9 Aligning risk and return

9.1 Key Messages

- **Financeable plan on both actual and notional financial structure:** A3 and BBB+ ratings maintained whilst delivering a 10.5% real reduction in customer bills
- **WACC and retail margins in line with Ofwat's early view:** Assumed RPI stripped appointee WACC of 2.4%, with a retail margin equivalent to 0.1% of WACC, and the remaining 2.3% applied equally to all four wholesale price controls
- **Resilient capital structure with c60% gearing by 2025:** In line with Ofwat's notional company assumptions and resilient to extensive stress testing
- **Upfront guarantee to customers of sharing outperformance:** CommUnity Share builds on £500m of benefit sharing over past decade
- **Responsible policies on gearing, dividends and benefit sharing:** Consistent with Ofwat's determination on 'Putting the sector in balance'
- **Reduced advancement of revenue through the PAYG mechanism (£102m compared with £179m in AMP6):** Represents the best tool to address financeability constraints and supported by customers
- **Notional company RORE range of 0.4% to +8.6%, midpoint of 4.5%, on a blended RPI/CPIH stripped basis:** In line with Ofwat high/low case guidance
- **Executive performance pay incentives linked to delivery for customers:** Revised policies will be in place for AMP7 building on a strong track record
- **Fair sharing of bills between current and future customers:** Intergenerational equity over the long term, smoothed bills during AMP7

9.2 Overview

To deliver excellent levels of service at a price that customers can afford and which can be financed on a fair and efficient basis, it is important to ensure that our business plan for 2020-25 and beyond strikes an appropriate balance of risk and return. This chapter explains how we have understood and assessed the risks in the business plan and provides evidence of the risk management measures we have in place. We have undertaken a thorough assessment of the impact of these risks on the RORE range and average customer bills and conclude that they are appropriate.

Section 9.3 sets out the importance of aligning risk and return. Section 9.4 covers our approach to key financial elements of the plan including WACC, taxation, pensions and our base dividend assumption. Section 9.5 sets out details of our proposed revenue recovery and bill profiles. Section 9.6 sets out our approach to considering financeability. Additional evidence underpinning this section is provided in supplementary document S7003 "Evidence of financeability" and third party report T7003 "Board letter on financing: Goldman Sachs". Section 9.7 sets out our risk analysis and RORE ranges by price control and for the business overall. Section 9.8 explains how we will manage downside risk associated with the business plan. C0011 contains the Board's Viability Statement to 2025. Section 9.9 provides an overview of our benefit sharing, dividend and gearing policies. Further background information on our dividend policy is provided in S7006 "Capital structure and dividend policy." Section 9.11 describes our approach to executive performance pay.

We set out a clear, sustainable and responsible approach to gearing, dividends and benefit sharing for AMP7. This approach embeds a clear commitment to responsible financing and benefit sharing, contributing to building trust and confidence in the company and its treatment of the broadest range of stakeholders. Our CommUnity Share provides a substantial package of company funded measures to support vulnerable customers and an upfront guarantee that if we pay dividends over a certain threshold or, in the unlikely event we become highly geared, we will ensure that customers benefit through bill discounts or other investments in community schemes. We also describe our approach to alignment and transparency on how executive pay links to the delivery of service to customers.

We have based the cost of capital for each wholesale price control at 2.3% RPI stripped and the retail margin equivalent to 0.1% of WACC, aligned to Ofwat's guidance. Our plan does not propose any risk mitigation mechanisms except for assurance in our determination that if the Manchester and Pennines Resilience project could not be delivered (for whatever reason) by a third party Competitively Appointed Provider (CAP), the project would fall back within the remit of the Water Network+ business with AMP7 expenditure being applied as an NPV neutral adjustment to the opening AMP8 RCV.

We confirm that the plan is financeable on both an actual and a notional company basis, as evidenced in this chapter and confirmed in the Board's assurance statement provided in C0011. Some financial metrics presented on the notional company basis are at the margins of acceptability. However we are able to accept the plan in the round due to the overall strength of the company's actual financial metrics resulting from past prudence and efficient treasury management.

Our plan will ensure we continue with our responsible approach of maintaining sector-leading levels of financial resilience with gearing aligned to the notional company and our target credit ratings of A3/BBB+ for the actual company providing efficient access to debt capital markets throughout the economic cycle. We will continue to pay our fair share of tax in AMP7 and take a responsible approach to pension risk management which has provided us with one of the most robust and resilient pension schemes in the UK.

We propose to accelerate £102m of revenue from future periods by adjusting the PAYG ratio which is less than the £179m PAYG advancement applied in AMP6. We have concluded this represents the most appropriate tool to address financeability constraints in the notional company. Customer research indicates that they are supportive of this smoother bill profile and as part of our assessment we also considered bill affordability both in AMP7 and beyond (for more details see section chapter 3 section 3.4).

9.3 The importance of aligning risk and return

A fair alignment of risk and return that balances the provision of great service at the best possible price and provides support for the long term sustainable and efficient financing of the company is crucial to a successful business plan. The regulatory framework for PR19 provides scope to earn greater return by delivering improvements in customer service at lower costs. This requires us to innovate and challenge ourselves to do things differently. But in doing so, we must also be aware of the potential consequences of such changes and ensure that we continue to operate the business in a responsible manner. This means that risks we do take need to be appropriately managed.

In contrast, a strategy which did not seek innovation or question the 'status quo' may reduce some elements of risk but would not naturally lead to a step change in service delivery for customers. As a result of the regulatory framework, it would also fail to deliver the best possible returns for investors in the company. Repetition of the same strategies might also give rise to additional risks if this meant we were not looking to adapt to a changing operating environment: appearing to reduce short-term risk in this way may serve to increase long-term risks to customers.

Our business plan provides a strong risk and return balance to ensure that we can deliver the service improvements expected by customers, including through innovation, whilst ensuring that customers and investors are appropriately protected against or rewarded for any increase in risk associated with these innovations.

Alongside offering customers a high quality, resilient and value for money price and service package, we must ensure that the investment proposition offers returns commensurate with the level of systematic risk. This helps to secure that, in an environment where there is an abundance of alternative investment options, the cost of financing the sector remains as low as possible, allowing us to continue to attract the most economic funding available to invest in maintaining and improving services.

9.4 Components of a stretching and responsible plan

There are a number of key components that make a plan demonstrably stretching. At its core, it must embed stretching performance targets for services to customers. In chapter 5 we set out our approach to setting these in a way that will require us to innovate in order to deliver and which exposes investors to out- and under-performance risks which are consistent with customer valuations. A stretching plan must also deliver cost efficiency. Chapters 6 and 7 describe the steps we have taken to ensure that we will provide services at an efficient level of operating and capital expenditure which minimises the demand for financing and ensures that customer bills are kept as low as possible.

In this chapter we consider the financial components of a stretching plan and describe how we intend to deliver them in a responsible manner which is responsive to a variety of stakeholder needs. In particular, we set out our approach to delivering an appropriate financial structure, paying our fair share of tax and ensuring that pension promises made to employees are kept.

9.4.1 A responsible and industry leading finance structure

Low embedded financing costs and WACC

Our robust financing structure supports the business plan by ensuring we maintain appropriate credit ratings, can adequately manage financial risk and raise finance at efficient costs. We have delivered one of the sector leading financing costs which has not only been to the benefit of customers in our own region – including the sharing of outperformance in AMPs 5 and 6 – but which has also fed into a lower industry average cost of debt, setting tougher benchmarks and thereby reducing bills for all customers in England and Wales. We also have clearly articulated hedging policies to manage our exposure to inflation, interest rates and foreign exchange rates[1].

Responsible financing structure enabling absorption of cost/performance shocks

Water companies provide a vital public service so it is in the best interests of customers and all stakeholders for water companies to be financially resilient and to avoid excessive levels of financial risk. Our capital structure has been set to ensure long-term financial resilience. As a conventionally financed company we have consistently operated with a responsible level of gearing over a long period, ensuring that we have a robust functioning equity buffer and are not subject to overly restrictive covenants.

Our capital structure is set with reference to long term, transparent and well communicated policies approved by the Board. These include a debt to RCV gearing target range of 55 to 65% (around the same level as Ofwat's notional company) and an aim to at least retain an A3 rating with Moody's and a BBB+ rating with Standard & Poor's (S&P). Our policies in these areas have proven robust and resilient over several AMPs. Our responsible track record and demonstration of high levels of financial resilience is detailed in chapter 4, section 4.7.

We have embraced Ofwat's plans to transition indexation of the wholesale price controls to CPIH from RPI. During AMP6 we have proactively sought opportunities to issue CPI linked financial instruments, which are currently the best available financial instrument to match CPIH. We were the first UK utility company to issue CPI linked debt. To date, we have successfully raised £165m of CPI linked bonds. As availability of CPI linked instruments is scarce, this represents just 2% of our net debt portfolio but we will continue to increase this when we are able to do so at good relative value.

Our business plan maintains this stable and financially resilient profile, crucially by retaining a robust and functioning equity buffer to absorb cost/performance shocks.

9.4.2 Accepting a tough industry cost of capital

For AMP7 we have based the cost of capital that underpins each of our wholesale price controls, and the margin that underpins our residential retail price control, on the guidance provided by Ofwat in its methodology statement. Our business plan assumes the same WACC and cost of equity for each price control.

[1] See "Our competitive advantage" on page 13, the financing section on page 26 and market risk section pages 162 to 165 of the UUG annual report and financial statements 2018, https://www.unitedutilities.com/corporate/investors/reports-and-results/annual-reports/

The appropriate WACC for PR19 is lower than at PR14 as the current low interest rate environment has resulted in lower financing costs, which we have benefitted from and used to reinvest for the benefit of customers. Table 9.1 shows the appointed and wholesale cost of capital on a nominal, RPI real, CPIH real and RPI/CPIH blended real basis (blended in proportion to the average AMP7 RPI and CPIH indexed elements of the RCV).

The breakdown of the appointed cost of capital into its constituent parts on a nominal basis is included in data table App32, which mirrors the breakdown given by Ofwat in its 'early view' WACC. The wholesale cost of capital has been allocated into its constituent parts by mirroring all of the appointed WACC sub-elements with the exception of the wholesale beta. We consider it appropriate to adjust the wholesale beta as opposed to any other sub-element as this represents the relative 'riskiness' of the wholesale business which will differ from the appointed business by virtue of the absence of the retail business. The breakdown of the wholesale cost of capital into its constituent parts on a nominal basis is included in data tables Bio6, Wwn7, Wn5 and Wr5.

Table 9.1: Appointed and wholesale business cost of capital and retail margin for AMP7

AMP7	Nominal	RPI stripped	CPIH stripped	AMP7 average RPI/CPIH blend stripped
Appointed vanilla WACC	**5.47%**	**2.40%**	**3.40%**	**2.95%**
Impact of 1% residential retail margin	(0.1)%	(0.1)%	(0.1)%	(0.1)%
Wholesale vanilla WACC	**5.37%**	**2.30%**	**3.30%**	**2.85%**

As a part of assessing whether we were able to accept Ofwat's WACC guidance we commissioned EY to prepare a report setting out their view of the appropriate wholesale costs of capital and residential retail margin for the UK water sector (document T7002 – WACC in the context of Risk, Return and Resilience at PR19). We have compared EY's recommended range to Ofwat's guidance in tables 9.2 and 9.3 (all on an RPI stripped basis):

Table 9.2: Ofwat WACC guidance and EY recommended appointed and wholesale cost of capital

AMP7 (RPI real)	Ofwat guidance	EY Low end of range	EY High end of range
Overall cost of debt (RPI real)	**1.33%**	**1.2%**	**1.8%**
Cost of equity (RPI real)	**4.01%**	**4.3%**	**5.75%**
Gearing	60.0%	65.0%	60.0%
Appointed vanilla WACC (RPI real)	**2.4%**	**2.3%**	**3.4%**
Impact of 1% residential retail margin	(0.1)%	(0.1)%	(0.1)%
Wholesale vanilla WACC (RPI real)	**2.3%**	**2.2%**	**3.3%**
RPI CPI wedge	1.0%	1.0%	1.3%
Wholesale vanilla WACC (CPI real)	**3.3%**	**3.2%**	**4.6%**

Table 9.3: Ofwat WACC guidance and EY recommended residential retail margin

AMP7	Ofwat guidance	EY Low end of range	EY High end of range
Residential retail margin	1.0%	1.0%	1.5%

Tables 9.2 and 9.3 show Ofwat's WACC guidance lies towards the bottom end of EY's recommended range, with certain sub-elements (notably the cost of equity) lying outside the bottom of EY's recommended range.

