UUW70

Capital structure and dividend policy

October 2023

Chapter 9 supplementary document

This document provides an unabridged version of our AMP8 benefit sharing, dividend and gearing policy, detailed in main chapter re: aligning risk and returns and includes an useful illustrative example of how the policy would work in AMP8 assuming an AMP7 level of performance.

United Utilities

Water for the North West

Contents

1. Capital structure and dividend policy

1.1 Key messages

- **Strong track record demonstrating responsible approach to gearing, dividends and benefit sharing:** Targeted gearing within a 55%-65% range, a sustainable base dividend, with further payments only where there is demonstrable outperformance, and £1,225m of shareholder funds that has been retained in the enterprise rather than distributed as dividends across 2010-25.
- **AMP8 financing a mixture of debt and equity:** Reinvesting profits by not distributing inflation uplift component of equity return and setting AMP8 base dividend policy at the allowed cost of equity less c.1%. Assumed further equity contributions across AMP8 of £1.35bn.
- **Updated dividend policy provides clear alignment with Ofwat's recent licence changes:** Building on our transparent AMP7 dividend policy and disclosures, enhancing our responsible and fair approach to gearing and dividends, demonstrating a sustainable approach that inspires trust and confidence in the company as to how we treat a broad range of stakeholders.
- **Guaranteed benefit sharing with customers:** Where we pay outperformance dividends above allowed base cost of equity plus 3%, we will match 1:1 the amount of outperformance distributed as dividends.
- **Continuing our commitment to share financial benefits with customers in the event of high gearing:** We provide additional assurance that if gearing were to exceed 70%, we would share half the financial benefits of gearing above 65%.
- **Launch of Community Share 2030:** An upfront commitment to sharing benefits with customers if gearing or dividend distributions are much higher than in our business plan.

1.2 Structure

1.2.1 This document is structured as follows:

- **Section 2** - sets out our strong track record demonstrating our responsible approach to gearing, dividends and benefit sharing across 2010-25
- **Section 3** - outlines how we have further cemented our responsible approach to gearing, dividends and benefit sharing for AMP8 including:
  - **Section 3.1** – Our four key principles covering gearing, dividends, benefit sharing and overall performance;
  - **Section 3.2** – Our definition of gearing and how we treat pension deficits as debt;
  - **Section 3.3** – How we plan to finance our plan, maintaining a robust capital structure with a responsible mix of equity and debt financing;
  - **Section 3.4** – How we propose to share financial benefits in the event of high gearing;
  - **Section 3.5** – Our base dividend proposal;
  - **Section 3.6** – Our outperformance dividend proposals and justification of the proposed 3% RORE cap prior to customer sharing;
  - **Section 3.7** – Shows how our policy links through to the 2022/23 financial flow tables in the APR and also provides an illustrative example applying our AMP8 policy to AMP7 performance, including alternative approach with zero totex reinvestment; and
  - **Section 3.8** – Sets out our plans to further enhance transparency of reporting in AMP8, including reporting against the four key principles and how commitments to our expanded Community Share 2030 programme.

2. Strong track record of fair financing

2.1.1 UUW not only embodies resilience in its approach to financing: it seeks to demonstrate fairness to customers. As a responsibly financed company, UUW has 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. This reflects our board's focus on long-term responsible financial stewardship rather than short-term financial engineering. We have also sought to share the benefits of outperformance between investors and customers where these have been realised.

2.2 Gearing

2.2.1 We have always adopted a responsible approach to gearing with UUW having a long-track record of reporting gearing levels below the water sector average. This is expected to continue going forward, with UUW's gearing projected to remain below 65% throughout AMP8.

2.3 Dividends

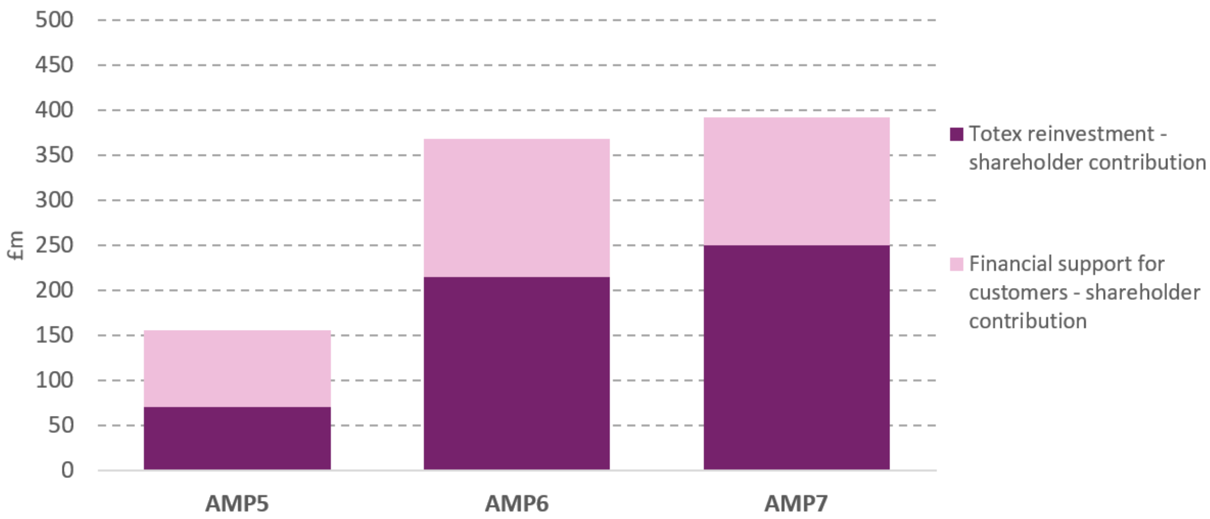
2.3.1 Across AMP7 UUW reduced its base dividend policy to only pay 4% of the equity portion of the RCV, broadly aligned to Ofwat's allowed cost of equity, and down from 5% previously. Recognising that reinvestment of base returns is prudent for regulated businesses with real RCV growth, we are proposing an AMP8 base dividend policy of Ofwat's allowed real cost of equity less c.1%. Payments above the base dividend level are only made where there is demonstrable outperformance.

