Anglian Water's response to Ofwat's discussion paper on financial resilience

January 2022

1. Executive Summary

Anglian welcomes the opportunity to respond to Ofwat's discussion paper on financial resilience in the water sector. This paper is one of many discussion papers and consultations which Ofwat have recently published setting out its emerging thinking for PR24.

We agree that it is important that companies have adequate levels of financial resilience to deliver on obligations and commitments to customers and the environment now and in the long-term. This is necessary for supporting the investment required to meet the challenges of asset resilience and climate change. We also agree that continued transparency about the purpose and operation of financial structures would facilitate assessment of whether they incentivise companies to act in the best interests of customers and not just investors.

Resilience also requires a profile of customer bills and investment that is sustainable over the long-term. As expressed in our response to Ofwat's PR24 discussion paper on 'Long term delivery strategies and common reference scenarios'[1], we wholeheartedly support shifting the price review framework to focus on the longer-term.[2] This shift is particularly important for PR24 where the number of strategic priority areas (including net zero, water resilience, environmental improvements among other priorities) presents a risk of a large accumulation of potential investments. These must be appropriately prioritised, whilst managing both shorter and longer term bill pressures in a way which ensures intergenerational equity and timely service improvements for customers and the environment, whilst maintaining a financially resilient sector attractive to long term inward investment at the scale required to meet future challenges.[3]

The need for long term investment to meet these challenges is likely to create upward pressure on bills, so it will also be imperative to ensure a range of tools are in place, such as effective social tariffs to support those who are struggling to pay. **Our concern is that the aims of the Long-Term Delivery Strategy paper, which we firmly support, would be undermined if the proposed changes in the financial resilience and risk and return papers were implemented.**

The financial resilience discussion paper lacks a clear exposition of a market failure that would require regulatory intervention. We note that Ofwat is concerned that a company with weak financial resilience may take years to recover and that this may be associated with poor operational performance. We agree that it is not fair for customers and the environment to bear the real consequences of poor service delivery for extended periods of time. However, the evidence for a link between operational performance and financial resilience is weak and concerns about the former are best addressed directly. We are concerned that the case study of a single poor operational performer (Southern Water) is being used to justify sweeping interventions across the industry. It is important that Ofwat is clear about the problems it is trying to address and uses remedies that are proportionate and well-targeted on outcomes for customers and the environment. We expect Ofwat to carry out a full regulatory impact assessment of any proposed interventions to ensure they meet these tests.

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[1] Ofwat (2021), 'PR24 and beyond: Long-term delivery strategies and common reference scenarios', November.

[2] Anglian Water (2022) response to 'PR24 and Beyond: Long-term delivery strategies and common reference scenarios discussion paper', 6 January.

[3] "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." Moody's (2022), Regulated Water Utilities – UK: 2022 Outlook stable as regulatory certainty balances environmental and social risks.

Financial resilience is the responsibility of company boards and most of the issues that Ofwat raises in the paper are already addressed within the existing regulatory framework (and in Anglian's case resilience is further augmented by its covenanted structure). Ofwat's paper sets out a range of potential changes and interventions relating broadly to financial resilience. Where we see merit in some changes, and where the proposed remedy is well-targeted and proportionate, we highlight these and support them. Where we see that remedies are not well-targeted or proportionate, we explain why this is the case, and also where in the regulatory framework and the financial structure they are already dealt with.

Proposals we support	Proposals we reject
Not defining limits on capital or financing structures	Increasing the credit rating threshold for triggering dividend lock-up,
Companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level	Ofwat's proposal to link dividend lock-up to service performance
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	The need for licence changes to align with Ofwat's broader expectations for dividend policy
Companies to maintain two investment grade issuer credit ratings	Reporting of holding company debt levels (for example to state holding company gearing levels) in company Annual Performance Reports
Companies to formally notify Ofwat of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals)	
Removing dispensations from the requirement to maintain an investment grade credit rating	
Enhancing the transparent reporting of the use of swaps	
Improving the transparency of pension deficit reporting	
PR24 business plans to include a board assurance statement of financial resilience	

A notable omission from the paper is any discussion of the influence that Ofwat has on company financial and operational resilience. Ofwat determines the revenue allowances and thereby determines the size of the equity buffer at which the notional company operates. The equity buffer is the financial headroom afforded by the price control to each company to absorb financial risks and therefore plays a vital role in maintaining financial resilience. As was noted at the CMA in the PR19 redetermination, the equity buffer depends heavily on the allowed equity return.[4]

Ofwat also determines the allocation of risk to the notional company and hence the **required** equity buffer through the setting of cost efficiency targets and Performance Commitments (PCs), together with the incentive mechanisms that are applied to these areas. The allowances and risk allocation mechanisms that affect the required equity buffer are the outcome of complex analyses and regulatory judgement in the presence of uncertainty, which emphasises the need to look at their cumulative impact on the required equity buffer. It is therefore essential that Ofwat keeps close observation on the equity buffer in their development of the PR24 price control and that there is sufficient buffer given the allocation of risk between companies and consumers.