Although we have assessed that certain sub-elements of the wholesale cost of capital and retail margin are set at the very low end of (or even below) an acceptable range, we have been able to adopt the above industry wholesale cost of capital and retail margin on an overall basis, as part of the risk and return balance and price control package set out in this document. This includes the adjustment to the PAYG ratios that we have used to mitigate financeability constraints (see sections 9.5.4, 9.5.5 and 9.6).

In particular, we consider that a cost of equity of 4.01% is especially low. In assessing the financeability of our plan (see 9.6 for more detail), we have identified that Moody's adjusted interest cover is one of the key financeability constraints for the notional company. This ratio effectively just compares the allowed real cost of capital to cash interest, which is fixed for the notional company, and as Moody's adjusts for any PAYG advancement there are no effective means of improving this ratio for the notional company. As a result – and as we consider the notional company to be at the margin of acceptability – we assess that if the allowed cost of equity were to drop any further we would not consider the notional company to be financeable.

Whilst we do not anticipate large injections of equity finance in our business plan, it remains important that equity investors are adequately remunerated. At times during 2018, listed water companies have traded at a discount to RCV. An inadequate cost of equity settlement could increase the risk that equity investors may lose confidence in the sector and withdraw support. Credit investors rely on a well-functioning equity buffer and may not be willing to lend to the sector in such a scenario. Therefore, an adequate cost of equity is important for all providers of finance.

Our assessment of an AMP8 WACC

As Ofwat did not give a view on an AMP8 WACC in its final methodology, in order to calculate projected bill profiles into AMP8, we commissioned EY to set out their view on a likely industry cost of capital range for this period. For our business plan projections we have selected a point estimate from EY's recommended range which is towards the lower end of the range, whilst maintaining gearing at 60%. This point estimate and EY's range are shown in the table 9.4 with all numbers presented on an RPI stripped basis.

Table 9.4: EY's recommended AMP8 appointed cost of capital and UU's chosen spot position within EY's range, RPI stripped basis

AMP8 (RPI real)	UU's chosen AMP8 spot position	EY: Low end of range	EY: High end of range
Overall cost of debt (RPI real)	**1.69%**	**1.60%**	**1.95%**
Cost of equity (RPI real)	4.79%	4.43%	5.88%
Gearing	**60.0%**	**65.0%**	**60.0%**
Appointed vanilla WACC (RPI real)	2.93%	2.6%	3.5%
Impact of 1% residential retail margin	**(0.1)%**	**n/a**	**n/a**
Wholesale vanilla WACC (RPI real)	2.83%	n/a	n/a
RPI CPI wedge	**1.0%**	**n/a**	**n/a**
Wholesale vanilla WACC (CPI real)	3.83%	n/a	n/a

Data table App32 details on a nominal basis the AMP8 appointed cost of capital shown in table 9.4. Similar to the AMP7 WACC, the AMP8 wholesale cost of capital has been allocated into its constituent parts by mirroring all of the AMP8 appointed WACC sub-elements with the exception of the wholesale beta. The breakdown of the AMP8 wholesale cost of capital into its constituent parts on a nominal basis is included in data tables Bio6, Wwn7, Wn5 and Wr5.

9.4.3 Paying our fair share of tax

We are committed to acting in a responsible manner in relation to our tax affairs[2] and will continue to pay our fair share of tax in AMP7. The company has a simple transparent corporate structure including no offshore financing arrangements. We are forecasting total corporation tax payments of around £232m and a further c£700m of other economic contributions in the form of business rates, employer national insurance contributions, environmental taxes and other regulatory fees.

The average cash tax rate is forecast to be below the 17% headline rate of corporation tax, at around 14%. The benefit of this in-period tax saving passes immediately to customers reducing total bills by around £60m across the AMP.

The above tax saving is mainly due to optimising available tax reliefs on the company's capital expenditure supported by a full tax deduction being available in relation to all of the company's interest costs; such available reliefs having been explicitly encouraged by successive governments. Our approach thereby ensures that we maximise the available benefit for customers whilst also ensuring that we embody responsible corporate behaviour in relation to tax.

We fully support the new regulatory tax sharing mechanism introduced for PR19 as it achieves a good balance between continuing to incentivise us to act efficiently in relation to tax matters whilst also allowing for the automatic sharing with customers of the most likely tax benefits or costs that are outside of our control.

[2] See our tax policies and objectives on page 116 of our UUG annual report and financial statements 2018.

As a responsible company, we note the following points in calculating corporation tax within our business plan:

- We have taken account of all available capital allowances and assumed no capital allowance disclaimers
- We expect the company to generate taxable profits during AMP7. However, should it receive/surrender losses from/to a fellow group company, payment will always be made at the headline corporation tax rate
- We expect to obtain a full tax deduction for all interest payments, on the assumption that the 'Public Infrastructure Exemption' (PIE) will apply and that there will be no related party debt for these purposes

9.4.4 A responsible approach to pensions

We have the most robust and resilient funding position in respect of our defined benefit pension schemes in the industry and one of the strongest in the UK, resulting from our responsible approach to risk management and a collaborative approach with the schemes' trustees. See chapter 4, section 4.7.2 for evidence and more information on our approach.

This means that customers and investors are protected from significant exposure to pension scheme deficits due to our pension schemes being fully hedged against equity, interest rate and inflation volatility.

[✂]

[✂]

9.4.5 Our AMP7 base dividend assumption

Our business plan assumes a nominal base dividend of 5% of the equity portion of the RCV for each year of AMP7, which is consistent with Ofwat's guidance on the cost of equity and the 'Putting the sector in balance' position statement[3]. This is also in line with our AMP7 base dividend policy as set out in section 9.9, assuming gearing is between 60% and 70%.

9.5 Revenue and our assessment of average customer bills

Our business plan proposes stretching improvements in service to customers for a significantly lower price. Chapter 3 sets out the results of research on the acceptability of our plan. This shows that 82% of customers support that the plan overall is acceptable and when asked to only consider proposed changes to bills, 77% of customers believe our proposed AMP7 bills will be acceptable. Only 13% said they found bill proposals unacceptable with the remainder being undecided. Chapter 5 sets out our package of stretching service improvements in more detail. This section sets out the price control "building blocks" components of our plan, and how this has resulted in our proposed bill reductions over 2020-25.

9.5.1 The building blocks of our revenue requirement

Our revenue calculations reflect the costs of delivering the plans (as set out in chapter 7), along with assumed WACC, PAYG ratios, RCV run-off rates and average asset lives.

We have calculated the revenue requirement for each of the price controls using Ofwat's financial model. For more information on the calculation of our revenue requirement please see our data tables App7, App17, Wr3, Wn3, Wwn5, Bio4 and R7. We have also provided our financial model and an associated commentary alongside our business plan submission in P0004 and P0005.

[3] https://www.ofwat.gov.uk/consultation/putting-sector-back-balance-consultation-proposals-pr19-business-plans/

Table 9.5: Revenue requirement

Revenue requirement AMP 7 £m (2017/18 CPIH prices)	Water network plus	Water resources	Wastewater network plus	Bioresources	Residential retail	Total
PAYG – operating costs	1,433	317	1,238	206	-	3,195
PAYG – advancement	39	7	49	7	-	102
Return on RCV	479	76	964	62	-	1,581
RCV run-off	864	88	1,486	198	-	2,637
Taxation	71	13	105	21	-	210
Revenue from AMP6 Incentives	(1)	1	(0)	-	14	13
Capital and other income	(2)	(4)	14	4	-	12
Residential Retail costs	-	-	-	-	441	441
Retail margin (1%)	-	-	-	-	59	59
Re-profiling (NPV neutral)	(1)	(0)	(1)	(0)	-	(2)
Revenue requirement	**2,883**	**498**	**3,855**	**498**	**514**	**8,248**

9.5.2 A more affordable customer bill delivering improving levels of service

The average 2024-25 residential bill of £382 consists of the four wholesale service elements and retail. We have used Ofwat's financial model to calculate expected bill levels, which are summarised in the table 9.6.

Table 9.6: Average residential bill per by price control and year, real terms

Wholesale Water Bills (2017/18 prices)	2020-21	2021-22	2022-23	2023-24	2024-25
Water resources – revenue (£m)	95.33	96.62	97.22	101.17	107.91
Water network plus – revenue (£m)	575.73	584.83	580.15	574.13	567.82
Direct Procurement for Customers	-	-	-	-	2.11
Residential apportionment (WR)	70%	70%	70%	70%	71%
Residential apportionment (WN+)	74%	74%	74%	74%	75%
Residential water customers ('000s)	2,967.21	2,990.07	3,013.96	3,038.87	3,064.81
Average water wholesale bill (£)	**166.02**	**167.69**	**165.60**	**164.00**	**163.41**

Wholesale Wastewater Bills (2017/18 prices)	2020-21	2021-22	2022-23	2023-24	2024-25
Wastewater network plus – revenue (£m)	781.98	772.27	764.19	763.50	772.83
Bioresources – revenue (£m)	96.49	98.21	99.72	100.99	102.74
Residential apportionment (WWN+)	64%	64%	64%	64%	64%
Residential apportionment (BR)	78%	79%	79%	79%	79%
Residential wastewater customers ('000s)	2,969.73	2,992.09	3,015.46	3,039.83	3,065.20
Average wastewater wholesale bill (£)	**192.99**	**190.11**	**187.42**	**186.27**	**187.25**

Total customer bills (2017/18 prices)	2020-21	2021-22	2022-23	2023-24	2024-25
Average wholesale water bill (£)	166.02	167.69	165.60	164.00	163.41
Average wholesale wastewater bill (£)	192.99	190.11	187.42	186.27	187.25
Average retail bill (£)	34.92	34.17	33.16	32.47	31.67
Average residential bill (£)	**393.92**	**391.96**	**386.19**	**382.74**	**382.33**
Average residential bill, 2019/20 (£)	427.14	-	-	-	-
Change in bills, 2019/20 to 2024/25	-	-	-	-	-10.5%

The average bill includes 52 pence related to the recovery from customers of the Competitively Appointed Provider (CAP) payments in 2024/25, following the proposed DPC Manchester & Pennines Resilience Project. This is included in table 9.6 and Ofwat's financial model – calculated bill, excluded from the bill in data table App7.

9.5.3 RCV run-off rates

We have calculated RCV run-off rates in a way that is consistent with the economic utilisation of assets within each price control. This results in noticeably higher run-off for Bioresources than the other three price controls, due to differences in the mix of assets, as Bioresources is the only price control without a significant proportion of infrastructure assets, and therefore it has a significantly shorter average asset life than the other three wholesale controls. More specific values for the RCV run-off rates applicable to each price control are set out in the relevant table commentaries to data tables Wr4, Wn4, Wwn6 and Bio5.

9.5.4 PAYG ratio

We have applied PAYG rates consistent with operating costs (which includes infrastructure maintenance expenditure) as a proportion of totex for each price control. It has also been necessary to advance 1.9% of additional PAYG (spread evenly across all wholesale price controls) in order to maintain financeability on a notional company basis. This is set out in section 9.5.5. More specific values for the PAYG rates applicable to each price control are set out in the relevant table commentaries to data tables Wr4, Wn4, Wwn6 and Bio5.

