Wessex Water
YTL GROUP

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17 May 2018

Dear Rachel

Putting the sector back in balance: Consultation for PR19

Thank you for the opportunity to respond to your consultation "Putting the sector back in balance".

We continue to support swift action to improve the legitimacy of the sector in the eyes of the public and improve its long-term resilience. To achieve this, we need to demonstrate that water companies deliver public benefit and the investment needed to maintain high environmental and quality standards over the long term.

One aspect of this is how we share outperformance. We consistently share outperformance with customers outside of the regulatory framework, both through additional investment and by reducing bills. Our PR19 submission will set out our sharing proposals which are consistent with the feedback we have received from our customers through the PR19 process. We also believe it is important that the sector retains strong incentive-based regulation. It is in the long-term interests of customers that incentives are not eroded and that we avoid a move towards rate-of-return regulation.

Our business plan is also being built on a broader model of more holistic solutions requiring the support and involvement of all stakeholders in the water environment. We see opportunities for greater innovation, more market-led solutions and growing competition. All of this requires the trust and confidence of a wider range of potential participants. To ensure their participation, it is important that the sector is seen to be in balance, delivering long-term environmental standards while putting customers at the heart of all we do, and achieving a fair sharing of risk, cost and benefits between customers, investors and other stakeholders.

Sharing of gearing outperformance

We agree that some companies have not acted in the best interests of their customers and acknowledge that you believe some companies' gearing is too high. In addressing this, however, some of the measures inadvertently penalise others for reasonable financing decisions made in good faith.

In particular, the expectation that 65% will be the threshold from which to start penalising higher gearing has no basis in historical precedent. It also goes against recent comments from Ofwat that suggested 70% as a threshold where concerns begin to be raised. To date, Ofwat's concerns with higher gearing have been linked closely to those companies with securitised structures, and this concern is reiterated in your consultation. Where companies wish to retain a solid investment grade credit rating at higher gearing levels, securitisation is typically needed when the sustained gearing level is above 70%. It follows that any mechanism should only have an impact above 70%.

Sharing of embedded debt

On the sharing of embedded debt outperformance, customers already see the benefits of more efficient financing each time prices are reset. The price control sets a sector-wide value including the level of outperformance achieved against market norms. All customers therefore benefit from efficient financing decisions made by companies.

Proposals to share outperformance in-period will reduce the incentives for making these efficient financing decisions. They also reduce the incentives for lower gearing which may reduce debt costs. We therefore do not consider it appropriate to include a mechanism to share embedded debt outperformance in our business plan. As noted above, we will however, be including other sharing mechanisms in our plan, including investment in community-based initiatives.

Dividend policy

While we agree with the broad thrust of your consultation principles, ultimately dividend policy remains a matter for company Boards. Any perception that investors could be prevented by regulators from benefitting fully from upsides, while always suffering all of the downsides will increase costs in the long-term for customers.

Our PR19 submission will set out further sharing proposals to ensure that we share outperformance transparently with customers. Alongside this we will continue to adopt a dividend policy that we believe strikes the right balance between investors, customers and other stakeholders. In particular, we see principles 1, 3 and 6 as consistent with our current practice, and indeed Directors' statutory duties, when assessing the company's capacity to pay dividends.

Executive pay

We agree that the performance-related element of executive pay must show the link to exceptional delivery for customers and the environment, for example in terms of cost savings and service outperformance.

We acknowledge the public focus on levels of executive pay and we commit to continuing transparency on our executive pay policy. Our current performance-related element of executive pay is based on performance in five areas, all equally weighted: customers, environment, staff, investors, personal. Targets are strongly aligned with our business plan performance commitments. We are reviewing this policy and a revised policy will be published as part of our PR19 submission.This policy will ensure that customer and environmental performance has the greatest weighting.

Financial resilience

We support the increasing focus on long-term resilience at PR19, be that operational, environmental, corporate or financial. We will continue to assess the long-term financial resilience of our business under a range of scenarios and report the outcome in our Annual Performance Reviews, together with any action that we believe we need to take to ensure ongoing financial resilience.

We note your proposal to specify scenarios that are common across all companies. While some of these match those that we already undertake, others are extreme and unlikely to reflect a plausible range for Wessex Water. In our view, it would be more effective for companies to propose a range of scenarios appropriate to their own circumstances, with strong evidence-based justification, rather than to model a fixed set of common scenarios.

So in conclusion, whilst we support the need for action to address the excesses of some companies, our shareholder who has taken a long-term, prudent approach, and indeed has been identified as the type of investor the industry needs, is concerned at being potentially caught up in these proposals.

As ever, we would be very happy to discuss any of these issues further.

Very best wishes,

Andy

Andy Pymer
Managing Director