Putting the sector back in balance

South East Water response

17th May 2018

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Contents

Executive summary

Thank you for the opportunity to comment on the consultation.

Overall we support the general themes and objectives that Ofwat are trying to achieve in terms of improving trust and confidence in the sector. A lot has been already achieved, in particular we have reduced our total leakage by 7 million litres of water a day since 2010, reduced customer complaints by 90% over the last 5 years, improved our customer satisfaction, paid lower dividends than the notional allowed dividend (£91m actually paid to shareholders in the last 5 years against notional allowed dividends of £206m) and provided support to those vulnerable customers who may struggle to pay their water bill. We have de-geared from 82% to 78% over this regulatory period and plan to de-gear to below 75% during the next regulatory period.

However the sharing financing gains and potential capping of dividends proposals are major concerns. In particular the proposals around:

- Sharing outperformance associated with higher gearing; and
- Potentially introducing an absolute dividend payout ratio

represent changes to the basis of regulation in the UK upon which companies in the water sector, as well as their debt and equity investors, have invested for years that are retrospective and fundamental.

These proposals undermine established finance theory that is adopted by all the UK regulators and would be a change to one of the core founding principles of UK incentive-based economic regulation that it is for companies, not the regulator, to choose their actual financing structure and determine the level of dividend payout based on annual results, outperformance and forward-looking liquidity requirements of the companies.

We support transparency and will commit to provide explanation to customers around our adoption of higher gearing than the notional company in our Business Plan and other appropriate customer communication media. However, we do not believe that incentivising companies to adopt the notional gearing structure would improve trust and confidence in the sector or address an issue where evidence of customers' concern has been provided.

As we explain below, customer bills are based on an allowed WACC set by Ofwat for a notionally efficient company, irrespective of companies' actual capital structure. Mainstream finance theory also explains that companies' cost of capital is broadly insensitive to the level of gearing, as a higher share of relatively cheaper debt is offset by the increase in cost of equity due to its higher risk. The CMA and other GB regulators have also drawn the same conclusions at recent price control reviews. Therefore, evidence indicates that companies do not accrue any "benefits" associated with higher gearing to the detriment of customers.

Water companies, in line with other GB and European network utilities, have increased gearing over recent years for a number of reasons:

- As a means to impose discipline on management;
- To allow access to a more diversified pool of equity funding sources for the industry, some of which seek higher equity risk; and
- To take advantage of favourable debt markets, with the latter fully passed-through to customers by Ofwat's low cost of debt allowance.

Alongside established finance theory and regulatory precedent, none of these factors imply that equity investors "outperform" at higher levels of gearing. Therefore, not only is there no "benefit" from higher gearing that the company accrue and could share, but for this reason Ofwat's gearing outperformance measure would undermine financial resilience by delivering (*by definition,* through the sharing of a non-existent benefit) an allowed equity return below the financing cost that Ofwat itself has set.

In addition, a clear customer benefit associated with higher gearing is the reduction in companies' tax liabilities, which has already been fully-passed through to customers under the existing regulatory rules for a number of current and past price controls. Conversely, Ofwat's proposals are likely to incentivise higher geared companies to de-gear even further with a consequent increase in tax liabilities, leading to higher customers' bills. Overall, we calculate customer benefit of around £16 over PR19 in terms of lower bills, where the company adopts a gearing structure of 75 per cent.

We also disagree with the proposals on sharing outperformance associated with the cost of debt. Ofwat's approach – by setting the allowance based on an industry average for embedded debt and an efficient industry benchmark – ensures that companies recover only efficient debt costs. Similar types of approach have been adopted in other UK incentive-based regulatory regimes for years. An asymmetric mechanism where companies that outperform the cost of debt share the upside with customers whilst companies that underperform do not share the downside with customers is inconsistent with other areas of regulation. For example both totex outperformance and totex underperformance are shared with customers.

Ofwat's proposals are without precedent. No other UK regulator, including CMA, Ofgem, and Ofwat itself with TTT, has perceived the need to complement cost of debt indexation mechanisms, which only allow for the recovery of efficient costs, with additional sharing mechanisms.

Sharing outperformance associated with gearing above notional

Ofwat has not demonstrated why they need to intervene to influence companies' actual gearing

Ofwat should have regard to the principles of best regulatory practice, which include ensuring regulatory activities are targeted only at cases in which action is needed. Ofwat have not demonstrated that higher gearing is of detriment to customers and the evidence supports the view that higher gearing is beneficial to customers through lower customer bills. Ofwat has not provided any impact assessment to determine the direct and indirect consequences of any outperformance sharing mechanism based on gearing.