2.3.2 We have demonstrated a cautious approach to paying dividends as evidenced during COVID-19. During 2020/21 the board took the difficult decision to defer paying any dividends due to the heightened uncertainty surrounding COVID-19 at this time. While we could have made a case for dividend payments in FY20/21, we deferred paying a dividend because our board considered this the right thing to do in taking a responsible approach, thus reinforcing trust and confidence with stakeholders.

2.4 Benefit sharing

2.4.1 UUW has a strong long term track record of sharing outperformance with customers and other stakeholders across 2010-25. As shown in Figure 1 below this includes:

Figure 1 - Total shareholder contributions covering reinvestment/financial support per AMP



Source: UUW reported totex reinvestment of outperformance outside the scope of the final determination allowance to deliver additional customer and environmental benefits; *UUW reported financial support contributions to shareholder funded schemes.*

2.4.2 Totex reinvestment of £1,170m, with a shareholder contribution of £535m (shown by purple bars in Figure 1 above):

- AMP5 spend (£240m total; £70m shareholder contributions) covering Future concept of operations; Private sewers and Spend to save initiatives
- AMP6 spend (£430m total; £215m shareholder contributions) covering expenditure to improve resilience, proactive drought mitigation and AMP7 flying start investment
- AMP7 planned spend (£500m total; £250m shareholder contributions) covering: £250m to help us improve environmental outcomes, making an early start on implementation of the Government's new Environment Act including delivery of the pledges we set-out in our Better rivers plan; and £250m to accelerate improvements in service for customers to drive ODI performance.

2.4.3 Support for customers in difficult financial circumstances of £565m, with a shareholder contribution of c£380m.

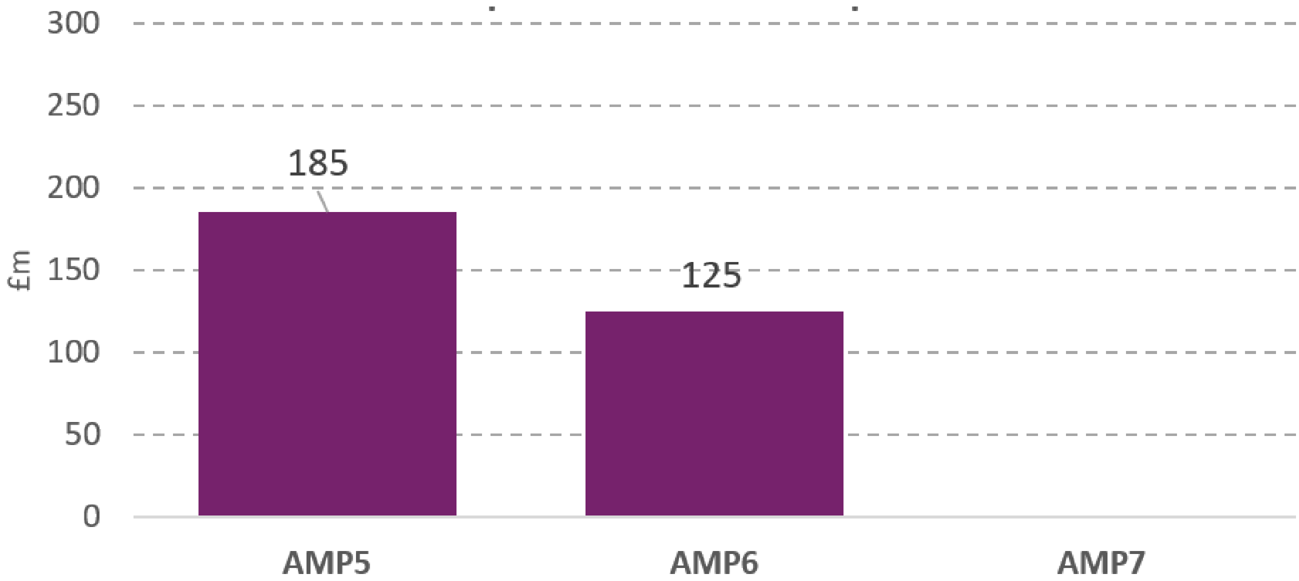
Figure 2 - Support of customers in difficult financial circumstance per AMP

