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17 May 2018

Dear Rachel,

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

This letter summarises the key points of our initial response to the consultation document "Putting the sector back in balance: Consultation on proposals for PR19 business plans". For a consultation on such a fundamental change in regulatory policy, we are disappointed that Ofwat has allowed only 3 weeks for responses. We also consider that it is unreasonable for proposed changes to the PR19 methodology to be consulted upon after the PR19 methodology has been finalised, and only weeks before PR19 plans are due to be submitted.

Ofwat states that its goal is a thriving water sector that holds the trust and confidence of customers and wider society. That is a goal that Thames Water shares. We have recently begun a new chapter in which we are, more than ever, putting the interests of our customers at the heart of our decision-making. Last year, with the unanimous support of our shareholders, we prioritised investment in our business over paying dividends. This year, we are expecting to do the same again whilst developing plans underpinned by industry leading customer engagement. Across our business, a renewed optimism about our future has been gaining strength in which our owners, Board and management are all aligned in serving the long-term interests of customers and the environment, supported and challenged by an independent economic regulatory regime which shares our aspiration.

It is not putting it too strongly, therefore, to say that the Board of Thames Water was seriously concerned at the ramifications of the proposals described in the chapter entitled "Sharing financing outperformance". The proposals appear to us to be unjustified, retrospective and disproportionately punitive, as well as being analytically flawed and inconsistent with good regulatory practice:

- **Unjustified** – No objective justification is provided for the proposed change in regulatory policy in this area, notwithstanding broad statements that Ofwat has observed that more highly geared structures are potentially less flexible and more vulnerable to cost shocks than companies whose gearing levels are closer to the notional gearing assumption. No objective evidence is presented that the current

regulatory framework – in which companies and investors determine their financial arrangements in the context of a defined 'special administration' resolution mechanism that deters over-indebtedness – operates against customers' long term interests. Nor is there any evidence that the quantum of equity invested in TWUL, or other companies with gearing in excess of the current notional assumption, is inadequate to cope with the cost shocks that it might face, or even that this risk has worsened in the few months since Ofwat last confirmed its policy as part of its PR19 Final Methodology. Indeed, in March 2018, TWUL committed to progressively reduce gearing to the mid-70s, thereby reducing the case for any such intervention.

- **Retrospective** – Notwithstanding statements to the contrary, Ofwat's proposals effectively abandon its long-standing regulatory principle that financial arrangements are a matter for companies, as the proposals severely penalise companies with capital structures that deviate from the notional gearing assumption. Ofwat's proposals are not supported by evidence of the issues being raised nor by evidence of customer detriment. We recognise that regulators may need to evolve regulatory policies from time to time, not least to reflect the changing features and circumstances of the industries that they regulate. But – where such changes are significant – it is essential that regulators properly consider the impact of such changes, including the risk of unintended consequences. Moreover, unless there are overwhelming reasons to the contrary, regulators should ensure that any changes to regulatory policy apply prospectively, not retrospectively. That financing is a matter for companies and its investors has been repeatedly affirmed by Ofwat (and the Competition and Markets Authority,[1] and its predecessor organisations[2]) for decades. Over that period, companies and their investors have developed capital structures that are predicated on that policy, and that cannot be modified immediately in light of a sudden shift away from that policy. It follows that, if Ofwat considers that current (or committed) levels of gearing are too high, it should consider ways in which companies can be incentivised prospectively to progressively reduce gearing over an appropriate time period.

- **Disproportionately punitive** – If we have correctly interpreted the proposals, implementation would equate to a 12.5% reduction in the proposed AMP7 appointee WACC from 2.4% to 2.1% (i.e. in the case of TWUL this would reduce returns by around £35m a year). In present value terms – and assuming the policy continued beyond AMP7 – it could amount to a one-off reduction in the enterprise value of TWUL of the order of half a billion pounds. These sums are substantial, and completely out of proportion to the (undefined and unsubstantiated) harm they are designed to remedy.

- **Analytically flawed** – These proposals appear to be based on questionable financial analysis. The proposals are asymmetric in that they seek to reflect in prices the interest rate benefits of securitisation arrangements but not the associated costs and risks. The proposals also ignore the fundamental tenet of corporate finance theory, namely, that the cost of equity naturally increases as the ratio of debt to equity rises.

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[1] See, for example: "Bristol Water plc, A reference under section 12(3)(a) of the Water Industry Act 1991 Report", Competition and Markets Authority, October 2015, p.300, "Gearing - Discussion".

[2] See, for example: "Bristol Water plc, A reference under section 12(3)(a) of the Water Industry Act 1991", Competition Commission, August 2010, p. 69 and 71, "10. Financeability - Our finding regarding the Section 2(2A)(c) duty".