Companies earn the same return irrespective of capital structure

Ofwat argues that companies which adopt gearing levels above the assumed notional level enjoy "benefits" in form of higher returns and that such "benefits" should be shared with customers:[1]

We disagree with Ofwat's assertion that companies with gearing levels above notional earn "benefits" in form of higher returns. All companies earn the same baseline return, based on the allowed WACC determined by Ofwat for a notionally efficient capital structure at the price control review.[2]

[1] *"We still consider it is appropriate for companies to choose their financing structures, but we consider it is important that* ***where companies adopt higher levels of gearing, that they share their higher returns with their customers****. In the absence of sharing mechanism,* ***investors in such companies earn higher returns, with no equivalent benefit to customers****."* Ofwat (April 2018), Putting the sector back in balance: Consultation on the proposals for PR19 business plans, p.4.

[2] In practice, companies' actual returns will vary depending on their operational and financial performance. However, allowed returns determined by Ofwat ex-ante are equal to the notional WACC.

Companies' actual financial structure decisions have no impact on allowed revenues and therefore no impact on customer bills. Indeed, this is the reason why Ofwat and most other UK regulators, including the CMA in its consideration of the Bristol Water appeal[3], adopt a notional approach, i.e. to ensure that the allowed revenues reflect the allowed WACC for a notionally financed company, irrespective of companies' actual financial structure choices.

Given there is no "benefit" in the form of higher returns for companies with actual gearing above notional and indeed no corresponding additional "cost" to customers, there is no need to adopt a sharing mechanism for outperformance that does not exist.

Ofwat's assumption of gearing outperformance contradicts mainstream theory

It appears that Ofwat considers that in particular companies' shareholders (as opposed to debt and equity investors jointly) enjoy benefits from higher gearing, equal to the *"difference between the cost of equity and the cost of debt for the actual proportion of gearing that is above [Ofwat's] notional assumption."*[4]

However, this argument is flawed. Higher returns earned by equity holders of companies with actual gearing above the notional level do not represent "outperformance" but compensation for greater risk. Mainstream finance theory explains that the cost of equity increases with the level of gearing, due to an increase in equity risk resulting from financial leverage. Intuitively, the reason for this is as follows:

- Equity bears the full impact of cash-flow volatility, as debt represents a fixed claim on the company's cash-flows that is satisfied before equity;
- Increasing the level of debt reduces the amount of cash-flows leftover for the return on equity;
- As a result, the same *absolute* shock to the company's cash-flows (revenues or costs) will have a higher proportionate impact on the equity return the higher the gearing level, due to the same *absolute* shock being spread over a smaller equity return base; and
- The higher volatility in equity returns resulting from increasing financial leverage increases risk to equity which translates into a higher expected return.

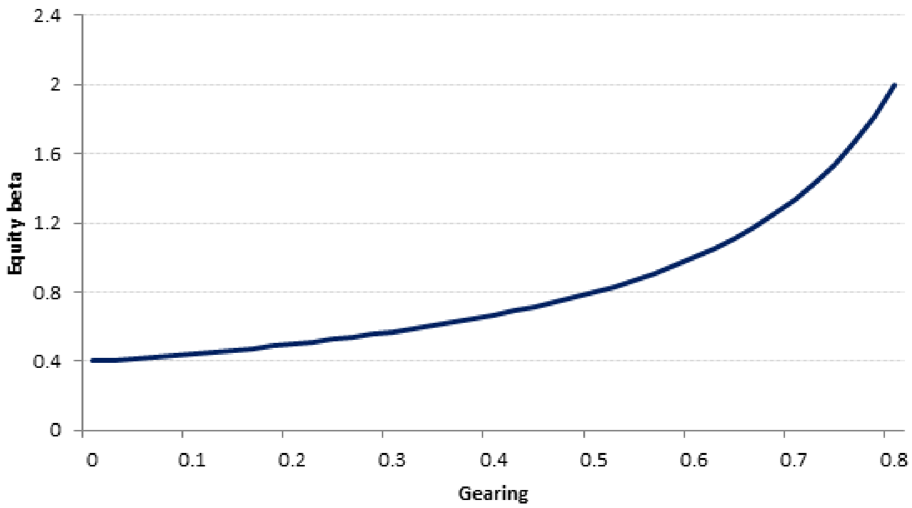
Standard financial literature describes a direct relationship between equity risk (as measured by the equity beta) and financial leverage, e.g. through the Miller formula:

$$\text{Beta}_{\text{equity}} = \frac{\text{Beta}_{\text{asset}}}{(1 - \text{Gearing})}$$

[3] CMA (October 2015) Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991, p. 308, para 10.28. Link: https://assets.publishing.service.gov.uk/media/56279924ed915d194b000001/Bristol_Water_plc_final_determination.pdf

[4] Ofwat (April 2018), op. cit., p.15.

