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Rachel Fletcher
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By Email Only

Dear Rachel

Consultation on demonstrating financial resilience and sharing outperformance

We welcome the chance to respond to this consultation in order to help shape your decisions in this important area for the legitimacy and trust of the sector. While the level of trust and more generally satisfaction with services is judged to be high, with the Consumer Council for Water reporting that “customer perception that companies care about the services they provide, and customer trust in water companies both remain high”[1], it can of course be improved and we know we cannot take the trust of our customers for granted.

We acknowledge that some of the corporate behaviour in the sector could have diminished this level of trust. This places obligations on us all to work with you to develop a regulatory framework that works for our customers while not diminishing the important role investors play in delivering the significant service improvements that we have seen in the past and that we continue to build on.

We welcome much of the content of your consultation. We support its focus on ensuring transparency and clarity in the way we operate. This aligns with similar moves being made across the wider corporate world, as demonstrated through proposed updates to the Financial Reporting Council’s UK Corporate Governance Code and Guide to Board Effectiveness.

We fully support the need for transparency and clarity in the way we determine and explain dividends and executive pay settlements in the context of what we deliver for our customers. We would welcome clarity in what is meant by dividends only being paid “after they have confirmed that obligations and promises to customers have been delivered”. There are many aspects to delivering for customers and in any given year we may have a mix of out- and underperformance. We agree that in paying a dividend we need to explain this mix of performance and how it has been used to responsibly determine payments. We do not agree that the dividend should be set based on meeting pre-defined hurdles or be limited to a maximum percentage yield. Any policy change that creates these barriers seriously risks creating a framework based on rate of return regulation and discouraging investment and

[1] CC Water’s Water Matters report on customers’ views (sections 1.1.1), June 2017.

innovation in a sector that has much to deliver to ensure long-term resilience in services. We consider such a development would be to the detriment of customers in the long term.

Regulatory policy must encourage a fair balance of risk and return between investors and customers and a regulator needs to have powers to step in where they see companies making decisions that may present a risk to customers or diminishes their trust in the sector and the services it delivers. With this in mind we welcomed Ofwat's focus on monitoring a suite of financial metrics under its approach to Monitoring Financial Resilience. We are concerned that Ofwat's proposed financial outperformance mechanism moves this wider examination of financial resilience towards a focus on only one metric – gearing.

We are also concerned that the proposed mechanism is aimed at sharing outperformance of companies with gearing above 60% when there is no evidence that this level of gearing, when viewed in isolation of all other aspects of a company's financial structure, presents a risk to customers. We suggest that gearing of 60% (or c.65% if applying a deadband) does not represent a "highly geared structure".

While we acknowledge that higher gearing benefits investors, retaining a framework that encourages investment ultimately benefits customers too. We would urge you to reach your decision on when the outperformance sharing mechanism should be applied based on evidence of what level of gearing results in greater risk to customers. This would ensure that the creation of an additional regulatory driven constraint on the industry has some basis in relation to your duty to protect the interests of consumers. We do not agree that this level should be set at 60%. We have consistently demonstrated that we remain financially resilient, and therefore are not placing an unacceptable risk on customers, with gearing of around 77%. This is backed by our choice to maintain a structure that incorporates features designed to protect the appointed business (and ultimately customers) from payments to shareholders in excess of what the business can sustain in the long term. This includes cash and dividend lock up protections and an independent intermediate holding company (with independent directors) that can restrict dividend payments.

We also maintain the investment grade credit rating required by our licence. This assessment takes account of structural protections incorporated in our financing structure in a consistent and completely independent manner and provides evidence of where financial markets deem there to be risk associated with the level of gearing. We are of course in the process of reviewing our financial structure to ensure that we can continue to demonstrate financial resilience to you and our customers through our proposed business plan; to our bond holders; and to credit rating agencies. Reducing gearing is one of many considerations in ensuring that our financially resilient position is maintained.

In summary, we agree that customers should benefit from the additional returns realised from highly geared structures. But the introduction of a new mandated mechanism must be examined in the context of continuing to encourage investment in a capital intensive sector. We suggested an alternative sharing mechanism in our original PR14 Business Plan. This was based on matching dividend payments above a proposed threshold with an equivalent customer benefit. This focus on cash leaving the business recognised that higher returns – from whatever source – were actually advantageous to customers if retained within the business, thereby strengthening the financial resilience of the appointed business. We disagree with the inference that gearing of 60% equates to a highly geared structure. We would welcome sight of the evidence that you use to make your final decision on what is a highly geared structure and why you have decided that stepping in and requiring a mechanism is appropriate at this level when viewed in the context of balancing your duties to protect the interests of consumers and securing reasonable returns on the capital invested.

In appendix 1 we provide our response to the questions posed. Please get in touch with Joanna Campbell (Joanna.campbell@seswater.co.uk, 01737 785 692) if you would like to discuss any aspect of our response in more detail.

Yours sincerely

Anthony Ferrar
Managing Director

Appendix 1 – response to 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 initial assessment of plans (IAP)?

Regulatory policy must encourage a fair balance of risk and return between investors and customers and a regulator needs to have powers to step in where they see companies making decisions that present a risk to customers or diminishes their trust in the sector and the services it delivers. With this in mind we welcomed Ofwat's focus on monitoring a suite of financial metrics under its Monitoring Financial Resilience approach. It demonstrated that measuring the financial resilience of a company was more complex than just looking at what level of gearing a company has.

