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Dear Ofwat

Putting the sector back in balance: Consultation on proposals for PR19 business plans

This letter sets out Bristol Water's response to Ofwat's consultation to amend and clarify the PR19 price setting methodology. The observations we make in this response are set within the context of our support for the wider programme of work that Ofwat CEO, Rachel Fletcher, set out in her letter to CEOs on 13 April 2018. We offer some technical suggestions and questions Ofwat may want to consider further, as well as providing suggestions for amendments and clarifications.

Our support for this priority area for Ofwat and the sector aligns with Bristol Water's long term ambitions. In our public consultation, **Bristol Water…Clearly** we set out our "trust beyond water" vision and our mission to be "A company that our communities trust and are proud of. To deliver excellent experiences and create economic and social value". This is aligned with the themes within the consultation.

As a summary of our response, we believe that any additional changes to the Price Review methodology should be "targeted" and "voluntary". In the covering note below we set out why we believe sector diversity requires a "targeted" approach, and why balance of regulatory control and financial flexibility requires a "voluntary" approach.

Sector Diversity
The water sector consists of organisations with diverse backgrounds and operating environments. In Bristol Water…Clearly, and our wider communications, we have set out our unique heritage of over 170 years of private ownership, very distinct from the nationalised regional water authorities. Bristol Water was set up in 1846 as a social enterprise, through a competitive process leading to an Act of Parliament to bring fresh, clean water to the all communities in the area we serve and not just the wealthy few. Through being trusted by our customers, this status as a private social enterprise has continued and remains just as relevant today as in 1846. In our view, companies that want to be around for the decades to come, must ensure that society and the environment is at the heart of everything they do.

In addressing the perceived wider national legitimacy challenges, we should be mindful that not all the behaviours requiring rebalancing apply to the whole sector. In addition, we note that using the reference point of privatisation may not be directly relevant to the whole sector. At the same time, we

believe it is in the interest of the sector for us to support Ofwat's intentions to address the current perceived challenges to sector legitimacy.

The difficult challenge Ofwat and the sector face today is balancing fairness, by targeting measures at companies whose past behaviour challenges sector legitimacy, with public confidence that the right incentives and measures are in place to protect customers now and in the future. In this respect, we support the intention of the consultation to achieve this balance, in particular the amendment to the PR19 guidance to consider transparency of dividend policies and performance related pay with services to customers in the initial assessment of business plans (IAP).

Sharing of financial outperformance

We support in principle, the approach suggested for a voluntary sharing mechanism on financing outperformance. However, we would suggest that the proposed approach on sharing financial gains from high gearing requires further development.

We would suggest that further clarification is needed in the scope of the application of the sharing mechanism. The consultation states that the benefit sharing proposals only apply to highly geared companies, and on a voluntary basis. We would support this approach. However, the consultation Question 1 implies a level of expectation that goes beyond the voluntary consideration within the consultation text. As we explain in our detailed response, a standard mechanism that is imposed will not achieve benefits for customers, as reflecting the diverse financing structures in the industry would result in either a significant shift in regulatory risk, or a complex mechanism which would not benefit sector transparency and legitimacy.

For any sharing mechanism, we agree that using the notional cost of equity and actual cost of debt is appropriate in nominal terms, but for the cost of equity we suggest using actual rather than long-term inflation for consistency. The sharing mechanism could also consider adjusting for the whole of the actual cost of debt where this is below Ofwat assumptions, not just the marginal amount on higher gearing. Ofwat could also consider whether a dead-band on the level of sharing (say 10% of the cost of equity) would be appropriate for company specific financing arrangements (such as timing of dividends), given that the mechanism is asymmetric.