Source: UUW reported contribution per support scheme

- As shown in Figure 2 above, this includes company funded support schemes across all AMPs: Payment matching (c£195m); Support Tariff (c£80m); Trust Fund (c£70m) and Social Tariff (c£14m) plus £20m special customer discount in 2014/15.
- On top of customer funded schemes including Watersure, Back on Track support and help to pay social tariffs.

2.4.4 In addition, we have made company funded pension deficit repair contributions of £310m (in excess of regulatory allowances), shown by Figure 3 below.

Figure 3 - Pension contributions in excess of regulatory allowances per AMP



Source: Total pension deficit repair contributions less allowed regulatory contributions per final determinations

2.4.5 The above contributions in excess of regulatory allowances were made in previous AMPs and our pension schemes are now fully funded on a low risk and a low dependency basis

2.4.6 Our robust pensions position provides a highly secure position for members, due to our longstanding responsible management

2.4.7 In total, this represents over £2bn of reinvestment over the period, of which £1,225m was met through shareholder funds that were reinvested in the business for the long term rather than distributed as dividends.

3. Further cementing our responsible approach to gearing, dividends and benefit sharing for AMP8

3.1 Four key principles for AMP8

3.1.1 We are continuing to refine our comprehensive approach to gearing, dividends and benefit sharing in AMP8 that builds on a track record of paying a reasonable and sustainable dividend, maintaining gearing in line with our responsible board policy and voluntary reinvestment of outperformance across AMP5-AMP7.

3.1.2 During AMP7, we established a dividend policy with robust and well-evidenced principles, which complies with or exceeds the updated licence condition P requirements and historic Ofwat guidance including "Putting the sector back in balance" publications. Our board remains committed to providing clear explanation of our approach and decision (including any change in dividend policy) as part of our Annual Performance Report. This was recognised with UUW being one of only four water companies who paid a dividend in 2021/22 to be assessed by Ofwat as,

"The company has generally met our current expectations on dividend policy and its application"[1].

3.1.3 For AMP8, we have revisited our principles with the aim to make them clearer to understand and offer more explicit alignment with the licence changes introduced by Ofwat. We expect that our approach to dividends, both in policy and practice, will exceed the requirements now embedded in the licence. We recognise the guidelines published by Ofwat in IN23/04 and the Board is committed to taking into account these guidelines to support its decision making when the Board makes its assessment of declaring or paying dividends. In particular:

3.1.4 When declaring or paying a dividend, the Board will:

- Take account of a full range of matters including service delivery for customers and the environment;
- Consider company performance in the round and over time, encompassing all aspects of delivery against its licence, including delivery against performance commitments, investment plans, cost efficiency and other areas of its operations;
- Give consideration to the company's current and future investment needs and financial resilience over the short and longer term; and,
- Have due regard to whether the dividend rewards efficiency and the effective management of the business, including performance across a number of periods.

3.1.5 The Board recognises that it has a responsibility to explain its decisions in relation to declaring and paying dividends and that customers and other stakeholders expect to understand how the Board has taken into account the full range of stakeholder interests and consideration of the external environment when making decisions about the dividend.

3.1.6 Whilst the Board recognises that there is a strong presumption amongst investors in favour of dividend payments, and that this is a significant and legitimate part of the returns to equity that attracts necessary investment in the company, there may nevertheless be future circumstances where dividend payments need to be curtailed, deferred or suspended. Examples of such circumstances could include when payment of a dividend would be expected to materially impair the ability of the company to deliver services in future, materially impair the company's ability to finance the delivery of such services or would materially impair service recovery from an identified major incident, which was known to be resulting in a service failure.

[1] Ofwat's Monitoring financial resilience report 2021/22 (published December 2022)

3.1.7 The Board will set a base dividend that takes account of the price determination made by Ofwat and the company's anticipated level of performance against that determination. The Board also recognises that RCV growth is also a component of equity returns.

3.1.8 The Board notes that Ofwat will review companies' approach to dividends paid or declared each year and that Ofwat may undertake enforcement action against companies that are in breach of the dividend licence condition. Given our commitment and ambition to delivering fair and balanced returns for all stakeholders, we would like to assure Ofwat and all stakeholders that were the company to be subject to any such action, this would be treated as a matter of serious concern. We consider that our approach in AMP7 has demonstrated the strength and depth of our commitment to a considered, fair and balanced approach to dividend payments and we expect this to continue in AMP8.

