



Yorkshire Water

Regulatory Ring-fencing
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Yorkshire Water
Western House
Halifax Road
Bradford
West Yorkshire
BD6 2SZ

T: 01274 691111

By email: FinanceAndGovernance@ofwat.gsi.gov.uk

08 January 2019

Dear Sir or Madam

Consultation on strengthening the regulatory ring-fencing framework

Thank you for the opportunity to contribute to the consultation published on 20 November 2018 on proposals to strengthen the regulatory ring-fencing framework to bring all licences up to a common industry standard.

In principle we support the approach to standardise licence conditions for ring fencing certificates, change of control and reporting of material issues. However, with regards to the proposals to harmonise conditions so that all Appointees' licences require that they "must ensure" they maintain an investment grade credit rating at all times, we do not believe the current proposals are practical. We have provided suggestions to improve their practical application while achieving the same protections for customers.

Regarding the proposal to adjust the definition of issuer credit rating (aligned to the modification of the licence of Thames Water), we again have some practical concerns which undermine the objective of achieving a uniform industry standard. We offer some additional ratings for consideration that are relevant for Yorkshire Water and may also be suitable benchmarks for the regulated businesses of other companies.

Our detailed responses to the questions contained in the consultation are attached. We would be pleased to discuss any of the matters raised further before finalisation of the proposed licence modifications.

Yours faithfully,

Wendy Kimpton
Head of Regulation

Enc.

Yorkshire Water response to the Ofwat strengthening the regulatory ring-fencing framework consultation

This document provides the responses from Yorkshire Water to the questions raised by Ofwat in its regulatory ring-fencing consultation published on 20 November 2018.

2.1 Maintaining investment grade credit ratings and cash lock-up

Q1. 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 believe finance resilience is a broad matter to consider, as demonstrated by the assurance work undertaken for the PR19 business plans; credit ratings are one element and represent an assessment purely from a creditor's viewpoint. The proposed use of credit ratings as a "hard" condition means the risk of a licence breach being originated externally would be increased.

Regarding the proposals to maintain an investment grade rating, the Whole Business Securitisation (WBS) already provides such assurance in that it protects the financing to support the regulated business and its activities, including the use of ratings triggers and the ability to resolve issues in times of stress or under a default situation.

The WBS is linked directly to the licence where its removal is notified or happens, but a breach of licence would also need to be assessed in terms of its materiality and potential reaction of secured creditors. Both the licence and credit ratings are in the public domain, so it is clear Yorkshire Water would need to issue a public update if its rating breached the licence condition as a result of a downgrade.

Although there may not be substantive grounds for secured creditors to claim an event of default, there would be scope for challenges on decisions taken by Yorkshire Water (e.g. paying dividends, raising debt) where it may have been assumed there was knowledge of a possible licence breach that could be deemed a potential event of default.

Comparing licence conditions across companies may be a reasonable starting point with the intent to harmonise, yet this may not necessarily lead to harmonised outcomes as each regulated company will have different financing conditions that are embedded in its the governance and management of businesses with regulated activities.

The proposal that all Appointees' licences require that they "must ensure" they always maintain an appropriate investment grade credit rating may well give rise to issues of a practical nature. A specific scenario may be where a company refers an Ofwat determination to the CMA. Where the nature of the determination is sufficiently important to concern ratings agencies and the rating agency in question acted to reduce a rating before the CMA process

concludes, then the company would be in breach of its licence according to the Ofwat proposals. Where the CMA reached an alternative determination, this may mean the rating downgrade would be unwound.

In conclusion, we believe that the introduction of “must ensure” requirement raises several significant practical challenges, dependent on the underlying circumstances that would trigger a credit rating downgrade. Our preference is that a breach of licence would not be declared until there was an opportunity to understand the root causes of a ratings downgrade and to determine possible remedies. Therefore, a practical and common approach would be the introduction of a clearly defined grace period before a licence is deemed to be breached. This would allow sufficient time for discussions with a ratings agency and Ofwat to review a downgrade and to identify possible remedies. In the particular instance, where a ratings downgrade results from an action or announcement by Ofwat (e.g. consultation outcome, determination) then the impacted company would not be in breach of its licence until there had been time for a CMA inquiry process to conclude.