Efficient Level of Gearing

As a company with a relatively low level of gearing and close to Ofwat's view of the notional level of gearing, we welcome a mechanism that recognises the customer benefits of good financial discipline. We would however welcome clarification on Ofwat's view of the efficient level of gearing. The consultation states in places that 60% gearing ratio is an efficient level for companies to aim for, in order to demonstrate financial resilience. In other places the consultation seems to suggest this may not be the case. In practice, it is in customers' interests for Ofwat to retain the more flexible approach to the definition of efficient level of gearing, rather than determining a precise number, to avoid negative

perception by investors and ratings agencies, noting that only one company currently has below 60% gearing. Ofwat will need to explain the difference in a new, lower, point level for gearing to the range of 2020 gearing levels that formed part of PR14 determinations.

With the proposed gearing mechanism, there is a risk that companies are being incentivised to reduce investment or accelerate revenues from the future to avoid sharing some of the Ofwat assumptions on industry notional financing costs with customers. It is clearly not Ofwat's intention, given the focus at PR19 on inter-generational equity, to create a disincentive for long term investment, or create an incentive to accelerate revenues to avoid a compulsory gearing mechanism. We show in our response to the detailed questions in an annex to this letter why we think this needs consideration and what the alternatives could be that would better meet the objectives.

Linking the proposals with forthcoming licence modifications

Financial resilience and legitimacy should also be protected through the forthcoming proposals for licence changes. The industry needs to work with Ofwat on these proposals. There is a risk that strengthening investment grade requirements in the Licence and codifying resilience duties might conflict with the mechanisms proposed in this consultation. We suggest below an approach that allows the potential consequences of IAP tests to consider industry progress on licence changes to avoid this risk, accepting that it is not possible in practice for Ofwat to directly link the two.

Gearing and Dividend Policy

If the gearing sharing mechanism suggested is compulsory, more consideration of the implications will be required than the consultation timescale has allowed. In setting the cost of capital using CAPM and a notional structure, financial theory assumes that there is no change in the cost of capital from increasing the gearing. This is why Ofwat have always used actual tax in the financial model at price review for companies geared above the notional assumption, as this is the only theoretical benefit from higher gearing. Fundamentally this makes it difficult to impose this mechanism and retain other aspects of incentives untouched. If compulsory sharing means that companies expected returns on average do not equal the cost of equity and that shareholders cannot choose whether to retain this value or receive it through dividends, there is a strong argument that beta and the cost of equity must increase from such a systematic risk. The views and perceptions of investors on these proposals, and the ability to shape them for company circumstances, is therefore critical.

We question whether company consideration of their own dividend policy as part of their plan, and whether to adjust these to reflect actual gearing as the consultation proposes, would be better from a regulatory incentive perspective. This would allow companies to reflect their own existing financing structures and reduce the potential for detailed industry rules that would otherwise be necessary for a compulsory mechanism to operate with such a diverse set of current financial arrangements. Voluntary

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cost of debt sharing to reflect company specific challenges, whether to financial resilience, legitimacy or performance may also in that context have a role to play.

Initial Assessment of Plans (IAP)

Ofwat's proposed amendments will add substantial complexity to the IAP, particularly when assessments are carried out against a range of volunteered approaches. To understand the implications on individual company resilience, Ofwat would need to engage with companies in the context of their current performance and trade-offs for PR19. The trade-offs and proposals for our business plan will be affected by the outcome Ofwat reach on these proposals. The IAP test approach already puts significant incentive weight on "significant scrutiny" classification, for instance totex cost sharing that is heavily skewed to underperformance risk and skewed potential towards outcome under-performance incentives. The IAP test amendment proposed within the consultation must in any case, given the importance of legitimacy and financial resilience, have a significant weighting in the overall IAP assessment.

We would suggest that a better approach would be to consider the impact of imposing sharing mechanisms as well as the other IAP incentives in the full context of a company's plan. Whether to impose a "high gearing" sharing mechanism and dividend policy on a company could therefore become a consequence of "IAP status". This avoids perceptions of double-jeopardy, inconsistency with financial theory, and would do much to avoid unwanted consequences that might result in very complex rules for what, ultimately, needs to be simple enough to build trust through transparency.

We hope our contribution supports Ofwat's objectives on the issues under consultation. If you require any further clarification on our response, please do not hesitate to contact us.

