financial flows in their Annual Performance Reports. The purpose of reporting on financial flows is to provide greater transparency and clarity about the financial returns to the company's equity holders each year. Financial flows information allows clear comparison between the financial flows under actual capital structures that companies have adopted and the structure we have used in setting the prices that customers pay. This is particularly notable where companies have adopted a complex, highly-leveraged structure.

The Financial Flows metric looks at the returns that equity holders achieve. It compares the RoRE on two bases against the capital structure and returns assumed by Ofwat at the last price review in 2014.

1. The actual returns that companies achieved based on Ofwat's assumed capital structure.
2. The actual returns that companies achieved on their actual capital structure.

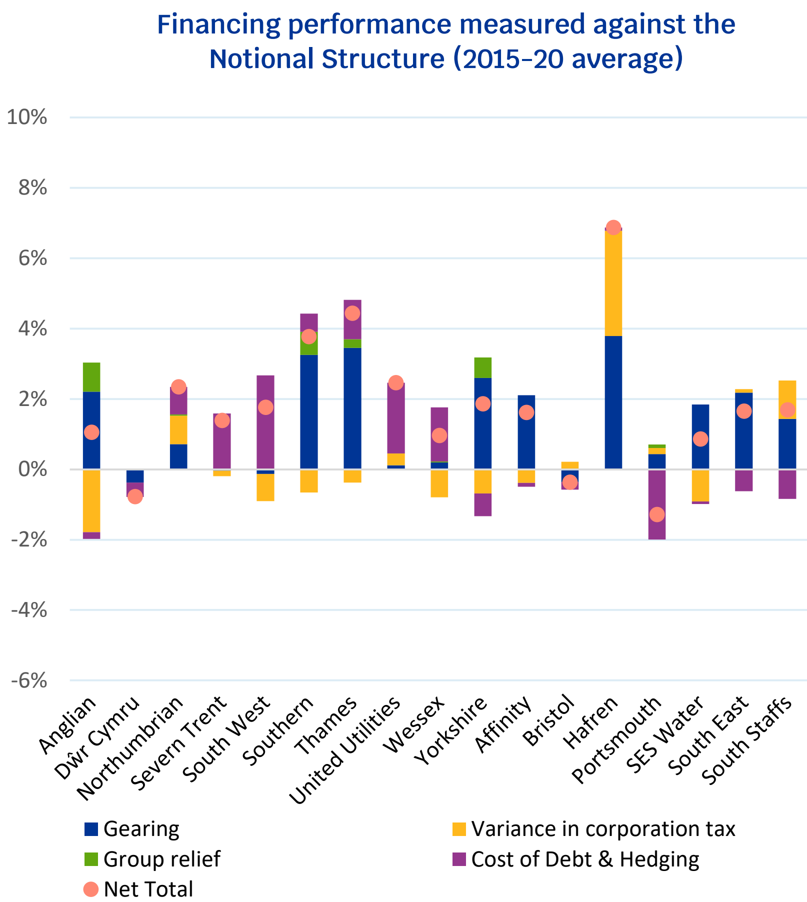
The metric starts with the base RoRE assumed in price limits set in 2014 adjusted for reconciliation adjustments for incentives in previous price reviews. Changes in RoRE are then analysed into changes due to (i) financing over/underperformance and (ii) operational over/underperformance. Inflation is then added to create the total shareholder return.

