

July 2019

Trust in water

PR19 draft determinations

**Southern Water – Securing long-term
resilience actions and interventions**

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PR19 Draft Determinations: Southern Water – Securing long-term resilience actions and interventions

Following our initial assessment of plans, we categorised two types of actions for slow-track and significant scrutiny companies:

- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery); and
- advised actions for companies to do by a specific date but that are not required for our draft determinations.

Table 1 below sets out the required and advised actions, a summary of the company's response to the action, our assessment of the company's response, and any further interventions we are making as part of the draft determination.

Each action has a unique reference. The prefix 'SRN' denotes the company Southern Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Actions whose numbers are preceded with an 'A' denote required actions and actions whose numbers are preceded with a 'B' denote advised actions.

Table 2 below sets out any further interventions that are not resulting from an action which we are making as part of the draft determination.

Each further intervention that is not resulting from an action has a unique reference. The prefix 'SRN' denotes the company Southern Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Intervention numbers are preceded with a 'C'.

For all other documents related to the Southern Water draft determination, please see the [draft determinations webpage](#).

Table 1 – Southern Water's response to required actions and interventions for draft determinations

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|-------------------------------|------------------|-------------|---|---------------|---|---|------------------------|
| Securing long-term resilience | SRN.LR.A1 | Required | The company should provide a commitment that it will, by 22 August 2019, prepare and provide to us an action plan to develop and implement a systems based approach to resilience in the round and ensure that the company can demonstrate in the future an integrated resilience framework that underpins the company's operations and future plans showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework. The action plan should work toward understanding the baseline resilience risk of the water and wastewater operational activities as well as steps that will improve resilience (operational, financial and corporate). | 1 April 2019 | Southern Water has confirmed its commitment to complete the action by 22 August 2019. | No intervention required. The company has complied with the required action. | N/A |

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|-----------|------------------|-------------|--|---------------|---|--|---|
| | SRN.LR.A2 | Required | The company's assessment of financial stress scenarios extends only to 2025. The company should commit to demonstrating that its assessment of financial resilience extends beyond 2025 in its next Long Term Viability Statement. | 1 April 2019 | Southern Water has committed to demonstrating that its assessment of financial resilience extends beyond 2025 in its next Long Term Viability Statement. | No intervention required. Southern Water has responded satisfactorily to this requirement. | N/A |
| | SRN.LR.A3 | Required | Clarify that the possible outcome of all extant regulatory investigations have been taken into account in the company's assessment of financial resilience. | 1 April 2019 | <p>In response to our initial assessment of its plan, Southern Water has confirmed that the possible outcome of all extant regulatory investigations has been taken into account in making its assessment of financial resilience.</p> <p>There is evidence in Southern Water's plan that investor support will be required to maintain financial resilience in scenarios that consider the outcome of extant regulatory investigations.</p> <p>The company says that, without mitigating action, the impact of investigation outcomes could pose a risk to its investment grade credit rating. However, it says that mitigating action could include additional capital injections or other financial restructuring to reduce financing costs and maintain an AICR ratio consistent with a Baa2 credit rating.</p> | <p>Intervention required.</p> <p>Since Southern Water submitted its revised business plan:</p> <ul style="list-style-type: none"> we have issued a penalty notice, which invites comments on our proposal to impose an enforcement penalty on Southern Water in light of our findings in the Southern Water investigation. Subject to comments received to the notice, this could result in payments and penalties of about £126m. Moody's has downgraded Southern Water's financing subsidiary's senior debt from Baa1 to Baa2 with negative outlook. S&P has downgraded Southern Water's financing subsidiary's senior debt from A- to BBB+ with negative outlook. <p>Furthermore, the company remains subject to an ongoing investigation by the Environment Agency.</p> | <p>We expect Southern Water to set out clearly the steps it is taking to maintain its long term financial resilience, both now and in the long term. We expect the company to provide Board assurance setting out the steps it has taken to demonstrate that the company will maintain financial resilience in the long term, taking account also of action SRN.LR.C1. We expect this to be accompanied by evidence of support from its equity investors and to be accompanied by independent assurance about the long term viability of the company including its ability to maintain sufficient headroom with respect to its target credit rating.</p> <p>In its future reporting, we expect Southern Water to apply suitably robust stress tests in its long term viability statements in 2020-25.</p> |