Yours sincerely

Mel Karam
Chief Executive

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Annex – Response to specific consultation questions

Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP

The wording of this question appears to be inconsistent with the proposals in the consultation. On page 4, Ofwat state *"We propose that highly geared companies either adopt this mechanism in their business plans or propose alternative sharing arrangements which deliver equivalent or greater benefits to customers. As our proposals are specific to those companies with gearing above the notional level, we do not consider this should lead to any increase in the cost of equity that is set on the basis of a notional financing structure"*

So, either Ofwat are requiring mechanisms to be proposed by all companies (which would potentially increase the notional cost of equity), or just by those that are currently highly geared. Page 10 is clear that the PR19 methodology only considered that **voluntary** sharing of the embedded cost of debt may be appropriate.

The challenge arises because the consultation does not make a clear distinction between high levels of gearing based on company past financing decisions (where there is a case for imposing a sharing mechanism), and the level of gearing starting from a notional position that are associated with Ofwat's own past, or future, determinations. Ultimately there is little clarity in the consultation as to whether the highly geared companies (above 70%) have the compulsion to introduce a mechanism, or whether Ofwat are now stating that any gearing above the notional number rather than range (60%) is the issue. If it is the latter, Ofwat are effectively determining the financing structure for the industry, which is clearly not the intention of the consultation.

If Ofwat are imposing sharing financing outperformance from a level of gearing that was inherent from past determinations, then this could well increase the industry cost of equity. A mechanism for all companies that is forward looking, and protects customers through sharing the benefits of future gearing up **outside of the plan / determination assumptions** also may have merits. But as we set out in our assessment of the potential gearing mechanism in question 3, compulsion may see significant dis-benefits to customers. For instance, the implication could be that companies should be allowed cash flows to maintain the single level of gearing that Ofwat has set. This may require acceleration or deceleration of revenues through PAYG rates.

There are good reasons why gearing above 60% or 65% in practice can be efficient (and why this has been assumed in past determinations), for instance to reflect lumpy investment with a long life, or borrowing when debt is cheapest. This is a normal situation for infrastructure businesses. In the former case customers benefit immediately from the investment (as the alternative to increased gearing is Pay

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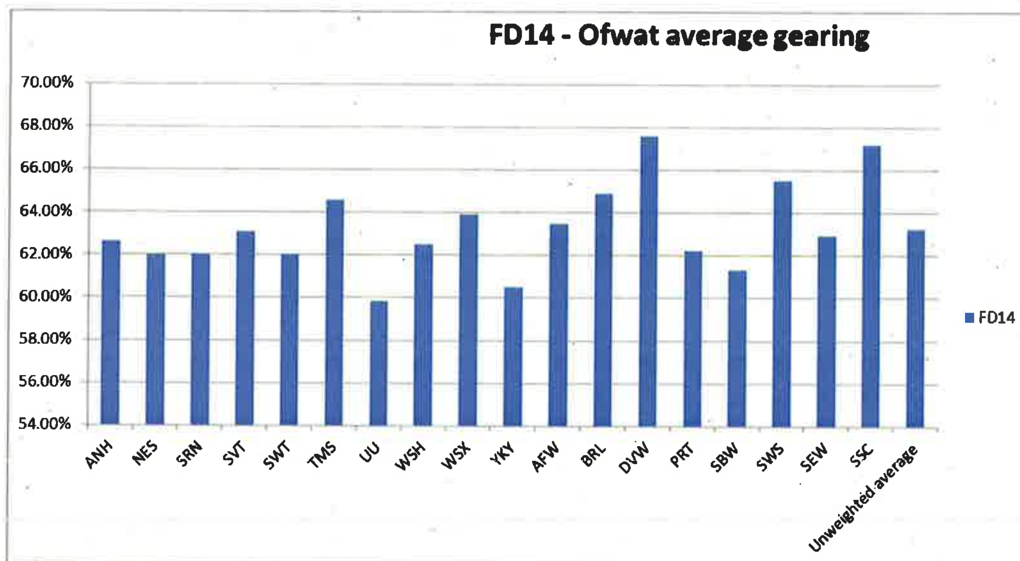
As You Go rather than over the life of the asset), and in the latter case the industry cost of debt is ultimately lowered.