9.5.5 Revenue re-profiling and PAYG advancement

As set out in section 9.6.3, in order to support the financeability of our plan, on a notional company basis, it has been necessary to advance revenues by increasing PAYG above the “natural” rate, by 1.9% of AMP7 totex (c.£102m, or 1.2% of AMP7 revenue). To mitigate the value of this, we have also re-profiled revenues to “flatten” the profile of key ratios over 2020-25, and hence minimise the required level of PAYG advancement.

We have pro-rated PAYG advancements in proportion to wholesale totex in each price controls, and apportioned revenue re-profiling relative to wholesale RCV. The values of these adjustments and the impact on customer bills are shown in table 9.7.

Table 9.7: Impact on bills of PAYG advancement and revenue profiling

	2020-21	2021-22	2022-23	2023-24	2024-25
Average residential bill pre PAYG advancement and revenue re-profiling (£)	382.39	381.53	380.88	379.03	379.94
Impact on average residential bill, PAYG lever (£)	6.78	6.76	6.37	7.33	6.64
Impact on average residential bill, revenue re-profiling (£)	4.75	3.68	(1.06)	(3.62)	(4.24)
Final proposed bill profile (£)	393.92	391.96	386.19	382.74	382.33

The average bill includes 52 pence related to the recovery from customers of the Competitively Appointed Provider (CAP) payments in 2024/25, following the proposed DPC Manchester & Pennines Resilience Project.

These adjustments are necessary to ensure that our plan, on a notional company basis, achieves adequate ratio values, consistent with Baa1/BBB+ credit ratings to ensure that the plan is adequately financeable and resilient. The bill impacts of these adjustments are relatively minor and still enable us to propose a substantial reduction in bills over AMP7 as part of our business plan which has received high levels of customer acceptability of c82%[4].

We conducted qualitative research with customers[5] on future bill profiles and intergenerational changes in bills across AMP periods. A majority of customers supported bill profiles which were more stable over time, in preference to larger bill reductions in AMP7 followed by further increases to future bills in the longer term. This re-affirmed the results of similar customer research we undertook at PR14. These customer views support our proposals to manage financeability of the notional company via advancement of PAYG. We expect that there will be upward pressure on bills in AMP8 due to completion of the Manchester & Pennines Resilience scheme as well as further transition to CPIH and forecast increases to WACC components (see section 9.4.2). Therefore advancing PAYG will help to smooth bills between AMP7 and AMP8 and beyond. Smoothing of bills over time also helps to support customers that are behind on their water bills – work with them[6] shows that stable bills helps with household budgeting and avoiding arrears.

[4] T1029 - Acceptability testing for PR19 stage 2
[5] T1082 - Performance commitments, ODIs, and bill profiles
[6] T1103- Retail customer research regarding affordability and vulnerability – disengaged mainstream customers

9.5.6 Demonstrating bills are affordable post 2025

Chapter 3 section 3.4, sets out our forecast for average residential bills and our assessment of affordability for AMP8.

9.6 Our financeability assessment

This section demonstrates that our business plan submission is financeable on both a notional and actual company basis and sets out the methodology used and the evidence that supports our assessment.

9.6.1 Our plan is financeable on both an actual and a notional company basis

Our business plan as set out in this document is financeable on both an actual and a notional company basis. Our board has provided a clear statement of assurance on this, with appropriate supporting evidence, in its assurance statement provided in document C0011 stating:

"The plan is financeable on both a notional and actual company basis. Our financeability assessment, supported by independent assurance, targets the maintenance of appropriate credit ratings of Baa1 with Moody's and BBB+ with Standard and Poor's for the notional company, albeit with limited headroom, in order to achieve a fair and balanced plan. On an actual company basis this corresponds to credit ratings of A3 with Moody's and BBB+ with Standard and Poor's, albeit with limited headroom against the Standard and Poor's rating."

As explained further in section 9.6.2 below, we have targeted different ratings for the notional and actual company. This is because the cost of capital and index-linked debt assumptions for the notional company do not enable a rating above Baa1 with Moody's, which we assess to be the absolute minimum needed to be financeable. Whereas our actual company benefits from a higher proportion of index linked debt and low embedded costs of debt enabling a higher rating of A3 with Moody's, which we assess to be a tight but more resilient financeable position.

The Board's financeability assessment has been supported by the evidence in this chapter, chapter 4, (securing long-term resilience), supplementary document S7003 and third party document T7003.

9.6.2 Our financeability assessment approach

It is in the best interests of all stakeholders to maintain a stable capital structure and credit ratings profile, given our significant financing requirements across AMP7 and need to access finance at an efficient cost. As such, our financeability assessment targets the maintenance of appropriate credit ratings and investor returns to enable us to finance our activities, albeit with limited headroom, in order to achieve a stretching, fair and balanced plan.

We have targeted credit ratings of Baa1/BBB+ for the notional company and A3/BBB+ for the actual company. An A3/BBB+ rating provides an appropriate level of headroom for AMP7 as it offers robust access to funding (including in times of market disruption) and efficient debt financing costs, compared to lower ratings (see supplementary S7003 for more details and evidence). Our experience of targeting A3/BBB+ ratings over AMP6 has proven such ratings offer robust access to debt markets in a variety of conditions. Whilst we assess A3/BBB+ to be the most appropriate rating for a UK water company, we do still consider a Baa1/BBB+ rating to be just about financeable, but with a lower degree of financial resilience.

For the purposes of our financeability assessment below, we have had to calculate a number of revised financial ratios to address certain discrepancies in the financial model (see P0004), which have been included as UUW proposed financial ratios in table App10. These revised financial ratios follow the same ratio calculation methodology as Ofwat's financial model, but adjust for discrepancies in the underlying numbers, for the following issues (also see our table commentary to App10 in P0005 for further details):

- **FFO:Debt and FFO:Debt (alternative version)** – Ofwat's model deducts ongoing pension costs as part of the measure. However, this value is already included within opex, and so the additional deduction of pension costs acts to double count this value, artificially reducing the value of these ratios. Our proposed revised calculations are identical to Ofwat's financial model, except for removal of the duplicative deduction of pension costs
- **Adjusted interest cover (alternative version)** – The published model is seeking to "look through" adjustments to PAYG and RCV run-off, but the sign convention for the wholesale operating expenditure is the reverse of what would be expected. Our proposed revised calculation simply changes the sign convention of this line in addition to removing the duplicate pension costs deduction as described above

- **Dividend cover** – The approach to depreciation in the financial model is a simplified one, utilising a single asset life for each price control. We have assumed asset lives consistent with the correct overall value of depreciation projected to be incurred over AMP7, however, we forecast that our depreciation profile will be much flatter than that calculated within Ofwat's model and this materially impacts the result. Our proposed revised dividend cover measure adjusts the calculation to reflect the true depreciation profile, which it is not possible to replicate in Ofwat's model

In our financeability assessment in sections 9.6.3 to 9.6.5 below, we have taken our adjusted ratios as the basis for our assessment and consider that this is the appropriate way to conduct the financeability assessment, in line with the intention of the methodology, having adjusted the outputs of the financial model to adjust for unintended issues arising from the design and functionality of the model.

Approach to addressing financeability issues

In addressing any gap between the revenue requirements on a cost recovery building block basis and those based on our view of financeability, we have concluded that using PAYG levers is the most appropriate tool under PR19 methodology. This is because equity injections are only appropriate where gearing or investment needs are high, whereas in our business plan cash flow metrics have weakened, not because gearing is increasing above the notional assumption, but because the proportion of the nominal return that is earned as cash flow has decreased over recent AMPs. Dividend cuts offer little mitigation to cash flow metrics particularly at the start of an AMP period, whereas PAYG ratios directly address cash flow weaknesses caused by lower real returns at PR19 and can be used whilst still maintaining a stable capital structure and responsible levels of dividend distribution (see supplementary S7003 for more details including a worked example).

Therefore, in our financeability assessment output set out below, we have accelerated £102m through adjustments to the PAYG ratios as detailed in table 9.5. This advancement is the minimum needed to ensure financeability of the notional company with FFO to debt ratios being set to be just above the minimum threshold during AMP7 and is less than the £179m agreed at PR14. While our actual company is slightly better placed, as it benefits from low costs of embedded debt and a higher proportion of index linked debt, the advancement serves to provide limited, but essential, headroom as the FFO to debt ratios remain very tight for most years of the AMP.

This PAYG advancement is necessary for our plan, on a notional company basis, to maintain satisfactory credit ratings of Baa1/BBB+, which are consistent with that implied by Ofwat's WACC guidance. We recognise that this will reduce the size of the bill reduction we are able to offer customers in AMP7, however it is responsible given that it is necessary to support our adoption of Ofwat's WACC guidance. Our proposal to resolve notional company financeability via an adjustment to PAYG (rather than by any other route) also means that bill impacts will be neutral to customers over the long term (also see section 9.5.5 for evidence of customer support).

9.6.3 Debt financeability assessment

Table 9.8: Debt financeability: Appointed business financial metrics including PAYG advancement (notional company)

	2020-21	2021-22	2022-23	2023-24	2024-25	A3/BBB+ thresholds	Baa1/BBB+ thresholds
Gearing	59.9%	59.9%	59.7%	59.8%	60.0%	≤65%	≤72%
Interest cover	4.1	4.1	4.1	4.2	4.2	≥2.5x	≥2.5x
Adjusted cash interest cover	1.7	1.7	1.6	1.6	1.6	≥1.79x	≥1.59x
Adjusted cash interest cover (alt)	1.6	1.6	1.5	1.5	1.5	≥1.7x	≥1.5x
FFO to net debt	10.2%	10.0%	10.0%	10.0%	10.0%	≥10.0%	≥10.0%
FFO to net debt (alt)	9.3%	9.1%	9.1%	9.1%	9.0%	≥9%	≥9%
RCF to net debt	6.2%	6.1%	6.4%	6.4%	6.4%	n/a	n/a
RCF to capex	92.2%	93.1%	110.7%	79.2%	92.9%	n/a	n/a

Table 9.9: Debt financeability: Appointed business financial metrics including PAYG advancement (actual company)

	2020-21	2021-22	2022-23	2023-24	2024-25	A3/BBB+ threshold
Gearing	62.1%	61.6%	60.7%	60.3%	60.0%	≤65%
Interest cover	5.8	6.1	6.2	6.2	6.1	≥2.5x
Adjusted cash interest cover	2.4	2.5	2.5	2.4	2.4	≥1.84x
Adjusted cash interest cover (alt)	2.3	2.4	2.4	2.3	2.2	≥1.7x
FFO to net debt	10.8%	10.8%	10.9%	11.0%	11.0%	≥10.4%
FFO to net debt (alt)	9.4%	9.5%	9.6%	9.7%	9.7%	≥9%
RCF to net debt	7.2%	7.3%	7.6%	7.6%	7.5%	n/a
RCF to capex	111.1%	114.0%	134.2%	94.7%	109.9%	n/a

Tables 9.8 and 9.9 show our appointed business forecast AMP7 credit metrics for both the notional and actual companies. The tables include thresholds that we believe are appropriate for use in our debt financeability assessment, which have been taken from recent rating agency publications[7] for gearing, adjusted cash interest cover (alternative) and FFO to net debt (alternative) and internal calculations to adjust the rating agency published thresholds to reflect differences in financial ratio calculations between the rating agencies and the Ofwat financial model for FFO to net debt (adjusting the rating agency threshold for the absence of deduction of indexation from FFO) and for adjusted cash interest cover (adjusting the rating agency threshold for the absence of deduction of fast money from FFO). See supplementary S7003 for more details including detailed threshold calculations.

