Affinity Water
Taking care of your water

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Via email: OfwatPandO@ofwat.gov.uk

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Dear Sir / Madam,

## Financial resilience in the water sector: a discussion paper

Thank you for the opportunity to comment on Ofwat's discussion paper: Financial resilience in the water sector. We welcome Ofwat's focus on the topic of financial resilience, we are pleased to see a widening of the definition of 'financial resilience' and a move away from a reliance on gearing as a measure of financial resilience.

We are generally in favour of transparency and new disclosures outlined in the discussion paper, most of the additional information requirements discussed in the paper are items which we already make public and are happy to formalise this reporting in line with best practice.

However, we do have some fundamental concerns with certain proposals set out in the discussion paper. These concerns are addressed in this letter and the accompanying Annex which also includes responses to the specific questions raised.

Overall, we do not think the discussion paper presents compelling evidence that the existing framework for ensuring financial resilience is inadequate and poses material risk to customers or taxpayers. The need for additional regulation should be established conclusively before considering the design and specification of new regulation. This is required to ensure that any new regulation meets the evidentiary bar for regulatory innovation, is targeted and does not have unintended consequences. We have set out below some examples of mechanisms and arrangements that support financial resilience whose efficiency needs to be analysed systematically before considering any new regulation.

Ofwat has acknowledged that the current regulatory framework has multiple instruments in place that seek to "*insulate the regulated company and its customers from the risk of financial distress*". These include, *inter alia*, credit rating requirements within the regulatory ringfence, cash lock-ups, special administration, Ofwat's finance duty and risk allocation mechanisms that limit the level of downside risk companies are exposed to.

Water companies also have a regulatory obligation to publish annually Going Concern and Long-term Viability Statements which are reviewed by auditors and require the executive team and the Board to consider the evolving risks faced by the business, the financial impact of these risks and how they can be best mitigated to ensure financial resilience is maintained.

We note that companies' financial structures also imply a degree of protection. For example, companies already have incentives to maintain good credit ratings because this reduces the cost of debt and this incentive exists even if the regulator does not set any conditions on the requirement to have headroom against a minimum investment grade credit rating.

Whole Business Securitisation (WBS) arrangements like ours provide additional protections beyond those implied in non-securitised structures. The provisions of a WBS are designed to minimise business and financial risk and avoid disruption to the business in the case of financial distress. Ultimately, WBS ensure tight cash control and hence reduce the likelihood that a company will be unable to meet its financial obligations through a combination of (1) limitations and requirements on ongoing financing activities, (2) additional monitoring arrangements which result in closer management of projected cash flows, and (3) additional creditor protections which are triggered under defined circumstances (such as our cash trapping mechanism which prevents distributions if certain financial ratios are breached).

The discussion paper sets out a case study on Southern Water to illustrate that there can be a link between financial resilience and customer service levels, it is inappropriate to use this as a read across for the entire industry because it represents a single example and is not reflective of a systematic industrywide issue. There are other companies with high gearing but good service performance (such as Anglian Water). Southern Water triggered high levels of intervention (including fines and Serious Fraud Office involvement) that have not been seen recently at other companies. Ofwat has not demonstrated that this is repeated across the industry. It is not proportionate to place significant additional regulatory burden on the entire industry based on an outlier event.

We are not convinced the Southern Water case study shows a market failure – the market functioned properly as the regulator worked with Southern to recapitalise the business and the outgoing shareholder bore material losses during this process.

It is also not clear the regulation proposed would solve the performance issues that Ofwat is most concerned about. There is no evidence that weak financial resilience had any impact on customer service levels. There could be other variables that cause both – such as poor management – or it is possible that poor service performance could have led to poor financial resilience via the financial impact of regulatory fines and penalties. Therefore, regulating financial resilience equates to regulating a symptom rather than the cause, and cannot reasonably be expected to prevent this recurring in future.