- **Inconsistent with good regulatory practice** – The proposals are inconsistent with the five principles of better regulation. No Regulatory Impact Assessment has been undertaken. The proposals do not treat customers equally – customers of companies adopting gearing in line with Ofwat's notional structure would face higher bills than customers of more highly geared companies, other things being equal.

For all of these reasons, we are seriously concerned that the proposals set out in Ofwat's consultation document for sharing financial "outperformance" will deter investment in TWUL, and – more broadly – compromise the long term investability of the entire sector. This could be expected to weaken investment – and service levels – thus harming the long term interests of both customers and the environment.

That being so, we – at Thames Water – fully recognise that there is a public debate about the operation and financing of the industry. Clearly, it is critical that we continue to operate as responsible stewards of essential infrastructure assets. We are taking action to address perceptions, for example, by closing our Cayman subsidiaries, at shareholders' expense, despite them always being resident in the UK for tax purposes, and our deriving no tax benefit from their location. In this spirit, we will – as part of our AMP7 business plan – consider what alternatives we are able to incorporate in our business plan that ensure fairness of treatment between customers and investors, for example, by the adoption of a transparent and thoroughly considered dividend policy which, as well as recognising the prerequisite for satisfactory operational performance, may share prospective genuine financial outperformance with customers.

We would be happy to discuss this further with you as our thinking develops in the run up to, or on, the submission of our business plan in September 2018. Our initial view is that proposals for future outperformance sharing should contribute to alleviating any public concern without retrospectively penalising companies with capital structures that have evolved under a hitherto stable and principled regulatory framework.

In terms of the remaining proposals in the consultation document, we recognise the importance of ensuring transparency of dividend policies and executive pay. We also fully recognise the importance of financial resilience, although we question whether the specific assumptions for stress testing that are identified in the document are "severe, plausible and reasonable", nor is it clear what evidence has been used to develop the proposed scenarios. Our detailed comments on these topics are set out in Appendix 1.

In summary, we are seriously concerned that the proposals amount to a fundamental change in regulatory policy that potentially undermines the investability of the sector which has been a critical component of attracting long term and low cost capital into our industry. This is bad for customers. We therefore urge Ofwat to take the time to reflect on the proposals it has advanced.

Once you have had the opportunity to digest our response, we would very much welcome the opportunity to discuss with you the best way of putting the sector back into balance.

Yours sincerely

Steve Robertson
Chief Executive Officer

Appendix 1: Response to specific questions raised in the consultation

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?

For the reasons set out in the covering letter to this response, we have very serious concerns about the proposals for sharing financial outperformance. The proposals appear to be unjustified, retrospective and disproportionately punitive. So we do not support them.

That being so, we agree that is essential for the sector to have the trust and confidence of its customers. We recognise that as the largest company we play a critically important role in ensuring the legitimacy of the sector. Our employees, management, Board and shareholders are firmly committed to the principles of:

- being here for our customers, now and in the future – listening to our customers, understanding and anticipating their immediate and future needs and putting those at the heart of our decision making;
- ensuring that our assets are maintained, renewed and optimised to provide the very best whole life outcomes for our customers;
- operating our business with optimal efficiency and innovating continuously to keep up with the ever increasing needs and expectations of our customers and stakeholders, and the demands of growth in our region;
- transparency in all our activities, both internally and externally, where we are responsible custodians of the service experience we provide our customers and for the health and wellbeing of our assets; and
- ensuring we think beyond what customers say they want – creating agility and resilience in our capabilities and working with regulators to ensure we are able to respond effectively.

We also recognise that challenges remain with regard to demonstrating the legitimacy of the sector, including in relation to how companies are structured and financed. Whilst additional measures may be required, it will be important to ensure that these are proportionate to the issues and that they operate in the long term interests of customers.

In addition, we agree that companies should demonstrate that they are financially resilient. However, Ofwat has not shown that existing levels of gearing, taking in combination with other aspects of financial arrangements, harm customers. Indeed, as Ofwat notes in respect of securitisation benefits, the "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."

Moreover, there also exist a number of regulatory and financial mechanisms to protect customers from risk of financial failure (which higher gearing may arguably make more likely) – examples include regulatory ring-fencing, licence conditions requiring investment grade credit rating licence and Board statements on adequacy of financial resources, annual long term viability statements and financeability stress tests in company business plans. Again, Ofwat has failed to demonstrate that these mechanisms – ultimately supported by well-defined resolutions mechanisms – are inadequate to protect customers' interests.