Figure 2 in the consultation illustrates gearing compared to a new 60% notional expectation. Ofwat have always in the past referred to a notional **range** of gearing. This is an obvious point given notional gearing was set at 62.5%, and Ofwat have a determination that then allowed to increase in many cases. The gearing on **average** over 2015-20 from table A8.9 of Ofwat's PR14 final determination is shown below:



For many companies the end point of "notional" gearing in Ofwat's own determination was significantly higher (for instance for Bristol Water it was **67.4%,** and **71.6%** after revenue reprofiling and other technical adjustments). This differs widely across the industry, and in reality Bristol Water has reduced gearing below the FD level to below 65%. This determination outcome for notional gearing at PR14 is before considering the impact of the c1.5% reduction in the 2020 RCV across the industry from the correction of CIS inflation outstanding from PR14.

We urge more thought and dialogue about the degree of compulsion. Our preferred approach is for Ofwat to change the consequences of the IAP assessments to include specific consequences for cost of debt sharing in the context of the dividend policy, plan investment and legitimacy proposals.

It is right that customers should not bear any downside risk from a gearing or cost of embedded debt sharing adjustment. But equally this needs to be considered with clarity about what is being shared and

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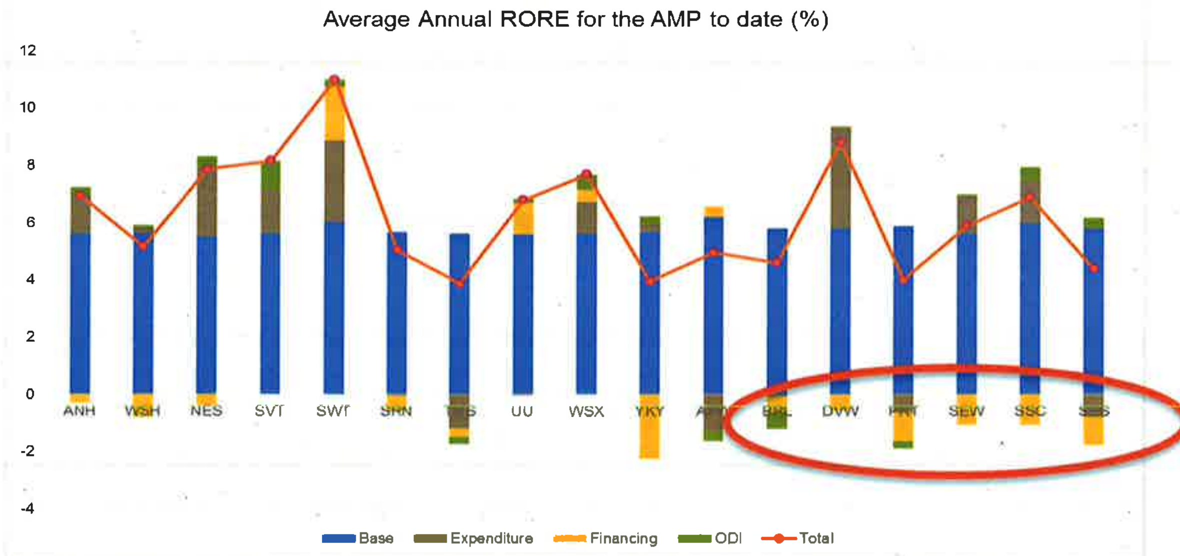
why it is in customer and investor interests to do so, particularly where a mechanism is compulsory and becomes a standard part of the regulatory framework.

It is worth remembering the context that the water companies are not currently universally outperforming the cost of debt or other regulatory incentives. This in part reflects the diversity of the sector but also the strength of the totex and outcomes framework has had in moving focus away from just financial performance. Financial outperformance, based on the current cost of debt is mixed, and for water only companies they all have higher debt costs than Ofwat assumed, as illustrated below in the Ofwat annual financial performance report.



