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Ofwat
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8th January 2019

Dear Sirs

Anglian Water Response to Consultation on strengthening the regulatory ring-fencing framework

1) In light of the summary of views expressed and our initial consideration of the points made to date, do you agree with, or have any further comments to make with respect to, the proposal that all Appointees' licences require that they "must ensure" they maintain an appropriate investment grade credit rating at all times? (See Annex: Condition P7) Do you think that this would give rise to any particular issues of a practical nature? If so, please explain and provide evidence of these impacts.

We broadly agree with the direction of travel, and with the changes proposed in this consultation. We agree that a licence condition requiring that all Appointees "must ensure" they maintain an investment grade credit rating will help to improve the financial resilience of the sector and provide reassurance to lenders that the industry will retain a strong and stable credit environment.

We support Ofwat having an approach which is transparent in its approach to financeability. The assumption of a level of credit rating for its notional company would be a positive move, and companies should then ensure that they have clear financial policies and hold appropriate levels of debt.

In terms of the second part of the question "do you think this would give rise to any particular issues…" it is worth revisiting the role key stakeholders play in maintaining credit ratings. We consider these issues as below:

- Credit rating assessment criteria
- The role of appointees
- The role regulation plays and supporting evidence

Assessment of financial risk is complex and the credit rating of an entity is assessed by experts - credit rating agencies. The level of customers' bills, which provide the income

received by the UK Water industry, is controlled by the economic regulator, recognising the monopolistic nature of much of the industry. Consequently, the credit position is significantly affected by regulatory determinations, and various regulatory mechanisms. Credit rating agencies and investors therefore place significant weight on the stability and predictability of the regulatory regime.

Over the last two decades the UK water sector has maintained a stable credit rating with all major credit rating agencies. In January 2018, however, Moody's changed their outlook for the UK Water sector to "negative" [1]. This had parallels to rating actions in 1999 which saw the sector decline from AA ratings to A. This reaction in January 2018 from a major credit rating agency has caused concerns for investors and companies. Anglian Water's debt ratings (across two tranches of debt) and Corporate Family rating have been "stable" for nearly two decades and remained stable through the Global Financial Crisis of 2008. Clearly one key reason for this stability has been the transparent and predictable regulatory environment provided by Ofwat, and the Company has also modified its leverage to maintain its credit ratings. However, our rating is now on a "negative" following Moody's change to the overall industry outlook, despite our commitment to reduce leverage.

UK Water credit rating assessment criteria

As explained by Moody's[2], the following factors play a key role in their assessment of credit risk pertaining to the UK Water sector. The high regard they have assigned to the stability and predictability of the regulatory regime has helped to maintain high investment grade credit ratings for many years, driving lower bills for customers:

1) Leverage and coverage ratios (35%) - *regulator (for notional structure)*
2) Stability and predictability of the regulatory regime (15%) - *regulator*
3) Cost and investment recovery (15%) - *regulator*
4) Scale and Complexity of capital programme (10%) - *company*
5) Financial Policy (10%) - *company*

The role of appointees

Over the long term, an appointee should maintain its credit metrics if it adopts a similar level of debt to that reflected by Ofwat within its price controls (assumed or de facto), and if management ensures the business is delivering the required operational performance, adopts prudent financial policies, and pays appropriate dividends to its owners.

Higher levels of debt have typically required higher levels of assurance for lenders in the form of operational and financial covenants. Ratings deterioration has been seen by

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[1] Source: Ofwat report 'Monitoring Financial Resilience' 2017 https://www.ofwat.gov.uk/wp-content/uploads/2017/11/Monitoring-financial-resilience-2017-Report.pdf

[2] Source: Moody's Rating Methodology for Water Utilities, December 2015

companies that have used derivatives to increase the level of debt financing, typically experienced with mandatory breaks on long term inflation derivatives with insufficient equity cushion to absorb higher costs, or poor operational performance.