Figure 2.1
Standard finance theory shows that equity risk increases with gearing



Ofwat and indeed other UK regulators including the CMA[5] recognise this relationship between the cost of equity and level of gearing in setting the allowed cost of equity. For example, in the PR19 final methodology, Ofwat calculated the equity beta based on its assumed asset beta and notional gearing, applying the Miller formula set out above.[6]

In addition, Ofwat's own consultation in a number of places recognises the very mechanism described above, through which equity investors in geared companies are exposed to greater risks compared to companies with a notional financial structure:

*"We note that where companies **underperform against our regulatory incentive mechanisms**, **the impact on equity returns is greater for a highly geared company** compared with the notional structure."*[7]

"*[…] companies with high levels of gearing have potentially lower levels of financial resilience, as the **impact of cost shocks or poor performance is magnified to a smaller equity base**.*"[8]

It is inconsistent for Ofwat to accept that equity risk and therefore cost of equity increases with gearing, while at the same time labelling this increase in equity returns as "outperformance".

Empirical evidence shows greater variation for equity returns at higher gearing levels

Empirically, UK water companies with higher gearing levels exhibit greater volatility in dividend payout ratios compared to companies with lower leverage, as shown in Figure 2.2 below. This empirical

5 CMA (October 2015), Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991, Appendices 5.1-5.11 and glossary, p. A10(1)-34, fn 75.

6 Ofwat (December 2017), Delivering Water 2020: Our methodology for the 2019 price review, Appendix 12: Aligning risk and return, pp. 61-62. The Miller formula presented above assumes a zero debt beta (for simplicity). We note that in the PR19 final methodology, Ofwat used a non-zero debt beta assumption, using an expanded version of the formula

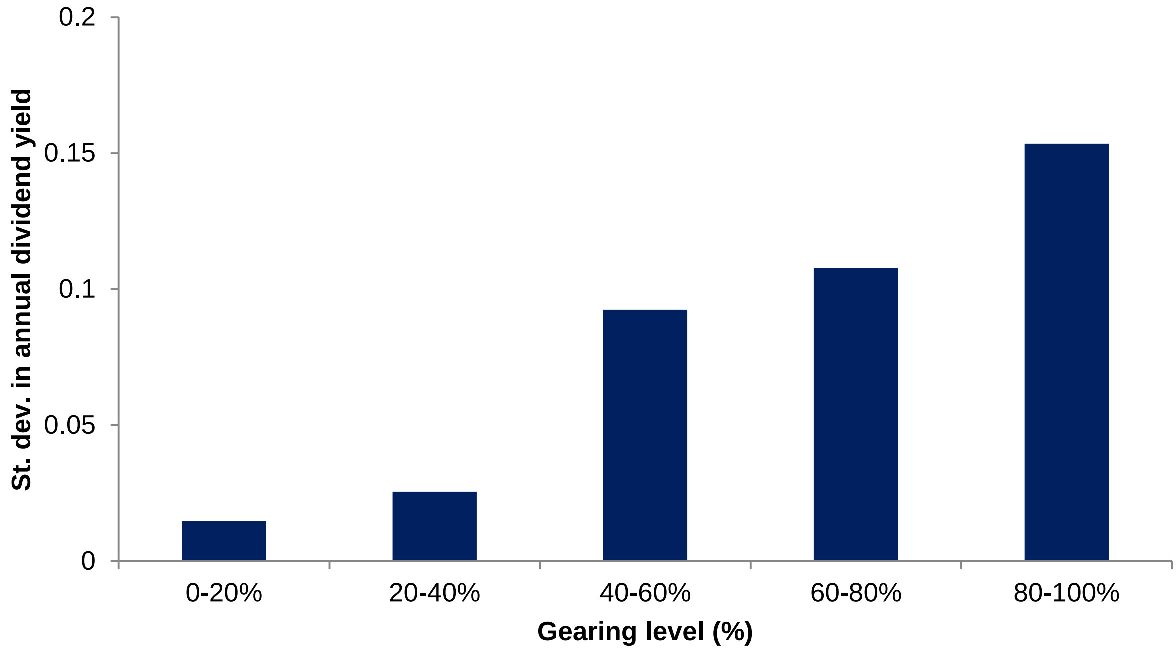
$$Beta_{\text{equity}} = \frac{Beta_{\text{asset}} - Beta_{\text{debt}} * Gearing}{(1 - Gearing)}$$

7 Ofwat (April 2018), op. cit., fn. 4, p.15.

8 Ofwat (April 2018) op.cit., p. 14

observation is consistent with finance theory, as discussed above, that higher gearing is associated with higher equity risk (as measured by volatility of payout ratios).