3.1.9 The four key principles we expect to deliver against when we consider gearing, dividends, benefit sharing and our overall performance are set out below:

1 – Responsible Stewardship

- Before declaring any dividend (including the base dividend) the company will take into account the full range of factors described above and whether a decision to declare or pay a dividend is consistent with the company's commitments and obligations under its licence.
- The Board will explain its decisions in the context of the company's performance and resilience and expect to be held to account for such decisions. Disclosures will be thorough and transparent and clearly communicated to stakeholders.

2 - A fair return to shareholders

- Assuming normal gearing levels (in the range 55-70% Net Debt/RCV[2]), and based on Ofwat's "early view" WACC, we would expect to set a base dividend[3] of the allowed cost of equity minus 1%, reflecting equity reinvestment to fund an element of the expected real RCV growth. This equates to a dividend yield of approximately 3% using Ofwat's early view real cost of equity of 4.14%, and consistent with Ofwat's expectation for companies with real RCV growth and that perform in line with their determinations for 2025-30.
- If it performs well, then the company might also distribute additional dividends reflecting demonstrable current or past outperformance (usually derived through the delivery of cost efficiencies, strong ODI performance, financial outperformance or a combination of these) up to 3% above allowed base cost of equity.

3 - Commitment to sharing benefits with customers

- Based on our business plan submission, we propose to provide £200 million of contribution to financial assistance schemes over AMP8, funded entirely by the company. Contributions to these schemes would be made each year, before consideration of any dividend payment.
- In the event that the company adopts a high level of gearing (above 70%) then we are committed to sharing the financial benefits arising from gearing exceeding 65% equally with customers.
- Consistent with our AMP7 commitments, dividend distributions made above a proposed 3% of RoRE outperformance threshold[4] above the base cost of equity will be matched 1:1 with customer benefits through discounted bills, targeted financial assistance or funding of community projects through CommUnity Share 2030. This means that if dividend distributions to shareholders were much higher than forecast in the business plan, customers would receive additional benefits through this matching.

[2] Measured by net debt divided by adjusted RCV (adjusted for actual spend, timing differences and including full expected value of end-of-AMP ex-post adjustment mechanisms)

[3] Base dividends applied on an average AMP-to-date basis

[4] Outperformance dividend threshold applied on an average AMP-to-date basis.

4 - Dividends will support appropriate gearing

- The dividend policies above assume that the company's gearing (Net Debt/RCV) is within the normal range of 55% to 70%.
- Where gearing falls below the lower bound then the base dividend could be increased up to the greater of 100% of profit after tax or 100% of the nominal allowed equity return for AMP8, in order to manage the company's gearing position efficiently and align it with credit ratings targets for the actual company and/or the notional company structure. This would only apply up to the point at which gearing reached 55%.
- Where gearing rises above the upper bound then the Board would give explicit consideration to whether it should restrict the base dividend in order to lower gearing and explain its decision. In the event that the Board approved a base dividend which left gearing above 70% then it would explain to stakeholders what the company's forward looking plan was to manage gearing back to within the normal range.

3.1.10 In truly exceptional and unforeseen circumstances, the board may have to deviate from these principles – for example to meet changing statutory requirements or during unexpected and exceptional events. However, if it were necessary to do so, the board would explain its reasoning to customers and stakeholders so that it could be judged on the extent to which it sought to meet these commitments and the reasons why a deviation was justified.

3.2 Definition of gearing and treatment of pension deficits as debt

3.2.1 Gearing for the purpose of the benefit sharing and dividend policy, is defined as that reported in the 2022/23 APR[2] adjusted for the IFRS measurement of pension scheme deficit and does not include any pension scheme surplus. We support Ofwat's view that the payment of dividends should incorporate explicit consideration of the company's obligations in relation to pension deficits. UUW has taken a long-term and prudent view on pension deficit funding, recognising that ultimately, obligations to a pension scheme are debt-like and funding should be on a low risk, self-sufficiency basis. Reflecting the IFRS valuation of the company pension scheme deficit as part of the gearing assessment provides a commitment that we are protecting customers' long-term interests. This is because it gives visible assurance that when making decisions about gearing we consider the existence of future pensions funding obligations to meet commitments made to employees. This approach is consistent with rating agencies' assessments of gearing.

3.3 Financing the plan

3.3.1 We are proposing to maintain a robust capital structure, with a responsible mix of equity and debt financing. We monitor our performance against key credit ratios to help us maintain strong and stable investment grade credit ratings, which gives us efficient access to debt capital markets across the economic cycle.

3.3.2 We have targeted credit ratings of Baa1/BBB+ for the notional company with two out of three of the ratings agencies and A3/BBB+ for the actual company with two out of the three ratings agencies. We consider that maintaining ratings in line with these targets provides a strong underpin for financial resilience and an appropriate level of headroom for AMP8, as such ratings offer robust access to debt markets (including in times of market disruption) and efficient debt financing costs, compared to operating with lower credit ratings.

