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By email: OfwatPandO@ofwat.gov.uk

31st January 2022

Dear Ofwat,

Financial resilience in the water sector: a discussion paper

The financial resilience discussion paper sets out a number of important challenges facing the water sector and its regulation. We welcome the opportunity to debate and discuss the proposals set out in the paper.

We believe that it is critical that management, directors and investors retain clear accountability and flexibility to manage the financial resilience of the water companies they operate. We acknowledge that additional measures and restrictions may be relevant in response to individual cases and we understand and support Ofwat's efforts to ensure the industry remains in robust financial health. However, we believe implementing a range of restrictive and specific measures in response to issues seen at individual companies may reduce flexiblility for companies and hinder rather than help the financial resilience of the industry in the long term.

We accept that Ofwat require the authority and tools to respond to cases where companies may be at risk with regard to financial resilience. However, such tools need to be proportionate and relevant to the situation in hand, and not trying to enact a 'one size fits all' approach on what is a complex, and sensitive topic. Consideration also needs to be taken of the numerous issues and factors that may feed into financial resilience and which may be outside management's direct control or temporary, with responses being relevant to the issue and not a response to past issues; our CMA appeal on the PR199 price determination, for example, led to a Baa2 (negative) rating by Moody's which has since moved rapidly to a positive outlook. The downgrading by Moody's of the industry as a whole as a response to the PR19 process is a further example of a change to credit rating from wider circumstances, not company specific issues, and for which time is required to understand and respond to the change in company specific ratings. As such, adopting factors across the industry in our view is not helpful, with focus instead be more appropriately made to understanding changes in circumstances as they arise, and challenging companies on their individual responses. We set out further views on this in the appendix below

We do support Ofwat having clear authority to intervene in company specific instances, to ensure the companies, and indeed the industry, are operating appropriately in managing financial resilience. This ensures Ofwat is acting on its regulatory authority, as well as ensuring the reputation of the industry as a whole can be protected. However, we are of the view that such authority already exists, albeit that there is perhaps an opportunity for earlier and greater

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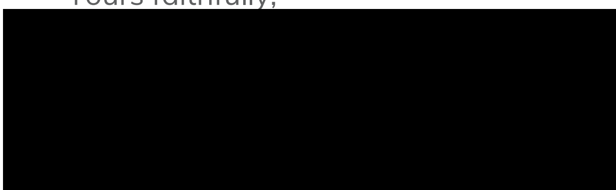
strategic dialogue about performance concerns, clarification of structures, holding company debt, derivatives, etc where such matters are of concern. Similarly, rather than introducing new assurance requirements and conditions, it should be possible to clarify or enhance existing Board assurance, improving rather than expanding on existing provision.

At PR19 targets and incentives provided a focus on transforming the business to meet a set of commitments to customers and the environment. Ofwat set out in the discussion paper the risk that Boards, because of investors and in some circumstances financing structures, focus on financial returns and costs at the expense of underlying performance. To an extent this is a symptom of economic regulation and the power of its incentives, and that the strength of the regime has supported a low cost of debt and cost of equity. If the incentives are well calibrated, balanced between the short and long-term (a topic Ofwat recognise throughout the recent PR24 consultations which we respond to separately), and with an effective reporting and monitoring framework, then the regime will work as a whole. Bristol Water's request that the CMA reviewed PR19 in the round was built on our view that the review was essential for long-term financial resilience, as well as being supported by evidence on individual regulatory judgements. It is difficult to separate price control decisions from on-going financial resilience and in responding to the discussion paper we suggest a clearer link needs to be made in considering some of the options.

In summary, this critical area for companies and regulators alike, is an area that requires dialogue, transparency and challenge between companies and Ofwat. We support engagement between regulatory and regulated, but note the sensitivity and complexity of the topic. As such, ensuring that companies retain accountability, as well as wide a range of tools as possible to respond to challenges they may face, is critical. Implementing targeted restrictions, whilst well meaning, may prove counter-productive in the long term, and we recommend caution is exercised in moving to the specific, rather than challenging the over-arching position of individual companies.

