

1. Introduction

Thank you for the opportunity to comment on the consultation on strengthening the regulatory ring-fencing framework. As at 17 December 2018, United Utilities Water Limited (UUW) has long-term corporate credit ratings of A3, stable outlook with Moody's Investors Service Ltd (Moody's) and A- stable outlook with S&P Global Ratings Europe Limited ("S&P"). Senior unsecured, listed debt issued by UUW's financing subsidiary, United Utilities Water Finance PLC ("UUWF"), which is guaranteed by UUW, is rated A3 with Moody's and A- with S&P.

As requested, the primary focus of United Utilities' response relates to the practical implementation of the changes proposed. We do not object in principle to any of the licence changes proposed but would welcome some drafting tweaks or clarification in particular areas identified in our response.

Additionally, we are concerned that in allowing certain Appointees dispensation to comply with the requirement to maintain, at all times, an investment grade credit rating, and with a lack of equivalence in the associated cash lock-up triggers, there is not a level playing field in relation to these provisions across the sector. Ofwat emphasises in the consultation document that it is important to bring all licences up to industry leading standard in respect of the ring fencing framework, and in allowing this dispensation, we believe that the proposals put forward do not achieve this.

We trust that our response is informative and helpful. If there are any areas where further information is required or where we can assist Ofwat's ongoing consideration of these issues then we would be pleased to discuss further.

2. United Utilities Water Limited responses to questions

- 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 previously commented (UUW's response to "Change of control – general policy and its application to Thames Water") that we believe the requirement to maintain an appropriate credit rating is an important consideration in ensuring the sector maintains trust and confidence of all stakeholders. We are therefore strong advocates that all Appointees should be required to maintain at least one credit rating, as this would ensure that all companies are treated consistently and equally fairly through regulatory mechanisms and would also eliminate risk for the regulator in administering alternative arrangements.

As drafted, the proposals provide that certain Appointees will be permitted not to have to maintain, at all times, an Issuer Credit Rating which is an Investment Grade Rating, and instead continue to provide an annual certificate whereby in the opinion of the Board (of the relevant Appointee) that the Appointee would be able to maintain an Investment Grade Rating, along with a statement of the main factors which that Board has taken into account in giving its opinion.

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We see incremental risk in Ofwat accepting such an approach, as credit ratings are forward looking, dynamic, capable of flex to evolving circumstances, and an independent third party opinion of the credit risk profile of the relevant company. Each rating agency's methodology will be nuanced incorporating an assessment of the business risk profile (including evaluation of the stability and predictability of the UK water regulatory environment, the asset ownership model, asset and revenue risk, and business performance), along with an assessment of financial risk (including key financial ratios - both actual and forward looking projections, which ratios are most prominent in the ratings methodology, and what adjustments need to be made to published and projected financial statements).

We struggle to see how a Board would have the same level of understanding of the detailed ratings methodologies if a direct relationship with the rating agency were not maintained, and even if such a certificate is supported by an 'independent' assessment, unless that assessment is provided by the actual rating agency, there is likely to be 'interpretation' risk.

In contrast to the forward looking and dynamic nature of credit ratings, an annual certificate of ratios is likely to be largely backward looking, static, and fixed in time so not able to evolve to changing circumstances. Therefore, it seems unlikely that the Board certificate approach would react promptly to a change in circumstances. Credit ratings are dynamic in that the ratings agencies react to specific developments regarding individual companies or the sectors in which they operate.

This was evidenced back in May 2018, when Moody's re-evaluated its assessment of the stability and predictability of the UK water sector regulatory regime, downgrading its sector risk assessment from Aaa to Aa and tightening financial metrics for the sector associated with a given level of rating, and placing a number of companies in the sector on negative outlook.

Practical implementation issues for U UW

U UW in Condition F 6A.6(1) currently has a requirement to "use all reasonable endeavours to ensure that it, or any Associated Company as an Issuer of corporate debt on its behalf, maintains at all times an Issuer credit rating which is an investment grade rating."

We have no issue with strengthening this obligation to "must ensure" (as per the new Condition P 7.2):

"The Appointee must ensure that it and any Associated Company which issues corporate debt on its behalf maintains, at all times, an Issuer Credit Rating which is an Investment Grade Rating."

However, the "and" formulation with reference to U UW's financing subsidiary, U UWF, does not work as under Moody's and S&P's ratings methodologies, an Issuer Credit Rating (note this term is used interchangeably with corporate credit rating by Moody's and S&P) is only assigned to U UW, with senior unsecured debt issued by U UWF being assigned a rating in line with U UW's corporate credit ratings. As such, to ensure practical compliance, this should be restored back to "or".