Figure 2.2
Water companies with higher gearing have higher variation in equity returns, as measured by variation in dividend yield



Sources: Calculation based on net debt figures from Table 8 and dividend figures from Table 10 of Ofwat's Financial Performance and Expenditure Publications from 2001 to 2010 (and then discontinued). Note: The standard deviation is the deviation in the % dividend yield, where the % dividend yield is annual dividend pay-out divided by mid-year RCV less debt

Mainstream theory and GB regulators assume the cost of capital is largely independent of capital structure

Ofwat's proposals would reduce allowed returns for higher geared companies. This approach implicitly assumes that the cost of capital falls with increasing leverage. While this assumption may be intuitively appealing, as higher gearing implies a greater share of relatively cheaper debt, it overlooks the impact of financial leverage on the cost of equity (as described above).

Established finance theory explains that the WACC is broadly unaffected by the level of gearing (referred to as the capital structure irrelevancy). The theory explains that increasing the level of gearing increases the share of relatively cheaper debt in the WACC, but this is offset by the increase in cost of equity due to higher equity risk caused by greater financial leverage, leaving the overall WACC broadly unchanged.

This conclusion is consistent with the position of the CMA. In the 2010 Bristol Water appeal, the CMA analysed the impact on WACC of gearing changes in a range between 50 and 80 per cent and concluded that the WACC is not sensitive to the level of gearing:

"[…] while a level of gearing above the company's actual gearing may lead to a lower WACC, the effect does not seem likely to be large […] our analysis suggests that, after taking account of the tax effect, the WACC is not sensitive to the level of gearing"[9]

Ofwat acknowledges that finance theory implies that equity returns increase in linear fashion with gearing but claims that such theories do not apply to securitisation arrangements. Ofwat claims that: "*Covenants in such arrangements allow companies to achieve a lower cost of debt (and a lower cost of equity) than would otherwise be the case for a given level of gearing*."[10] Ofwat provides no support for its assertion. While we would agree that covenants impose financial discipline and provide one reason (amongst many, as we set out below) for higher gearing, it does not imply that equity costs do not increase with gearing. Rather securitisation structures simply allow companies to gear-up beyond traditional corporate structures as debt takes comfort from the covenants, whilst equity takes on more risk as a consequence.

The increase in gearing over time reflects a range of factors

There are a number of reasons why companies may choose to adopt higher gearing levels above Ofwat's notional assumption:

- Agency theories explain that financial leverage can serve as a means for shareholders to effectively apply discipline on company's managers;[11]
- Debtholders also take comfort from covenants which allow for higher gearing than traditional corporate structures (but does not reduce equity risk);
- The increase in debt may have been in response to the risk-return profile required by a relatively new private equity investor class to the sector, that is, investors seeking greater equity risk; and
- Water-only-companies have adopted higher gearing levels due to minimum efficient scale of debt issuances relative to their RCV.

In addition, the increase in debt finance may reflect a decline in debt costs, which are fully reflected in Ofwat's cost of debt allowance. Indeed, an increase in gearing by European energy network operators has been observed over the past ten years or so.

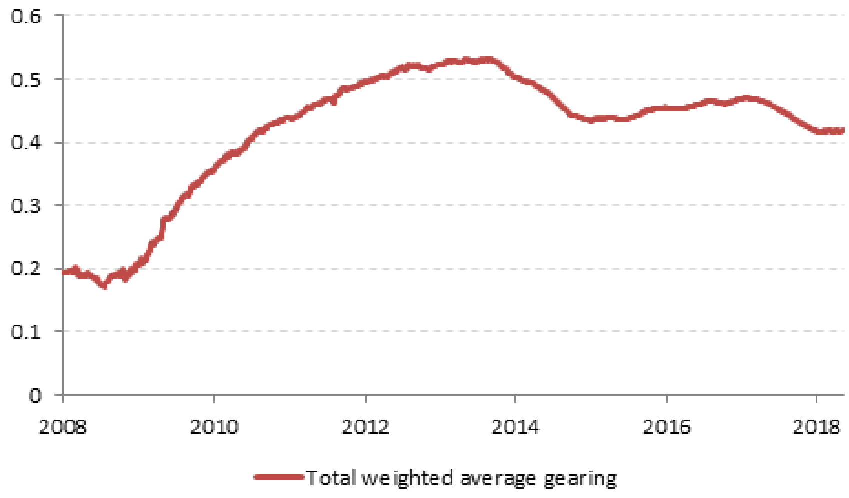
None of these factors imply that equityholders do not face higher risk at high-levels of gearing, as Ofwat assert.

9 CMA (February 2010), BRISTOL WATER plc Notice of Reference: Determination of Adjustment Factor for the period 2010- 2015, Appendix N para 30 and 32.