Our financeability constraint and the case for PAYG advancement

For the notional company, the key financeability constraint is both adjusted interest cover and FFO to debt. The key financeability constraint for the actual company is FFO to debt only. This is the case for both the Ofwat model version and the alternative versions of these ratios.

These constraints arise as the regulatory building blocks approach to the determination of revenue results in a revenue allowance that includes a real return on the RCV asset base with the inflation return being received as an RCV uplift. While the real return forms part of reported revenue reflected in the financial statements, the inflation return is not.

This creates a mismatch within the financial statements which reflect the real return on the RCV asset base in revenue but the full nominal cost of debt in interest expense. As a consequence this depresses the level of reported FFO, adversely impacting FFO based metrics, i.e. adjusted interest cover and FFO to debt ratio. This is principally a timing mismatch, as over a very long time period this effect should resolve.

This impact is exacerbated at PR19 due to the lower levels of real returns with the real cost of debt representing just 31% of the nominal cost compared to 47% at PR14, although the transition to 50% CPIH indexation offsets much of this impact.

As the issue relates to the level of reported FFO rather than the level of debt and is principally a timing issue, the most appropriate resolution to this issue should focus on supporting FFO while ensuring that the capital structure remains sustainable (as evidenced by the debt to RCV gearing). A worked example demonstrating that PAYG revenue advancement is the most appropriate financeability solution is available in supplementary S7003.

Therefore both adjusted interest cover and FFO to debt are the key financeability constraints for the notional company as they continue to be impacted by the timing mismatch of when real and inflationary returns are earned and associated costs incurred in the regulatory model, and have weakened further in AMP7 due to the reduction in the real cost of capital resulting in an even smaller proportion of returns being received through in-period revenues.

[7] "Regulated water utilities – UK: Regulator's proposals undermine the stability and predictability of the regulatory regime" – Moody's 2018 and "New Ofwat Regulations Will Keep U.K. Water Utilities On Their Toes" – S&P 2018

Financeability constraint 1: FFO to debt

Table 9.10: Debt financeability: Appointed business FFO to debt ratios pre & post PAYG advancement and revenue profiling (notional company)

Notional company	2020-21	2021-22	2022-23	2023-24	2024-25	BBB+ thresholds
FFO to net debt pre PAYG advancement and revenue re-profiling	9.7%	9.5%	9.7%	9.8%	9.8%	≥10.0%[8]
FFO to net debt post PAYG advancement and revenue re-profiling	10.2%	10.0%	10.0%	10.0%	10.0%	≥10.0%[8]
FFO to net debt (alternative) pre PAYG advancement and revenue re-profiling	8.8%	8.6%	8.8%	8.8%	8.8%	≥9.0%
FFO to net debt (alternative) post PAYG advancement and revenue re-profiling	9.3%	9.1%	9.1%	9.1%	9.0%	≥9.0%

As can be seen from table 9.10, for the notional company, without the PAYG advancement, both FFO to debt and FFO to debt (alternative) ratios are below the required thresholds of 10% and 9% respectively. Therefore the notional company would not achieve a BBB+ rating from S&P, likely being allocated a BBB flat rating, which we would not consider financeable. Additionally, a BBB rating from S&P would not be in line with Ofwat's rating assumptions used in setting the cost of debt component of the WACC guidance (which reflects a 50:50 average of the iBoxx non-financial A and BBB rated 10yr+ indices), being more than one notch lower.

In contrast, with PAYG advancement these ratios just hit 10% and 9% respectively and are therefore just financeable.

Further, in chapter 4 we set out the results of stress testing applied to our business plan, which shows that the 'combined common scenario' is the most detrimental scenario tested. As table 9.11 shows, without the benefit of the proposed £102m PAYG advancement, the resultant underperformance on FFO to debt (i.e. the persistent impact following the initial cost shock) would result in 8.2% and 7.2% for FFO to net debt and FFO to net debt (alternative) respectively for the AMP7 exit point with a downward trend, which corresponds to the required thresholds of 8% and 7% respectively for a BBB rating.

Table 9.11: Debt financeability: Appointed business FFO to debt ratios under the 'combined common scenario' pre & post PAYG advancement and revenue profiling (notional company)

Notional company	2020-21	2021-22	2022-23	2023-24	2024-25	BBB thresholds
FFO to net debt under the 'combined scenario' pre PAYG advancement and revenue re-profiling	9.30%	8.79%	8.60%	8.36%	8.17%	≥8.0%[8]
FFO to net debt under the 'combined scenario' post PAYG advancement and revenue re-profiling	9.83%	9.31%	8.93%	8.63%	8.40%	≥8.0%[8]
FFO to net debt (alternative) under the 'combined scenario' pre PAYG advancement and revenue re-profiling	8.39%	7.87%	7.66%	7.41%	7.21%	≥7.0%
FFO to net debt (alternative) under the 'combined scenario' post PAYG advancement and revenue re-profiling	8.92%	8.38%	7.97%	7.67%	7.42%	≥7.0%

This ratio output implies that the under the 'combined common scenario', our business plan AMP7 exit point would be taken to the precipice of the minimum investment grade credit rating, which has material impacts for the ongoing financial resilience and future cost of debt for the company. It would leave us extremely vulnerable to further downgrade, e.g. from the various external factors that also affect credit ratings.

It is also notable that the 'combined common scenario' does not include the impact of higher interest rates. However, this would be a natural consequence of a fall to a rating of BBB, which we estimate would increase the cost of new debt raised by c0.2% in benign market conditions to over c1.0% in adverse market conditions. This would push the 'combined

[8] See supplementary document S7003 for the calculation of this threshold.

scenario' FFO to net debt and FFO to net debt alternative ratios below the 8% and 7% BBB thresholds respectively and into the minimum investment grade credit rating of BBB-, which would be materially divergent from the credit rating implied by Ofwat's WACC guidance.

For these reasons we consider it necessary to advance PAYG by at least £102m, to ensure that both a) the notional company is financeable on a similar credit rating basis as that implied by Ofwat's WACC guidance, and that b) there is sufficient headroom in the notional company to avoid falling into the lowest investment grade credit ratings category.

It is also important to note that S&P are only one of the three rating agencies not (yet) to have tightened its financial indicator thresholds which apply to credit ratings for the UK water sector. This serves to cast further doubt as to the financial resilience of the notional company, unless some additional revenue is advanced, such as via PAYG advancement as we propose in our plan.

Therefore overall, with the c£102m PAYG acceleration, the notional company should just meet the relevant thresholds to achieve a BBB+ rating with S&P.

For the actual company the FFO to debt ratios are supported by the actual company's low embedded cost of debt and therefore results in a modest amount of headroom above the notional company's FFO to debt ratios. Given the c£102m PAYG acceleration needed for the notional company financeability, the actual company shows a limited but essential amount of headroom above the FFO to debt BBB+ threshold. Therefore we assess that the actual company will achieve a BBB+ rating with S&P.

Financeability constraint 2: Adjusted interest cover

Ideally we would have targeted an A3/BBB+ rating for both the notional and actual companies, however, the adjusted interest cover ratio in the notional company is relatively low being towards the bottom threshold for a Baa1 rating. However, as the adjusted interest cover ratio effectively just compares the ratio of the real cost of capital earned to cash interest (see supplementary S7003 for more details) and removes the impact of PAYG advancement, for the notional company with no outperformance and set index-linked debt assumptions there are no available means of improving this ratio.

For the notional company, both the adjusted interest cover and adjusted interest cover (alternative) ratios just hit the required thresholds for a Baa1 rating of 1.79% and 1.59% respectively and we assess that the notional company should be able to achieve a Baa1 rating from Moody's and is therefore just financeable.

The actual company benefits from a low embedded cost of debt and a higher proportion of index-linked debt that is treated favourably by the adjusted interest cover ratio, and therefore the actual company has more headroom in these ratios with adjusted interest cover and adjusted interest cover (alternative) being above the required thresholds of 1.84x and 1.7x for an A3 rating respectively. Therefore we assess that the actual company would achieve an A3 rating with Moody's.

If we deliver our plan effectively, meeting our efficiency challenges, then overall we should achieve Baa1/BBB+ and A3/BBB+ ratings for the notional and actual companies respectively, which we consider to be financeable. In setting financeability at such a tight margin, particularly for the notional company, we have assessed that our proposal results in the lowest achievable customer bill impact whilst being sufficient to maintain a financeable plan (albeit with limited headroom) although it puts greater pressure on the appointed business to deliver outperformance.

Any deterioration in the above metrics would seriously risk a Baa2/BBB flat rating. We do not consider a Baa2/BBB flat rating to be appropriate for water companies with significant and on-going debt financing requirements as it would not afford as robust access to financing or as efficient financing costs as a BBB+ rating. S7003 includes additional evidence of this.

9.6.4 Maintaining a healthy level of public equity investment

A fair and balanced business plan should provide a fair return to equity investors, taking account of the risks they face. To ensure that we can retain and attract sufficient equity investment to finance our plan and that debt investors can be confident that there will be a functioning equity 'buffer', we need to ensure that the appointed business can earn a sufficient return and that the returns we pay out to our equity investors are sustainable.

Whilst we do not anticipate large injections of equity finance in our business plan, it remains important that equity investors are adequately remunerated. Delivering sufficient and sustainable equity returns is essential to maintaining the confidence of equity investors in a world where capital is easily re-deployed. At times during 2018, listed water companies have traded at a discount to RCV and a harsh cost of equity settlement could increase the risk that equity investors may lose confidence in the sector and withdraw support. Credit investors rely on a well-functioning equity buffer and may not be happy lending to the sector in such a scenario. Therefore, an adequate cost of equity is important for all providers of finance. Tables 9.12 and 9.13 show the key equity financeability ratios for the appointed business (both notional and actual companies) over AMP7:

Table 9:12 Equity financeability: Appointed business financial metrics (notional company) AMP7 average, RPI/CPIH blended rate

	2020-21	2021-22	2022-23	2023-24	2024-25	AMP7 ave
Return on capital employed (building blocks)	3.0%	3.0%	2.9%	2.9%	2.9%	2.9%
RORE	4.5%	4.6%	4.6%	4.6%	4.7%	4.6%
Appointed business dividend cover	0.9	1.0	0.9	1.0	1.0	1.0

Table 9.13: Equity financeability: Appointed business financial metrics (actual company) AMP7 average, RPI/CPIH blended rate

	2020-21	2021-22	2022-23	2023-24	2024-25	AMP7 ave
Return on capital employed (building blocks)	3.0%	3.0%	2.9%	2.9%	2.9%	2.9%
RORE	4.6%	4.6%	4.6%	4.6%	4.6%	4.6%
RORE – UUW proposed including financing outperformance	5.3%	5.6%	5.7%	5.6%	5.6%	5.6%
Appointed business dividend cover	1.2	1.2	1.2	1.2	1.3	1.2

The average building block ROCE over AMP7 is expected to be 2.9% for both the actual and notional company respectively. This shows that if our plan is efficiently delivered, the business should earn returns just over the vanilla wholesale WACC of 2.85% (RPI/CPIH blend real) at the appointed business level. This WACC sits in, but towards the bottom of, the WACC range that our advisors EY deem to be appropriate for the sector over AMP7 (see 9.4.2 for more details) and therefore should be considered acceptable to our equity investors.