Investors will inevitably respond to a gearing sharing mechanism. Whilst they may support voluntary proposals in the context of a company five-year business plan, any mechanism which moves away from financial theory and that would require complex rules (for instance on intercompany debt) will affect the wider availability and cost of finance for the industry. How these rules are introduced, and in what context, is therefore more important than the principle of the mechanism itself.

Q2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?

We answer this question by assuming the wording in Q1 on being required to propose mechanisms for high gearing / debt sharing was not in fact the case for all companies, as outlined in the consultation document.

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We agree that there are circumstances where Ofwat could consider intervening in a determination to impose a sharing mechanism. However, we do not think it is likely to provide good regulatory incentives and meet the objectives of "putting the sector back into balance" in practice (due to practicalities that we explore in Q3) if this is only linked to a single level of gearing or through simple cost of equity to cost of debt sharing.

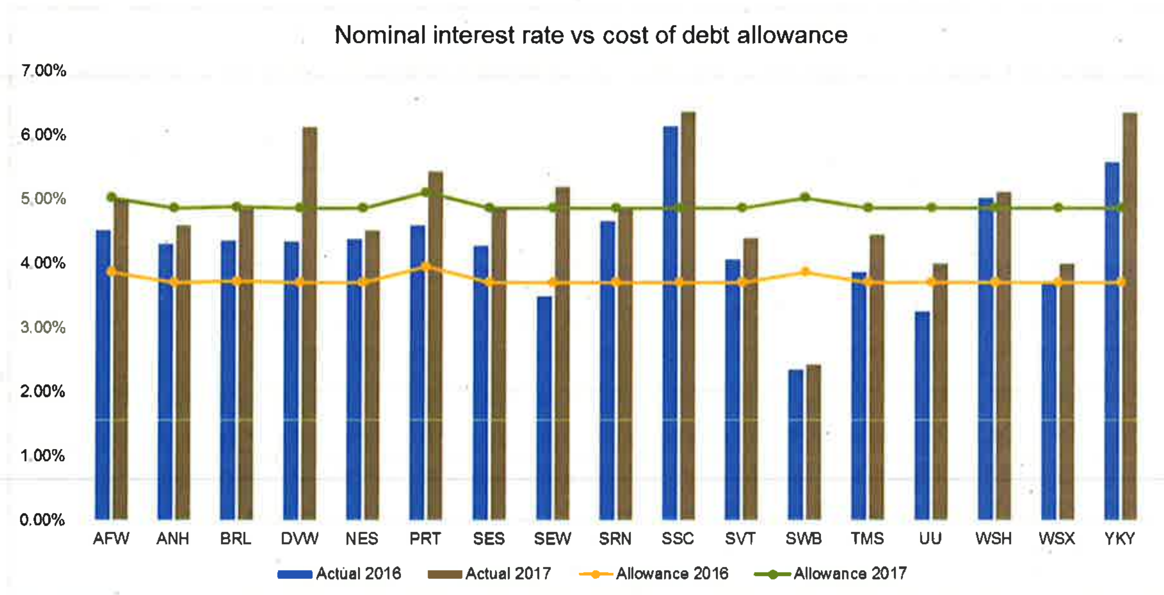
Our answer to Q1 suggests that higher levels of gearing in practice can be efficient, for instance to reflect lumpy investment with a long life, or borrowing when debt is cheap. In the former case customers benefit immediately (as the alternative to increased gearing is Pay As You Go rather than over the life of the asset), and in the latter case the industry cost of debt is ultimately lowered.

The degree of compulsion is important. There is a significant risk that compulsion would result in a) less innovation in company own sharing and service proposals, b) perceptions that the regulatory framework was dis-incentivising long term investment (which resulted in an increase in gearing for a period of time) and c) had a negative rather than a positive impact on financial resilience. This is assuming no impact on the cost of equity for the industry (which as we show above could apply with a mechanism that included most companies).