10 Ofwat (April 2018) op.cit., p. 15

11 Managers, who control the firm's cash flows, in theory have an incentive to maximise their income at the expense of the equity and debt holders, who do not as directly influence the running of the company. Increasing leverage decreases the free cash flows at the managers' disposal and therefore limits the extent to which they can increase their wealth at the expense of the company.

Figure 2.2:
European networks have increased gearing over the past decade, potentially as a consequence of favourable debt market conditions



Source: Analysis of Bloomberg data. The sample comprises listed European network operators: Enagas, Snam, Terna, Acea, Gas Natural, Red Electrica. Gearing calculated as net debt to market value.

<u>The benefit associated with higher gearing is lower tax costs for customers</u>

The benefit associated with companies' actual gearing levels above notional relates to lower tax liabilities associated with the increase in the debt tax shield relative to the notional assumption. However, under Ofwat's current approach, which it intends to retain at PR19,[12] this benefit has been for years and is still currently fully passed through to customers in form of lower customer bills, with companies' retaining zero tax outperformance. Our analysis shows that a customer of a company that chooses to adopt a leveraged structure of, say, 75 per cent, would save around £16.00 on their bills over PR19 compared to a customer of a company with notional gearing of 60 per cent.

Ofwat's proposals to share the alleged "outperformance" associated with higher gearing as well as other proposals (e.g. constraining dividends), if implemented, will incentivise higher geared companies to reduce gearing levels and bring them down to the notional level. This in turn will increase companies' tax liabilities, through the reduction in the debt tax shield, resulting in higher customer bills as a result. Our analysis shows that the average customer bill will increase by around £11.50 over PR19 if all companies adopt a gearing of 60 per cent. [13] The increase for SEW's customers will be greater at around £18.50[14], and be around £22.50 for some companies' customers.[15]

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12 Ofwat (April 2018), op. cit., p.14.

13 We calculate that the industry allowed revenues and hence bills will increase by £54.6 million per annum (March 2017 prices) if all companies de-geared to 60%. The increase in revenues is calculated as: Nominal RCV (end 2017)*(Actual gearing end 2017 (APRs)-60%)*PR19 nominal cost of debt (4.36%)*expected corporation tax rate (17%). Dividing by total number of customers (ca. 47mil based on Ofwat econometric benchmarking data at end 2017) shows impact on average HH bill will be £1.15*2=£2.30 per annum for a dual service customer.

14 The impact on the customer depends on both the company's gearing, as well as the ratio of RCV to customers. We have a gearing of around 78 per cent which in part explains the more pronounced effect on our customer base.

15 For example, the customers or Thames and Anglian Water.

As a result, we consider that Ofwat's proposals are demonstrably not in the customers' interest, as they lead to higher customer bills compared to the existing approach of a notional WACC applied to all companies irrespective of their capital structure choices.

Ofwat has not shown that de-gearing to 60 per cent is efficient

Ofwat's early view of notional gearing of 60 per cent is below the industry average gearing and the notional assumption for PR14 of 62.5 per cent. [16] Ofwat appears to have chosen the minimum of the range of observed actual gearing levels to inform its early view, and all companies bar one have gearing above the PR19 "notional" level.

The implication of Ofwat's proposals is to incentivise higher geared companies to de-gear to 60 per cent. However, Ofwat has not provided any evidence that this is the efficient level. By contrast, it is at the low-end of observed gearing decisions in the water sector and lower than most comparable regulatory decisions (as set out below in our response to question 3).

Ofwat has also not demonstrated that a company at the notional gearing level is financially more resilient than when it chooses its capital structure itself.

Ofwat has other levers which are sufficient to ensure companies' financial resilience

Ofwat states that: "*[…] companies with high levels of gearing have potentially lower levels of financial resilience, as the impact of cost shocks or poor performance is magnified to a smaller equity base.*"[17]

However, Ofwat's financial resilience measures, enforced through licence provisions, have adequately addressed such concerns, obviating the need for mis-placed "gearing outperformance" measures, e.g. licence conditions which require companies to have adequate financial resources and facilities to enable them to carry out their regulated activities, to maintain an investment grade credit rating.[18] **Perversely, Ofwat's gearing outperformance mechanism would in fact undermine financial resilience by reducing *by definition* the allowed return below the efficient financing cost via the sharing of a non-existent "gearing benefit".**

Ofwat's approach is akin to retrospective regulation

Companies have determined their capital structure based on long-established and recently confirmed regulatory rules, which have explicitly stated that capital structure is a decision for companies and not for regulators.[19] Despite these established rules, Ofwat intends to introduce an effective cap on capital structure less than 24 months prior to the start of the PR19 price control, although companies' capital structure consists of long-dated funding that cannot be changed without substantive cost in such a short space of time. For these reasons, Ofwat's approach amounts to retrospective regulation.