The average RORE over AMP7 is modelled to be 4.6% for both the actual and notional company respectively. As shown in section 9.7, our RORE modelling anticipates a symmetrical risk distribution around the base return and therefore our expected return is in line with our base case financials. This shows that if our plan is efficiently delivered, the appointed business should earn returns around the allowed cost of equity at the appointed business level. Whilst this cost of equity sits below the cost of equity range that our advisors EY deem to be appropriate for the sector over AMP7 (see section 9.4.2 for more details), this should be strengthened by embedded financing outperformance resulting from the low cost of embedded debt in the actual company (as shown by the 5.6% RORE including financing outperformance) and for both the actual and notional companies the cost of debt included in the WACC being above the minimum deemed appropriate for the sector by EY, which will flow to equity returns as financing outperformance along with any other outperformance achieved under the regulatory model (not included in the above numbers). Therefore this ‘strengthened’ cost of equity should be considered acceptable ‘in the round’ to our equity investors

The ability of the appointed business to earn the assumed returns above is contingent on the successful delivery of our plan. Our plan includes stretching cost and performance targets, which, if we fail to deliver in full, will reduce the underlying return earned.

Dividend cover is an important measure of sustainability of the equity return, and equity investors will start to have concerns if dividend cover consistently drops below 1.0 times cover, with trend being an important factor. Dividend cover is expected to be 1.2x and 1.0x on average for the actual and notional company respectively. Therefore these dividend covers should just about be considered acceptable by equity investors.

Overall we assess the notional and actual companies to be financeable to equity investors.

9.6.5 Ensuring each price control can individually fund its operations

We have performed the bulk of the financeability testing at the appointed business level, as providers of finance will primarily be concerned with the sufficiency and sustainability of financial metrics at that level. However, we have also performed high-level headroom checks at the individual price control level.

We note that performing a full financeability assessment of the individual price controls would be extremely challenging. This is because, amongst other reasons, it is not immediately apparent how existing appointed debt should be allocated across the price controls nor what level of gearing would be appropriate for each price control with differing risks and attributes. Therefore as a full financeability assessment is not feasible, any headroom check will be very approximate in nature and should not be considered as robust an assessment as that conducted for the appointed business.

In particular, our headroom check is based on information available within the Ofwat financial model, which means that for the purposes of this headroom check only, we have adopted Ofwat's assumption in the financial model that the appointed debt is allocated to each price control in proportion to the RCV. We note that for a full robust financeability assessment this would not necessarily be an appropriate assumption.

As there is no independent guidance on how to assess the financeability of the individual price controls, we have followed Ofwat's proposals set out in the final methodology. Therefore we have considered whether the wholesale price controls *"support financial ratios at a level equivalent to an investment grade credit rating"* in line with the PR19 methodology. In the final methodology Ofwat states that it does not *"necessarily expect each control to have the same level of financial headroom"*, which we have interpreted to mean that Ofwat will test the financial ratios against thresholds that are set one notch worse than the level required for the appointed company. Therefore we have compared the financial ratio output to financial ratio thresholds for a Baa2/BBB flat rated water company.

Our high level check looks just at the key financeability constraint, which is FFO to debt for both the actual and notional company. We have interpreted Ofwat's methodology that as these are not separate businesses the financial ratio output should be tested against a lower level of financial headroom, as long as the appointed business retains sufficient headroom (as has been confirmed above). Therefore we have used an FFO to debt threshold equating to a BBB flat rating, being FFO to debt of 7%, refer to supplementary S7003 for further details.

As the retail business has no RCV and therefore the Ofwat financial model allocates no debt to that price control, the usual financial ratios are not available and we have interpreted Ofwat's proposal of checking *"each control can generate sufficient cash flow to service its working capital needs"* as simply checking that net cash flow is expected to be positive on average over AMP7.

Table 9.14: Individual price control financeability: FFO to debt and net cash flow (notional company)

	Water resources	Water network	Wastewater network	Bioresources	Residential retail
AMP7 average FFO to debt (alt)	7.2%	9.9%	7.7%	17.5%	n/a
AMP7 average net cash flow	n/a	n/a	n/a	n/a	£14.4m

Table 9.15: Individual price control financeability: FFO to debt and net cash flow (actual company)

	Water resources	Water network	Wastewater network	Bioresources	Residential retail
AMP7 average FFO to debt (alt)	8.2%	10.5%	8.1%	18.3%	n/a
AMP7 average net cash flow	n/a	n/a	n/a	n/a	£13.1m

Overall whilst there is variation between each price control, as both the actual and notional company FFO to debt (alternative) ratio exceeds 7% on average for each price control, we assess that each individual wholesale price control would likely support financial ratios at a level equivalent to a rating of BBB and therefore is sufficiently financeable as part of the appointed business.

As the residential retail individual price control is expected to demonstrate positive cash flow, we assess that it is sufficiently financeable as part of the appointed business.

9.7 Our assessment of risk and RORE ranges

We have an established, mature and robust risk management framework in place that has been assessed as being best practice as set out in chapter 4 section 4.5.4. In this section we look to provide a clear understanding and assessment of the potential risks we face in delivering our business plan, including the effect of the risk management measures we will have in place, across each of the price controls. In performing this assessment we have prepared RORE ranges using the relevant scenarios from data table App26.

9.7.1 Assessment of risk by price control

Our analysis below has been prepared to provide the upside and downside scenarios. The high case (P10) and low case (P90) scenarios have been calculated in line with Ofwat's final methodology and as such, are before the impact of the regulatory mechanisms consistent with data table App26[9]. Our estimates have been made using a combination of historical and forward looking evidence or management judgements where appropriate.

Operational performance

The key risks we face in delivering our base case operational business plan are as follows:

- **Success of our plans to deliver stretching AMP7 efficiencies and performance targets** – this is underpinned by the success of our various innovations and new ways of doing things, more details of which are included in chapter 7
- **Principal risks facing our operations** – as identified and managed through our risk management framework, there is a comprehensive range of risks we actively monitor and look to mitigate, which impact on our service delivery, more details of which are included in chapter4 section 4.5.

Table 9.16: Totex (including Residential retail) RORE range for the notional company by price control

RORE scenarios (AMP7 total 2017/18 prices)	High case (£m)		Base case (£m)	Low case (£m)	
Water network plus	3.7%	248.8	2,073.8	-3.7%	-248.8
Water resources	6.0%	64.1	374.4	-7.2%	-77.0
Wastewater network plus	2.3%	314.1	2,613.2	-2.3%	-314.1
Bioresources	12.8%	110.5	372.5	-12.8%	-110.5
Residential retail	-	75.0	489.6	-	-75.0
Appointee	**3.7%**	**812.5**	**5,923.5**	**-3.7%**	**-825.3**

Table 9.17: ODI RORE range for the notional company by price control

RORE scenarios (AMP7 total 2017/18 prices)	High case (£m)		Base case (£m)	Low case (£m)	
Water network plus	2.3%	157.1	0	-2.0%	-135.7
Water resources	2.3%	24.8	0	-2.2%	-23.7
Wastewater network plus	1.5%	200.3	0	-1.6%	-211.6
Bioresources	0.9%	8.1	0	-1.4%	-12.4
Residential retail	-	26.2	0	-	-26.7
Appointee	**1.9%**	**416.4**	**0**	**-1.8%**	**-410.1**

Table 9.18: C-MeX RORE range for the notional company by price control

RORE scenarios (AMP7 total 2017/18 prices)	High case (£m)		Base case (£m)	Low case (£m)	
Residential retail	0.3%	61.7	0	-0.3%	-61.7

[9] Includes the impact of the debt indexation mechanism per the guidance in data table App26

Table 9.19: D-MeX RORE range for the notional company by price control

RORE scenarios (AMP7 total 2017/18 prices)	High case (£m)		Base case (£m)	Low case (£m)	
Water network plus	0.0%	1.7	0	-0.0%	-2.3
Wastewater network plus	0.0%	1.8	0	-0.0%	-3.7
Appointee	**0.0%**	**3.0**	**0**	**-0.0%**	**-6.0**

Financing

Table 9.20: Financing RORE range for the notional company by price control

RORE scenarios (AMP7 total 2017/18 prices)	High case (£m)		Base case (£m)	Low case (£m)	
Water network plus	0.1%	9.4	479.5	-0.1%	-9.4
Water resources	0.1%	1.5	75.7	-0.1%	-1.5
Wastewater network plus	0.1%	18.9	963.9	-0.1%	-18.9
Bioresources	0.1%	1.2	62.1	-0.1%	-1.2
Appointee	0.1%	31.0	1,581.1	-0.1%	-31.0

The key risk we face in delivering against the financing costs within our business plan is in relation to new debt and our potential performance against the indexation mechanism. The key assumption we have made in preparing this risk analysis is to ignore the impact of inflation on embedded debt consistent with the final PR19 methodology. For more commentary and information on the assumptions we have made in our "high case" and "low case" scenarios see the commentary to data table App26.

9.7.2 Assessment of RORE ranges

In this section we present our RORE range and a range for each individual price control, based upon the information set out in section 9.7.1 and overlaying the impact of the various regulatory mechanisms. In relation to the totex sharing mechanism, we have assumed a 50:50 allocation between customer and investors, consistent with Ofwat's base case assumption.

RORE range – notional and actual company

We present our RORE range for the actual and notional company, which is broadly in line with the indicative range presented in the final PR19 methodology. We consider our base plan to be very stretching as delivering this will be dependent upon the successful realisation of cost savings identified by our MEM process (see chapter 6 section 6.4), and achievement of efficiencies and service improvements from our innovation culture (see chapters 6 section 6.3).

To help demonstrate the level of stretch in our business plan, we have calculated what RORE would result from assuming an AMP6 exit level of performance against our AMP7 business plan proposals — i.e. assuming no improvement in performance in AMP7 and our AMP6 costs. This is shown by the 'AMP6' lines in figure 9.1. Based upon these calculations, we would earn a 2.3% RORE in the notional company, requiring an additional 2.2% RORE to be earned through delivering improvements in AMP7, to achieve the 4.5% base RORE. On an actual company basis, we would earn a 3.2% RORE, requiring an additional 1.3% RORE to be earned through delivering improvements in AMP7, to achieve the notional 4.5% base RORE.

The other points to note from figure 9.1 are:

- The RORE range of the notional company is +0.4% to +8.6%, which is broadly in line with the -0.3% to +9.4% indicative range presented in the final PR19 methodology[10]
- The 5.5% base return in the actual company and +1.0% to +10.0% RORE range, is higher than the notional company, largely due to financing outperformance on embedded debt. The 5.5% actual base return is broadly in line with the mid-point on EY's cost of equity range (5.6%) and principally due to this additional headroom in the actual company, we are able to accept Ofwat's notional company WACC. See section 9.4.2 for more information on our acceptance of Ofwat's WACC guidance

[10] We have assumed +/-0.3% of financing out/underperformance in the Ofwat indicative RORE range, presented in the final PR19 methodology.

- The notional company RORE range +0.4% to +8.6% is broader and more symmetrical than our PR14 range +1.6% to +7.8%; with a 90bps lower base return and more of the return linked to performance, this represents a stretching plan with a greater alignment of risks and returns between customers and investors
- The -1.8% to +1.9% ODI range on the notional company reflects a total incentive range over five years of £410m penalty to £416m reward. This range is wider and more symmetrical than was the case at PR14 and demonstrates that service performance is a key focus of our risk and return package
- The -1.9% to +1.8% totex range on the notional company represents approximately a 10% totex under- and over-performance in line with the final PR19 methodology. This range is slightly lower than the +/-2% totex range presented in the final PR19 methodology, as a result of our relatively high RCV to totex ratio

Our advisors EY have independently assessed that our base case RORE and range are within an appropriate range required by investors (see supporting EY letter T7001.)