We acknowledge that higher gearing benefits investors but retaining a framework that encourages investment ultimately benefits customers too. Ofwat has always, rightly, maintained the line that company structures are a matter for companies. This proposal undermines this long-standing principle and creates further constraints on the ability of companies, and their investors, to make choices about such matters. There is a real concern from investors that proposed changes to the regulatory framework will diminish interest in investing in the sector which ultimately will carry a price that will be paid by customers.

The introduction of a new mechanism must be examined in the context of continuing to encourage investment in a capital intensive sector and reach a balance between your duties to protect the interests of consumers and securing reasonable returns on the capital invested. We agree that customers should benefit from the additional returns realised from highly geared structures.

We disagree with the inference that gearing of 60% (or c.65% if applying a deadband) equates to a "highly geared structure". We would welcome sight of the evidence that you use to make your final decision on what is a highly geared structure and why you have decided that this is the point where you need to step in and require a mechanism.

We have consistently demonstrated that we remain financially resilient, and therefore are minimising the risk to customers, with gearing of around 77%. In addition, our structure incorporates features designed to protect the appointed business (and ultimately customers) from payments to shareholders in excess of what the business can sustain in the long term. This includes cash and dividend lock up protections and an independent intermediate holding company (with independent directors) that can restrict dividend payments.

We also maintain the investment grade credit rating required by our licence. This assessment takes account of structural protections in a consistent and completely independent manner and provides evidence of where financial markets deem there to be risk associated with the level of gearing.

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?

If you decide, following this consultation, to change the PR19 Methodology to include a financial outperformance sharing mechanism then it should be imposed on those companies that do not follow the revised methodology.

The final decision needs to provide further information on how you will decide what will pass the “adequacy” test. For example, if a company demonstrated that it was in the best interests for its customers to share outperformance from gearing at a level greater than the notional gearing level would this be judged as adequate?

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?

We agree that the mechanics of the proposed mechanism are appropriate except for the calculation of the gearing difference. As explained in our answer to question 1 we consider that the gearing difference should be based on the difference between actual gearing and a level of gearing that is supported by evidence of additional financial risk adopted and therefore ultimately presents a risk to customers. We support the inclusion of a deadband around the chosen level of gearing to address the variability in gearing as per the points made in the consultation.

It is also worth considering whether the sharing rate adopted should align with the sharing rate applied to totex out- and under-performance.

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 service to customers, financial resilience and employee interests?

We fully support the need for transparency and clarity in the way we determine and explain the dividends paid in the context of what we deliver for our customers.

We would welcome clarity in what is meant by dividends only being paid “after they have confirmed that obligations and promises to customers have been delivered”. There are many aspects to delivering for customers. In any given year we may have a mix of out- and underperformance on the diverse range of performance commitments we have made to our customers. We agree that in paying a dividend we need to explain this mix of performance, how we have delivered against other elements of the price control framework and how this has been used to responsibly determine payments.

While we support providing transparency in how we reach a decision on the level of dividend we do not agree that the dividend should be set based on meeting pre-defined hurdles or be limited to a maximum percentage yield. Any policy change that creates these barriers seriously risks creating a framework based on rate of return regulation and discouraging investment and innovation in a sector that has much to deliver to ensure long-term resilience in services.

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 fully support the need for transparency and clarity in the way the industry responsibly determines and explains performance related elements of executive pay. We agree that the business plan needs to reference the overarching policy that will be applied over 2020-25. We will also explain our approach on an annual basis through our Annual Report and the approach we take will align with best practice and the latest UK Corporate Governance Code and Guide to Board Effectiveness as published by the Financial Reporting Council (FRC).

An update to the UK Corporate Governance Code is due out before business plans will be assessed and therefore we would expect Ofwat to take this into account in its assessment of companies' approaches and therefore for the requirements of Ofwat to align with those of the FRC.

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 have no objection to the changes proposed to the test question in this area. Based on the proposed wording we would expect you to take into account all aspects of a company's plan to share outperformance and not limit the assessment to the new measure you are proposing in the consultation.

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

We agree that demonstrating financial resilience is a crucial part of a well-justified and high-quality business plan and therefore assessing it is an essential part of the business plan review process.

On an annual basis we demonstrate financial resilience through our Annual Report, and for the last couple of years, this has included a Long-Term Viability Statement. The latest guidance you have issued on long-term viability[2] rightly leaves the choice of scenarios for the stress test to each company stating "the assumptions used in the stress testing should be consistent with the wider risk assessment undertaken by the company and reported in its statutory accounts" and "companies should stress test their forward looking plans by modelling appropriate scenarios and sensitivities which reflect the risks that the business faces".

We consider that the approach you currently take, namely allowing each company to choose the scenarios used for stress testing based on their own assessment of risk, is the right approach. We therefore do not agree that the minimum list of scenarios provided is appropriate as it forces companies to look at scenarios which may not be appropriately severe, plausible or reasonable for its individual circumstances and risks.

We consider that it is more appropriate for each company to be allowed the flexibility to adopt scenarios that align with its own circumstances and risks, and where this does not capture all the scenarios proposed in the consultation that the company provides an explanation on why it

[2] IN 18/04 Expectations for companies in issuing long term viability statements, March 2018.

has not been adopted. We would welcome clarification on whether this is your intent when you state “unless a company can demonstrate a particular scenario is not relevant” (page 37) or whether we would be penalised for taking the approach of explaining why some of the scenarios are not appropriate.