In addition, forcing companies to de-gear will focus management attention on managing the de-gearing process rather than raising debt and equity in order to optimise capital structure and minimise overall financing costs over PR19.

16 Ofwat (April 2018), op. cit., p.13.

17 Ofwat (April 2018) op.cit., p. 14

18 Indeed, most companies' licences require them to maintain an investment grade credit rating, and all companies currently have a rating at least one notch above the minimum requirement. See: Ofwat (2017) Financial resilience 2016-17, p. 7. link: https://www.ofwat.gov.uk/wp-content/uploads/2017/11/Monitoring-financial-resilience-2017-Report.pdf

19 Indeed, as recently as 2016, Ofwat re-iterated its commitment to a notional approach to setting the allowed returns, noting that: *"Companies are free to choose their actual capital structure […] but customers will only face the efficient cost of debt for a notionally structured company."* However, under its proposed approach, companies will be effectively obliged to de-gear to 60 per cent. Source: Ofwat (September 2016), Water 2020: consultation on the approach to the cost of debt, p. 16

Sharing outperformance on cost of debt

We disagree with the introduction of an asymmetric mechanism to share outperformance of the cost of debt with customers.

Ofwat has not demonstrated why they need to intervene to share outperformance of the cost of debt with customers

Ofwat should have regard to the principles of best regulatory practice, which includes ensuring regulatory activities are targeted only at cases in which action is needed. Ofwat have not demonstrated that the current regulatory treatment of cost of debt which incentivises companies to optimise their cost of funding and debt profile is of detriment to customers.

Ofwat's existing approach allows companies to recover only benchmark industry costs

Ofwat's long standing policy to the recovery of efficient debt costs has been to set the allowance for embedded debt in reference to industry average costs (cross checked against market benchmarks) and a forecast new cost of debt assumption for the industry. The second element relating to forecast cost of new debt is uncertain at the time of the review, potentially leading to gains/losses to companies resulting from Ofwat's forecast errors. However, for PR19, Ofwat intends to remove the forecasting error by introducing a true-up of the cost of new debt assumed at review based on actual benchmark cost of debt rates over the PR19 period. As a result, there is no uncertainty in relation to estimating the industry average cost of debt over PR19. An additional sharing mechanism beyond the indexation of new debt costs is unnecessary, as Ofwat's PR19 approach should already ensure that companies recover no more than average industry costs.

Ofwat's approach of using an industry average to setting allowed cost of debt is consistent with the approach taken by other GB regulators. For example, Ofgem sets a single cost of debt allowance for each of the sectors it regulates, based on a trailing average of benchmark iBoxx rates, without any adjustments for individual companies' actual performance against the allowed index within the sector. According to Ofgem, and as confirmed by the CMA in the 2015 BGT appeal, Ofgem's indexation approach provides companies with a strong incentive to issue debt efficiently and minimise debt costs, given that companies retain the benefit/bear the cost of out/underperformance over the lifetime of the bond.[20] Similarly, the Utility Regulator in Northern Ireland, and indeed Ofwat for Thames Tideway Tunnel, have introduced cost of debt indexation mechanisms without the perceived need for further sharing mechanisms.[21,22]

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20 CMA (September 2015), British Gas Trading Limited v The Gas and Electricity Markets Authority, Final determination, paras 8.35-8.43.

21 UR (September 2016) Final Determinations, Annex 14 http://www.uregni.gov.uk/uploads/publications/Annex_14_-_Rate_of_Return_Adjustment_Mechanism.pdf

22 Ofwat (September 2014), Draft license for the Infrastructure Provider of Thames Tideway Tunnel, p. 65, para. 6.7. For the TTT, Ofwat has introduced a dead-band around the iBoxx index value, such that the cost of debt allowance does not change until the iBoxx value moves outside the dead-band of +/- 50 bps relative to the reference value determined in the licence. The allowance then partially reflects the change in the iBoxx where the change lies in the range of 50-100 bps, and the change in the index value is only fully reflected in the allowed cost of debt once the change in the iBoxx index relative to the reference value exceeds +/- 100 bps. However, the TTT mechanism is conceptually different to Ofwat's proposed mechanism for PR19. For PR19, Ofwat's proposes to share the difference between the allowance and companies' *actual cost of debt* where this is lower. By contrast, the TTT approach does not involve an examination of the infrastructure provider's (IP) actual cost of debt, or therefore

Ofwat's asymmetric approach does not allow the industry as a whole to recover costs

Using an industry average approach to setting the allowed cost of debt *by definition* implies that some companies actual cost of debt will be lower than the allowance, while others will be higher. Ofwat's proposed approach to claw back outperformance for companies that are below this average, while making no adjustment for companies with higher debt costs above the average, implies that the industry no longer has a prospect of recovering efficient debt costs.