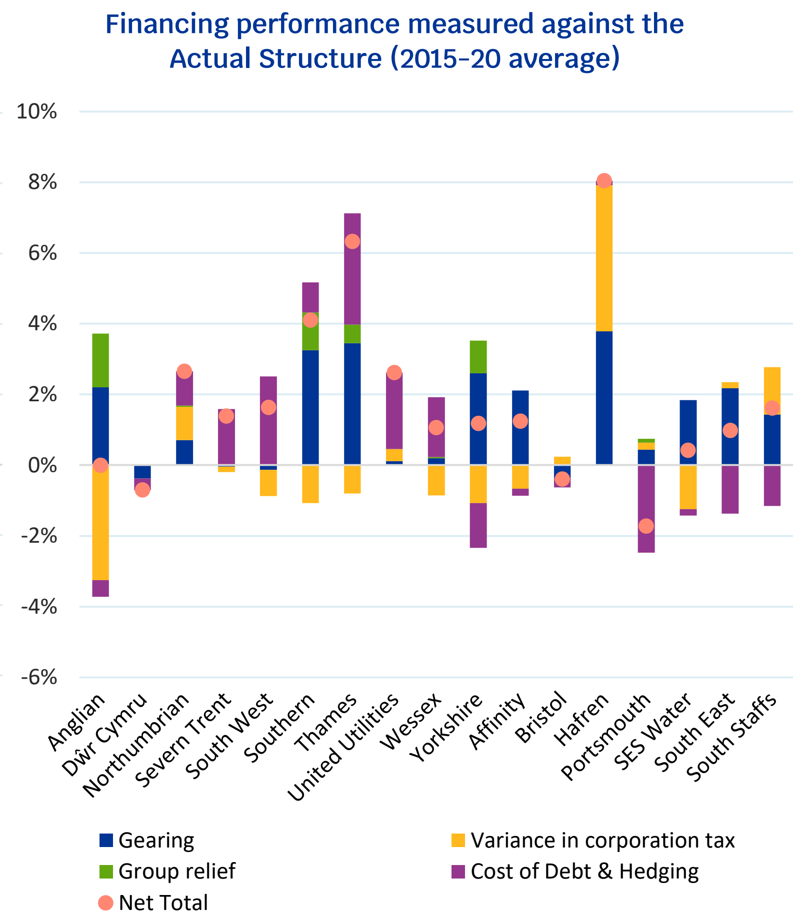
There are slight differences between some of the component parts of RoRE and the comparable component parts used in financial flows (reported on pages 24 and 25). This is a result of differences in the underlying calculations, eg the treatment of corporation tax and the building blocks of interest.

As part of the reporting requirement, companies are also required to provide supporting narrative to explain the data contained in the table. This narrative needs to enable the reader to interpret and understand the data within the table. We have seen some improvements in the quality of companies' supporting narrative compared to the previous year.

Going forward we expect companies to continue to focus on providing a clear supporting narrative to further aid readers' understanding of the information.

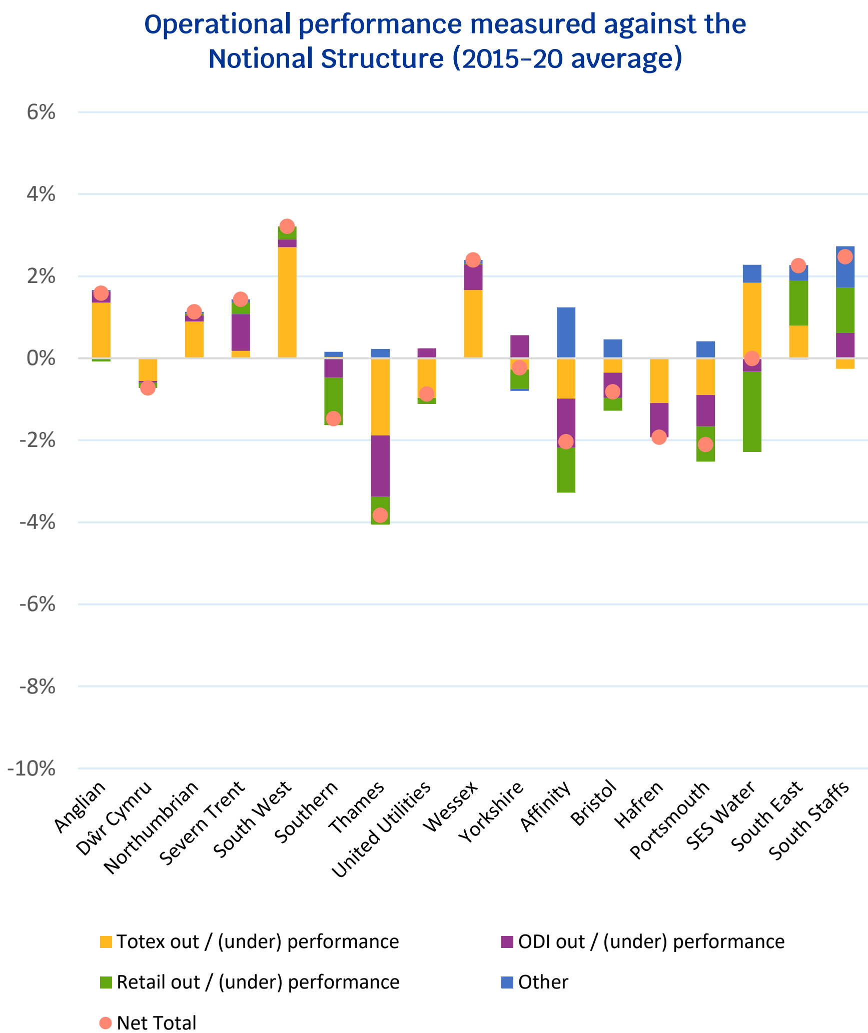
Financial – out/under performance – 2015-20 average