The equity return has *decreased* as a result of every price control since PR04, and the associated cash equity buffer has halved in just ten years between PR09 and PR19 (see Table 1). Ofwat's proposed changes to risk and return suggest a lower base equity return in PR24, which will reduce the equity return buffer even further.[5] At the same time, the risks have increased substantially, which means companies are less resilient given their smaller equity buffer. In PR19, Ofwat reduced the level of notional gearing to support notional financeability, however it is clear that this has done little to offset the lower financial resilience arising from the reduction in the allowed equity return (see Table 1).

Table 1 Reduction in notional equity return buffer since PR04

	Calculation	Units	PR04	PR09	PR14	PR19
Notional gearing	*a*	%	55	57.5	62.5	60
Cost of equity (real RPI)	*b*	%	7.73	7.08	5.65	3.18
Anglian Water RCV	*c*	£m	4,995	6,571	7,650	7,943
Equity buffer	***d = (1-a) x b x c***	**£m**	**174**	**198**	**162**	**101**

Note: Anglian's RCV numbers are the average nominal outturn closing RCV for each price control. The PR19 value is based on 2020/21 only. See https://www.ofwat.gov.uk/publications/regulatory-capital-value-updates/.

Sources: Ofwat (2004), 'Future water and sewerage charges 2005-10'; Ofwat (2009), 'Future water and sewerage charges 2010-15: Final Determinations; Ofwat (2014), 'Setting price controls for 2015-20 – Final price control determination notice: policy chapter A7 – risk and reward', December, pp. 41-42; Ofwat (2019), 'PR19 final determination: Allowed return on capital technical appendix', December, pp. 4-5. Oxera calculations.

We would like to see Ofwat recognise that financially resilient companies will target a sufficient equity buffer to avoid being downgraded from Baa1/BBB+ and should be funded for this through allowed revenues.[6] For example, at PR19, Ofwat and the Competition and Markets Authority (CMA) tested the financeability of the notional company against the bare minimum investment grade financial ratios for a Baa1/BBB+ credit rating. Our position on the financeability framework for PR24 is outlined in more detail in our response to the risk and return discussion paper.[7] For the PR24 price control to support financial resilience it is necessary for companies to be funded for a credit rating

[4] CMA PR19 noted "The increase in WACC relative to Ofwat's determination is largely due to our assumption of a higher cost of equity, and this contributes favourably towards financeability by providing an additional equity buffer against the risks faced by the Disputing Companies." Final Report, 10.74(a)
[5] Anglian Water (2022) response to 'PR24 and beyond: Discussion paper on risk and return', p. 5.
[6] CMA PR19 observed "It is therefore important to consider whether the assumptions made about costs and outcomes are likely to be achievable in practice, and whether the balance of risk for the companies is consistent with those credit ratings." Ibid, 10.73(d)
[7] Anglian Water (2022) response to 'PR24 and beyond: Discussion paper on risk and return', section 5.

that is comfortably in the Baa1/BBB+ band and provides a sufficient equity return buffer against downgrade.

We consider that there are better targeted measures than setting dividend lock-up triggers above minimum investment grade and we do not support triggering dividend lock-up based on service performance metrics

Before turning to Ofwat's proposed interventions, it is important to note that companies already have multiple layers of protections in place to support their financial and operational resilience. In particular, companies are required under the Companies Act to consider the long-term implications of their decisions on all stakeholders. In the case of Anglian Water this is further enshrined in the company's Articles of Association which the Board amended in 2019 to enshrine the social and environmental purpose of the company. The governance framework therefore already provides strong safeguards against board decisions that would lead to credit ratings deteriorating to Baa3/BBB- negative designation or to deterioration of service quality in both the short- and long-term.

Companies have dividend lock-up at a trigger of Baa3/BBB- negative designation in their existing licence conditions. Ofwat's proposal to increase the credit rating threshold is unwarranted as it is the responsibility of company boards to maintain financial resilience and decide on dividend policy. Where financial resilience and credit quality is seen to deteriorate, we consider that Ofwat's proposals for weak credit ratings to trigger company resilience plans and/or board assurance statements are better targeted ways to diagnose the cause of the deterioration in resilience, engage company boards and to identify solutions appropriate to the circumstances of specific companies. This will ensure consumers and the environment are protected from any incremental deterioration of service delivery due to poor resilience.