3.3.3 In considering the implications of our business plan on the associated metrics for our targeted ratings, we have assessed these 'in the round', taking account of a range of factors. This includes not having a strict requirement for every ratio to meet the required thresholds in every year, but to have due consideration of which metrics are primary or secondary and overall performance and trend.

3.3.4 We have therefore assumed that UUW will be retaining/sourcing new equity;

- Firstly by not distributing the inflation uplift component of the equity return;
- Secondly in setting a base dividend policy that will retain 100bps of the allowed real CPIH cost of equity; and,
- Thirdly in obtaining new equity from its listed parent to maintain debt financeability in line with our ratings targets, which assumes a total equity contribution of c£1.35 billion phased across 2026-2030.

3.3.5 For the actual company, we also recognise the benefit of positive AMP7 reconciliations along with our actual embedded debt and proportion of index-linked debt, as these all benefit certain ratings metrics. These measures should ensure the plan remains financeable as discussed further within Chapter 9, section 6.

3.3.6 As UUW is the principal operating subsidiary of its listed parent, United Utilities Group PLC (UUG), UUW would make a call on UUG to consider putting in an appropriate amount of capital at the required time.

3.3.7 On the assumption that the overall PR24 risk and return package and the level of allowed equity return are set at an appropriate level at the final determination, UUG is expected to be well placed to fulfil such equity calls from UUW, and is likely to deploy some or all of the following sources of capital:

(a) Injection of group cash – the UUG group has typically operated with lower levels of gearing than UUW and therefore could look to inject this cash into UUW and/or convert to equity any existing intra-group loans made from group to UUW.

(b) Issuance of debt higher up the group capital structure to inject as equity into UUW – UUG's intermediate holding company, United Utilities PLC, has access to debt capital markets and could therefore consider issuing 'holding company' debt (including hybrid debt) to downstream an equity injection into UUW.

(c) UUG equity issuance – as UUG is a listed company on the London Stock Exchange it could consider a specific equity raise and/or share increase – via placement, rights issue, or scrip dividends.

3.3.8 It would be for the board of UUG to determine the most appropriate way of making any equity injections into UUW, at the appropriate time.

3.4 Sharing financial benefits in the event of high levels of gearing

3.4.1 We recognise the importance of maintaining gearing at reasonable levels, particularly in the context of delivering larger expected investment programmes in AMP8, helping to ensure companies can continue to raise finance efficiently.

3.4.2 UUW does not currently expect to increase gearing to the levels observed in highly geared companies. However, we want to provide stakeholders with confidence that, in the event that gearing were to increase significantly beyond our projections, then customers would share in the financial benefits that are derived from this. This is fair because, in our view, highly geared companies offer customers a lower degree of resilience and therefore a sharing of the financial benefit is partially compensatory for customers.

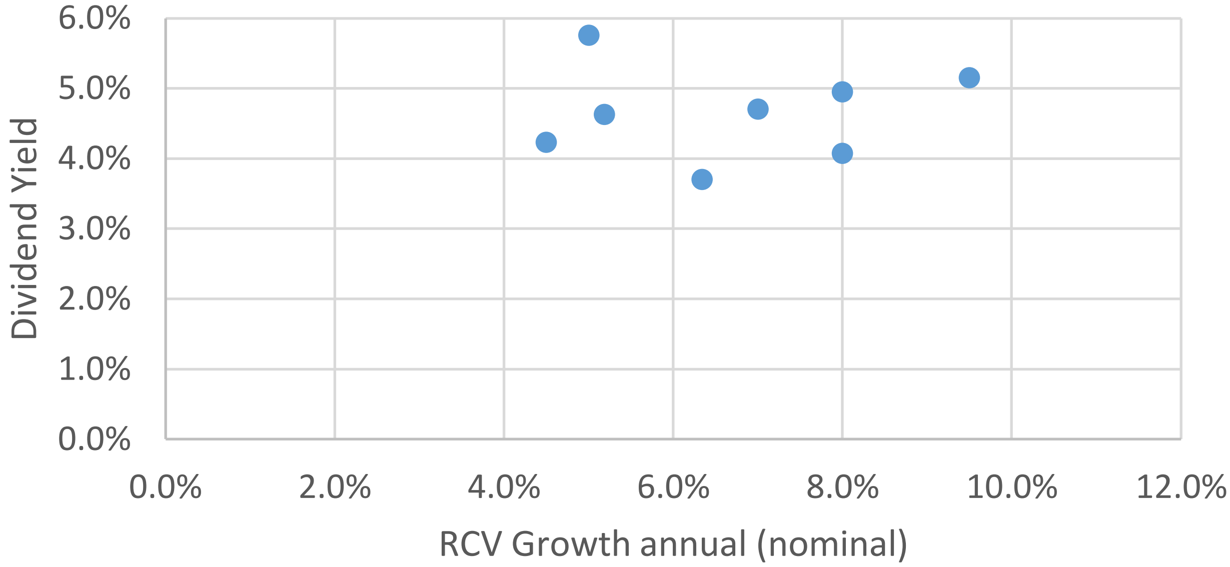
3.4.3 If gearing exceeds the 70% trigger, we will continue to share 50% of the difference between the notional cost of equity and notional cost of debt, on the average gearing for the year above 65%.