This means that if the notional company ratios at final determination are below 1.5x (as per the table), which reflects a credit rating level of Baa2 (one notch above the investment grade), an efficiently performing actual company should expect to achieve similar ratings at a similar level of gearing. If an appointee runs higher gearing levels, the owners of the business would be expected to introduce higher levels of controls and operational scrutiny to provide protections and assurance to lenders. Should the Appointee enter into inefficient capital structures/financial instruments that are not transparent and well controlled - this may reduce ratings below the notional company level and that should be at the appointee's own risk.

Rating agencies consider strong operational performance and prudent financial policies with operational and financial covenants as highly supportive to credit ratings and recognise the management role of the appointee plays as the main determinant of maintaining credit ratings. However, experience has shown that in the UK Water sector, regulation also plays a significant role. This is clear from the assessment criteria rating agencies have published.

The role regulation plays and supporting evidence

The criteria shows that for a notional company structure, almost 65% of 'credit assessment' relates directly to regulatory determination.

This also explains why Ofwat has explained its assumed minimum level of credit rating in historic price controls (see PR04 and PR09 FD).

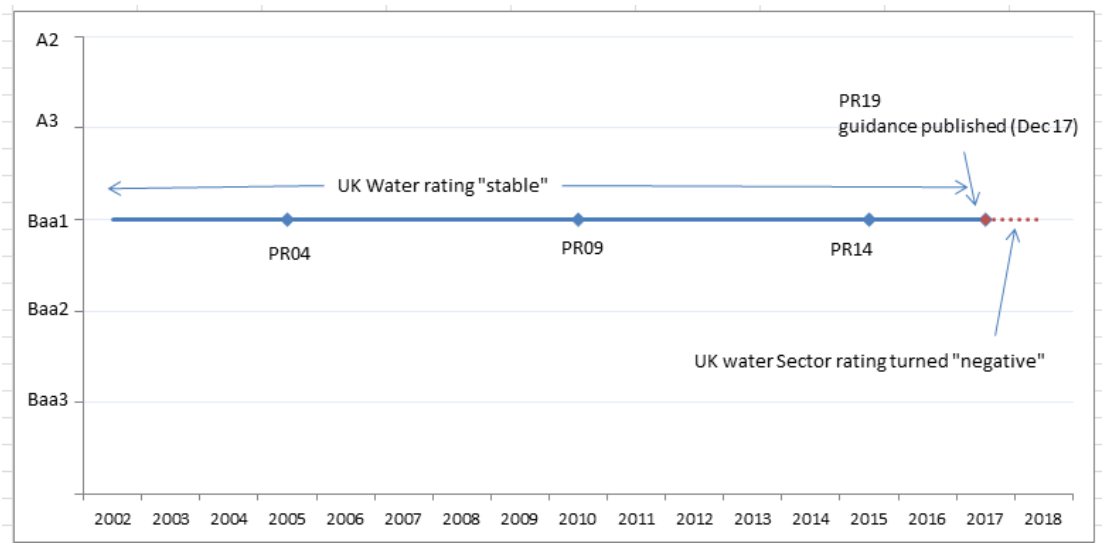
All rating agencies have credit assessment criteria which give a strong weight to the nature of sector regulation. Water company management teams have a key role in delivering performance through efficient operations and implementation of prudent financial policies. It is clear though that Ofwat also has a key role in the company's credit profile. In setting the allowed WACC and investment recovery rates at a level sufficient to ensure that a notionally financed company will be financeable the Regulator is able to demonstrate it is meeting its legal duty to ensure that efficiently managed companies remain financeable.

The UK water sector has maintained "stable" ratings for over a decade. However, following Ofwat's publication of its PR19 Final methodology, with a much lower indicative WACC, Moody's changed its outlook for the UK water sector from "stable" to "negative".

Anglian Water has maintained stable credit ratings since 2002 across two investment grade tranches of debt and a Baa1 corporate family rating with Moody's, providing a two notch headroom to maintaining an investment grade credit rating. This ensures long-term lenders do not experience a downgrade on their existing debt position which is

costly from a regulatory capital position for them. It is important for the industry to retain and attract capital and avoid dissuading large lenders. Along with the rest of the industry, this ratings outlook was changed to 'negative' in January 2018.