The Performance Commitments (PCs) and ODIs framework[8] complements the duties of boards and provides powerful incentives to improve service performance (through rewards) and hold companies to account where these targets are not achieved (through material penalties). Ofwat made the framework more stretching in PR19 (compared to PR14) to require a higher level of outcomes relative to cost allowances, as well as introduced more scope for downside than upside performance.[9] We note that companies have on average incurred ODI penalties in the first year of PR19.[10] We consider that the PCs and ODIs framework is a targeted way within the existing regulatory framework of achieving the desired outcomes for customers and the environment.

It is not clear that the level of dividends paid out has a causal impact on service performance—in fact, linking dividend lock-ups directly to service performance would increase the uncertainty of dividends, thereby destabilising the equity investment case which is premised on predictability. We thus do not support the introduction of service performance triggers for dividend lock-up.

We do not support amending license conditions for dividend policy or additional reporting on the financing arrangements of holding companies

We support continued transparency about how decisions to declare and pay dividends have been made and that these decisions should reflect the performance of the regulated company taking into

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[8] The framework is designed to ensure that service performance by the companies is measured against the outcomes that customers want from their water and wastewater providers. In addition, it provides a means of assessing companies' standards of service delivery, and acts as a tool for incentivising companies to improve their performance.
[9] Anglian Water (2022) response to 'PR24 and Beyond: Discussion paper on risk and return ', 02 February, p. 14.
[10] Ofwat (2021), 'Monitoring financial resilience report year ended 31 March 2021', p. 5; and Ofwat (2020), 'Monitoring financial resilience report', December, p. 29.

account commitments to customers, employees and the environment. However, amendments to company licence conditions to reflect a more prescribed dividend policy are unnecessary and inappropriate. Our Board decisions on dividends are guided by the purpose we outline in our Articles of Association, which is 'to conduct its business and operations for the benefit of members as a whole while delivering long term value for its customers, the region and the communities it serves and seeking positive outcomes for the environment and society.' [11]

We consider that concerns about holding company debt are unfounded. It is not clear what risk Ofwat is trying to mitigate. Company boards of both private and public companies have a legal obligation to assess dividends independently and not to put the financial or operational resilience of the company at risk. Failing to meet this obligation would be a serious matter. Were Ofwat to have evidence that boards of private or public companies were in breach of this obligation, it should investigate these specific cases and act proportionately. We consider that it would be *ultra vires* for Ofwat to require water companies to provide more information on how their shareholders finance themselves.

Anglian supports greater transparency regarding swaps reporting and Ofwat's 'minded-to' position of not defining limits on capital or financing structures

Ofwat proposes to increase the transparency of swap reporting. We welcome the attention that Ofwat is prepared to pay to this area as swaps perform an important role in our financial resilience to macroeconomic shocks (such as the current volatility in both RPI and CPIH inflation)[12]. As a securitised company we already provide extensive reporting of our swaps positions to the security trustees and investors. We would be happy to share that reporting with Ofwat in a format that is suitable and efficient, such as filling in standardised templates in our Annual Performance Report (APR).

We welcome Ofwat's 'minded-to' position of not defining limits on capital or financing structures. There is no optimal capital structure that works for every company in the industry and, consistent with Ofwat's previous positions, it remains that companies are best placed to make decisions about their capital structure given their circumstances. In terms of capital structure incentives, we welcome Ofwat's acknowledgement of the views expressed by the CMA and companies on the gearing outperformance sharing mechanism (GOSM). As we have set out previously and also referenced by the CMA in its final redetermination, the GOSM weakens rather than enhances resilience as it obliges companies to pay penalties if the gearing threshold is breached.

We support additional transparency around credit ratings, pension deficit reporting, and board assurances

Finally, we agree that companies should maintain two investment grade credit ratings and Ofwat should also remove dispensations from this requirement unless these are well-justified. Furthermore, companies should notify Ofwat upon any changes in credit ratings and outlooks, the transparency of pension deficit reporting can be improved, and PR24 business plans should include a board assured assessment of financial resilience.

[11] 'Articles of Association of Anglian Water Services Limited', p. 3. Available: https://www.anglianwater.co.uk/siteassets/household/about-us/articles-of-association.pdf

[12] See our discussion on swaps in Anglian Water (2022) response to 'PR24 and Beyond: Discussion paper on risk and return ', 02 February

2. Response to Ofwat's questions and discussion points

In this section, we respond to the specific proposals in Ofwat's discussion paper. We indicate whether we agree or disagree with each proposal and set out the reasons supporting our position where necessary.