If this is not deemed to be possible then there should be a clearly defined remedy period following a breach, allowing Ofwat and the relevant company to consider the causes of the breach and the remedies required.

Q2. 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 note the expansion of the current licence definition of issuer credit rating to allow for the use of a corporate family rating, in line with agreed modification of the licence of Thames Water.

This rating definition is limited to an issuer or corporate family rating, which for Yorkshire Water limits to one the rating agency relevant to the licence condition, Moody's. We understand that neither Fitch nor Standard and Poor's (S&P) will provide issuer ratings for securitised debt structures. We believe this will also apply to other water companies with securitised debt structures.

Although not directly affecting Yorkshire Water, when considering the objective of establishing an industry standard, we are concerned at the flexibility granted to unrated companies to self-certify their investment grade status. Also, it is unclear as to Ofwat's approach if Moody's decided to not issue corporate family ratings at some point in the future. We would welcome the opportunity to discuss these points further with you.

Specifically for Yorkshire Water, there is a mismatch with the WBS where there is a covenant, on a reasonable endeavours basis, to meet investment grade rating criteria for Class A and Class B bonds and failure to do so would be a trigger event or an event of default.

Current ratings are:

	Family	Class A	Class B
S&P	n/a	A-	BBB
Moody's	Baa 2 (neg.)	Baa1 (neg.)	Ba1(neg.)
Fitch	n/a	A	BBB+

This leaves the possibility that the Moody's family rating could fall below investment grade, breaching the proposed absolute obligation, whilst Class A and Class B ratings continue to meet the WBS covenant. The likelihood of this happening needs to be considered since it would form part of the assessment as to whether the proposed licence change is material and how a change would be communicated to secured creditors.

This has additional relevance as Ofwat determinations or announcements may be the trigger for such rating changes, as evidenced by Moody's recent assessment of greater regulatory risk for the UK water companies following Ofwat's publication of its high leverage consultation.

In conclusion, we believe that Ofwat should further consider the practical implications of its application to water companies with different financing structures. We suggest that the proposal should acknowledge a corporate family rating should not be the sole benchmark when other more applicable ratings are available.

In particular for Yorkshire Water, we would propose that the Class A rating is more relevant when considering financial resilience as it represents the rating for the majority of publicly issued debt, reflects the benefit of the WBS and would align better with the obligations defined in the WBS.

Q3. 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 do not object to the proposals to align the cash lock-up provisions in all licences and move them from Condition F to Condition P.

However, it should be noted again there is a mismatch of ratings definitions and, in this instance, greater sensitivity since a one notch downgrade to the family rating from Moody's with negative outlook maintained would trigger Ofwat's lock up provisions but not necessarily represent a WBS trigger event unless Fitch and S&P took actions involving a downgrade of two or more notches.

2.2 Providing ring-fencing certificates

Q4. What are your views on the licence changes we have set out to bring the provisions relating to ring-fencing certificates for all companies into line with industry-leading standards? (See Annex: Condition P9)

We do not see any material issues with the proposals to make the provisions relating to ring-fencing certificates consistent with the most current industry-leading standard. We do not have any objections to such provisions being gathered together in a new Condition P.

Q5. 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 note the emphasis Ofwat place on its expectations of companies about the information provided with ring-fencing certificates and we support the three areas covered.

2.3 Reporting material issues

6. Do you agree with, or have any further comments to make with respect to, the 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 are broadly supportive of the proposal to make licences consistent under Condition P in relation to reporting material issues to Ofwat. However, we would need to review details regarding the types of matter that could be considered material and any guidance.

The practical concern is that “material” can be interpreted differently by various stakeholders including lenders. There is currently insufficient detail to assess Ofwat’s proposal. Therefore, we reserve the right to comment until further information or detailed drafting is available.

2.4 Change of control and other matters

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

We have no other comments to make at this stage.