A sharing mechanism weakens incentives, and is complex to implement

There are reasons for Ofwat not to adopt a mechanism which adjusts for companies' actual debt costs relative to the industry average. An approach which recognises companies' actual debt costs could undermine incentives to issue debt efficiently as the actual cost would be passed through to customers, potentially increasing industry financing costs as a result. Indeed, there is no regulatory precedent in the UK to support a mechanism of sharing of cost of debt outperformance based on individual companies' actual costs.

There are also a number of practical difficulties with measuring companies' actual cost of debt for the purpose of calculating out/underperformance. For example, Ofwat would need to develop very detailed rules on how the actual cost of debt will be calculated including its treatment of: foreign currency debt issuance; on the inclusion and valuation of derivatives; how it accommodates deviations in actual inflation from Ofwat assumption and its impact on companies nominal and ILD cost; differences between actual and notional gearing and their impact on the cost of debt etc. These issues will be complex to deal with, and difficult to codify to cover all instances. The risk of an incomplete set of rules introduces subjectivity and regulatory risk where the debt sharing mechanism is based on actual debt costs.

the IP's out or under-performance. The TTT dead-band is also symmetric, and therefore value neutral to the IP whereas Ofwat proposes an asymmetric approach which claws-back outperformance only.

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?

We disagree with Ofwat's proposal to share "outperformance" associated with gearing levels above Ofwat's notional assumption.

Proposals around sharing outperformance associated with higher gearing represent a retrospective and fundamental change of the basis of regulation in the UK upon which companies in the water sector have invested for years (and investors invested) and fundamentally undermine established finance theory that is adopted by all the UK regulators. It would be a change to one of the core founding principles of UK economic regulation that it is for companies and their directors, not the regulator to choose their actual financing structure.

We do not believe that incentivising companies to adopt the notional gearing structure would improve trust and confidence in the sector or address an issue where evidence of customers' concern has been provided.

There are a number of reasons why companies may choose to adopt higher gearing levels above Ofwat's notional assumption, including:

- Agency theories explain that financial leverage can serve as a means for shareholders to effectively apply discipline on company's managers;[23]
- Debtholders also take comfort from covenants which allow for higher gearing than traditional corporate structures (but does not reduce equity risk);
- The increase in debt may have been in response to the risk-return profile required by a relatively new private equity investor class to the sector, that is, investors seeking greater equity risk; and
- Water-only-companies have adopted higher gearing levels due to minimum efficient scale of debt issuances relative to their RCV.

Ofwat's gearing outperformance measure would undermine financial resilience by reducing the allowed return below the efficient financing cost.

For all the reasons stated above and earlier, such mechanism should therefore not be assessed in the IAP.

We also disagree with the proposals on sharing outperformance associated with the cost of debt. As explained in the Executive Summary, Ofwat's approach – by setting the allowance based on an industry average for embedded debt and an efficient industry benchmark – ensures that companies recover only efficient debt costs. Similar types of approach have been adopted in other UK incentive-based regulatory regimes for years. In addition, an asymmetric mechanism where companies that outperform the cost of debt share the upside with customers whilst companies that underperform do

[23] Managers, who control the firm's cash flows, in theory have an incentive to maximise their income at the expense of the equity and debt holders, who do not as directly influence the running of the company. Increasing leverage decreases the free cash flows at the managers' disposal and therefore limits the extent to which they can increase their wealth at the expense of the company.

not share the downside with customers is inconsistent with other areas of regulation. For example both totex outperformance and totex underperformance are shared with customers.

Ofwat's proposed approach to claw back outperformance for companies that are below this average, while making no adjustment for companies with higher debt costs above the average, implies that the industry no longer has a prospect of recovering efficient debt costs.

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?

As set out in our executive summary, we do not agree – as demonstrated by both finance theory and extensive regulatory precedent - with the concept of there being "benefits" of higher geared structures that companies would share with customers, and hence do not consider an adjustment as appropriate. It would also result in incentivising higher geared companies to de-gear to the notional gearing, leading to higher tax liabilities and an increase in customer bills. We therefore conclude that such an adjustment that leads to higher customer bills without any corresponding benefit is demonstrably not in the customers' interest. Ofwat has not demonstrated that customers are penalised by "highly geared structures".

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 do not consider that a mechanism for sharing "gearing outperformance" should be implemented at all for the reasons explained above.

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?

Actual dividend policy should be assessed in the context of actual financeability (only)

Companies should explain their approach to actual dividend policy in their business plans, where this is relevant for the purpose of demonstrating that the company is financeable based on the actual financial structure. Ofwat's IAP assessment of companies' dividend policy should focus on the impact of the company's dividend policy on companies' financeability on an actual basis, as well as financial resilience to downside scenarios.