We have not seen any evidence which proves a causal link between levels of financial resilience (which all else equal do not directly affect customer service levels) and operational failures and underinvestment (which could affect customers). This is recognised by Ofwat's advisers Professors Mason & Wright, who comment that:

*"Mason and Wright: 'there is still relatively little data on which to base an assessment of whether there is a robust relationship between measures of financial resilience and operational performance"*

Regulating financial resilience is at best an indirect way to address concerns around customer service. For example, a company with weak financial resilience could have great customer service and a company with strong financial resilience company could have poor customer service.

As already mentioned, while we are generally supportive of transparency and disclosure, we think that the hurdle for making more substantive licence changes has not been met by the content of this paper. Licence changes have a wider impact and real-world consequences which could reduce the company flexibility that would best support customer interests.

We believe that many of the options in the discussion paper would not produce a clear customer benefit but may inadvertently create customer disbenefit by making the sector less investable or imposing additional costs on companies/customers without improving service levels.

Finally, we are concerned that the interconnection between the two highly related areas of Risk and Return and Financial Resilience has not been properly considered. On one hand Ofwat raises concerns with financial resilience, on the other it is proposing methodological changes to the cost of equity which, all else being equal, will weaken financial resilience. The balance of risk and return has a large impact on financial resilience and the topics should not be viewed in isolation.

We recognise the importance of this issue to the future of the sector, and we hope that these thoughts, and those contained in the Annex, are useful contributions to Ofwat's thinking in this area.

As always, we would be very happy to meet to discuss our comments further and look forward to future engagement with Ofwat on this topic.

Yours faithfully,

[redacted]

[redacted]

Interim Regulation and Strategy Director

## Annex

In this annex we set out our answers to the specific questions raised in the discussion paper.

Q1. Do you agree that it is not appropriate for providers of essential infrastructure to operate at, or be at risk of falling to, the lowest investment grade credit rating?

We do not agree. While financial resilience is important, there is no evidence to show that there are implications for customer service levels from operating at the lowest investment grade credit rating.

The current framework which requires companies to maintain an investment grade credit rating is appropriate because prudent companies manage their credit rating to create headroom above the minimum investment grade level. This is currently the case for all companies except Southern Water.

It is not appropriate for providers of essential infrastructure to provide poor customer service or underinvest in their networks. Regulation should target the stated root concerns about poor service and investment levels issues directly, rather than focus on credit ratings which are not related.

We welcome the change in the approach to assessing financial resilience from a narrow focus on gearing to the consideration of credit ratings which reflect a broader range of factors than just gearing. However, by themselves, credit ratings do not represent a sufficient measure of financial resilience and should not be treated as such.

There is already a mechanism in place designed to protect customers in cases where companies are operating at the lowest investment grade credit rating and are at a risk of downgrade. The BBB-/Baa3 (negative outlook) rating in the existing cash lock-up provisions was assessed as appropriate when the current licence was drawn up and we have not been provided with any evidence that changes to this level are appropriate to enhance customer protection. Many companies in various sectors operate successfully at BBB-/Baa3.

Q2. Do you agree with the notion that a company should be taking actions to improve its credit rating well before it is downgraded to the lowest investment grade credit rating?

It is reasonable and expected by the market for a company, under its own initiative to take actions to maintain investment grade credit rating. However, we do not agree that further regulation is required - there are already strong economic incentives for companies to manage their credit ratings, including the efficiency of debt issuance and covenant compliance. We do not think that the discussion paper sets out evidence to justify further intervention in this area.

We note that despite an unprecedented period of change in society and technology over the last 15 years and exceptional economic shocks (Global Financial Crisis and COVID-19), no water company has failed. This means that companies have been undertaking appropriate actions to prevent downgrades to sub-investment grade.

Maintenance of a strong investment grade credit rating does not guarantee good customer service and investment levels given that there is no causal relationship between financial resilience and operational performance.