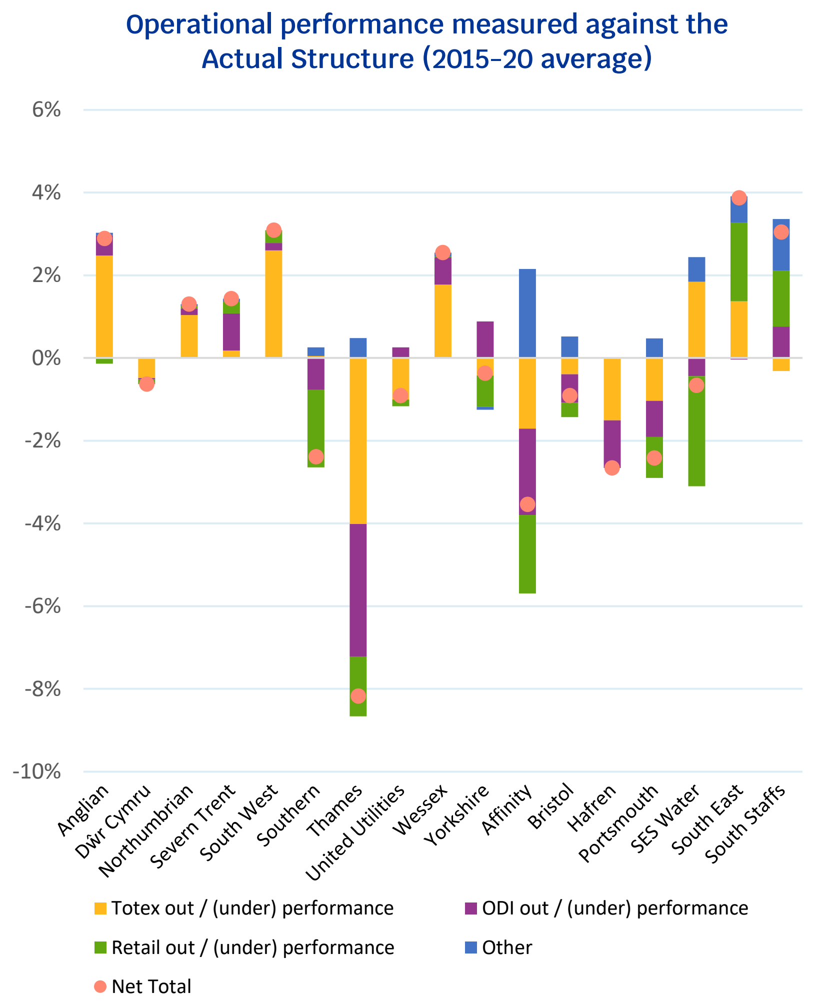




The charts above show the actual financial performance against the notional structure (62.5% gearing) and each company's actual financial structure. Companies that have adopted a financial structure higher than the notional structure will demonstrate amplified under and out performance in comparison with companies that have adopted an actual gearing structure closer to the notional gearing.