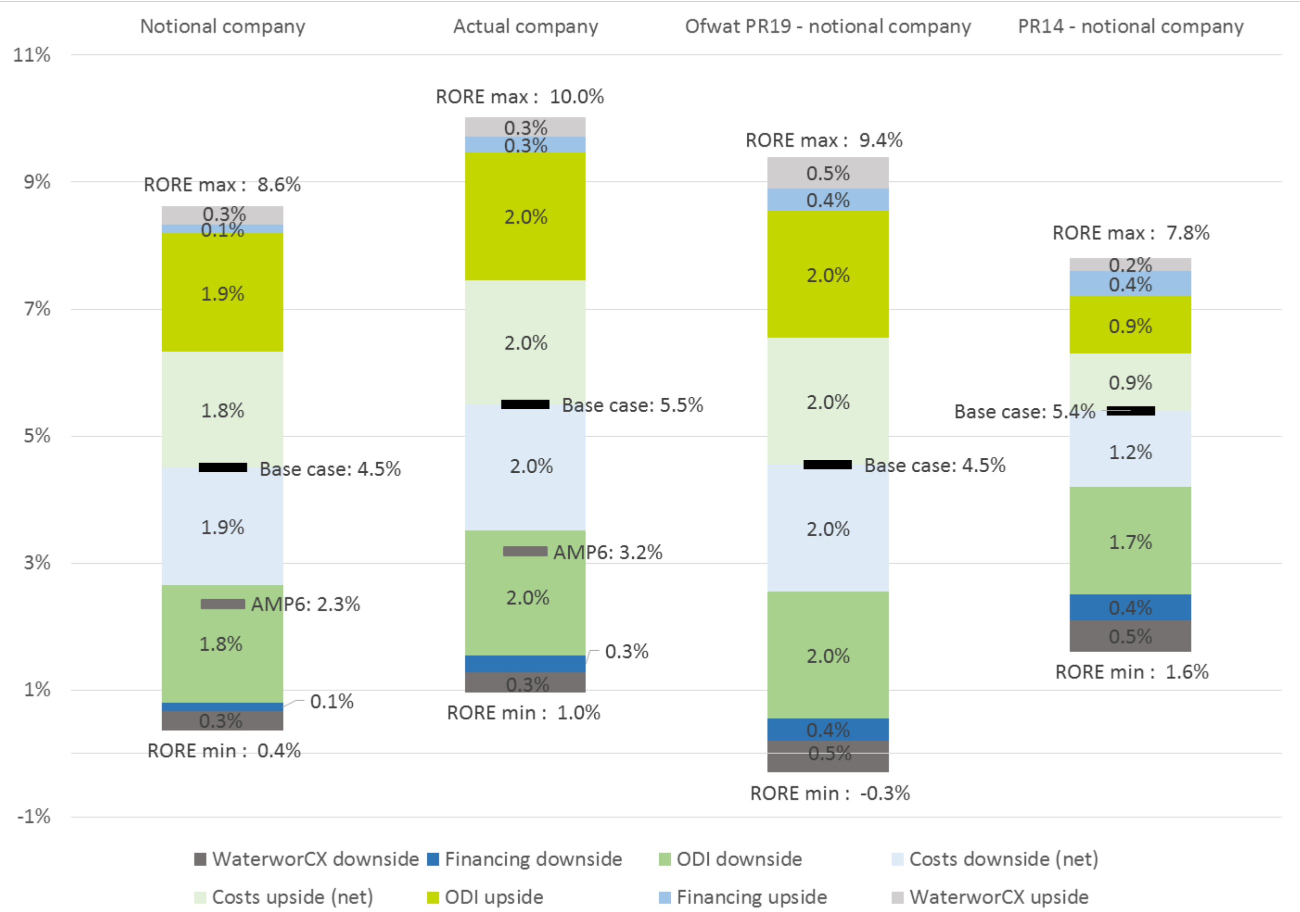
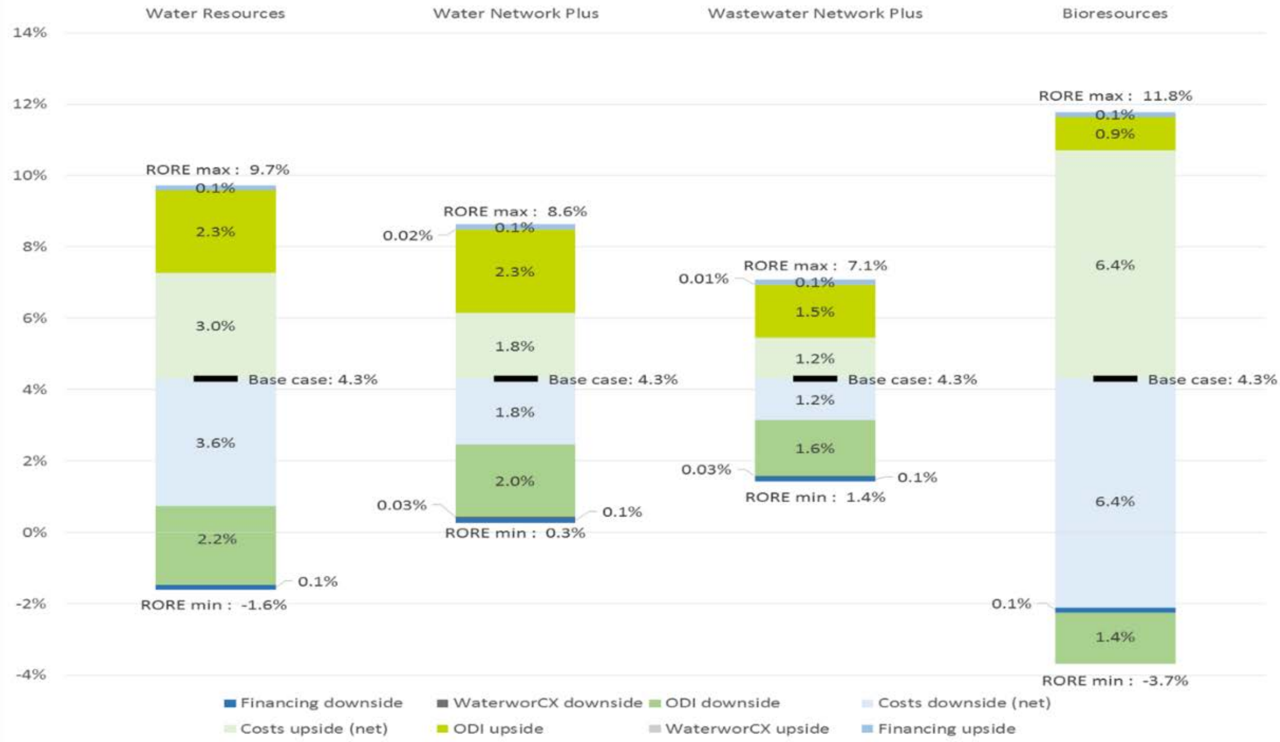


Figure 9.1: AMP7 RORE range (RPI/CPIH Blend) for both notional and actual company

Note: The base case RORE represents the opening AMP7 RPI/CPIH blended rate and excludes pension interest receivable included within the RORE calculated by the Ofwat financial model. In addition, we do not include water trading in our indicative RORE range as we do not plan to enter into any water trading during AMP7. The chart has been prepared based on our RORE model, as the Ofwat model was not calculating a totex range.

RORE range – individual price control, notional company basis

Figure 9.2: AMP7 RORE range (RPI/CPIH Blend) by price control, notional company



The RORE ranges by price control shows a lower range for Wastewater Network+ price control compared with other wholesale controls. This reflects the much larger RCV (and hence larger regulated equity) of Wastewater Network – it is about twice the size of Water Network+. However, as can be seen in table 9.16 and table 9.17, the total £m size of the high and low cases are larger for wastewater than water, and (given that we have similar numbers of water and wastewater customers) the customer bill impact of the wastewater range is higher than that of Water, despite having a lesser RORE range.

The Bioresources price control has a relatively large totex range mainly due to its relatively low regulated equity and the impact we expect competition to have on its value chain.

As Residential Retail does not have its own RCV (and hence no regulated equity) it is not separately shown in Figure 9.2, but is included within the overall appointee RORE shown in Figure 9.1.

9.7.3 How much bill volatility could there be for customers?

The average residential customer bill outlined in table 9.21 reflects what we expect our base performance to be in AMP7. Our business plan assumes that, overall, we achieve a net break-even position on ODI outperformance and underperformance payments. If our performance differs from this, customer bills could be different subject to the extent of any rewards or penalties. Using both Ofwat's guidance in this area and risk modelling, we have assessed what the high and low range of such bills could be across AMP7.

The average residential customer bill has been calculated using the high and low case scenarios presented in data table App26 and summarised in section 9.7.1. As such, the average bill modelled scenario for each year incorporates ODI and totex performance relating to that year where, in reality, performance on ODIs would only impact bills from FY2022-23 onwards in relation to the in-period ODIs and totex performance would only impact bills in AMP8.

Bill volatility in the later years of AMP7 through the application of in-period ODI outperformance and underperformance cannot be pre-determined and therefore cannot be smoothed in advance. As part of the development of our ODI package we have also reviewed the potential for the range to exceed the high and low scenarios, and even on extreme assumptions we consider that performance will not exceed +/-3% RORE. Acceptability testing showed that bills set at a level equivalent to incorporating 3% RORE outperformance would be acceptable to the majority of customers. If outperformance were to exceed 3%, we would consult customers to get current views on whether we should continue to drive forward performance, at the potential cost of increased bills.

Table 9.21: Customer bill range across AMP 7, real terms (17/18 prices)

High case (£)	2020-21	2021-22	2022-23	2023-24	2024-25
Average residential bill – base case	393.92	391.96	386.19	382.74	382.33
Average residential bill – ODI impact	11.39	12.93	23.28	17.69	35.07
Average residential bill – Other APP26 impact	41.12	41.80	41.38	46.92	47.65
Average residential bill – high case	446.43	446.70	450.84	447.36	465.05

Low case (£)	2020-21	2021-22	2022-23	2023-24	2024-25
Average residential bill – base case	393.92	391.96	386.19	382.74	382.33
Average residential bill – ODI impact	-21.40	-13.99	-14.79	-15.09	-33.58
Average residential bill – Other APP26 impact	-42.92	-44.62	-45.52	-51.07	-48.73
Average residential bill – low case	329.60	333.35	325.88	316.58	300.03

The average bill includes 52 pence related to the recovery from customers of the Competitively Appointed Provider (CAP) payments in 2024/25, following the proposed DPC Manchester & Pennines Resilience Project.

Bills can also vary in AMP7 due to volume differences such as the number of customers and their service usage, production volumes in Bioresources, and other factors. Regulatory mechanisms incentivise us to forecast volumes accurately and minimise unforeseen bill volatility through these effects. However, such differences do ultimately feed through to customer bills and ultimately arise from factors which are beyond our control and cannot be determined in advance.

We therefore need to consider how to deal with this uncertainty. There is a balance to be struck between – on the one hand – ensuring that changes in service performance are more promptly reflected in bills, as is implied by applying in-period ODIs – with the need to avoid bill volatility which customers would prefer to avoid (see chapter 3 section 3.4). A similar balance is reflected in Ofwat's charging guidance which requires companies to balance cost reflectivity, incidence effects and stability when setting charges.

We will continue to apply Ofwat's charging guidance when setting charges so that incidence effects and stability are important considerations in setting charges. Where bill volatility appears to be particularly high, such that it cannot be managed through the charges setting process we will consider making applications to Ofwat as part of the annual reconciliation process if there needs to be NPV neutral deferral of changes in revenue. We note that this process has been applied for some companies which already have in-period ODIs and believe that, exercised responsibly, it can work well.

The degree of deferral that might be appropriate is substantially determined by the broader circumstances at the time – for example, what other upward or downward pressures might already be applied to bills – and also what forecasts exist for the same factors in the future. Given the overall uncertainty in this area, we have not assumed that there is any asymmetric impact, that any deferral would be NPV neutral over the long term. In the event that deferral of revenue were required, then we consider that the company has sufficient financing headroom to be able to manage temporary deferral of revenue on an NPV neutral basis.