3.4.4 Any financial benefits of high gearing will be shared with customers through the CommUnity Share 2030. This principle means that customers are compensated financially in the event that the company takes on a high level of gearing.

3.5 Base dividend approach

3.5.1 Our base dividend approach recognises Ofwat's expectation[5] for companies that perform in line with their determination. We agree that it is prudent for a regulated business with high real RCV growth to retain an element of the real cost of equity allowance in addition to also retaining the inflation uplift to the RCV.

Figure 4: European utilities RCV growth vs dividend yield



Source: Company published reports for asset base growth; Bloomberg for dividend yields

3.5.2 Under our base plan, AMP8 RCV growth is expected to be in the region of c7% real per annum. Whilst this is higher than historic water regulated asset growth (sector average of 1.6%[6] in AMP7 for instance), this growth level is comparable to other UK regulated utilities. Figure 4 above, showing all regulated utility companies across UK, Germany and Italy, highlights that European utility companies with high RCV growth generally have dividend yields above 4%. It is important that we are able to provide listed equity investors with a reasonable and sufficient dividend, in order to maintain the health of our equity base and in order to fund substantial new investment. This equity base underpins our robust financial resilience and our ongoing ability to raise new debt and equity to fund our investment programme and do this at efficient cost.

3.5.3 Our base dividend policy is to apply Ofwat's allowed cost of equity less 1%. As setout in chapter 9 section 3, we are applying Ofwat's early view allowed cost of equity of 4.14% real CPIH within our business plan submission. We retain c1% of the real return on equity, recognising expected real RCV growth and the need for retention of profits, we are deducting 1% from this to give an assumed base dividend of 3.14%. For simplicity, his has been rounded down to 3.0%, which aligns to Ofwat's financial model assumption.

3.5.4 Dividends will be reviewed annually by the UUW board, taking into account the impact on all stakeholders including investors, customers, employees and pensioners. The level of the base dividend for AMP8 will be subject to specific consideration of gearing as follows:

[5] Ofwat final methodology December 2022.

[6] Source: Ofwat PR19 FD Aligning-risk-and-return-technical-appendix

- The ability to pay a base dividend of the real equity return less 1% is an important means of ensuring that both debt and equity financeability are adequately maintained, however there should be flexibility to amend the amount of the base dividend in certain circumstances.
- Such circumstances could prevail if gearing were to fall below 55% to enable the company to optimise capital structure. It is important to note that the ability to increase the base dividend would only apply up to the level which would see gearing reach 55% - i.e.: in line with the notional company assumption. At 55% gearing, dividends would return to the base level of no more than the CPIH real allowed equity returns less 1% for AMP8. Furthermore, the additional safeguard of restricting the level of dividend to the greater of allowed equity returns or profit after tax means that excessive dividend distributions are prevented.
- **We see it as unlikely that UUW's gearing would exceed 70% in AMP8.** However, were such a situation to arise then the board will give explicit consideration to restricting the base dividend as a means of helping to return gearing to the more normalised 55-70% range. If reported gearing were more than 70% and the board did not restrict the base dividend then the board will explain its reasons for this to customers and other stakeholders and explain its planned approach to returning gearing to below 70%.

3.6 Outperformance dividend approach

3.6.1 Incentive based regulation means that companies are incentivised to outperform regulatory targets. This lessens the problem of asymmetry of information between the regulator and the regulated company and means that potential outperformance is more easily revealed.

3.6.2 Outperformance arises where companies successfully respond to the incentives in the regulatory model – for example, by outperforming on performance commitment targets and so earning additional outperformance payments from ODIs, by outperforming cost targets and thereby sharing in totex savings or by outperforming cost of debt targets and thereby achieving financial outperformance. Companies are incentivised to outperform because this translates into efficient incentives for management, performance and long-term value creation which benefits both investors and customers.

3.6.3 It is important that investors are able to access this through the potential for improved dividend payments.

3.6.4 A key measure of outperformance of regulatory assumptions is the "Return on Regulated Equity" or RORE. Base RORE in AMP8, applying Ofwat's early cost of equity view, is 4.17% for the notional company. Companies can outperform or underperform this assumption through things like significant cost savings, outperforming on ODIs and financing outperformance.