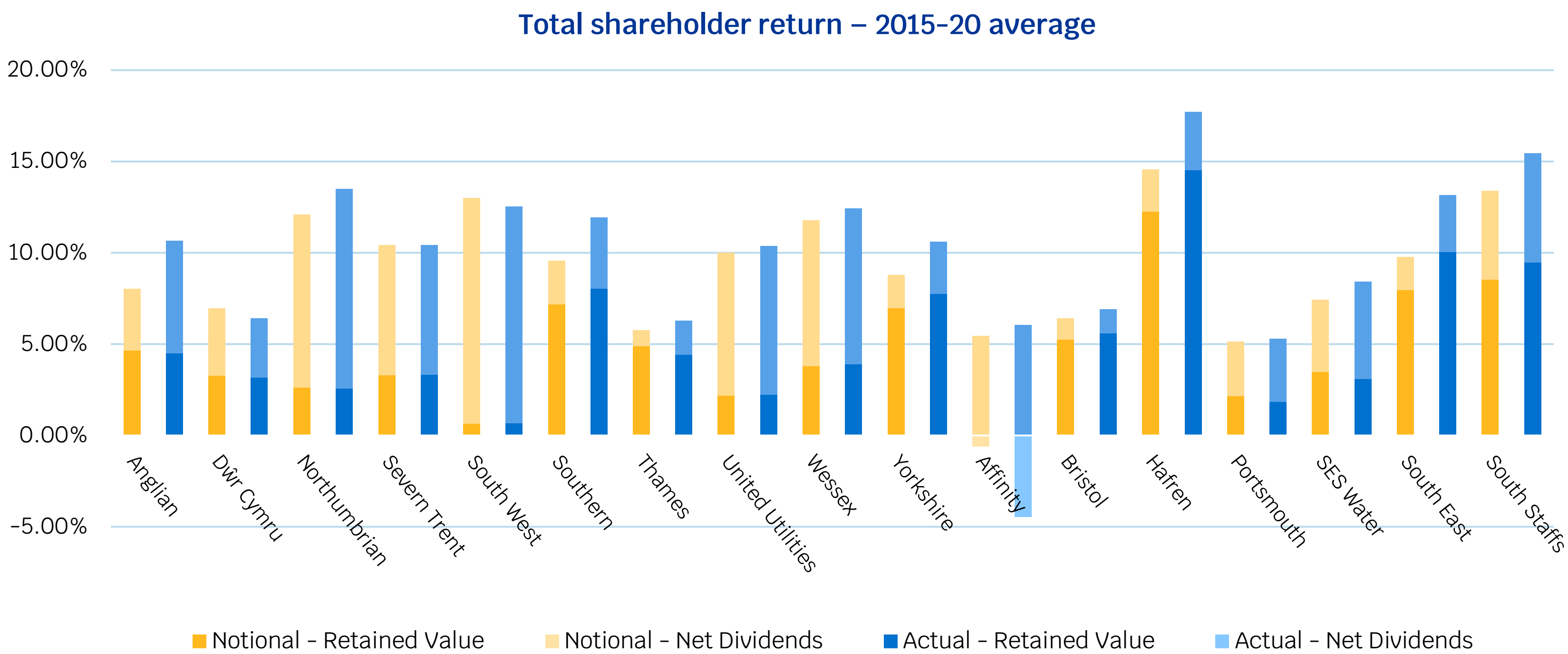
Operational – out/under performance – 2015-20 average





The charts above show the actual operational performance against the notional structure (62.5% gearing) and each company's actual financial structure. Companies that have adopted a financial structure higher than the notional structure will demonstrate amplified under and out performance in comparison with companies that have adopted an actual gearing structure closer to the notional gearing.

Total shareholder return



The Total Shareholder Return, shown by the full length of the bar in the chart above, represents the value attributable to the company's shareholders for the reporting period (before the distribution of any dividends). This is calculated with reference to both notional and actual regulatory equity. The value attributable is built up from a base return set at PR14, an inflation amount and any out- or underperformance for operational and financial activities.

The chart shows the net dividends paid as a proportion of Total Shareholder Return. Affinity paid dividends in excess of its Total Shareholder Return in the 2015-20 period.

Net dividend is the total appointee dividend less the total amount of interest income received on intra-group loans as included in the P&L Account. Retained value is Total Shareholder Return minus net dividend.