We also have serious concerns with regard to Ofwat's proposed mechanism for sharing financial outperformance on following grounds:

- notwithstanding claims to the contrary in the consultation document, it amounts to a fundamental change to the long held regulatory principle that financial arrangements are a matter for companies and their investors – a policy which has been in place since privatisation;
- of greater concern is that the proposed mechanism amounts to a retrospective change in regulation, thus undermining investor confidence;
- its operation would make it less likely that companies will be able to do what customers want, e.g. to attract the investment required to provide safe and dependable water and waste services;
- its imposition could be expected to increase regulatory uncertainty, which would feed through into a higher cost of debt and cost of equity, which is not in customers' long term interests; and
- the mechanism would thus jeopardise the availability of equity investment in the sector.

Ofwat's proposals also appear to be inconsistent with the five principles of better regulation, which are:

- proportionality – regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised. Ofwat has not demonstrated that high gearing harms customers, nor that market mechanisms have failed; financial and regulatory ring-fencing have been proven to prevent harm and equity levels have remained constant in absolute terms over time;
- accountability – regulators must be able to justify decisions, and be subject to public scrutiny. Ofwat's proposals will, at least, move some accountability for financial structure from companies to Ofwat. It is unclear what governance process Ofwat is proposing in order for it to demonstrate that its choice of capital structure is the most efficient and in customers' long term interests, and how this will be monitored over time;
- consistency – Government rules and standards must be joined up and implemented fairly. The proposed change to the long-standing regulatory principle that financial structure is a matter for companies appears to put at risk the stability and predictability of returns which has underpinned the low cost of capital for the sector, thus acting against delivery of the efficiency objective;
- transparency – regulators should be open, and keep regulations simple and user friendly. Proposing to change such a fundamental regulatory principle, at limited notice and in the absence of a full regulatory impact assessment puts at risk the delivery of both transparent and targeted regulation. If the driver is simply to meet a political direction then such a rationale should be spelt out very clearly in the consultation; and
- targeting – Regulation should be focused on the problem, and minimise side effects. Ofwat has not shown that the market mechanisms to set the most efficient capital structure and cost of capital have failed. Accordingly if any issues are company-specific then these should be addressed by measures targeted at that company, rather than measures which apply to all companies or a sub-set of companies. The imposition of the proposed mechanism increases regulatory uncertainty, which will feed through into a higher cost of debt and cost of equity.

At first sight, there also appear to be a number of practical flaws in Ofwat's proposed mechanism:

- customers of companies adopting gearing in line with Ofwat's notional structure would face higher bills than customers of more highly geared companies, other things being equal;
- should a more highly geared company subsequently opt to degear, this would increase customer bills – merely because the company has selected a different financial structure. Gearing would therefore be no longer a matter only for companies, it would also be a matter for customers; and
- a company with high dividends and lower gearing (which may go hand in hand), will be seen to pay high dividends without sharing any with customers.

We take financial resilience very seriously. We have always had a requirement to maintain investment grade ratings. We are currently rated as BBB+ by S&P for Class A and Baa1 corporate family rating by Moody's. In both cases this is two notches above the minimum investment grade required under the terms of our licence.

Securitisation also enhances resilience, for example by precluding material non-regulated activities within the same debt structure, setting current and forward-looking financial ratio trigger events that prevent dividends being paid and requiring liquidity to cover 12 months of operational activity.

Alternative mechanism

As noted in our introduction to this response, we recognise that public concerns remain regarding how companies are financed, and that companies can still do more to improve the levels of trust and confidence of customers in the sector.

For the reasons set out above we have significant concerns regarding the suitability of Ofwat's proposed mechanism. Nevertheless, we will consider what alternatives we might put in our business plan that ensure fairness between customers (both current and future) and investors (both current and future), for example through a transparent and thoroughly considered dividend policy which may share prospective genuine financial outperformance with customers.

The short timescale allowed for the response by Ofwat has not allowed the Board and shareholders to develop and consider the specifics of such a mechanism, but we would be happy to work further with Ofwat and other companies to work up an appropriate alternative.

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?

No – we do not support these proposals. Instead, we believe Ofwat should revise its approach to permit companies to adopt mechanisms that are forward-looking in nature, consistent with the five principles of better regulation. The advantage of such approaches is that they would not be perceived as including any element of retrospection and would be in customers' interests as they would not put at risk either the availability or cost of investment in the sector.

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 think that the mechanism suggested in the consultation is appropriate, for the reasons set out above in our response to Q1.

However, in designing any sharing mechanism, it will be important to ensure that the mechanism is compatible with any other outperformance incentives or sharing mechanisms. This could include, for example, ensuring that any out/underperformance on the cost of debt is not double counted, and that there are no perverse incentives. A sharing mechanism that reflects the actual cost of debt is at risk of overlapping with any cost of debt outperformance mechanism. Similarly, using actual cost of debt could generate a perverse incentive, whereby the sharing is lower when actual cost of debt is higher, thus weakening the incentives to maintain a low cost of debt.

