South Staffs Water
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Ofwat,
Centre City Tower,
7 Hill Street,
Birmingham,
B5 4UA

By email to: water2020@ofwat.gsi.uk

17 May 2018

Dear Sir,

South Staffs Water response to putting the sector back in balance

Thank you for the opportunity to respond to the above consultation.

We are supportive of the approach and agree with most of the proposals. We do have some specific points we would like to draw to your attention.

A lot of the current concerns around corporate behaviour are in relation to excessive dividends as well as highly leveraged capital structures. It is the combination of the two that needs to be guarded against. The capital structure should be set at a level which allows shocks to be absorbed and enables companies to readily maintain access on an efficient basis to the bank and bond markets. It is clear from history as well as the work done by others, including Moody's, that gearing of up to 70% allows companies to achieve this.

This aligns with the view expressed recently by Jonson Cox at the City Conference in March and referred to in correspondence, that those companies with gearing above 70% would be classed as highly leveraged.

Companies need a level of flexibility to manage their capital structure in a way that facilitates capital investment, service improvement for customers and an appropriate return to investors. To think that companies with gearing above 60%, but below 70%, are considered to have a highly geared structure somewhat removes this flexibility, discourages investment and may even increase bills through higher corporation tax which would not be in customer interests.

We recognise the political difficulties that have been caused by companies which put in place highly leveraged structures through excessive dividends and therefore we believe that a more flexible approach is needed to deal with this problem.

We believe that any sharing should only occur when gearing rises above the level that facilitates ready and efficient access to the capital markets (around 70%). If a company decides to restrain dividends, say below a nominal yield of 5%, either as part of a long term undertaking by the Board to reduce gearing or in order to reinvest in the business, then we do not think that the sharing mechanism should apply.

Separately, some companies gearing calculations for covenant compliance purposes are significantly different to book debt. For South Staffs Water gearing at March 2017 was 64% for covenant reporting compared to 70% on a book debt basis as shown in figure 2 of the consultation. As explained in our APR, the covenant position is the key figure for gearing used by the Board, lenders, ratings agencies and investors. It is therefore important that the covenant figure is used in any sharing calculation.

In reviewing the approach to financial resilience, we have considered whether the scenarios set out are indeed plausible. We have looked at the risks facing the business and considered what a severe impact would mean to us. Even in the most extreme scenarios we have not identified anything that would realistically lead to an underperformance on totex of 15%. We think that an underperformance of 5% to10% is therefore more reasonable.

Our specific responses to the consultations questions are attached to this letter.

Yours faithfully,

P. J. Sayn

Philip Saynor,
Director of Regulation
South Staffordshire Water PLC

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 agree with the implementation of a financing outperformance mechanism. However, it is important that customers feel that the benefits from the sharing mechanism proposed by their own water company is fair and equitable as part of the overall Business Plan as well as compared to other companies. We think that Ofwat should consider this when reviewing company proposals.

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?

Yes, we agree.

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?

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If Ofwat still believes that the starting point should be the notional gearing of 60%, an alternative would be to have a deadband above this set at 10% above the notional gearing.

We do agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt.

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?

Yes, we agree

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?

Yes, we agree

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?

Yes, we agree. We have already included a bespoke performance commitment for trust in our PC definitions submitted on 3 May.

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

No