2.1. Question 1 and Question 2: 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? 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?

We agree it is important that companies have adequate levels of financial resilience to deliver on obligations and commitments to customers and the environment now and in the long-term. This is necessary for supporting the investment required to address the challenges of asset resilience and climate change. Companies should not be operating at or be at risk of falling to the lowest investment grade credit ratings and we consider that the proposals for weak credit ratings to trigger company resilience plans and/or board assurance statements are well-targeted.

Resilience also requires a profile of customer bills and investment that is sustainable over the long-term. As expressed in our response to Ofwat's PR24 discussion paper on 'Long term delivery strategies and common reference scenarios',[13] we wholeheartedly support shifting the price review framework to focus on the longer-term.[14] This shift is particularly important for PR24 where the number of strategic priority areas (including net zero, water resilience, environmental improvements among other priorities) presents a risk of a large accumulation of potential investments. These must be appropriately prioritised, whilst managing both shorter and longer term bill pressures in a way which ensures intergenerational equity and timely service improvements for customers and the environment, whilst maintaining a financially resilient sector attractive to long term inward investment at the scale required to meet future challenges.

The need for long term investment to meet these challenges is likely to create upward pressure on bills, so it will also be imperative to ensure a range of tools are in place, such as effective social tariffs to support those who are struggling to pay. Our concern is that the aims of the Long-Term Delivery Strategy paper, which we firmly support, would be undermined if the proposed changes in the financial resilience and risk and return papers were implemented.

The financial resilience discussion paper lacks a clear exposition of a market failure that would require regulatory intervention. We note that Ofwat is concerned that a company with weak financial resilience may take years to recover and that this may be associated with poor operational performance. We agree that it is not fair for customers and the environment to bear the real consequences of poor service delivery for extended periods of time. However, the evidence for a link between operational performance and financial resilience is weak and concerns about the former are best addressed directly. We are concerned that the case study of a single poor operational performer (Southern Water) is being used to justify sweeping interventions across the industry. It is important that Ofwat is clear about the problems it is trying to address and uses

[13] Ofwat (2021), 'PR24 and beyond: Long-term delivery strategies and common reference scenarios', November.
[14] Anglian Water (2022) response to 'PR24 and beyond: long-term delivery strategies and common reference scenarios', 6 January.

remedies that are proportionate and well-targeted on outcomes for customers and the environment.

Financial resilience is the responsibility of company boards and most of the issues that Ofwat raises in the paper are already addressed within the existing regulatory framework (and in Anglian's case resilience is further augmented by its covenanted structure).

Companies already have multiple layers of protections in place to support their financial resilience.

- Section 172 of the Companies Act requires that directors of companies must act to promote the success of the company having regard to the likely long-run consequences for the company and stakeholders of any decisions that are taken.

- The way in which a company is governed affects its ability to deliver quality services and maintain financial resilience. Decisions by the Board of Anglian Water are guided by the company purpose 'to conduct its business and operations for the benefit of members as a whole while delivering long term value for its customers, the region and the communities it serves and seeking positive outcomes for the environment and society.'[15]

- Anglian became the first water company in July 2019 to enshrine these public interests in our Articles of Association. We have also aligned our annual reporting of environmental, social and ethical activities to the best practice reporting standards adopted by public interest entities in Europe, although we are not considered to be a public interest entity in the UK. We believe these actions have a role to play in our ability to deliver quality services and maintain financial resilience.

- Some companies make use of covenanted structures that trigger cash lock-ups at pre-defined thresholds for financial ratios. In our common terms agreement (CTA), we are obligated to restrict dividends in the event that triggers are met. We must also undertake an independent review to outline the path to improve financial resilience. Under our covenanted structure, proportionately higher risk is borne by equity investors, and the structure still allows for innovation and flexibility, as is shown in our track record and strong operational performance.[16]

A notable omission from the paper is any discussion of the influence that Ofwat has on company financial and operational resilience. Ofwat determines the revenue allowances and thereby determines the size of the equity buffer at which the notional company operates. The equity buffer is the financial headroom afforded by the price control to each company to absorb financial risks and therefore plays a vital role in maintaining financial resilience. As was noted at the CMA in the PR19 redetermination, the equity buffer depends heavily on the allowed equity return.[17]

Ofwat also determines the allocation of risk to the notional company and hence the **required** equity buffer through the setting of cost efficiency targets and Performance Commitments (PCs), together with the incentive mechanisms that are applied to these areas. The allowances and risk allocation mechanisms that affect the required equity buffer are the outcome of complex analyses and

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[15] 'Articles of Association of Anglian Water Services Limited', p. 3. Available: https://www.anglianwater.co.uk/siteassets/household/about-us/articles-of-association.pdf

[16] Ofwat (2021), Service Delivery Report 2020-21.

