Dŵr Cymru
Welsh Water

Pentwyn Road
Nelson
Treharris
Mid Glamorgan
CF46 6LY

Tel: +44 (0)1443 452 300
Fax: +44 (0)1443 452 323
Web site: www.dwrcymru.com

Heol Pentwyn
Nelson
Treharris
Morgannwg Ganol
CF46 6LY

Ffôn: +44 (0)1443 452 300
Ffacs: +44 (0)1443 452 323
Safle gwe: www.dwrcymru.com

Keith Mason
Senior Director of Finance and Networks
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

4 August 2015

By e-mail: keith.mason@ofwat.gsi.gov.uk

Assurance on adequacy of financial capital

Dear Keith

You wrote to me on 22 July in relation to Ofwat's consultation on its financial monitoring framework, particularly with regard to capital adequacy and financial headroom. Your letter requested information on our current practises and views in three related areas and these are set our below.

1) Sensitivity testing to provide assurance on the annual statement of capital adequacy

Scenario modelling is an integral part of our business planning process to ensure that our plans are financeable; we perform a range sensitivity analyses when developing our plans and present summaries of these to our Board when seeking approval of our 'core' business plan and subsequent updates. We also prepare a number of sensitivity-adjusted variants of our financial plan for rating agencies who wish to understand the impact on financeability of movements in inflation, cost shocks and changes in the cost of debt. Some of the most common sensitivities we model are:

- Inflation: zero inflation, low inflation (1%), high inflation (5%);
- Totex overspend: 5%, 10%;
- Cost of debt +200 basis points; and
- Combination of these.

Our attention focuses on the impact of these stresses on our key rating metrics which underpin the "A-grade" credit ratings we endeavour to preserve; principally these are the adjusted interest cover ratio, adjusted FFO/net debt and post-maintenance interest cover ratio as used by Moody's, Standard and Poor's and Fitch. Our Board-approved business plans allow sufficient headroom to withstand foreseeable financial pressures while retaining our current ratings; in this regard, the Board has approved and published a regulatory gearing policy (being the ratio of net debt to regulatory capital value) at or around 60% for the five years to 31 March 2020.

As you are aware, our ownership structure is different from that of other water and sewerage companies and, as such, our published dividend policy for Dŵr Cymru Cyfyngedig is unrelated to the distribution of reserves for shareholder gain. We do not experience the same pressure as equity-financed companies to return surpluses to shareholders and all value generated within the business is used for the benefit of customers; such distributions are made at the Board's discretion and may comprise additional investment or reductions in bills, or a combination of both.

2) Ofwat's proposals for sensitivity testing and publication of the results

Ofwat's consultation on the financial monitoring framework includes a section on stress testing of business plans. We concur that the purpose of these tests should be to assess the level of financial headroom present in a company's business plan (i.e. whether realisation of the proposed stresses would result in financial covenants being breached) based on its actual capital structure. The types of sensitivities proposed are consistent with those we already model as part of our internal business planning processes and are requested periodically by rating agencies, and the indicative stress levels noted in the report are within the ranges we currently use.

We recognise that such sensitivity tests may not assess the full extent of available headroom and we monitor this separately; we view our financial headroom as the amount by which our regulatory reserves (RCV less net debt) exceed our gearing target of 60%; this is closely linked to our distribution policy as mentioned in 1) above.

We can see benefit in companies reporting the results of their stress testing against certain metrics, however this would require absolute clarity over the calculations to be applied, e.g. would a totex overspend be on a regulatory (RCV depreciation and PAYG) or a cash (opex and capex) basis? If the former, should any changes to published PAYG rates be disclosed?

With regard to the actual metrics to be reported on a prospective basis, we see most value in those which are used for rating purposes, i.e. regulatory gearing, adjusted interest cover and FFO/debt and, importantly, based on the definitions of these metrics as used by the rating agencies in assessing our credit ratings.[1]

3) Extension of statement of capital adequacy beyond one year

You have sought our views on whether the statement of capital adequacy could be extended to cover a period longer than one year and if so, for how long. The statement of capital adequacy is made by the Board based on its understanding of the company's financial forecasts which are informed by Ofwat's most recent determinations of revenue controls. While Ofwat is committed to ensuring that company's business plans are financeable, the Board does not currently have certainty over its regulatory targets post 31 March 2020 and would potentially have difficulty in making any statement of capital adequacy which extended beyond this date.

We consider that the statement, perhaps modified to incorporate the results of sensitivity testing, could potentially be extended to align with the end of the latest revenue control period in respect of which Ofwat has published its final determination.

Yours sincerely

Mike

Mike Davis
Director of Strategy & Regulation

[1] e.g. Moody's and Fitch definitions of adjusted interest cover ratios, although each different, both adjust for "excess fast cash" so that the PAYG ratio does not affect the ratio calculations; the S&P net debt/FFO calculation is fundamentally different from that used by Ofwat at PR14, mainly due to the deduction of indexation of index-linked debt in the calculation of FFO.