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|-----------|------------------|-------------|---|---------------|---|---|---|
| | | | | | | | We will continue to engage with the company on issues associated with its long term financial resilience. |
| | SRN.LR.A4 | Required | The company has noted the possibility of additional equity investment as a financial risk mitigation measure. Please explain the steps and risk management approaches the company has taken to ensure equity will be available if such support is required. | 1 April 2019 | Southern Water says that its capital structure has been strengthened by a significant £700m recent injection of equity. It does not refer to any proposal for further equity injections but says that this remains a possibility in conjunction with a flexible dividend policy. | Intervention required. | See required intervention for SRN.LR.A3. |
| | SRN.LR.A5 | Required | Please explain how the company has taken account of the risks associated with its current credit ratings of Baa2 (negative) with Moody's and A- (stable) with Standard and Poor's and its plan to achieve higher ratings in the period from 2020 onwards. | 1 April 2019 | <p>Southern Water set out in its revised plan that it considers that its credit ratings are consistent with its licence obligations, which efficiently balance risk and cost factors and do not attract a debt cost premium. It says that, to address Moody's negative outlook it has recently arranged a £330 million revolving credit facility to backstop upcoming debt maturities. The company notes that its Moody's Baa2 corporate family rating has been removed following the repayment of all of its class B debt.</p> <p>Southern Water says that it monitors its financial resilience and credit ratings continually with Executive/Board level participation. It also says that it is addressing operational risks that could have an impact. It says that it is not actively targeting higher credit ratings in 2020 to 2025 but is keeping the position under review.</p> | The company has provided the required explanation. However, since submission of the business plan, the credit rating of its financing subsidiary has been reduced from Baa1 to Baa2 and placed on negative outlook. | See required intervention for SRN.LR.A3. |

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|-----------|------------------|-------------|--|---------------|--|--------------------------------------|--|
| | SRN.LR.A6 | Required | <p>The company should set out:</p> <ul style="list-style-type: none"> • how the company will achieve the planned reduction of gearing to 70% or lower referred to in its plan; • the company's assessment of the impact of the gearing outperformance mechanism for PR19 on its financial metrics in case the planned gearing reduction is not achieved; and • outline associated risk management/mitigation approaches identified by the company to provide assurance on long term financial resilience. | 1 April 2019 | <p>Southern Water says that it has completed a strategic refinancing and expects its gearing to be around 68% by 31 March 2020. It has a long term gearing target of 70%, but notes that its gearing level might vary in the short term.</p> <p>The company sets out that, although it does not agree with the gearing outperformance mechanism, it has taken into account the possibility of payments being required at PR24.</p> <p>Southern water says that its approach to long term financial resilience is underpinned by regular and detailed consideration of</p> <ul style="list-style-type: none"> • forecast cash flows, risks, liquidity and operational scenarios that form part of its business as usual risk • management process, regularly reported on to the business's executive • leadership team, Board, and investors. <p>The company also refers to obligations and restrictions under its securitised structure. Southern Water says it has a flexible dividend policy that is intended to support its target credit ratings where required. The company says that assurance is evidenced via its three lines of defence model. This includes a sophisticated and experienced internal group treasury function and internal audit team.</p> | Required response has been provided. | See required intervention for SRN.LR.A3. |

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|-----------|------------------|-------------|--|---------------|--|--|--|
| | SRN.LR.A7 | Required | Please explain how the company has taken account of the risks associated with capital for the business raised as debt elsewhere in the corporate group. | 1 April 2019 | <p>Southern Water says that new equity injected into the Appointee is on an unconditional basis, forming part of its 'equity cushion'. It says that capital has been raised on a transparent basis and that the company's board has full control over dividend payments.</p> <p>Southern Water says that its interest costs for AMP7 will be reduced and no further equity injection will be required, unless significant downside risk materialises.</p> | Required explanation has been provided. However, we expect the company to provide further evidence of the steps it is taking to maintain its long term financial resilience in the context of action SRN.LR.A3 | See required intervention for SRN.LR.A3. |
| | SRN.LR.A8 | Required | The company should clarify and provide board assurance that the assessment of financial resilience set out in the business plan remains current in the context that the financial restructuring was finalised after business plan submission | 1 April 2019 | <p>Southern Water says that it has carried out a fresh assessment of its financial resilience in relation to its actual structure and considers that the company remains financeable with an adequate level of financial resilience, having considered all extant regulatory investigations in reaching this conclusion.</p> <p>It confirms that its strategic refinancing has been completed and that it has continuing access to significant liquidity facilities.</p> <p>The company's Board assurance statement in response to our initial assessment says that 'The Board is satisfied that the Plan, and the company's governance and assurance processes, will deliver enhanced operational, financial and corporate resilience over the next control period and in the longer term.'</p> | Required information provided. | See required intervention for SRN.LR.A3. |

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|-----------|------------------|-------------|--|---------------|---|--|------------------------|
| | SRN.LR.A9 | Required | The company should also provide a commitment to work with the sector to develop robust forward looking asset health metrics and provide greater transparency of how its asset health indicators influence its operational decision making. | 1 April 2019 | Southern Water has confirmed this commitment. | No intervention required. The company has complied with the action. | N/A |
| | Advised actions | Advised | No advised actions. | N/A | N/A | N/A | N/A |

Table 2 – Further interventions for draft determinations

| Intervention reference | Our assessment and rationale | Interventions |
|------------------------|--|---|
| SRN.LR.C1 | The Board assurance on actual and notional financeability and financial resilience in the revised business plan was provided on the basis of the assumptions made in the business plan, prior to any interventions we have made in the draft determination and our updated view of the cost of capital. There is evidence of further downward pressure on the cost of capital in very recent market data which will be considered for our final determination. | We expect companies to provide further Board assurance, in their responses to the draft determination, that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Cost of capital technical appendix' and the specific issues we have set out related to the financial resilience of the actual financial structure. |

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gov.uk

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