Given that Ofwat's stated objective is to tackle operational underperformance, Ofwat should instead target regulation to focus on service and investment levels.

### Q3. our option not to define limits on capital or financing structures at this time and whether it might be necessary to define limits for companies where financial resilience does not improve.

We agree with the discussion paper that having a regulator defined limit on capital or financing structure would not be suitable. As acknowledged in the discussion paper, focus on gearing only is unlikely to capture the full range of risks to financial resilience and would result in limited financial flexibility.

We have not seen any evidence that indicates any correlation between gearing and performance levels, our own investigation suggests that both relatively high and low geared companies out- and under-perform on key measures of investment and customer service. This strongly suggests that any mechanism that attempts to address concerns of poor customer service by regulating gearing will not be appropriately targeted and is unlikely to be effective.

Furthermore, even if there were an evidenced causal relationship between high leverage and poor customer service, implementation of any new mechanisms would require robust analysis and impact assessment to show that (1) existing regulatory mechanisms – as well as wider corporate governance arrangements – are insufficient to address the identified market failure; and (2) any proposed new mechanism(s) would promote efficient market outcomes, imply the right incentive properties and avoid introducing distortions. Ofwat has not presented sufficient analysis to meet the evidentiary bar for regulatory innovation to demonstrate that the options are in line with better regulation principles.

The existing framework already creates a constraint on capital structures through the requirement to maintain an investment grade credit rating. Market forces also directly mitigate the risk of companies adopting a high level of gearing, as increased gearing will ultimately lead to an increase in the cost of debt.

### Q4. amending the existing trigger level for the cash lock-up conditions to a higher credit rating and the potential for the trigger to be linked to measures of service performance.

We do not believe that any amendments to the cash lock-up conditions are warranted. As an overarching point, we do not see robust evidence and justification that additional regulatory intervention is required in the first place, given the existing mechanisms and arrangements to maintain financial resilience and protect customers.

The current regime has proved to be robust and fit for purpose, as evidenced by the lack of water company failures despite the two significant crises experienced in the last 15 years.

Ofwat has not undertaken any systematic analysis of the existing protections across regulatory mechanisms and corporate governance arrangements to evidence their sufficiency or lack thereof. We note that our WBS arrangements imply additional relevant protections. For example, a cash trapping mechanism, which is designed to maintain and restore credit quality by preventing distributions and retaining cash in the company and is triggered if certain financial ratios are breached. We expect other securitised structures will include broadly similar provisions.

Below we comment separately on each proposed change to the cash lock-up conditions.

*Proposal to increase the cash lock-up trigger level to a higher credit rating*

There is no justification from Ofwat why, for example, the BBB/Baa2 (negative outlook) threshold should be used as the target, or what additional evidence has come to light since the introduction of a cash lock-up trigger in the licence that would indicate that the BBB-/Baa3 (negative outlook) threshold is no longer appropriate.

There is no evidence of a deterioration in credit ratings on average across the sector, which would suggest that significant changes to cash lock-up thresholds might be required.

Credit ratings are not solely a function of a companies' capital structures. They are decided by independent third-party rating agencies with their own views and are impacted by various external factors such as macro-economics, politics and critically regulators' decisions.

We note that the changes in the regulatory framework implemented by Ofwat at PR19 resulted in a downgrade in the predictability and stability of the regime and more challenging thresholds for the key metrics to achieve the same rating. Rating agencies continue to perceive risk of regulatory and political intervention in the sector, for example, Moody's highlights in its most recent sector outlook[1] that:

*"We could change the outlook to negative if it appears likely that the credit fundamentals for the sector will deteriorate, in the context of a weakening economic outlook or* ***greater affordability constraints preventing companies from being able to fund necessary investments to improve or enhance performance****."*

***"Ongoing regulatory pressure and, in particular, the two opposing themes of long-term resilience investment needs and affordability constraints, continue to weigh against a positive outlook."***

There is a risk of circularity whereby the changes to the framework proposed or implemented by Ofwat are perceived to be credit negative by the rating agencies who then place the industry/individual companies on negative watch based primarily on Ofwat's decisions. As a result, companies will face cash lock-up due to regulatory policy which is outside of their control.