3.6.5 The risk of underperformance against RORE is ultimately borne by shareholders. Conversely, investors have the potential to benefit from outperformance against RORE. Our proposed approach means that underperformance against RORE is not shared with customers but that customers can potentially benefit from outperformance against RORE when it is distributed to shareholders as a dividend. Because of this asymmetry – and in order not to undermine the intended regulatory incentives for outperformance – our proposed approach allows shareholders to benefit from dividend distributions of past or current outperformance equivalent to up to 3% of RORE above the allowed base cost of equity. Customers will receive a 1:1 benefit share for distributions above that level.

3.6.6 The choice of this threshold is an important balance. This 3% proposed threshold will likely capture an upper quartile level of outperformance and any exceptional returns beyond a typical RoRE range, which might be perceived as a financial 'windfall' (for example due to high realised inflation) or be indicative that the regulatory contract was not adequately stretching.

3.6.7 In setting the threshold we have taken account of the following factors:

- Investors can receive an element of AMP8 out performance before sharing, which avoids undermining the regulatory incentive mechanisms, which underpin the price control methodology. It is important that investors retain the potential to receive a meaningful performance based return above the base allowance, particularly recognising the considerable broadening of the penalty range for under performance;

- 3% outperformance threshold is consistent with Ofwat's proposed threshold in its aggregate sharing mechanism for net ODI payments[7];
- RORE outperformance of 3% is likely to at least equate to an upper quartile performance, based upon AMP7 performance to date with three (30%)] of the ten WaSCs companies reported outperformance representing at least 3% of RORE for the three years ending FY2023 (4.8%, 4.1%, 3.8%);
- It provides protection for customers against the distribution of gains from financial 'windfall' to shareholders, for example arising from high realised inflation; and
- Our past outperformance is not the result of high gearing and we have paid a fair share of tax

3.7 Linking the policy to the financial flows table in the APR

Our AMP7 performance

3.7.1 Our capital structure and dividend policy maps across to Ofwat's Financial Flows table (1F) in the 2022/23 APR, presenting our returns earned and how much of this was either distributed as dividends or retained in the company. The table in Figure 5 below is an extract from our 2022/23 APR summarising our reported cumulative performance for the first three years of AMP7.

[7] Ofwat's final methodology chapter 5.5.4 (published in December 2022)

Figure 5: Financial flows table 1F 2022/23

Financial flows for the 12 months ended 31 March 2023 and for the price review to date

			Average 2020-25					
Line description			Notional returns and notional regulatory equity	Actual returns and notional regulatory equity	Actual returns and actual regulatory equity	Notional returns and notional regulatory equity	Actual returns and notional regulatory equity	Actual returns and actual regulatory equity
	Units		%			£m		
Regulatory equity	DPs		2			3		
Regulatory equity	£m	3	4458.251	4458.251	3839.504			
Return on regulatory equity								
Return on regulatory equity	See Column Heading		3.94%	3.39%	3.94%	175.721	151.334	151.334
Financing								
Impact of movement from notional gearing	See Column Heading			0.55%	0.28%		24.388	10.412
Gearing benefits sharing	See Column Heading			0.00%	0.00%		0.000	0.000
Variance in corporation tax	See Column Heading			1.62%	1.92%		71.991	71.991
Group relief	See Column Heading			-0.01%	-0.01%		-0.549	-0.549
Cost of debt	See Column Heading			2.07%	2.74%		92.071	102.445
Hedging instruments	See Column Heading			0.45%	0.54%		20.108	20.108
Return on regulatory equity including Financing adjustments	See Column Heading		3.94%	8.07%	9.41%	175.721	359.341	355.740
Operational Performance								
Totex out / (under) performance	See Column Heading			-0.56%	-0.66%		-24.801	-24.801
ODI out / (under) performance	See Column Heading			0.41%	0.48%		18.082	18.082
C-Mex out / (under) performance	See Column Heading			0.03%	0.04%		1.420	1.420
D-Mex out / (under) performance	See Column Heading			0.01%	0.02%		0.623	0.623
Retail out / (under) performance	See Column Heading			-0.26%	-0.30%		-11.371	-11.371
Other exceptional items	See Column Heading			0.04%	0.04%		1.564	1.564
Operational performance total	See Column Heading			-0.33%	-0.39%		-14.482	-14.482
RoRE (return on regulatory equity)	See Column Heading		3.94%	7.74%	9.02%	175.721	344.859	341.258
RCV growth	See Column Heading		6.18%	6.18%	6.18%	275.371	275.371	237.153
Voluntary sharing arrangements	See Column Heading			-0.22%	-0.25%		-9.734	-9.734
Total shareholder return	See Column Heading		10.12%	13.70%	14.94%	451.093	610.497	568.677
Dividends								
Gross Dividend	See Column Heading		3.00%	5.16%	5.99%	133.748	230.068	230.068
Interest Receivable on Intercompany loans	See Column Heading			0.00%	0.00%		0.000	0.000
Retained Value	See Column Heading		7.12%	8.54%	8.95%	317.345	380.429	338.609
Cash impact of 2015-20 performance adjustments								
Totex out / under performance	See Column Heading			0.29%	0.34%		12.871	12.871
ODI out / under performance	See Column Heading			-0.02%	-0.02%		-0.686	-0.686
Total out / under performance	See Column Heading			0.27%	0.32%		12.186	12.186

Source: Table 1F 2022/23 Annual Performance Report

Returns earned

3.7.2 Figure 5 above shows that for the three years to March 2023, we earned a nominal total shareholder return of 14.94% p.a. on average. This comprised a real base equity return of 3.94%, financing outperformance of 5.47% and RCV growth (inflation uplift) of 6.18%, partly offset by operational underperformance of 0.39% (largely driven by totex reinvestment, see section below).