Like gearing, dividend policy should be a matter for companies not the regulator

Beyond consideration of the dividend policy as part of wider financeability assessment for the actual financial structure, Ofwat should not assess or regulate companies' dividend policies. Ofwat and other GB regulators have long maintained the policy of regulating companies on the basis of a notional financial structure, with companies free to choose their actual financial structure without regulatory intervention (subject to compliance with licence obligations e.g. in relation to maintaining investment grade credit rating).[24]

Ofwat appears to agree that dividend policy is a matter for companies in its consultation, as it notes that "*decisions around actual financial structure are a matter for companies and shareholders who make their own choices about their financing structure"*.[25] Companies' dividend policy is one of the key factors which determine actual capital structure. Therefore, if Ofwat were to regulate companies' dividend policies, this would inevitably imply a regulation of companies' actual structure, contrary to Ofwat's stated policy of regulating companies on a notional basis. This would again represent a fundamental departure from long established regulatory principles in the UK.

Furthermore, under UK corporate law it is the responsibility of the company's directors and them alone to set the dividend policy and level of pay-out based on a number of factors, taking into account annual results, but also forward-looking liquidity requirements of the company as well as financial resilience and the interests of all stakeholders including customers and employees. Ofwat is not in a position to assess these factors for the companies.

The comparison to FTSE companies' payout ratios is not relevant

We disagree with the comparison to FTSE companies presented in the consultation, which argues that water companies payout ratios should be towards the upper end of payout ratios observed for FTSE companies of 40 to 70 per cent.

As set out above, the payout ratio should be a matter for each individual company, reflecting its particular financing needs and choices, namely, the net capital financing requirement or growth in RCV and capital structure decision. For example, if a company expects no growth in the RCV over the regulatory period and seeks to maintain its capital structure, it should be free to pay out the full real allowed cost of equity within the period in which it is earned. By contrast, if such a company were to face a limit on the payout ratio below 100 per cent, this would result in de-gearing and higher cost to customers in form of tax liabilities, as discussed in the executive summary.

Dividends by default will reflect companies' performance to customers over the price control

We agree with Ofwat's statements in the consultation that dividends should reflect the delivery to customers in relation to companies' performance under the various cost, service, or output incentive mechanisms. Companies pay dividends from the profits they have achieved for the period, which already take into account their performance under the various costs and performance incentive mechanisms and therefore already reflect the sharing of the benefits/costs of such performance with customers. For example, if companies perform poorly under the ODI or SIM during AMP6, their profits will be correspondingly reduced to reflect any penalties under these mechanisms, which implies profits available for distribution (and therefore returns to investors) will be lower as a result.

We therefore consider that there is no need for further adjustments to dividend policy, as the company performance is already reflected in the level of allowed revenues which in turn determines the profits available for distribution in form of dividends.

[24] For example, in the Bristol Water appeal, the CMA commented in relation to dividend policy that: "*As with debt, it would be for Bristol Water to determine its actual financial profile". Source: CMA (2015) Bristol Water, para. 11.50, p. 355*

[25] Ofwat (April 2018) op.cit., p. 15

Companies with leverage above notional pay-out lower dividends

Ofwat appears to be concerned with the level of dividends paid by companies which have gearing levels above Ofwat's notional level. While the dividends paid in percentage terms are necessarily higher than Ofwat's allowed notional cost of equity, the amounts in £million terms are unambiguously lower than the notional dividend calculated as (1-notional gearing)*RCV*allowed cost of equity.[26] To put this in context SEW's cumulative distributions in the last 5 years are £91m compared to a notional dividend of £206m and investments of £413m.

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 with Ofwat's proposal around performance related executive pay. South East Water's performance related element of executive pay already demonstrates a substantial link to exceptional delivery for customers in the current regulatory period, reflecting a linkage to cost saving, the Service Incentive Mechanism and Outcome Delivery Incentives. The performance related element of executive pay is set out transparently in the company's annual report which is available from the company's website.

Determination of executive pay is a matter for companies' boards, not the regulator, and it should remain the boards' responsibility to be able to attract the best talent in the interest of the company and all its stakeholders, in a competitive recruitment market.

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 revision to provide a test around appropriate measures to provide a fair balance between customers and investors. For the reasons set out in the executive summary we do not believe it is appropriate to share outperformance on gearing or cost of debt.

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

We have no comments on the assessment to financial resilience in the IAP.

[26] This is because the overall allowed return if £million terms is independent of the capital structure, as explained in our response to question 1. As leverage increases above the notional, the total £million amount paid to debt investors increases above the notional interest assumed by Ofwat, leaving the £ million available to be paid out to equityholders lower than the assumed notional dividend.