We are also concerned that an excessive focus on credit ratings – which are not a complete measure of financial resilience – can divert management attention from investment and customer service initiatives.

The proposed mechanism construes financial resilience as relating solely to the ability of companies to service debt and ignores potential impacts of the overall risk reward balance for equity investors, particularly as it increases the prospect of sustained periods of dividend lock-up. Given the sector challenges and the need for equity funding in the future, the prospect of further dividend cuts would be gravely detrimental to equity financeability.

*Proposal for the cash lock-up trigger to be linked to measures of service performance*

Linking the cash lock-up trigger to measures of service performance would be a complex and subjective exercise. For example, there is a broad range of performance commitments and companies could be exposed to regulatory discretion as to whether service performance across multiple and complex measures is sufficient to justify dividend payments.

The structuring of cost and outcome incentives clearly links financial performance to customer service levels, which over time – if a company is not meeting service levels – will reduce free cashflows available for distribution and would organically form part of company distribution choices.

We also note that the assessment that our Board undertakes to determine dividend levels has regard to delivery against the final determination for AMP7, in particular, of performance commitments with associated ODIs as set in the final determination and

[1] Moody's (2022), Regulated Water Utilities – UK, 2022 outlook stable as regulatory certainty balances environmental and social risks

any ODI penalties or rewards earned. We comment on our dividend policy in greater detail in the response to question 6 below.

This mechanism could introduce a departure from market expectations for utilities dividends (which are typically seen as income stocks) and undermine the attractiveness of the sector as an equity investment proposition at a critical time, especially given the increased investment required to meet the Government's ambitions as set out in the draft SPS.

As a result, any limitation or restriction of dividend payments could deter equity investment in the sector in the future.

### Q5. a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.

It is not clear what the value add of the proposal would be for financial resilience given existing arrangements and reporting requirements for the sector, especially since Ofwat has not explained what might be included within the plans and the "defined level" at which the plans will be required.

Companies are already subject to a significant governance regime which is partly designed to ensure that the company remains financially resilient.

For instance, the companies are subject to a Price Review cycle every 5 years which includes the publication of a detailed 5 year plan which receives substantial scrutiny within and outside the organisation and includes explicit consideration of financial resilience.

Companies undertake detailed and regular analysis of financial resilience to demonstrate Going Concern status and Long Term Viability at least annually, during the audit of the financial statements.

Our own Viability Statement in our March 2021 accounts involved modelling 10 different scenarios for revenues, costs, inflation and exceptional events, each over a 10 year period.

Where companies are maintaining or improving customer service levels and have an investment grade credit rating above the minimum investment grade, we are not clear that additional reporting would be appropriate, There is no customer harm and it adds cost and distraction to the business.

Q6. a requirement for additional board assurance statements when dividends or other distributions are declared or made, and credit ratings are below the targets stated for the notional capital structure at a price review.

In relation to the board assurance statements when dividends or other distributions are declared and made, we do not consider that this would add to the existing structure for ensuring financial resilience given that our board provides annual Long-term Viability and Going Concern statements and assesses whether dividend reflects and/or would compromise the long-term social, financial and operational commitments made to stakeholders.

The latter assessment includes, *inter alia*, long-term financial resilience of the company in relation to liquidity, distributable profits of the company, cash facilities available, financial ratios, customer service and operational commitments.

We are also concerned about the potential implications of this proposal in combination with wider PR24 policy options. Under Ofwat's proposed options the notional capital structure would become increasingly divorced from water sector market evidence and does not represent a robust, stable and predictable structure that corresponds to water company financing.

Q7. a requirement for companies to maintain two investment grade issuer credit ratings.