[17] CMA PR19 noted "The increase in WACC relative to Ofwat's determination is largely due to our assumption of a higher cost of equity, and this contributes favourably towards financeability by providing an additional equity buffer against the risks faced by the Disputing Companies." Final Report, 10.74(a)

regulatory judgement in the presence of uncertainty, which emphasises the need to look at their cumulative impact on the required equity buffer. It is therefore essential that Ofwat keeps close observation on the equity buffer in their development of the PR24 price control and that there is sufficient buffer given the allocation of risk between companies and consumers.

The equity return has *decreased* as a result of every price control since PR04, and the associated cash equity buffer has halved in just ten years between PR09 and PR19 (see Table 1). Ofwat's proposed changes to risk and return suggest a lower base equity return in PR24, which will reduce the equity return buffer even further.[18] At the same time, the risks have increased substantially, which means companies are less resilient given their smaller equity buffer. In PR19, Ofwat reduced the level of notional gearing to support notional financeability, however it is clear that this has done little to offset the lower financial resilience arising from the reduction in the allowed equity return (see Table 1).

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Sources: Ofwat (2004), 'Future water and sewerage charges 2005-10'; Ofwat (2009), 'Future water and sewerage charges 2010-15: Final Determinations; Ofwat (2014), 'Setting price controls for 2015-20 – Final price control determination notice: policy chapter A7 – risk and reward', December, pp. 41-42; Ofwat (2019), 'PR19 final determination: Allowed return on capital technical appendix', December, pp. 4-5. Oxera calculations.

We would like to see Ofwat recognise that financially resilient companies will target a sufficient equity buffer to avoid being downgraded from Baa1/BBB+ and should be funded for this through allowed revenues. For example, at PR19, Ofwat and the Competition and Markets Authority (CMA) tested the financeability of the notional company against the bare minimum investment grade financial ratios for a Baa1/BBB+ credit rating. Our position on the financeability framework for PR24 is outlined in more detail in our response to the risk and return discussion paper.[19] For the PR24 price control to support financial resilience it is necessary for companies to be funded for a credit rating that is comfortably in the Baa1/BBB+ band and provides sufficient equity return buffer against downgrade.

[18] Anglian Water (2022) response to 'PR24 and beyond: Discussion paper on risk and return', p. 5.
[19] Anglian Water (2022) response to 'PR24 and Beyond: risk and return discussion paper', section 5.

2.2. Question 3: We welcome views on 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 support Ofwat's "minded-to" position of not defining limits on capital or financing structures and do not consider it necessary to define limits as a means to improve financial resilience. Capital structure decisions are a matter for company boards to consider in light of their legal obligations.

We welcome Ofwat's acknowledgement of the views expressed by the CMA and companies on the gearing outperformance sharing mechanism (GOSM). There is not a straightforward relationship between high levels of gearing and low levels of financial resilience, and the CMA did not find any reason to believe that the level of gearing of any of the four companies that disputed PR19 was likely to represent a significant threat to their viability.[20] As we have set out previously, and as acknowledged by the CMA, the GOSM is not effective at enhancing resilience as it obligates companies to pay penalties if the gearing threshold is breached.[21]

The CMA considered whether alternatives to the GOSM should be introduced and concluded:

> "We have not been convinced that the risks of high gearing for the Disputing Companies in current circumstances merit any additional mechanisms over and above those that are already available to Ofwat."[22]

The financial resilience paper authored by Mason and Wright considers the GOSM and an alternative mechanism – a special administration fund – under the heading of "price-based" mechanisms.[23] We agree with the assessment of Mason and Wright that there are significant theoretical and empirical challenges with implementing a special administration fund in the water sector.

The Mason and Wright paper recommends that Ofwat should consider introducing a cap on gearing into water company licences, citing the existence of a single regulatory precedent (in the air traffic navigation services sector) as a reason to consider such an option.[24] The cap on the gearing of NERL was introduced as part of a package of measures to remedy the financial distress experienced by the company due to the sharp downturn in air traffic following the 9/11 terrorist attacks. Aside from the unique circumstances in which the cap was introduced, there are important economic differences between the situation of NERL and the water sector, not least the exposure to traffic risk and the 49% equity stake owned by the UK government. The reasons for NERL having a gearing cap do not apply in the water sector.[25]

The unavoidable problem with capital structure regulation is that no single capital structure works for all companies in the UK water sector—companies have different financing requirements that vary with their circumstances (company size, investment requirements, maturity of embedded debt, credit quality, corporate structure). This is supported by the academic literature on capital structure and was also recognised by Professors Mason and Wright.[26] As a result, the level of observed gearing and interest rate risk profile may differ significantly across the industry. For example, the range in