Further, there can be a difference in rating between a Company's issuer credit rating, corporate credit rating or issuer default rating and the rating of that Company's senior unsecured debt (for example, Fitch, which currently rates U UW on an unsolicited basis, assigns an issuer default rating of BBB+ to U UW whilst assigning an A- rating to senior unsecured debt issued by U UW (or its financing subsidiary, U UWF). This reflects the issuer default rating being an assessment of likelihood of default, whilst the senior unsecured debt rating also factors in the prospects for recovery. In our experience, bondholders and credit investors tend to place most weight on the senior unsecured rating of the debt instrument they hold.

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However, we recognise that for those companies that have implemented a whole business securitisation (WBS), they will have different classes of debt which will attract different ratings (reflecting structural subordination and suchlike).

We understand that Ofwat's objective in formulating the investment grade credit rating obligation is to attach to a measure of credit worthiness that reflects more generally the credit quality of the Appointee rather than what might be a small tranche of an Appointee's debt structure.

We are supportive of this, provided the obligation is "or" rather than "and" in relation to UUWF (as described above), and the definition of Issuer Credit Rating in Condition A be amended as follows to capture the different terminology used by the ratings agencies for an Appointee's long-term rating:

"Issuer Credit Rating" means, either;

- (a) an issuer credit rating, corporate credit rating or issuer default rating assigned to an issuer of corporate debt or the long-term rating assigned to all senior unsecured debt obligations rated by a Credit Rating Agency; or
- (b) a Corporate Family Rating assigned by a Credit Rating Agency to the Appointee for so long as the Appointee continues to be a member of a corporate group approved for this purpose by the Water Services Regulatory Authority."

In the new "**Credit Rating Agency**" definition in Condition A, we do not recognise "Standard and Poor's Ratings Financial Services LLC". UUW is rated by S&P Global Ratings Europe Limited and this entity is not a subsidiary of Standard and Poor's Ratings Financial Services LLC.

To ensure that no company runs the risk of a 'technical' breach in being rated by an S&P entity that is outside the scope of this definition, and to 'future proof' for any subsequent changes for all three agencies, we recommend that the highest company in S&P's corporate structure is referenced and flexibility is built-in for successor companies for all three referenced agencies, as follows:

"Credit Rating Agency" means:

- (a) S&P Global Inc. (or any of its subsidiaries or other company registered as a credit ratings agency under Regulation (EC) No. 1060/2009 or equivalent UK or US regulation in the S&P group corporate structure or its successors);
- (b) Moody's Investors Services Incorporated (or any of its subsidiaries or other company registered as a credit ratings agency under Regulation (EC) No. 1060/2009 or equivalent UK or US regulation in the Moody's group corporate structure or its successors);
- (c) Fitch Ratings Limited (or any of its subsidiaries or other company registered as a credit ratings agency under Regulation (EC) No. 1060/2009 or equivalent UK or US regulation in the Fitch group corporate structure or its successors); or
- (d) any reputable credit rating agency which has been notified to the Appointee by Water Services Regulation Authority as having comparable standing to Standard & Poor's Ratings Group, Moody's Investors Services Incorporated and Fitch Ratings Limited in both the United Kingdom and the United States of America; ...

For UUW, the definition of "**Lowest Investment Grade Rating**" should also be similarly amended by replacing "Standard and Poor's Ratings Financial Services LLC" with "S&P Global Ratings Europe Limited".

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With regard to the definition of “**Financing Subsidiary**” we note the requirement to: (1) a) be wholly owned by the Appointee; and (1) b) have a sole purpose of which, as reflected in the company’s articles of association, is to raise finance on behalf of the Appointee for the purposes of the Regulated Activities; or (2) which Ofwat has agreed in writing to be considered a Financing Subsidiary.

With reference to UUWF, whilst its articles do state that the objects of the company are to raise money and lend money and grant or provide any form of credit, finance or other financial accommodation to UUW or any company which is at the relevant time a subsidiary of UUW, it does not explicitly state for the purposes of the Regulated Activities. Further, whilst we obtained various consents from Ofwat upon establishing UUWF in 2014, we do not have confirmation in writing that Ofwat considers UUWF to be a Financing Subsidiary. **We should be therefore be grateful if Ofwat would kindly acknowledge in writing that it considers UUWF to be a Financing Subsidiary** in order to demonstrate compliance with this provision.

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)

We believe that a corporate family rating is only assigned to those companies which have implemented a WBS structure. As such, UUW has no objection to its inclusion in the definition of Issuer Credit Rating but it is not applicable in the case of UUW.

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 note that the proposed cash-lock up provisions are substantively the same as the existing provisions in UUW’s licence in Condition F 6A, and as such, we are comfortable with these provisions, although as set out in question 1, UUW requests that Ofwat acknowledge in writing that it considers UUWF to be a Financing Subsidiary.

However, with regard to certain Appointees being permitted not to have to maintain, at all times, an Issuer Credit Rating which is an Investment Grade Rating, and instead provide an annual certificate, we believe this gives rise to a clear lack of equivalence in the cash lock-up provisions. For example, ratings assessments are forward looking and it is not clear how the certificate approach objectively incorporates the range of forward looking factors that a ratings agency would consider in making its assessment.