3.7.3 Of the 14.94% nominal return earned, we have paid 5.99% (40%) as dividends and retained 8.95% (60%) to support the ongoing business and maintain overall financial resilience in line with our credit rating and gearing policy.

Impact of Totex reinvestment

3.7.4 We have also voluntarily committed to reinvest £500m, with a £250m shareholder contribution, to drive long-term sustainable performance improvements and environment benefits. This represents £250m of shareholder funds that been retained in the enterprise rather than distributed as dividends.

3.7.5 This £500m of gross reinvestment, when combined with £110m expected additional overspend driven by additional spend on Vyrnwy, gives a resultant expected totex overspend of c£610m across AMP7. The 0.66% (£25m) totex underperformance reported in 2022/23, as presented in Figure 5 above, represents the reported totex overspend to date.

Applying AMP8 policy to AMP7 performance including alternative approach with zero totex reinvestment

3.7.6 Here we consider the impact of applying our proposed AMP8 dividend policy to: (1) baseline AMP7 performance, including the proposed £500m of totex reinvestment and (2) alternative approach where the £500m of totex reinvestment was not made, and instead the Board chose to distribute the £500m as dividends to shareholders.

3.7.7 In both cases the three year average performance (other than the adjustments necessary to reflect the full totex reinvestment or removal of totex reinvestment and replacement with extra dividends) is assumed to remain constant through the remainder of the AMP.

3.7.8 This analysis also includes the key assumption that AMP7 total dividends (5.99%) comprises the allowed AMP7 real cost of equity (4.19%) with the remaining balance (1.80%) assumed to relate to outperformance dividends.

Table 1: Sharing mechanism baseline vs additional dividend distributions

	Scenario 1- Baseline		Scenario 2 - Pay dividends	
	Dividends	Retained	Dividends	Retained
AMP7 Financial flows (FY2023 reported)	5.99%	8.95%	5.99%	8.95%
Adj: Full impact of totex reinvestment	-	-0.72%	-	-0.72%
Adj: Remove £500m totex reinvestment	-	-	-	+1.13%
Adj: Payout £500m extra dividends	-	-	+2.22%	-2.22%
AMP7 Financial flows (assumed full-AMP)	**5.99%**	**8.23%**	**8.21%**	**7.14%**
	Dividends	**CommUnity Share**	**Dividends**	**CommUnity Share**
Allowed real (CPIH) cost of equity (AMP7)	4.19%	n/a	4.19%	n/a
Outperformance dividends (up to 3% sharing threshold)	1.80%	n/a	3.00%	n/a
Outperformance dividends (above 3% sharing threshold)	-	-	1.02%	1.02%
Total dividends position Five year £m total (17/18 prices)	**£1,115m**	**-**	**£1,504m**	**£190m**
Total dividends position Five year £m total (outturn)	**£1,323m**	**-**	**£1,823m**	**£221m**

Source: Table 1F 2022/23 Annual Performance Report; UUW financial flows workbook calculations

3.7.9 The outcome of the alternative scenario 2 shown in Table 1 above, is that:

- instead of reinvesting £500m in the business, the company chose to distribute an additional £500m of dividends and as such the dividends to shareholders increased by 2.2% to 8.2%;
- dividends above the base dividend exceed the 3% threshold by 1.0% and so there is a matching 1.0% (c£220m) contribution to the CommUnity Share 2030.

3.8 Further enhanced transparency in AMP8

3.8.1 We commit to further enhancing our transparency through our APR in AMP8 about the dividends paid and how these relate to our updated dividend policy. This will be clearly aligned to the consolidated principles, including explanation of how any dividend paid takes account of overall performance for customers and the environment over time. This should help the readers of the document to better understand our policy and approach. This remains in addition to the existing statutory and regulatory requirements that we already disclose.

3.8.2 In addition, we will continue to explain how dividend payments have been determined and how these relate to our performance. We commit to clearly explaining and setting out which year's performance is covered by any outperformance dividends and explain how the outperformance has arisen. We will provide an explanation of how the allowed equity return relates to that achieved under the actual company structure and how the dividend policy relates to the actual equity returns during the AMP. Where there is any change in dividend policy, we commit to explaining this in our APR.

3.8.3 We will provide transparency of how payments from the CommUnity Share 2030 have contributed towards the resilience of communities in the North West.

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