Graph-1



Subsequent to the initial rating action in January 2018, Ofwat announced a further consultation to claw back "high gearing outperformance" in April 2018. Whilst Moody's noted that lower gearing in the sector was 'credit positive' and good for the ratings, a sudden regulatory change of this magnitude was not. Moody's responded with an increase to the required ratio headroom at each rating level by 10bps. Moody's said:

'…these measures further illustrate increasing regulatory risk and we have revised the score for predictability and stability of the UK water regime"

As a result of this change, Moody's increased the required headroom level (see table 3 below).

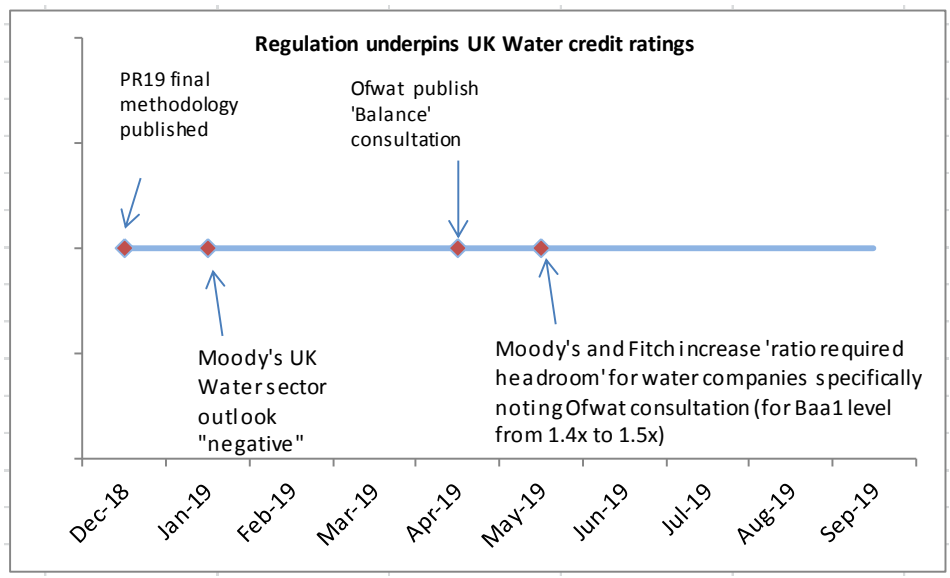
Table-2

Moody's ratio guidance for the UK water utilities

Issuer Rating	Maximum RCV gearing (previous)	Maximum RCV gearing (new)	Minimum AICR (previous)	Minimum AICR (new)
A2	≤ 60%	≤ 55%	≥ 1.8x	≥ 2.0x
A3	≤ 68%	≤ 65%	≥ 1.6x	≥ 1.7x
Baa1	≤ 75%	≤ 72%	≥ 1.4x	≥ 1.5x
Baa2	≤ 85%	≤ 80%	≥ 1.2x	≥ 1.3x

Note: Ratio guidance applies to standalone regulated businesses funded on a senior unsecured corporate basis. Actual credit quality may also reflect the consolidated financial profile of a wider group, or the benefits of structural enhancements. Because of their smaller size and the associated risks in relation to cash flow stability, we would expect smaller companies, such as the water-only companies, to exhibit a stronger AICR for an equivalent gearing level.
Source: Moody's Investors Service

Table-3



Following Moody's announcement, rating agency **Fitch** also announced a similar 10bps increase in headroom requirement. Moody's and Fitch now require 1.5x AICR to maintain Baa1 level; which means higher cash revenues are required by companies to maintain the same level of credit ratings.