We review each of the options from the consultation in an appendix to this letter. Our overall suggestion is that Ofwat explicitly considers financial resilience measures as part of the risk and return balance at PR24. There should be greater strategic dialogue with companies ad Ofwat about performance concerns, and where company-specific price control deliverables relate to this then the funding could come with financial resilience conditions.

Yours faithfully,



Chief Financial Officer

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Response to specific comment questions

1. 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 consider, consistent with the licence conditions, that providers of essential infrastructure should operate at investment grade credit rating. However, we note that the 'risk' associated with operating at, or falling to, the lowest investment grade credit rating, is notably different to falling below such a grade. As such, we believe it is important to consider the measures being taken in the context of such differentials and therefore not to pre-empt action that may not be in the interests of companies (or indeed investors) in the medium or longer term. We would particularly note that operating at a Baa2(negative) level, for example, does not indicative an immediate risk of losing an investment grade credit rating. Rather, operating at a Baa3 level, with a negative outlook, is a far greater risk. Covenants and similar restrictions tend to focus on action to be taken at a Baa3 level for good reason; acting prior to this point would, in our view, be pre-emptive and disproportionate. As such, we would understand Ofwat wishing to understand financial resilience plans at a Baa2(negative) level, and would expect management to be ensuring they could strengthen a company's balance sheet without impacting service performance. However, we would argue that restrictions on, for example, dividend payments, should not be considered until the lowest investment grade credit rating is reached.

We also note that credit ratings are one of a number of measures that may provide a view on the financial resilience of a company. Notably, such ratings are intended to provide a view for those providing credit to a company and may not take into account perspectives of equity investors, which are also critical for the long term resilience of both individual companies and the sector as a whole. Further, other stakeholders (customers, for example) are not taken into account. As such, we believe credit ratings are a key performance measure of financial resilience but need to be taken in the context of the overall financial position of the company, its investors and performance and not in isolation.

Ofwat may therefore wish to consider aligning the licence position so cash lock up applies at Baa3 rather than Baa3 negative watch. This recognises the narrow band for Baa3 metrics, and that the regulatory framework itself should prevent a deterioration below this level. For consistency this change would also need to be reflected in financeability testing at PR24.

2. 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?

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Yes, we agree and believe it remains important that both management and investors have the flexibility and ability to take actions as they sees fit in the best interests of long term financial resilience. Naturally, this would include at the point at which downgrade is a risk, particularly if this takes a company below the targeted level. However, credit ratings remain one of a number of indicators, and as noted above, can reflect circumstances outside management control. It is therefore important to look at not just short term actions but medium to long term implications, in responding to any risk of downgrade.

We understand that Ofwat would wish to be informed of risks associated with a downgrade, as well as actions being taken to mitigate such risks, but believe existing regulatory protections (for example as set out in the requirements of the Long Term Viability and Ring-Fencing certificates), provide this information or protection without requiring additional measures to be implemented.

Views on the options

> **3. 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 that defining limits on capital or financing structure across the whole sector Is not necessary and should not be implemented. We agree it is more targeted and proportionate to consider individual company measures, particularly where these are agreed during an Ofwat investigation or enforcement action. As the paper notes, some forms of financial structures appear to reduce financial risk and very similar structures in other situations appear to be more risky, which does not lend itself to limiting the sector from particular types of financing structure.

An alternative option is to separate historic arrangements from new, which Ofwat has done in recognising that circumstances (as well as legitimacy expectations) change over time.

> **4. 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 agree with these options. There is a cost to the regulated business of cash lock-up, which may well trigger debt conditions beyond covenants, increasing the cost of debt and reducing financial resilience. Therefore, it is difficult to justify specifying a higher credit rating in isolation.

Further, we do not consider linking triggers to measures of service performance is appropriate, as this could further limit companies' options as to how to respond to short term challenges – that could be brought about, for example by bad weather or external factors – but could lose confidence by investors in the ability to provide stable, consistent returns, as expected by many equity investors in the sector. We further note that Ofwat's actions around linking dividend policies to service

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performance already achieve the outcome of linking returns to service performance and does not need to be duplicated or further complicated.