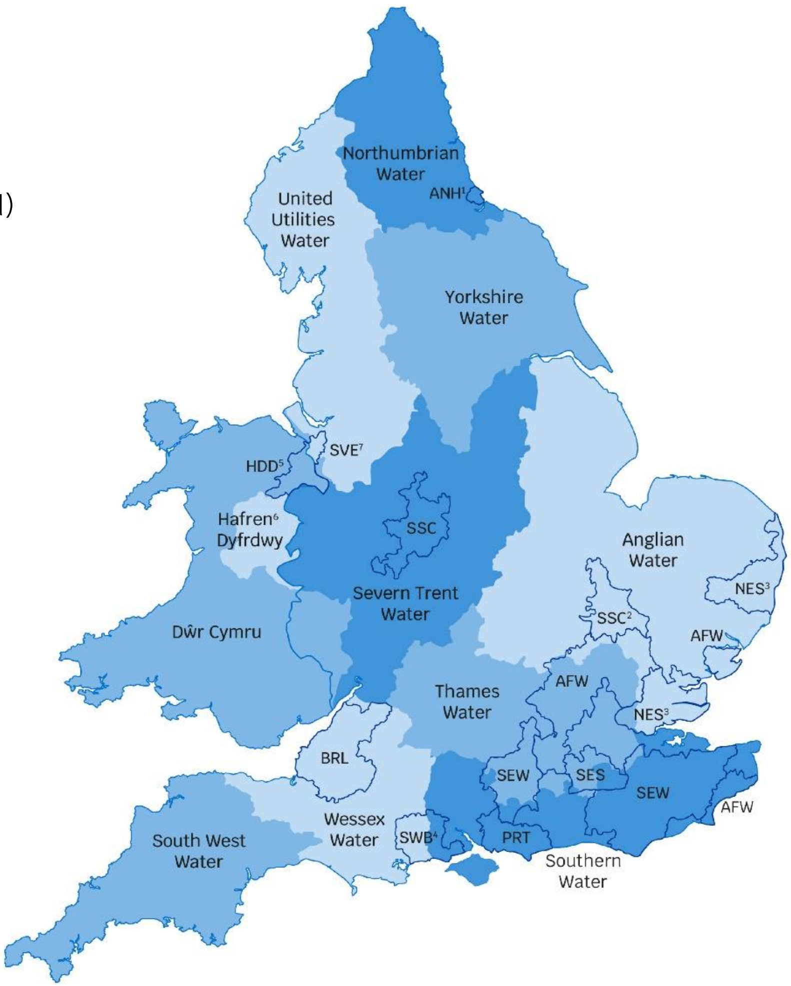
Appendix 1: Glossary

APR	Annual Performance Report – annual report of performance published by the appointed companies
FFO	Funds from operations – calculated as cash generated from operating activities adjusted to remove changes in working capital, less net interest paid and tax paid
FD	Final Determination - the final determination of allowed revenues and costs set out by Ofwat
Gearing	Net debt / RCV
Net debt	Net debt is calculated as all borrowings of the company less cash. It excludes any pension deficit liability and mark-to-market accounting adjustments
Nominal	Interest rates, prices and costs are said to be in nominal terms if they include the impact of inflation
Notional	Ofwat 'notional' capital structure for setting prices. For the 2015-20 period the notional gearing is 62.5%
PR14	The price review which covers the period 2015-2020 (1 April 2015 to 31 March 2020)
PR19	The price review which covers the period 2020-2025 (1 April 2020 to 31 March 2025)
RAGs	Regulatory Accounting Guidelines
Real	Interest rates, prices and costs are said to be in real terms if they exclude the impact of inflation
Regulatory deprecation	The amount by which the RCV is depreciated
RCF	Retained Cash Flow equals FFO less equity dividend paid
RCV	Regulatory capital value – this is the regulatory value of the investment that has been made in the company
Regulatory Equity	RCV less net debt. This can be in actual or notional terms
RoRE	Return on Regulatory Equity – a return metric calculated using the notional level of net debt
Securitisation	Securitisation enables a company to raise debt by granting a mortgage (charge) over an identifiable stream of future cashflows
Totex	Total expenditure which includes both operational expenditure (opex) and capital expenditure (capex)
WaSC	Water and wastewater company
WoC	Water only company

Appendix 2: Company glossary

Water and sewerage companies

Anglian	Anglian Water Services Limited
Affinity	Affinity Water Limited
Bristol	Bristol Water plc
Hafren	Hafren Dyfrdwy Cyfyngedig (previously Dee Valley Water Limited)
Northumbrian	Northumbrian Water Limited
Portsmouth	Portsmouth Water Limited
Severn Trent	Severn Trent Water Limited
South Staffs	South Staffordshire Water Plc
South West	South West Water Limited
South East	South East Water Limited
Southern	Southern Water Services Limited
SES Water	Sutton and East Surrey Water plc (trading as SES Water)
Thames	Thames Water Utilities Limited
Tideway	Bazalgette Tunnel Limited
United Utilities	United Utilities Water Limited
Dŵr Cymru	Dŵr Cymru Cyfyngedig
Wessex	Wessex Water Services Limited
Yorkshire	Yorkshire Water Services Limited



Credit Rating Agencies

Moody's	Moody's Investors Services, Inc.
S&P	S&P Global Ratings
Fitch	Fitch Ratings, Inc.

Appendix 3: Comparability of data

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

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

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

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

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

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

End notes (1)

1. While we have undertaken a high-level review of the information published by companies which has been included in this report to ensure consistency, the responsibility for the accuracy of the information that each company publishes and which we have used when compiling the report remains with each of the appointed companies.

Where companies have restated figures and / or revised its 2019-20 APRs prior to our publication of this report, we have updated the data in line with the revisions made by companies. If companies were to restate figures and / or revise their 2019-20 APRs following the publication of this report these changes will not be reflected in this report.