Table-4 (How WACC flows through to credit ratings)

	Ofwat indicative WACC
Assume RCV	**£100**
Notional debt (60%)	**£60**
Inflation linked proportion of debt	***33% * (RPI)***
Interest (at 4.36% - nominal rates assumed in its December statement; RPI assumed to be 3%; RPI debt coupon =1.33%)	**-£2.01 (£40x4.36%+ £20 x 1.33%)**
Interest	**-£2.01**

Blended WACC 2.9% (including retail)	**+2.9**
PMICR ratio (WACC/Interest)	**1.44x (lower than 1.5x)**

Practical Issues

Recognising the prevailing "negative" outlook for the sector, it is helpful for both Ofwat and companies to commit to maintain Investment Grade ratings. Ofwat having an approach which is transparent in its approach to financeability and the assumption of a level of credit rating for its notional company would be a positive move, and companies should then ensure that they have clear financial policies and hold appropriate levels of debt.

There is a clear role for both companies and Ofwat to ensure a dialogue is maintained with the credit rating agencies to ensure that ratings remain strong, which ultimately helps to drive lower customer bills.

Case for Ofwat to assume a minimum credit rating within price determinations

Historically Ofwat has assumed a minimum level of target credit rating in its price determinations (A3 for PR04 and PR09); this has meant that a notional company should be able to achieve a minimum level of ratio headroom to key credit ratios. This is also supported by the criteria discussed above that nearly 65% of 'credit assessment' depend on regulatory determination. Our calculations (which we have already shared with Ofwat) show that, other things being equal, a notional company will need a certain level of WACC to maintain a credit rating consistent with the selected Iboxx index for future cost of debt.

2) Do you agree with the proposal to adjust the definition of issuer credit rating to explicitly allow for the use of a corporate family rating? (See Annex: Condition P7)

Yes. For companies issuing tranches of debt this is essential. Using an Issuer Credit Rating is preferable to a rating of specific debt issues as a number of companies issue tranches of debt with different protections for creditors and consequently different credit ratings.

3) Do you agree with, or have any further comments to make with respect to, the proposal to include the most up-to-date cash lock-up provisions for companies where they are currently not included? (See Annex: Condition P7)

We agree. Anglian Water already has this as a condition in our financing documents.

4) What are your views on the changes we have set out to bring the provisions relating to ring-fencing certificates into line with industry-leading standards? (See Annex: Condition P9)

The ring-fencing provisions were introduced into our licence as Condition F.6A many years ago and we have been complying with them since. The proposed modifications represent a simplified re-drafting of the requirements and we have no objections to them. We welcome the removal of the requirement for the Reporter to submit a report on the Certificate as this requirement has become redundant.

5) Do you have any views about the form and consistency of information provided with ring-fencing certificates or our expectations in relation to these matters?

We observe the requirements of the licence in determining the form of our certificate. We will continue to do this and to respond to stakeholder feedback in determining the form of our certificate in future.

6) Do you agree with our proposal to bring all licences up to the same standard in relation to the reporting of material issues, but not to develop guidance? (See Annex: Condition P10)

We have no objections to the proposed modifications. We agree that guidance is not required on issues which are likely to be considered material and that companies should use their own judgements in this matter. The examples quoted in the consultation document are helpful.

7) Do you have any other comments on the issues discussed above or elsewhere in this consultation that you would like us to consider?

In terms of the drafting we have one particular comment relating to the obligation to "inform the Water Services Regulation Authority as soon as reasonably practicable if the Appointee becomes aware that … arrangements are in progress or in contemplation which, if carried into effect, may lead to a change to the Ultimate Controller(s) of the Appointee".

The general aim of the obligation is not in issue. In our view, however, licence conditions should, wherever possible, represent "bright lines", so that Appointees can be clear as to compliance. Our concern is that 'awareness' of arrangements in the mere *contemplation* of third parties, which *may* have a particular effect is too nebulous a concept.

Consequently, Appointees may be tempted to err on the side of caution and give notifications that are not only unhelpful to the regulator, but more than that, obscure the true picture.

Our recommendation would be to make the obligation much more binary in nature, for example:

"inform the Water Services Regulation Authority as soon as reasonably practicable if the Appointee becomes aware that … arrangements are in progress ~~or in contemplation~~ which, if carried into effect, ~~may~~ would lead to a change to the Ultimate Controller(s) of the Appointee"

Please do not hesitate to contact us should you require any further information or clarification.

Kind regards

Alex Plant
Regulation Director