The proposal to link triggers to, for example, Moody's Baa2(negative) could also impact on companies before actions being taken by management have time to take effect, or for events to reach clear conclusions. As such, we believe amending the trigger level could be pre-emptive and unhelpful. We would expect and welcome discussions with Ofwat on the financial position, risks and mitigating actions being taken when such a position arises, but do not consider a 'bright line' cash lock-up condition at this juncture would be helpful. Bristol Water experienced this with the Competition and Markets Authority redetermination and Canals and Rivers Trust arbitration; both of these issues contributed to a Baa2 (negative) outlook due to the risk they presented to the company. However, on resolution, the negative outlook was removed, with no further action required. The company carefully managed its financial resilience in the short term, but pre-empting issues with cash lock ups and definitive action would likely have contributed to further concerns and challenges.

We also take this opportunity to note that the PR24 Ofwat risk and return consultation assumes financeability testing to 1.0x. We disagreed with this at PR19 and saw that the notional testing should be to the point at which a downgrade to below minimum investment grade (negative watch) would apply at 1.1x. If an additional notch would be required, then this notional testing would increase for adjusted cash interest cover to 1.3x (ie a downside shock assessment on totex, ODIs and movement in market finance costs, rather than expected return financeability).

In addition, if assuming a higher cash lock-up trigger rating, then Ofwat would also need to include more notional financial resilience headroom when financeability testing. Although it is not Ofwat's policy for this to result in an immediate cost to customers (e.g. through the choice of point estimate within a range for the cost of equity), this relies on the financial ratio issue at the price review being caused by a factor that is a timing difference with future price reviews. The CMA in the 2019 redeterminations accepted our position that where, as at PR19, 12 companies at a notional level require financing support, timing adjustments are not likely to be appropriate. Where higher actual credit rating levels are required, a higher trigger for support in notional financeability testing would be required.

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

We do not think a new requirement is necessary, as based on our understanding, Ofwat can already require this where there is a relevant event, which would include a rating downgrade. This was demonstrated in PR19, whereby if the CMA outcome had not mitigated the potential for a credit rating downgrade, then an updated Long Term Viability Statement and Ring Fencing Certificate would have been required. This was discussed with Ofwat at the time.

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We also note that plans to manage financial resilience are often highly sensitive and confidential. As such, whilst providing to and discussing with Ofwat plans in such circumstances is, in our view, to be expected, we do not think that publishing such plans would be helpful or meaningful given the content.

6. 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.

We do think that it is important that company dividend policies are clear and transparent, but note Ofwat's actions in this area already underway. An additional board assurance statement is not needed given that the existing financial statements and reporting already required board assurance. Notably, directors also have statutory and fiduciary duties that require consideration to be given to a company's financial resilience in declaring a dividend.

We note that there already exists a wide range of individual board assurance statements, so some consolidation of existing requirements that better align and reflect key topics would be our preference. A more targeted focus for specific financial resilience issues, alongside transparent dividend policy reporting across the sector, is therefore our view of how Ofwat should proceed.

There are a number of reasons why credit ratings may be below the targets stated for the notional capital structure at a price review, including the view of credit rating agencies about the regulatory regime, or uncertainty surrounding price review outcomes, or temporary challenges that are being managed and mitigated by the companies. The implication of the proposal implies the potential that such a position is as a result of specific, intended action by companies; yet, at PR19, the likely occurrence of a global pandemic, and resultant financial and operational ramifications thereof were not factored into the financial resilience monitoring per se. The pandemic could of itself easily have impacted companies to a level affecting credit ratings and credit structures, yet providing additional board assurance would not necessarily of itself have assisted or changed companies response thereto. We raise this as an example where companies respond to circumstances that may be beyond there controls but may require time and clarity. Requiring additional board assurance is, in our view, duplicative to existing obligations and unlikely to alter actions or responses to the situation itself.