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[20] Competition and Markets Authority (2021), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: final report', para. 9.1203.
[21] Ibid., para. 9.1206.
[22] Ibid., para. 9.1225.
[23] Mason and Wright (2022), 'A report on financial resilience, gearing and price controls', 3 December, p. 22.
[24] Ibid, p. 21.
[25] CMA PR19 noted "… water companies have large physical asset bases, and by nature, suffer little variability in demand. This suggests relatively high levels of gearing are likely to be sustainable." para 9.1202
[26] Ibid, p. 24.

actual gearing observed for water companies was 46% (Hafren Dyfrdwy) to 83% (Thames) in 2020/21.[27] Some companies use a high proportion of index-linked debt (89% by South Staffs) and others use low proportions (22% by South West).[28] Ofwat would risk increasing costs to companies and customers by introducing capital structure limits that result in inefficient financing decisions.

To reiterate our position in section 2.1, we share Ofwat's view that companies must maintain adequate levels of financial resilience to deliver on obligations now and in the long-term. However, we consider that a well-targeted and proportionate solution to support financial resilience is enhancing credit quality and equity financeability instead of limiting the capital structure. We welcome the shift in the discussion paper towards using credit ratings. These are more comprehensive indicators of financial resilience than gearing as they consider the full range of qualitative and quantitative factors of the price control package on cash flows. As a result, highly geared companies that are able to maintain their credit quality can be as financially resilient as less geared comparators, if not more so.

Our covenanted corporate structure allows for gearing to be at higher but sustainable levels in a way that retains financial resilient and delivers benefits to customers. In a securitised structure, the risk of gearing is taken away from customers and instead passed on to providers of equity, through the introduction of stringent covenants. Proportionately higher risk is borne by equity investors, and the structure still allows for innovation and flexibility, as is shown in our track record and strong operational performance.[29]

For companies that have weak financial resilience it is important to diagnose the cause (or causes) and to develop a recovery plan. In such cases, the arbitrary imposition of limits on capital structure and financing decisions could do more harm than good. We consider that the proposals for weak credit ratings to trigger company resilience plans and/or board assurance statements would be better targeted ways to diagnose the cause of the deterioration in resilience and to identify solutions appropriate to the circumstances of specific companies.

2.3. Question 4: We welcome views on 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.

Companies requested cash lock-up conditions in their licences in the early 2000s, linked to the requirement to maintain an investment grade credit rating. The results were positive—the level of investor confidence in the sector improved. We therefore recognise the benefits of cash lock-ups that protect investment grade credit ratings. However, we consider that the recommendation from Mason and Wright that Ofwat consider further tightening of cash lock-up triggers is unnecessary and disproportionate.[30]

As set out in detail in section 2.1, companies already have strong legal and economic incentives to target a Baa1/BBB+ credit rating. Above all, boards are required under the Companies Act to consider the long-term implications of their decisions on all stakeholders. In the case of Anglian Water this is further enshrined in the company's Articles of Association which the Board amended in 2019 to enshrine the social and environmental purpose of the company.

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[27] Ofwat (2021), 'Monitoring financial resilience report year ended 31 March 2021', p. 5.
[28] Ibid., p. 25.
[29] Ofwat (2021), Service Delivery Report 2020-21.
[30] Mason and Wright (2022), 'A report on financial resilience, gearing and price controls', 3 December, p. 24.

The governance framework therefore already provides strong safeguards against board decisions that would lead to credit ratings deteriorating to Baa3/BBB- negative designation or to deterioration of service quality in both the short- and long-term.

In terms of economic incentives, at PR19 Ofwat set an allowed cost of debt by reference to a Baa1/BBB+ credit rating and therefore companies with credit ratings lower than this would be underfunded. Rather than amending cash lock-up conditions, we would like to see Ofwat recognise that resilient companies will target a sufficient equity return buffer to avoid being downgraded from Baa1/BBB+ and should be funded for this through allowed revenues.

Nevertheless, we consider that there is merit in the proposals for weak credit ratings to trigger company resilience plans and/or board assurance statements, because these are better targeted ways to diagnose the cause of the deterioration in resilience, engage company boards and identify solutions appropriate to the circumstances of specific companies.