In setting the cost of capital using CAPM and a notional structure, the financial theory assumes that there is no financial benefit to WACC from increasing gearing. This is why Ofwat have always used actual tax in the financial model at price review for companies geared above the notional assumption, as this is the only theoretical benefit from higher gearing. Fundamentally this makes it difficult to impose this mechanism and retain other aspects of incentives untouched. If companies expected returns on average do not equal the cost of equity, there is a strong argument that beta and the cost of equity must increase from such a systematic risk. We wonder whether therefore a base dividend yield cap with dividend policy linked to outperformance, adjusted to reflect actual gearing as the consultation proposes, would be better from a regulatory incentive perspective. However, this would have to be voluntary to reflect a company's specific business plan, and should be judged by Ofwat in this context. Voluntary cost of debt sharing to reflect company specific challenges to financial resilience, legitimacy or performance then has a role to play.

Q3: Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt.

The first challenge with the proposed mechanism is how likely it is to be triggered. If it is triggered in most circumstances rather than by exception, then it does not meet the objectives of the consultation as it is effectively reducing allowed returns below the cost of equity. As we show above, the level of the gearing trigger for such a mechanism would need to be company specific, to include the past and previous determination as a minimum. In addition, there is clear evidence that a significant deadband is required to avoid the situation we describe below. The range of notional gearing outcomes in the past suggests a level between 7% and 10% would be required. The impact of short term inflation movements on performance on the cost of debt, as indicated below between 2015 and 2016 within Ofwat's financial resilience report, also requires a significant deadband to avoid a asymmetric sharing mechanism being triggered for normal short-term variations in inflation.



The cost of debt performance in the industry is in part linked to inflation, which also affects the level of gearing. It is likely therefore that higher gearing is associated with lower inflation, which could be a transitory impact likely to reverse over the medium term. At the point that this temporarily resulted in sharing, companies would be more likely to be underperforming on the cost of debt in real terms. This confirms the logic of Ofwat's suggestion for the mechanism of using the nominal cost of debt and equity, to take into account inflation.

For any sharing mechanism, we agree that using the notional cost of equity and actual cost of debt is appropriate in nominal terms, but for the cost of equity we suggest using actual rather than long-term inflation for consistency. Ofwat could also consider whether a deadband on the level of sharing (say 10% of the cost of equity) would be appropriate for company specific financing arrangements (such as timing of dividends), given that the mechanism is asymmetric.

However, gearing is also going to potentially be impacted by other regulatory incentives, such as outcomes, and potentially voluntary sharing mechanisms (assuming these are not overwritten if Ofwat impose the specific cost of debt mechanism suggested in the consultation). Outcome underperformance may be more than offset by totex efficiencies, which will be returned to customers at the start of the next period (and potentially then increase gearing). A mechanism adjusting for regulatory incentives could become very complicated in order to meet the objectives of the consultation.

A mechanism that is "targeted" and company specific (necessary in our view, unless Ofwat accelerates revenues to standardise determination notional outcome gearing to the notional level, which would not be in customer's interests for bills or financial resilience) with a wide dead-band, would not improve sector transparency or legitimacy. Sharing based on the difference between the cost of equity and cost of debt where dividend distributions exceed an adjusted dividend yield for performance and gearing would meet the objectives of the consultation better than a complex mechanism. But we do not think this mechanism can be imposed without increasing the cost of equity, and therefore must only be for companies to voluntarily consider.

We agree that an adjustment in any gearing mechanism should be based on the notional cost of equity and the actual cost of debt, both in nominal terms. One approach would be to take a company specific approach based on the dead-band above Ofwat's PR19 determination for the company, the previous determination for the company (perhaps without a dead-band) or the new industry notional level of gearing, whichever is higher. Whilst relatively straightforward, this may not be sufficiently transparent to build confidence in practice. It would also still require rules on where in the corporate structure gearing was measured, which would have the potential to be avoided in practice without highly complex and detailed rules.

As an alternative we think Ofwat should encourage companies to consider a dividend yield adjustment approach should dividend policy become something that the regulatory framework decides to control, and this alternative approach would better allow for Ofwat to review these voluntary mechanisms in the proposed IAP test because of this context.