2. Severn Trent Water acquired Dee Valley Water in 2017

Variations and modifications to the Conditions of Appointment (licences) for both companies were made, effective 1 July 2018. The related boundary changes allowed Hafren Dyfrdwy (formerly Dee Valley Water) to become a water and wastewater services company based wholly in Wales and for Severn Trent Water to become a water and wastewater services company based wholly in England.

For ease of reference, this report refers to Severn Trent and Hafren for all years. The historic data for these companies has not been adjusted, therefore the data prior to 1 July 2018 is not reflective of the boundary changes, and prior to 2017 is not reflective of the acquisition.

As a result of these variations there has been a reallocation of allowed revenue and RCV between the two companies. The impact on Hafren was a reduction in RCV of around 27% and an increase in allowed revenue and costs. The impact of these changes is that the base RoRE that Hafren was able to earn in the financial year ended 31 March 2019 has increased to 6.9% and 8.2% for the year ended 31 March 2020 (average 6.5% for 2015-20) compared to the base RoRE of 5.8% (average 5.8% for 2015-20) assumed in the PR14 final determination. The impact on Severn Trent was an equivalent increase in RCV and reduction in allowed revenues. Due to the relative size of the two organisations the impact on the base RoRE of Severn Trent is less significant. Overall there have been no changes to the total allowed revenue the two companies are able to collect, or an increase in the total returns the combined businesses are able to earn, within the 2015-20 period.

Due to the boundary changes, Hafren's region is now more rural. The very low population density of its new supply area has driven up the asset and operating complexity of its network and therefore in turn driven up the cost of operating and maintaining its network. However, in line with the commitments made when Severn Trent acquired Dee Valley Water and when the boundary changes were proposed, Hafren's customer bills were not increased as a result of these increased costs therefore Hafren's revenue has not increased in line with its costs.

End notes (2)

3. Most companies' licences include a requirement with respect to maintaining an investment grade credit rating

The licences for South West and Hafren also contain this requirement, however, their licences allow them to seek our agreement to exempt them from need to maintain a credit rating. This is why no rating is shown in 2019 or 2020 for Hafren and no rating is shown in any year for South West in the chart on the Credit Rating slide. South West and Hafren's licences do nonetheless require each company's board to certify that the company would be able to maintain an investment grade credit rating along with the main factors, including financial ratios, the board has taken into account to come to its conclusion.

4. In December 2019 we published our final determinations for all water companies

Our 2019 price review final determinations set out a five-year price and service package that will enable water companies to deliver more for people today, invest for future generations and at the same time operate more efficiently and reduce bills. These will apply from 1 April 2020.

Four companies (Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water) have decided to appeal those decisions to the Competition and Markets Authority (CMA). The CMA redetermination process is in progress as the time of publication.

5. Anglian presented its financial metrics up to 2018 excluding certain internal transactions

The internal transactions which it excluded comprised: intercompany loan interest received and the corresponding dividend it made to its parent undertaking to enable it to service this interest. In 2018 this also included a special dividend it made to its parent undertaking to enable it to settle the intercompany loan.

6. Dŵr Cymru's ultimate parent undertaking is Glas Cymru Holdings Cyfyngedig

As Glas Cymru Holdings Cyfyngedig is a company limited by guarantee, it has no shareholders. Dŵr Cymru does not typically pay any dividends to its parent company, but where it does no monies are transferred out of the Glas Cymru group of companies and all financial surpluses are retained for the benefit of customers. Due to this, Dŵr Cymru's adjusted appointee dividend is deemed to be nil, therefore only a total dividend yield is presented in the dividend chart for Dŵr Cymru.

End notes (3)

7. Regulatory Investigations' impact on revenue recovery

Regulatory investigations into both Thames and Southern have resulted in packages of commitments that ensure that both companies return revenue to customers. Due to this, overall revenue recovery and certain metrics may be adversely impacted while the companies continue to return money to customers.

For more information on these cases see links below:

[Thames Water: Investigation into Thames Water's failure to meet its leakage performance commitments]

[Southern Water: Investigation into Southern Water's wastewater treatment sites and the company's reporting of relevant compliance information to us]

8. Securitisation

A number of privately owned companies have established 'securitised' debt structures and often have a higher gearing than non-securitised companies. Securitisation enables a company to raise debt by granting a charge over an identifiable stream of future cashflows generated by the business. In order to protect the quality of future cashflows, 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 may 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.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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