9.8 Managing the downside risk

In delivering our AMP7 plan, the downside risk represents those severe scenarios in which events prevent us from delivering our commitments and results in a lower RORE. In section 9.7 we quantify this downside risk in financial terms by representing a low case (P90) position. The downside risk also stretches beyond this low case position, although we consider this scenario to be extreme and fortunately unlikely.

In this section we cover the main ways in which we will manage the downside risk to ensure that customers and investors are best protected. In considering these options it is worth bearing in mind our past performance of effectively managing through extreme scenarios through our high levels of resilience (see chapter 4, section 4.7), whilst generally meeting our commitments to customers and providing investors with at least a base return, and achieving this without resorting to many of the extreme mitigations available to us, described below.

The key means of managing downside risk are as follows:

- **Risk management framework** – as discussed in section 9.7, this well-established and best-practice process ensures we have a comprehensive understanding of the risks we face, that these are monitored and we have adequate and effective mitigations in place to reduce the likelihood and impact of these risks taking place.
- **Alignment of pay with delivery for customers** – covered in section 9.11, our remuneration arrangements provide strong incentives on employees and executive directors to effectively manage the downside risks in the best long term interests of customers.
- **Regulatory mechanisms** – there are various mechanisms in place to help manage the downside risks and influence the extent to which these impact customers and investors.
- **Financial resilience** – our frontier levels of financial resilience, means we have the ability to effectively absorb and respond to extreme events providing further protection to customers.

Regulatory mechanisms

The various cost sharing mechanisms provided through the regulatory model are very effective at enabling us to manage downside risks. For example, the totex sharing model allows us to share certain costs between customers and investors and provides the means of funding additional investment during the AMP where it is cost beneficial to improve resilience or deliver a better service to customers. During AMP6, we reinvested £250m of outperformance through this mechanism to improve resilience for customers and in so doing, reducing downside risks in the future.

In more extreme circumstances, water company licences allow the reopening of price limits in certain limited circumstances subject to a materiality threshold. There are two types of interim determination, one of which is a 'Standard interim determination'. If, at the time of the price determination, uncertainty exists over the occurrence or impact of an event such that it is not included in the final determination, companies can raise these as notified items subject to Ofwat approval. We have not raised any notified items within our business plan submission.

The expectation is that our Manchester & Pennines Resilience project will be delivered by a third-party Competitively Appointed Provider (CAP), however, if this was not possible (for whatever reason) we expect that the project would fall back within the remit of our Water Network+ business. [✂] [✂]in AMP7 the costs incurred would be applied as a (NPV adjusted) midnight adjustment to its opening AMP8 RCV, and that this is set out in an appropriate licence amendment (see S5007 and S5007a for more details of this project).

We have incorporated this scenario as part of our financial resilience assessment, see Financial resilience assessment S4006 and have demonstrated we have the financial resilience to pre-fund this project in AMP7 assuming we receive the assurance we detail above. [✂] [✂], we are confident that we would be able to maintain an investment grade credit rating, before implementing mitigating actions to improve our credit ratings.

Financial resilience

We are the frontier company in the industry in terms of financial resilience as evidenced in chapter 4, section 4.7. What this means is that in the unfortunate event that things go wrong, despite all the mitigations we have in place, we have the ability to effectively absorb and respond to such events, and in so doing, ensure customers are best protected.

As part of our business plan submission, the Board has provided a high quality 7 year viability statement, which provides confidence in our ability to remain viable over at least this period, having modelled a number stress scenarios.

As part of this testing we have stress tested the worst severe but plausible risk scenarios facing our organisation as captured by our well-established, best practice risk management framework. In all scenarios, we were able to demonstrate our capacity to absorb these risks whilst maintaining an investment credit grade and without resorting to mitigating actions.

In addition, we also stress tested the Ofwat common scenarios, which represent a number of extreme downside events. Again, we were able to demonstrate our capacity to absorb these risks whilst maintaining an investment credit grade.

In the event that we did need to take mitigating actions to support the viability of the company, we have some significant mitigations at our disposal. As a consequence of having the largest equity base in the industry (equity portion of the RCV), dividends across the viability period represent c16% of the RCV, providing substantial headroom to improve our capital strength and credit ratings and/or allow the company to absorb more extreme downside scenarios. See chapter 4, section 4.7 for more information on the financial resilience assessment we performed on our business plan.

9.9 Balancing upside risks: benefit sharing, dividend and gearing policies

In this section we cover the main ways in which we will manage the upside risk to ensure that customers are adequately protected and in the event that we significantly outperform our service commitments there is an appropriate sharing of benefits between customer and investors. In considering these options, it is worth bearing in mind our past performance of acting responsibly in sharing outperformance with customers, paying sustainable dividends and maintaining a responsible long term approach to financial stewardship.

In section 9.7 we quantify this upside risk (excluding the impact of inflation) in financial terms by representing a high case scenario position. The upside risk also stretches beyond this high case position, although we consider this scenario to be unlikely given our very challenging business plan.

9.9.1 Track record of fair financing

We not only embody resilience in our approach to financing: we also seek to demonstrate fairness to customers. As a responsibly financed company, we have eschewed opportunities to undertake financial engineering which would have exposed customers to high levels of gearing or which would have led to excessive dividend payments. These decisions have sacrificed short term opportunities to profit from financial engineering in favour of a responsible long term approach to financial stewardship. Where there has been outperformance of the regulatory contract then the benefits of this have been shared between investors and customers to a greater extent than required by the regulatory contract – this is because we have taken a broader view based on the long term social contract.

- **Gearing:** During AMP5 and AMP6 UUW has targeted gearing in the 55%-65% range, with a central target of 60%. This is consistent with Ofwat's notional company assumption of 60% at PR09 and PR19, and was below Ofwat's notional company assumption of 62.5% at PR14. In AMP7 we will continue to target this range and our projection is to end 2025 with gearing of approximately 60%
- **Dividends:** Across AMP6 UUW has continued the dividend policy which commenced during AMP5, which was to pay a base dividend of 5% of the equity portion of the RCV. Payments above that level are only made where there is demonstrable outperformance
- **Benefit Sharing:** Across AMP5 and AMP6, UUW has voluntarily committed over £500m of reinvestment for the benefit of services to customers and the environment. In doing so, the company chose to reinvest for the long term, rather than paying additional dividends, building confidence that investors were taking a long term view of investing in the region. In section 9.10 we set out how our proposed approach to benefit sharing in AMP7 interacts with the voluntary approach to reinvestment we have adopted in the past

9.9.2 Enhancing our responsible approach to gearing, dividends and benefit sharing in AMP7

We are providing a comprehensive approach to gearing, dividends and benefit sharing in AMP7 which builds on a track record of paying a reasonable and sustainable dividend, maintaining gearing in line with Ofwat's notional company and voluntary reinvestment of outperformance in AMP5 and AMP6.

The key principles of our approach for AMP7 are that, at normal levels of gearing (60-70% Net Debt/RCV):

- We are committing £71m dedicated to financial assistance schemes over AMP7, funded entirely by the company. The contributions to these schemes will be made each year, before consideration of any dividend payment.
- We expect to pay a base dividend equal to 70% of nominal allowed equity returns (5% for AMP7). This is in line with the Ofwat IAP test.
- We may pay a further distribution by way of dividends of up to 2% of RORE. This may reflect current or past outperformance (usually gained through significant cost savings, strong ODI performance, financial outperformance or a combination of these)
- Distributions in excess of this amount will be matched 1:1 with customer benefits through discounted bills, targeted financial assistance or funding of community projects through CommUnity Share.
- This is in addition to any reinvestment which may be made on a voluntary basis through the normal regulatory mechanisms, as seen in AMP5 and AMP6.

Distributions may vary from this outline approach:

- to manage high (>70%) or low (<60%) gearing back into the normal range;
- in the event of the company delivering poor performance or materially failing statutory obligations;
- in the event truly exceptional or unforeseen circumstances cause the Board to change this approach; or,
- if payment of a dividend would seriously detriment financial resilience for stakeholders including customers and employees

High gearing scenarios

If gearing were to rise above 70%, we will share half the financial benefits of high gearing with customers through contributions to CommUnity Share. This approach is consistent with Ofwat's "Putting the sector in balance" approach and will apply with no glidepath. At this level of gearing the Board will not pay any dividend above the base level of dividend. It will also give explicit consideration to reducing the dividend to help reduce gearing. If the company were to continue to pay a base dividend which left gearing above 70% then the Board would explain to customers and other stakeholders why it considered this was appropriate and what the company's plan was to restore gearing to below 70%.

Low gearing scenarios

If gearing were to fall below 60%, then the base dividend could increase to the greater of 100% of nominal allowed equity returns (7.1% for AMP7) or profit after tax. This approach applies only until gearing returns to 60% and is designed to allow the company to manage its gearing profile and align to the notional company structure without facing penalties for doing so.

Impact of performance on dividends

Where the company considers paying outperformance dividends, then these would not be paid in circumstances where the company was known to be in material breach of statutory obligations. Furthermore, any payment of outperformance dividends in excess of the equivalent of 2% of RORE would not be made where the company was materially failing to meet its performance targets unless the dividend was accompanied by investment aimed at improving that position.

Other safeguards

The Board will explain its dividend policy every year. The overarching aim is to embed a clear commitment to responsible financing and benefit sharing and build trust and confidence in our treatment of stakeholders. We expect our decisions on dividends to be judged on that basis.

Benefit sharing

Details of our CommUnity Share approach are included in section 9.10. The £71m of funding for financial assistance schemes is guaranteed, before consideration of any dividend. Under the proposals set out above, additional contributions may also arise where gearing or dividend distributions are much higher than expected. This additional sharing rate should be seen as incremental to existing approaches to benefit sharing such as the voluntary reinvestment of £250m in each of AMP5 and AMP6.

Modelling our AMP7 policy based on our AMP6 performance

We have modelled for illustrative purposes the impact of applying the AMP7 policy in relation to our AMP6 performance, assuming that instead of the £250m of totex reinvestment in resilience initiatives we made in AMP6 the Board chose to distribute £250m as dividends to shareholders. Under this scenario our modelling shows that our AMP7 dividend policy would share c£220m with customers through the CommUnity Share.

We have set out further details of our comprehensive approach to gearing, dividends and benefit sharing in AMP7, including this modelled approach, in supplementary document S7006.

9.10 CommUnity Share: additional support and benefit sharing for customers

Overview

CommUnity Share is a new commitment where, as well as a guaranteed level of base funding, we will provide matching financial benefits for customers and communities in the North West if our dividends or gearing rise above thresholds that are significantly higher than forecast in our stretching business plan for 2020-2025. It builds on our track record of reinvesting outperformance – between 2010 and 2020 we will have invested over £500m of outperformance to improve services and benefit the environment.

The scheme provides three key sources of benefit to customers. Firstly, it gives a guaranteed level of core funding for financial support schemes for customers. Secondly, it provides a means of sharing financial benefits with customers if our gearing levels are much higher than expected in our plan. Thirdly, it offers a way to share benefits with customers if we pay dividends above the base dividend which are in excess of 2% of RORE.

Some important principles underpin the commitment we are making:

- all spend related to this initiative is outside regulatory mechanisms and any bill reduction or financial support would not be rebalanced onto customers;
- additional funding provided for community schemes of any sort would not displace spending that would otherwise have been made by the company in the normal course of business;
- customers see a benefit over and above what would normally have been expected so that they share in outperformance; and
- decisions on how funding is applied will be made in consultation with customers and stakeholders, overseen by the YourVoice CCG.

Together, these steps will ensure customers are protected in the event that significant outperformance is distributed as dividends, and/or gearing is elevated to high levels. CommUnity Share is in addition to other sharing that is already embedded in the AMP7 regulatory mechanisms or other voluntary reinvestment decisions we may take.

How CommUnity Share can benefit customers

The initiative is made up of three elements, set out in figure 9.3.