Such a mechanism could consider a base level of dividends (adjusted for changes in gearing above a dead-band), with sharing triggered by dividend pay-outs that differed from the policy that companies set out in their business plans. This would avoid the risk with gearing mechanisms that it did not reflect the plan or determination. It would also allow the cumulative dividend yield and performance over the price review period to be adjusted. For an asymmetric mechanism, this would allow adjustments that accrued in one year to reverse in future years, to reflect that companies make short term financing decisions in advance of performance being known. This helps to avoid the impact of short term inflation movements being excessively penalised. Because the mechanisms operate for a five-year dividend policy within a determination, they would need to be voluntary so that companies could propose adjustments to reflect

their own financing proposals, subject to Ofwat IAP scrutiny. We propose elsewhere in our response that the consequences of the IAP tests could include a standard gearing or dividend policy.

Although we think the 5% dividend yield in the consultation is a reasonable starting point for this type of mechanism, our approach would allow the company would propose the dividend yield policy and what payments to shareholders were included within it (e.g. to avoid group debt, preference shares etc that form part of the cost of debt) within the business plan). This can be done separately from the notional assumptions used in the financial model, which Ofwat may for cash flow purposes want to keep consistent in PR19 financial modelling.

Q4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of services to customers, financial resilience and employee interests?

We think the dividend policy approach should be the focus of the "putting the sector back into balance" proposals. As we explain above, this allows companies to develop sharing proposals based on wider performance, rather than just levels of gearing. This avoids the issues we see with a voluntary (or compulsory in practice) gearing sharing mechanism. It has the advantage that it could apply to all companies irrespective of their current level of gearing. It also allows Ofwat to consider the need for the mechanism and wider sharing in the context of the company's track record (e.g. is it currently highly geared), as well as providing protection to customers even where a company has historically had lower gearing. This provides a sector wider message on trust, as well as allowing targeting of the companies with specific issues.

Our view is that the best way of achieving this outcome is for Ofwat to change the consequences of the IAP assessment. Ofwat could change the consequences of "significant scrutiny" and perhaps "slow track" to include specific dividend control proposals, alongside the basket of other measures. This also allows Ofwat to reconsider how the current IAP consequences fit with these types of sharing arrangements, given the asymmetric totex underperformance and potential for no outcome rewards to in themselves result in financial viability concerns, and may conflict with proposals for the gearing and voluntary sharing mechanisms Ofwat would also like to see.

We agree with the consultation that a 5% base dividend yield would be considered reasonable, but it may not be appropriate for all companies in practice because the timing of returns to shareholders should not be restricted to a five-year price review period. Companies should be able to set their base dividend yield in the context of their own financial resilience and long-term financing plans with their shareholders.

We would note however that it is not clear from this consultation whether companies should set this base dividend yield at a level consistent with the cost of equity assumed in the business plan, together with a dividend yield assumption. This is something companies can consider within their proposals, but the approach should ultimately be consistent with the notional assumptions Ofwat use at PR19, particularly if standard gearing sharing mechanisms were being used. Otherwise, the assumptions used in the business plan on equity retention could then fall well within the dividend policy approach, which may not be consistent with long term financial resilience. We cannot conclude what mechanisms may be appropriate without the wider context of licence changes. Therefore we think that Ofwat requirements should be a consequence of the IAP assessment rather than being required on all companies.

We think a focus on dividend policy and dividend yield sharing, rather than just gearing mechanisms, may help to avoid many of the potential issues.

Q5. Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related element of executive pay demonstrate a link to exceptional delivery for customers.

We agree that Ofwat should consider performance related executive pay within the IAP test. However, Ofwat will need to consider the appropriateness of the test and the risk that it embeds requirements on companies when wider corporate governance requirements will change. The rules applying to the corporate governance of all companies are likely to change over time, and some degree of flexibility outside of the price review process may be required, for instance if Board structures or ownership changes there is a risk of sclerosis through fixed rules. We are not sure in practice, other than testing the commitment to transparency and link to performance, what the IAP test will measure on pay unless it is the intention to set thresholds (e.g. for remuneration), an approach which is unlikely to boost legitimacy.