Further, credit ratings are dynamic in that the agencies can quickly change a rating or a rating outlook at any time, in response to developments affecting a company or the sector. The certificate seems to be a ‘point in time’ assessment and therefore there may be a significant lag between a deterioration in the credit quality of the Appointee and this being reflected in the annual assessment.

The lack of equivalence in the precise circumstances in which cash lock-up would be triggered means that there is not a level playing field between those Appointees required to maintain an investment grade rating and those providing a certificate. This operates at two levels. Firstly, companies procuring a credit rating must incur material costs in procuring a rating from a ratings agency. Secondly, the companies have less flexibility in how to manage their financing arrangements given the obligation to maintain an investment grade credit rating and the need to maintain such a rating and avoid one of the ratings falling to BBB-/Baa3 with negative outlook or review for possible downgrade.

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For those companies providing a certificate, it is hard to see what criteria is specified to give Ofwat adequate warning of a deterioration in credit quality ahead of the company failing to provide confirmation that it would be able to maintain an investment grade rating.

We believe that Ofwat should apply cash lock-up provisions on a consistent basis across all companies - i.e. the lock-up should only be triggered where a company with credit ratings also fails the annual certificate test; or all companies are required to procure a credit rating and to maintain, at all times, an investment grade rating.

If this is not feasible, then we would advocate that for the annual certificate test, the cash lock-up trigger should be explicitly linked to key credit ratios falling below a level that would still provide a comfortable degree of headroom above sub-investment grade. This should be evidenced by the applicable Appointee publishing the annual certificate evidencing compliance with the key credit ratio thresholds on both an actual and projected basis – for example, maximum debt:RCV gearing not to exceed 72% and minimum adjusted interest cover of 1.5x in line with Moody's minimum criteria for a Baa1 rating; and minimum funds from operations to debt of 9% in line with S&P's minimum criteria for a BBB+ rating, with Ofwat retaining the ability to amend these requirements if the ratings agencies subsequently change their thresholds.

We would be willing to work constructively with Ofwat to help either shape an effective two-tier test or provide a view on an appropriate buffer (with regard to key ratio thresholds) above sub-investment grade. A two-tier test would help to provide a more level playing field between companies and provide customers and regulators with more assurance about the financial position of companies which do not maintain an externally procured credit rating.

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 conditions proposed in Condition P 9 are substantively the same as contained in U UW's current licence in Condition F and Condition K. As such, U UW has no objections to the wording proposed in the new Condition P 9.

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 consider that U UW already provides Ofwat (as part of our Annual Performance Report submission) with ring-fencing certificates that fulfil the expectations set out in the consultation as to:

- i. the form and consistency of the information provided, and
- ii. the scope and form of confirmation in respect of the auditor's review.

On this basis we are comfortable with the requirements described in the consultation, on the assumption that the current disclosure is sufficient fulfil the proposed criteria.

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 note the new Condition P 10 "reporting of material issues", and whilst this requirement arguably overlaps with other information requirements contained in U UW's existing licence, we agree that this overarching provision looks appropriate, and we agree that the formulation is appropriate with regard to "where the Board of the Appointee becomes aware of any circumstance that may materially affect the Appointee's ability to carry out the Regulated Activities the Appointee must inform the Water Services Regulatory Authority as soon as possible."

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We consider that it might be counter-productive if Ofwat were to be more prescriptive in terms of what specific circumstances may materially affect the Appointee's ability to carry out the Regulated Activities, with the onus being placed quite rightly on the Board to make this assessment.

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

The consultation document only contains extracts from the new Condition P. Before UUW can confirm acceptance of the new Condition P, we would need to review the full and complete text.

Many of the provisions in the new Condition P are intended to replace existing provisions in UUW's licence – e.g. the credit ratings, cash lock-up and ring-fencing provisions are currently contained in Condition F and the Ultimate Controller undertaking in Condition P of UUW's licence. It is not clear from the consultation how the old provisions will effectively be dis-applied or superseded. From a practical perspective, it will be important for this to be adequately dealt with to avoid duplication and areas of conflict in respect of the precise wording employed in the new Condition P versus the legacy wording.

With reference to the notification provision in respect of a change or event which may lead to a change to the Ultimate Controller(s) of the Appointee (new Condition P 3.6), we would like there to be an acknowledgement in these provisions along the lines of: "nothing in this Condition P 3.6 shall require the Appointee not to comply with any applicable legislation, regulation or rules relating to such disclosure, including (but not limited to) applicable listing rules and market abuse regulations, and the Water Services Regulation Authority expressly acknowledges that it will treat such information provided by the Appointee as confidential until such information is made public, and will confirm its compliance (on request) with all applicable legislation, regulation or rules relating to such disclosure."