As discussed in section 2.1, we have enshrined commitments to service performance in our Articles of Association. The Performance Commitments (PCs) and Outcome Delivery Incentives (ODIs) framework complements the duties of boards and provides powerful incentives to improve service performance (through rewards) and hold companies to account where these targets are not achieved (through material penalties). Ofwat made the framework more stretching in PR19 (compared to PR14) to require a higher level of outcomes relative to cost allowances, as well as introduced more scope for downside than upside performance.[31] We note that companies have on average incurred ODI penalties in the first year of PR19.[32] We consider that the PCs and ODIs framework is a targeted way within the existing regulatory framework of achieving the desired outcomes for customers and the environment.

It is not clear that the level of dividends paid out has a causal impact on service performance—in fact, linking dividend lock-ups directly to service performance would increase the uncertainty of dividends, thereby destabilising the equity investment case which is premised on predictability. We thus do not support the introduction of service performance triggers for dividend lock-up.

2.4. Question 5: We welcome views on the requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.

We support Ofwat's proposal provided that the resilience plans focus on the regulated company only (in line with the views we set out in section 2.11). We consider that this proposal is a well-targeted way to diagnose the cause of the deterioration in resilience and to identify solutions appropriate to the circumstances of specific companies.

2.5. Question 6: We welcome views on the 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.

We support Ofwat's proposal.

[31] Anglian Water (2022) response to 'PR24 and Beyond: Discussion paper on risk and return ', 02 February, p. 14.

[32] Moody's (2022) notes "… performance incentives and penalties have become more significant and the industry will have to return, in aggregate, £67m to customers in FY 2022-23 for performance below targets. This reflects overall net penalties of £22m & Severn Trent Water Limited's (Baa1 stable) decision to defer £45m of rewards earned in 2020-21 into future years." Ibid, p.3.

2.6. Question 7: We welcome views on the requirement for companies to maintain two investment grade issuer credit ratings.

We support Ofwat's proposal.

2.7. Question 8: We welcome views on 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).

We support Ofwat's proposal.

2.8. Question 9: We welcome views on removing dispensations from the requirement to maintain an investment grade credit rating.

We support Ofwat's proposal unless such dispensations are well-justified.

2.9. Question 10: We welcome views on the need to align the licence to our broader expectations for dividend policy.

We support continued transparency about how decisions to declare and pay dividends have been made and agree that these decisions should reflect the performance of the regulated company taking into account commitments to customers, employees and the environment.

The Companies Act imposes a legal obligation on boards to assess dividends independently and not to put the financial or operational resilience of the company at risk. Ofwat does not have an obligation of equivalent legal standing. Therefore, we do not consider licence modifications in this area are necessary or appropriate.

Furthermore, directors of companies (such as Anglian) that have defined their duties to different stakeholders in their Articles of Association already have legal duties to ensure that decisions on dividends do not compromise commitments to a group of stakeholders wider than investors alone. As discussed in section 2.1, our Articles of Association outline our company purpose which legally obligates us to consider wider public interest in the way we make decisions, including on dividend policy. We consider that our published dividend policy already provides a clear link between regulated company performance, financial resilience and dividends. For example:

- The Board must undertake an assessment of any proposed dividends to determine if payment of such dividends would compromise the commitment made by the company to the long-term social, financial, and operational commitments to different stakeholders, including customers, employees and pensioners. [33]
- In particular, the Board must have regard to performance measures for customers (such as C-MEX and D-MEX), operational commitments (such as leakage, per capita consumption, water quality, interruptions to supply, and risk of low pressure), wider social and environmental commitments (including, but not limited to, commitments in relation to vulnerable customers, sustainable abstraction, and community investment), and obligations

[33] AWS (2021), 'AWS dividend policy', p. 1. Available at: https://www.anglianwater.co.uk/siteassets/household/about-us/aws-dividend-policy.pdf

to employees (such as appropriate investment in health and safety, and appropriate funding of the Company's pension scheme). [34]

- The decision to pay a dividend must include an assessment of the long-term financial resilience of the Company. This means the company must have sufficient liquidity for at least 18 months to finance its operations and pay creditors and maintain sufficient headroom on financial ratios consistent with an investment grade credit rating and financial covenants defined in our CTA.[35]

Modifications to licence drafting on dividend policy could create a conflict between the licence and the legal obligations of boards. For example, Ofwat may outline the commitments to stakeholders differently to our Articles of Association, resulting in a different framework underpinning our decisions on dividends. Although such conflicts could be resolved by tailoring this element of the licence for individual companies and by introducing any future changes in this area to both documents simultaneously, this would create unnecessary burden.

We are mindful that Ofwat's intention is to provide an impetus to its guidance that dividends should not compromise delivery on long-term commitments to customers, employees and the environment. Rather than introducing more prescriptive licence drafting on dividend policy, we consider that actions by Ofwat such as the introduction of Long-Term Financial Viability Statements (LTVS) and board assurances for financial resilience is a more targeted way of achieving this objective.