On pay, the consultation refers to “exceptional” delivery for customers, which would conflict with corporate governance expectations that executive pay should adjust to reflect all performance, and not just “exceptional” delivery. Clearly in an ambitious plan, the targets should reflect what is exceptional, but in practice performance related pay and wider staff bonuses that emphasise the change in culture that companies need to deliver for their customers should vary over a range of performance, in the same way that dividends do.

We would urge some element of flexibility for Boards to recognise the wider context of performance, which effectively is what s.172 of the Companies Act 2006 expects companies to have regard to in aligning a wide range of factors with fulfilling their duties to shareholders. The key risks to trust in the

industry are not generally just captured in performance measures – an element of judgement and scrutiny to circumstances is required. Given this, there is a question whether the IAP tests should judge executive pay policy unless there are specific proposals in the business plan that the company is proposing that make this relevant, including sharing and other plan pledges that are likely to be company specific.

Q6. Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?

We agree with the proposed extension to the confidence and assurance test area. We would suggest that the wording is less definitive about what appropriate means, rather than being determined in the wording of the test. This is to emphasise the voluntary nature of the considerations, but that the perspective of trust and confidence is at the heart of these specific questions. Most importantly, the matters in this consultation are far from the only factors that affect trust and confidence, particularly where gearing is not high / high dividend payments have not been made. Customers may wonder for their company why there is a focus on issues that they do not recognise as a problem and have not been a problem in practice. The focus on these mechanisms must not lead customers to question whether what they believe about their company's performance in the past is in fact the case, just because a mechanism is introduced. Any mechanisms should therefore distinguish sufficient protections for the wider public perception of the whole sector from the general efficacy of its regulatory framework by only being applied by exception. We therefore suggest the wording (underlined where we make suggestions) is adjusted to

"To what extent has the company's full Board provided assurance that the company's business plan will enable customers' trust and confidence, **including through appropriate measures to provide a fair balance between customers and investors (which may include outperformance sharing, dividend policies and any performance related element of executive pay) and** high levels of transparency and engagement, on issues that matter to customers (which extends to their ability to understand corporate and financial structures and how they relate to its long-term resilience)?

Q7: Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?

We agree with the principle that Ofwat will require a common scenario tested as part of the IAP testing of financial viability. The standard levels proposed may be unrealistically severe in some cases, but we think companies should test at this level and then as part of their descriptions of mitigations explore why there are more appropriate scenarios. We think the consultation clarification was sufficiently clear on this.

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Totex underperformance and the level of bad debt in the scenarios may be the assumptions most open to question. If this was a general risk across the industry it could be argued that the mitigation would include interim determinations, including the "substantial effects" mechanism in the licence. Therefore, it may be appropriate for Ofwat to clarity if the totex underperformance should reflect a company specific (rather than industry new obligation) cost shock, which was considered to result from inefficiency. This would be consistent with the "turnover penalty" scenario. This is a more useful assumption for industry standard IAP tests. For their own scenarios companies will need to consider what specific and generic risks they can foresee and what the role of mitigation and risk sharing mechanisms may be, if any. This avoids the risk that the scenario testing is seen as inconsistent with standard water company licence mechanisms, which include significant judgement, particularly if for a single factor affecting the whole industry.

Financial viability, and the related licence provisions, should recognise the role of dividends. Gearing may increase due a cost shock, with the consequence being retaining equity through reducing or retiming dividend payments. This is why we have concerns about compulsory gearing sharing, rather than recognising the role for company dividend policy to reflect their business plan, including mitigation of risks.

The list of examples of factors on page 33 of the consultation that may affect a company's financial resilience we think should have included under "management and operations" an additional point "Delivery of outcomes for customers". Poor incentive performance as well as cost variability can affect a company's financial resilience and this is an important addition.