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

We do not believe this requirement would add significant value. There is a cost, both direct and indirect, to maintaining an investment grade credit rating, and there is a limited range of credit rating firms. We believe that it is sufficient to monitor a range of rating indicators (e.g. for Long Term Viability Statements and through business planning), rather than limiting this to the specifics of particular credit rating firms.

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8. 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).

We agree that this is good practice and have no objection for notification to be a formal requirement.

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

As we are not the recipients of such dispensations, we will leave this to others to comment.

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

We are not clear from the paper what the additional licence expectation on dividend would add, given the RAG requirements and Board Leadership Transparency and Governance (BLTG) principle requirements already have "licence backing".

The current licence and regulatory requirements are already extensive and the reference to the BLTG principles includes dividend policy, financial resilience and performance. As Ofwat noted in the recent financial resilience report, we had a clear dividend policy which met these expectations. We are open to further clarity in the licence and rationalisation of the various existing linked regulatory requirements if Ofwat believe they are not sufficiently focused.

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

There are extensive financial reporting requirements in this area under IFRS, which have been set by highly qualified, knowledgeable standard setters. We do not believe it is likely that enhancing reporting via regulatory intervention will achieve the desired effect, but rather that any concern around transparency or clarity should be addressed on a case by case basis directly with the company.

12. 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 including holding company reporting with Annual Performance Reports, as this will cause confusion with regard to the regulated entities; Annual Performance Reports should reflect the regulatory ring fenced company.

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If concerns exist with regard to holding company debt we suggest this is agreed on a case by case basis, given that specific consent from Ofwat is needed for such arrangements where they are secured on the assets or financial flows of the regulated entity.

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

This is not an issue that immediately affects Bristol Water but we note the comments made with regard to derivative reporting and believe that attempts to improve on accounting standards are unlikely to result in long term benefit. Rather, we consider that any concerns should be addressed on a company specific basis.

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

We believe financial resilience is an important part of any business plan and as such Board consideration of financial resilience will be a key component for their consideration However, we note that any assurance process will be based on a plan at any particular point in time, and the assumptions and challenges built into that plan. As such, disclosure of scenarios, assumptions and challenges will need to be part of any assurance process, and the assurance may, in certain circumstances, lead to the highlighting of concerns or caveats, rather than a 'clean bill of health'. We believe that this should be a constructive component of any business plan process, that enables two way discussion on the issues and risks of the plan.

15. 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.

Our social contract arrangement and its principles take the view that trust is built by companies going beyond the requirements of the regulatory framework and not being dictated by it. It becomes harder to justify to investors moving outside of the regulatory framework, if the regulatory framework is increasingly restrictive in setting the risk and return balance.

Our main critique of Mason & Wright is their assumption that, in the face of higher uncertainty, industry notional gearing should reduce. Moving away from the actual level of gearing (from beta comparisons) may result in more financeability adjustments being required. We do not think the linked assumption that the lower betas (rather than de / re-geared) arise are correct, and the]assumption could increase financial resilience concerns and headroom. They take a position that does not appear logical in application, and there are other academics (including Alan Gregory) and the CMA heard others, who disagree with Mason & Wright. There is also a cost to raising equity of such a measure was implemented, which is higher the smaller tranche of equity and size of issuer (something Ofgem have recognised in assuming lower notional gearing for financeability challenges).

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In our view, we either retain CAPM (with some, difficult to interpret cross checks such as MAR), or we consider the alternative models such as Fama French, as they recognise factors such as size and profitability in a portfolio that start to set a link to financial resilience.

Ultimately, if investment is needed and efficient finance is available, higher gearing may be the consequence for investment timing. To exclude this possibility has financial cost consequences, to be weighed against the less clear cost of financial distress (which hasn't happened in the water sector recently). As we describe earlier, if Ofwat are to use incentives for financing structures, it will need company specific (or some notional scenarios) to be used for the risk and return balance. Ofwat could create packages and then information would be revealed by which package companies chose in practice – which Ofwat could then assess. This requires a different approach to price reviews with more strategic dialogue about company specific plans and factors however, than currently proposed for PR24.