2.10. Question 11: We welcome views on enhancing the transparent reporting of the use of swaps and how this could be best achieved.

Swaps are a standard feature of treasury policy and perform an important role by enabling companies to achieve an appropriate interest rate risk and liquidity position across the debt portfolio. This enables companies to access the segments of the debt markets that offer greatest value at any point in time, thereby reducing financing costs to customers. We welcome the recognition of this role by Ofwat but are concerned that the financial resilience discussion paper presents swaps in an overwhelmingly negative light.

Anglian has used inflation-linked swaps in the past to align financing cash flows more closely with the RPI-linked cash flows of the regulatory regime up to PR19. The cost of these swaps therefore forms part of our actual cost of debt. Anglian continues to use inflation swaps, in particular to achieve a better match against CPIH-linked cash flows as there is currently little scope in capital markets to issue CPIH-linked debt in sufficient quantity. Swaps therefore allow us to better manage the inflation risk in our cash flows, which improves our resilience to respond to and recover from macroeconomic shocks (such as the current volatility in both RPI and CPIH inflation).[36] We expect swaps to play an essential role in managing financial risks at PR24 given the balance of risk and return set out by Ofwat in its risk and return discussion paper.

We do however recognise that swaps can be complex and that understanding their economic impact requires analysis at the portfolio level and in combination with the underlying debt instruments. We agree with Ofwat that swaps used to reprofile cashflows over time should be excluded from the cost

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[34] AWS (2021), 'AWS dividend policy', p. 2-3.
[35] AWS (2021), 'AWS dividend policy', p. 3.
[36] Further detail of our position on swaps is provided in section 4 of Anglian Water (2022) response to 'PR24 and Beyond: risk and return discussion paper'.

of embedded debt analysis, however in reality they represent a small proportion of industry swap positions. We support Ofwat's position to enhance transparent reporting of the use of swaps and welcome the attention that Ofwat is prepared to pay to this area.

As a securitised company we already provide extensive reporting of our swaps positions to the security trustees and investors. We would be happy to share that reporting with Ofwat in a format that is suitable and efficient, such as filling in standardised templates in our Annual Performance Report (APR).

We consider that Ofwat's proposals on credit rating requirements (in sections 2.6–2.8) will provide useful information on the economic impact of swaps. This is because rating agencies include swap positions when assessing credit risk. Furthermore, the requirement to hold two credit ratings reduces the effect of any differences in individual rating methodologies on the assessment of the swaps position.

2.11. Question 12: We welcome views on 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.

We do not support the proposal for companies to increase the reporting of holding company debt levels in their APRs. Ofwat's *vires* extend only to the regulated company as this is the entity that holds the licence. We consider that it would be *ultra vires* for Ofwat to require water companies to provide more information on how their shareholders finance themselves.

We consider that concerns about holding company debt are unfounded. It is not clear what risk Ofwat is trying to mitigate. Company boards of both private and public companies have a legal obligation to assess dividends independently and not to put the financial or operational resilience of the company at risk. Failing to meet this obligation would be a serious matter. Were Ofwat to have evidence that boards of private or public companies were in breach of this obligation, it should investigate these specific cases and act proportionately.

2.12. Question 13: We welcome views on the option to improve the transparency of pension deficit reporting.

We support steps to improve the transparency of pension deficit reporting, provided that they are proportionate and well-targeted.

2.13. Question 14: We welcome views on the expectation that PR24 business plans should include a board assured assessment of financial resilience.

We support Ofwat's proposal to include a board assured assessment of financial resilience.

2.14. Question 15: We welcome views on 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 support Ofwat's minded-to position of not defining limits on capital or financing structures. There is no optimal capital structure that works for every company in the industry and companies are best placed to make decisions about their capital structure given their circumstances (section 2.2).

In terms of capital structure incentives, we welcome Ofwat's acknowledgement of the views expressed by the CMA and companies on the gearing outperformance sharing mechanism (GOSM). There is not a straightforward relationship between high levels of gearing and low levels of financial resilience. As we have set out previously, the GOSM is not effective at enhancing resilience as it obliges companies to pay penalties if the gearing threshold is breached.

We consider that the existing regulatory framework already provides strong incentives to maintain a resilient capital structure.

- At PR19 Ofwat set an allowed cost of debt by reference to a Baa1/BBB+ credit rating and therefore companies with credit ratings lower than this would be underfunded. This incentivises companies to maintain credit quality in line with Baa1/BBB+.
- Clawback of tax savings from gearing above the level assumed for the notional company reduce the incentive to adopt higher gearing.