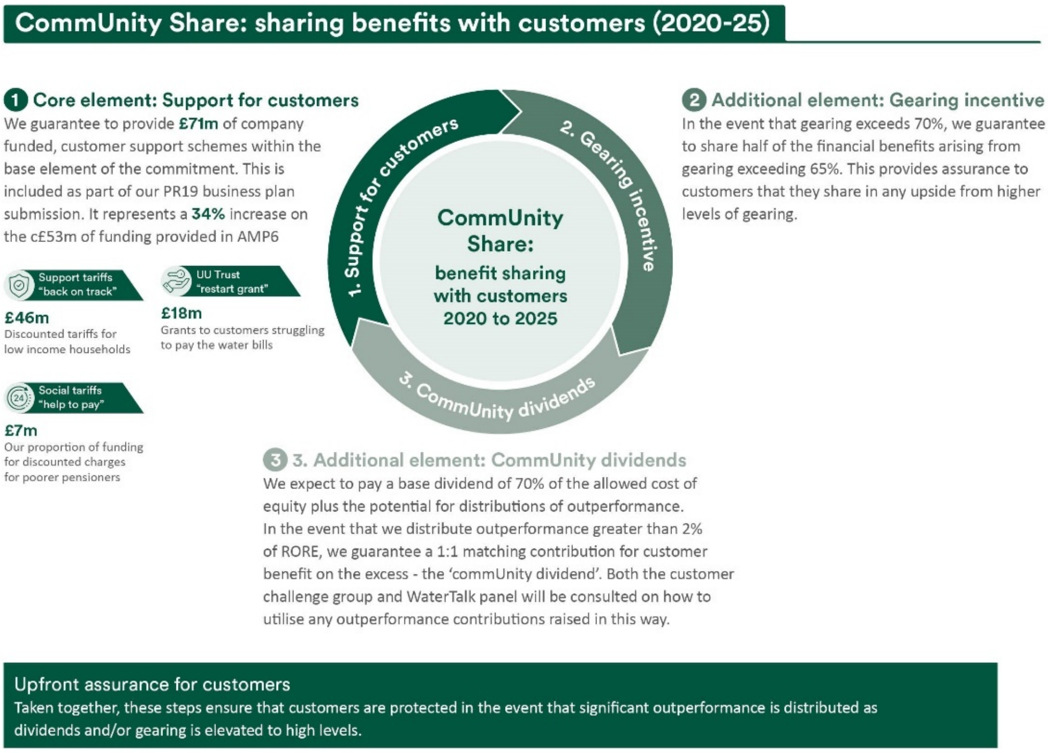


Figure 9.3: CommUnity Share providing additional support and benefit sharing for customers

Core element: the guaranteed £71m of base funding for CommUnity Share is ring-fenced for three financial assistance schemes for customers in need of financial support – the support tariff ("back on track"), the social tariff ("help to pay") and the UU Trust Fund ("restart grant").

Additional elements: should funding be available through either high levels of gearing or through outperformance, we will present customers with two options – financial support or CommUnity dividends. This allows flexibility to adapt the use of this money to match customer preferences over time.

Financial support: We will always present the option of using the money available to either reduce the average bill (across all customers) or alternatively use the funding to provide targeted financial support for customers facing financial hardship.

CommUnity dividends: We will present other options for consideration targeted at enhancing the resilience of the communities we serve. This investment would be available to support schemes that contribute to the social resilience of a community, or its financial or environmental resilience. They could represent a physical or environmental investment in resilience for a specific area or they could reflect a financial investment to secure the resilience of a valuable community facility in need of financial support.

To illustrate, if cutting bills in general is a priority - perhaps because of an economic downturn or higher than expected inflation - then we would expect stakeholder engagement to reflect this. However, at other times customers may prefer to see a more concentrated and targeted approach to investment, perhaps making a substantial difference to the resilience of a specific community.

Decision making: We will be transparent about how we reach decisions on how to apply this funding and it will only be spent following consultation with stakeholders. Our primary route will be through the 7,700 strong customer research panel, WaterTalk, and the YourVoice CCG to understand customer priorities. We will also ask the YourVoice CCG to scrutinise the approach we take to identifying options and consulting stakeholders and to report on this as part of the annual performance cycle.

Managing funds: Amounts to be made available through this mechanism will be clearly identified and the supporting infrastructure for the process of consultation and application of the funds will be proportionate to the sums involved. It will be important to ensure that where money is being set aside for customer benefit there is a credible and transparent process for its distribution.

As a result of WaterTalk and YourVoice CCG engagement, if it is recommended we support a community grant, we will consider a trust-like structure with adequate resources for administration to ensure confidence in the initiative. We describe this as the 'CommUnity dividend'.

We have a proven track record with this approach. Following the Lancashire water quality incident in 2015, we offered community groups the opportunity to apply for funding in recognition of the adverse impact of the boil water advice. We worked with the Community Foundation for Lancashire and Merseyside (CFLM) to establish a mechanism called the 'United Utilities Lancashire Community Fund'. Adopting this approach ensured there was complete transparency over how funds were allocated and a means by which there was confidence among stakeholders that the funds were being directed to appropriate causes, as the process was led by the CFLM's trustees.

This fund was used to support a variety of projects, similar to those that potentially could be recipients of the CommUnity dividend. Focused on enhancing the resilience of local communities, it addressed issues such as social and economic deprivation and isolation, ageing, debt and affordability, disability, mental health, general health and well-being, citizenship and community development and environmental protection and improvement.

9.11 Alignment of remuneration with delivery for customers

9.11.1 High standards of transparency and corporate governance in our approach to executive pay

As a FTSE 100 company we demonstrate high standards of transparency and corporate governance in relation to executive pay, complying with The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, the FCA Listing Rules and the UK Corporate Governance code. In line with legislation, shareholders have a binding vote on the company's directors' remuneration policy ('policy') and are consulted when changes to policy are proposed. The current policy was approved at the July 2017 AGM.

Executive pay policies and practices are governed by the remuneration committee in line with its terms of reference. These are published on our corporate website[11] and also provided in our United Utilities Remuneration Committee terms of reference supplementary S7007. The committee comprises four independent non-executive directors, recognising the potential conflict of interest of executives/management being directly involved in decision-making relating to their own pay. The committee regularly reviews the approach to executive pay policy in view of emerging best practice and considers the perspectives of key stakeholder groups including customers when determining incentive measures and targets. As set out in the terms of reference, the committee is required to ensure that "performance elements of executive pay are transparent, stretching and rigorously applied" and the committee's effectiveness is externally and independently evaluated at least every three years.

Disclosure of executive pay is provided in our Annual Performance Report and the United Utilities Water Limited statutory accounts. Both of these documents also provide a clear reference to the full executive pay disclosure which is provided in the UU Group PLC annual report[12]. This includes transparency about the link between pay and performance, alignment to business strategy, and disclosure of bonus and long-term incentive measures, targets and outcomes.

In recent years, the committee has taken steps to ensure that the policy can be rigorously applied, including the use of discretion to adjust incentive outcomes where appropriate. For example, in 2016 the committee reduced executive directors' bonuses to reflect the inconvenience to customers caused by the prolonged water quality incident in Lancashire in 2015. Additionally, executive incentives remain "at risk" (i.e. subject to withholding and recovery provisions) for a period over which the committee can withhold vesting or recover sums paid. The circumstances in which withholding provisions could apply include serious reputational damage or serious failure of risk management.

9.11.2 Alignment of performance pay with delivery for customers

As outlined in our current pay policy, executive pay arrangements are aligned to our purpose, vision and strategy, thereby incentivising great customer service and the creation of long-term value for all of our stakeholders.

A significant proportion of executive directors' pay is performance linked (67%) and long-term (50%). Since 2011-12, a considerable proportion of performance pay has demonstrated a substantial link to delivery for customers. Under our current incentive arrangements, 60% of annual bonus and 33.3% of long-term incentives are directly linked to delivery for customers through measures related to ODIs, delivery of capital programmes to time, cost and quality and customer service excellence as measured by SIM. Furthermore, as the same annual bonus measures are used throughout the organisation, all employees of the company are incentivised to achieve stretching levels of customer service.

As set out in more detail in supplementary document S7005 "Executive performance pay", we consider that this position already shows significantly more transparency of alignment between performance pay and delivery for customers than is evident elsewhere in the sector. Based on the information available to us about disclosures from other WaSCs:

- We are one of only two WaSCs where as much as 60% of annual bonus is based on customer focussed measures
- Of companies disclosing details of long-term incentive plans, we are one of only three companies with a clear and material customer-focussed component as a core metric.

We also have a long track record of performance pay reflecting a strong link to delivery for customers, with a substantial customer weighting evident for the last seven years. Additional supporting evidence is provided in supplementary S7005.

For both the annual bonus and the long-term incentive plan, targets are clearly disclosed in the directors' remuneration report, either in advance or following award so that stakeholders including customers can fully understand the basis of payments for performance.

Other targets used for executive performance pay (such as operating profit and total shareholder return) are subject to direct and/or indirect impact by the performance of the company in delivering services to customers, either through financial or reputational impacts. Reputational issues are particularly important for publicly listed companies and their employees as they have the potential to feed directly and quickly through into share price movements on a liquid equity market; this is not the case for privately owned companies where such issues are only reflected in company valuations on an infrequent basis.

[11] https://www.unitedutilities.com/corporate/investors/shareholders/corporate-governance/

[12] The 2017/18 directors' remuneration report commences on page 94 of the UUG plc annual report available at https://www.unitedutilities.com/globalassets/z_corporate-site/investor-pdfs/annual-reports/united-utilities-ar2018-web-ready.pdf. Reports for previous years are also available on our website or by request.

Additionally, the opportunity for the remuneration committee to exercise its discretion, as referred to in section 9.11.1, also ensures that reputational and customer delivery matters can be appropriately reflected when assessing incentive outcomes.

9.11.3 Directors' Remuneration Policy for AMP7

The current policy was approved by shareholders in 2017 and was intended to apply until our 2020 AGM. However, the committee has decided that the process for reviewing the policy, including performance pay criteria, will be accelerated compared to the usual three-year cycle, to ensure that our approach continues to be transparent and that incentive measures remain relevant and demonstrate a substantial link to stretching performance delivery for customers.

Given the legislative requirement for us to consult with shareholders on changes to pay policy, it is not yet possible to provide full detail of all performance pay policies for the period to 2025. However, the committee has agreed the scope of the policy review, and consultation with shareholders and stakeholders is expected to commence before the end of 2018.

The scope of the review includes:

- Consideration of incentive measures to ensure that they are verifiable and relevant to the commitments made in our business plan for AMP7;
- An expectation that measures which demonstrate a substantial link to stretching delivery for customers should continue to make up at least 60% of the annual bonus;
- An assessment of performance conditions for long term incentives with a view to increasing the weighting of customer-focussed measures beyond the current 33.3%, subject to shareholder approval;
- Consideration of the balance of annual bonus versus long-term incentives;
- Reviewing the adequacy of existing committee discretion to adjust incentive outcomes;
- Reviewing the adequacy of the withholding and recovery provisions; and,
- Reviewing the potential for further enhancements of our pay disclosures in our annual report including explanations of any changes to our approach.

In summary, the review will reflect a comprehensive assessment of performance-related pay arrangements, and will seek opportunities to advance the weighting given to customer-focussed measures and priorities.

The current intention is that following engagement in the winter and spring, a new remuneration policy will be formally put to shareholders at our 2019 AGM. This is, however, subject to the outcome of the consultation process. If necessary, the committee will continue consultations during 2019 and instead put the new policy to shareholders at the 2020 AGM. In either case, the new policy will apply for periods from the beginning of AMP7 and will be fully disclosed as part of our annual reporting. As the shareholder consultation process progresses we intend to share more detailed plans with Ofwat in spring 2019.