While this requirement would not impact us – given that we already hold two credit ratings in line with the rating requirements in our WBS – we are not convinced that this additional regulatory requirement is effective or proportionate.

Ofwat has not provided evidence to suggest that two credit ratings improve financial resilience.

The cost of maintaining a second credit rating is not trivial for a company of our size and should be weighed against any benefits of having two ratings, particularly as companies already have a credit rating and the obligation to maintain investment grade.

### Q8. a requirement for companies to formally notify us of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals).

A requirement to notify of published changes would not be of concern to us as rating assessments would be available publicly and formalising reporting to Ofwat could support more robust and timely regulatory monitoring. However, notification of planned or potential changes in advance of publication by the agencies themselves is inappropriate given the sensitive nature of the information.

Best practice is to minimise the distribution of market sensitive information even if technically allowable to share with regulator. So, if this is changed, we have a strong preference for it to be a post event notification rather than in advance.

### Q9. removing dispensations from the requirement to maintain an investment grade credit rating.

Not applicable to Affinity Water

### Q10. the need to align the licence to our broader expectations for dividend policy.

We are not convinced that the proposed licence changes are a targeted and proportionate way to address customer service and investment levels – as we state earlier in this response, these issues should instead be addressed directly. Regulation of dividend policies is unlikely to result in outcomes that would be consistent with the expectation in a competitive and efficient market equilibrium and could result in distortions.

As discussed above, our dividend policy already considers explicitly the ability of the Appointed business to finance the business considering current and future investment needs and financial resilience over the long term.

### Q11. enhancing the transparent reporting of the use of swaps and how this could be best achieved.

In general, we are supportive of transparency and disclosure on swaps where it is helpful to understand the risk exposure implied and to provide the information required to capture swaps in the calibration of the balance sheet approach.

Our annual reporting on derivative instruments complies with IFRS and APR requirements. Furthermore, our 2021 Annual report contained additional disclosure in the CFO's review, with description, rationale and cashflow impact of transacted swaps. We also disclosed the debt mix pre and post swaps.

We welcome further engagement with Ofwat on this subject.

Q12. whether disclosure requirements should be set for companies to increase the reporting of holding company debt levels (for example to state holding company gearing levels) in their Annual Performance Reports.

No specific comment but in general we are supportive of transparency and disclosure.

Q13. the option to improve the transparency of pension deficit reporting.

No specific comment but in general we are supportive of transparency and disclosure. Although it would be helpful to understand what additional transparency Ofwat considers might be useful. We note that we already publish substantial information related to our pension surplus in our annual report and APR.

Q14. the expectation that PR24 business plans should include a board assured assessment of financial resilience.

We note that we provided board assurance on our PR19 business plan and so would agree with the same requirement applying to the PR24 business plan.

Q15. how the incentives framework around capital structure should evolve at PR24 taking account of the other views set out in this paper and the scope to which companies should provide voluntary sharing arrangements at PR24.

We believe the incentives framework around capital structure should be evolved to remove the GOSM which was disapplied by the CMA on the basis that there was insufficient evidence to support its implementation and it may in fact be detrimental to financial resilience.

We agree with the CMA's findings that the mechanism is not supported by finance theory, correct diagnosis and evidence of the underlying problem and so cannot, by design, be targeted, proportionate and effective. In this context and further to the decision made by the CMA, we consider that any GOSM penalty relating to AMP7 should not apply in AMP8.

We believe new incentive-based mechanisms are not justified and would not be able to meet Ofwat's stated objectives because (1) they would not be targeted at addressing directly Ofwat's concerns about poor customer service levels and underinvestment, and (2) could reduce cash flows on an expected basis and could potentially result in funds being diverted from investment in the asset base and customer service levels. Such mechanisms assume that there is a single optimal structure and that the regulator (rather than market forces) is best placed to identify it – there is no evidence provided that either of these assumptions holds.