In general, we do not expect sharing mechanisms to be materially affected by whether the calculation is performed on a nominal or real basis.

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 that business plans should make full disclosure of dividend policy. This is an essential part of maintaining trust and confidence and we would like to reiterate the comments made in Ian Marchant's letter to Jonson Cox of 6 March 2018, in which we said:

- we have decided to prioritise investing in the business over paying dividends to equity holders (of our Holdco) in 2017/18, and are likely to do the same in 2018/19;
- we acknowledge the significant scrutiny that decisions on dividends will face, and are considering how Thames Water can demonstrate that any future dividend recommendations are made appropriately;
- we are considering how recommendations on dividends can be made by a majority of independent directors; and
- we are considering a new dividend policy that simply and transparently demonstrates when a dividend will be considered.

We agree that Ofwat's IAP test should include consideration of companies' dividend policies. We will look to ensure consistency between dividend policy and the executive pay framework with regard to application of performance-related criteria

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 and already apply the principles that the performance-related elements of Executive pay must be transparent and have a clear demonstrable link to delivery for customers.

Our current approach for AMP6 strongly links bonuses to operational performance, including that:

- the CEO will not receive a bonus until the end of the AMP;
- the CEO, Executive Directors and Executive team will be incentivised according to customer service, environmental performance, leakage and asset health;
- the Executive team will not be incentivised on dividends; and
- the remuneration of the CEO and Executive Directors will be fully transparent.

We will be designing the performance related elements of Executive pay for AMP7 in the coming months and will take into account the lessons learnt from application of our AMP6 scheme.

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 see gaining and keeping our customers' trust as a key component of how we do business, so we welcome the inclusion of an explicit reference to trust in the IAP test description.

We agree with the wording around striking a fair balance between customers and investors and have already agreed actions with our investors to improve this within the current AMP, for example by investing in infrastructure to improve leakage rather than paying dividends this year and next.

As noted in our response to Q4 we agree with the inclusion of a test on dividend policies. Similarly, as noted under Q5 we agree with the inclusion of a test on the fairness of the performance-related pay element of executive pay and are already putting in place policies this AMP that aligns with this.

Whilst we fundamentally disagree with the proposed mechanism to share the perceived gains of higher gearing as set out in the consultation (as set on in our response to Q1 above) we are considering alternative benefit-sharing mechanisms as part of our business plan.

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

We agree with the need for a financial resilience test, considering a range of appropriate scenarios.

However, we think that appropriate stress tests for financial resilience should be developed and approved by company Boards, taking into account the particular circumstances of each company. The process for completion of Long Term Viability Statements ("LTVS") provides an excellent example of best practice approach in this area and should, as a consequence, form the basis of assessment by companies in business plans.

One of the recommendations of the Sharman Inquiry[3] into going concern, liquidity and risk was for companies 'to provide information to stakeholders about the economic and financial viability of the company and to help demonstrate the directors' stewardship and governance of the company in that respect.'

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[3] The Sharman Inquiry: Going Concern and Liquidity Risks: lessons for companies and auditors. Final report and recommendations of the Panel of Inquiry, June 2012

The report concluded that information supporting this 'should be specific to the entity and avoid standardised language. The directors should be free to rely on their judgement, experience and understanding of the underlying business in making their assessment and in disclosing what they believe will be most relevant to shareholders and other stakeholders.'

Companies are, therefore, best placed to understand and quantify principal risks for both LTVS and Business Planning purposes, enabling development of combined scenarios which are severe but also reasonable, appropriate and plausible.

We consider that generic tests along the lines set out in the consultation are not the most robust and appropriate way in which to test for financial resilience. Ofwat has presented no evidence in support of its specific (and combined) scenarios which demonstrate that the variances are reasonable, appropriate and plausible. A company-specific approach would provide a more robust basis for the reasons set out above.

We are looking to further build on the work undertaken to date for our LTVS when testing our business plan for financial resilience. We intend to adopt the following principles in constructing the financial resilience tests for our business plan:

- To use our analysis of principal risks to define a number of severe, but plausible shocks to the business;
- To quantify these based on: historic impacts, desktop exercises (which have been agreed by our operational managers) and consideration of maximum fines or penalties as stated in various laws & regulations;
- To develop these into a number of scenarios and combined scenarios, covering the longer term (10 years for our LTVS); and
- To discuss and assess the output of these scenarios with our Board and Shareholders to understand the range of mitigation options available through management action, use of regulatory risk sharing mechanisms and broader financial solutions (which may involve reduced dividends and/or equity injection).