The voice for water consumers
Llais defnyddwyr dŵr

CCW's response to Consultation:

Financial resilience in the water sector: a discussion paper

CCW Response **January 2022**

1. Introduction

1.1 CCW is the statutory consumer organisation representing water and sewerage consumers in England and Wales.

1.2 We welcome the opportunity to respond to Ofwat's consultation. We have responded to the individual questions below. In short, we fully support strengthening existing arrangements to protect customers form the consequences of weak financial resilience.

1.3 In particular, we think that it would be helpful if companies provided an explicit explanation of how their dividends are determined with reference to performance - both financial and operations - in their APRs. This clarity could only improve trust in the eyes of the customer. Where companies are failing customers through poor operational performance or customer service, it would seem perverse for companies to be paying out sizeable dividends when they could use that cash to make stepped changes in their performance.

2. Our response

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 agree for the reasons set out in the paper.

In particular operating at or close to the minimum investment grade could imply financial resilience problems which may constrain a company's ability to raise finance and to withstand a wide range of shocks.

As the consultation makes clear, a potential consequence of poor financial resilience could be a company ceases to fund necessary maintenance activities and service improvements which could have a detrimental impact on performance, especially where this is already poor. The consequences of this may not emerge in the short term but could be damaging in the longer term.

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?

We agree for the reasons outlined in the paper.

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 agree with this approach. We think Ofwat's approach to strengthening credit rating requirements is more proportionate at this point. Ofwat recognises that gearing is but one element of financial resilience so by singling this out does not preclude financial resilience problems.

Gearing is an important indicator of credit risk but is not the only one. In this regard we welcome the dashboard Ofwat has introduced in its Monitoring Financial resilience report 2021 particularly the inclusion of mark to market valuations of derivatives and pension liabilities which are additive to the traditional liabilities of debt.

However, a case could be made to define limits on capital financing structures where companies' financial resilience is relatively poor and does not show any sign of improvement, coupled with sustained poor performance (operational and customer service). The Southern Water case study is a case in point.

We welcome views on the potential approaches set out for discussion, which comprise:

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;**
5. **a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level;**
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 think additional Board assurance in defined circumstances is a proportionate approach. While we are supportive of all the measures outlined in 4, we feel that reporting of dividends where credit ratings are lower than the company has targeted in its Business Plan and/or below Ofwat's targeted investment grade, ought to be happening anyway through companies' APRs. To the extent that this is not happening then we agree that it should.

With regard to cash lock-up provisions we agree that these should apply at a higher investment grade rather than the investment grade floor. It does not seem sensible to persist with an approach where cash-lock up provisions kick in at the investment grade floor as the potential to lock cash in at the appointee almost comes too late. We would support the cash lock up provision being introduced at a higher level for instance if the credit rating slipped below Ofwat's price review targeted investment grade or that targeted by a company in its Business Plan. Obviously this approach would not preclude distributions as it is contingent on Ofwat consent.

On the question of whether cash lock up provisions should be set with reference to service levels we think that this merits more consideration. Where companies are failing customers through poor operational performance or customer service, it would seem perverse for companies to be paying out sizeable dividends when they could use that cash to make stepped changes in their performance. It would be helpful if companies provided an explicit explanation of how their dividends are determined with reference to performance both financial and operations in their APRs.

While companies may argue that setting dividends with reference to service risks instability because of differences in year on year performance, we feel that companies have the opportunity, in discussion with Ofwat, to demonstrate how their actual annual performance, in the context of its forecast performance, supports its proposed dividend payments. There is also a potential upside for companies in terms of customer trust if companies are open and transparent about the link between dividends and performance (financial, operational and customer service).

The Southern Water case study demonstrates a voluntary decision to not pay dividends in view of operational performance and financial resilience. Other companies with poor performance, e.g. Thames Water, are also not paying dividends. From our perspective Ofwat's proposed measures would formalise prudent financial management which some companies are already exhibiting to various degrees.

We support a requirement for companies to report/submit resilience plans where credit ratings fall to a set threshold. Ofwat notes that its regulatory intervention occurs more frequently where companies have lower levels of financial resilience. The requirement to report would seem to be a natural formalisation of this and as such may not mean increased regulatory burden.

7. We welcome views on a requirement for companies to maintain two investment grade issuer credit ratings.

This seems sensible for the reasons outlined in the paper – the limited regulatory burden that this would create in view that 13 companies already hold this. It would also offer some protection against withdrawal of credit ratings.

In relation to the interface with cash lock up provisions we would suggest that if either of these issuer ratings fell below the investment grade threshold, however described, then the cash lock up is triggered.

8. We welcome views on 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 companies should be required to formally notify Ofwat of changes. As the consultation paper indicates whilst there is an expectation that companies notify Ofwat of these kind of changes, these aren't always communicated. In view of the other protections that Ofwat has signalled in the consultation paper, the ability to understand changes in credit risk assigned by the rating agencies underpins some of the other measures.

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

Notwithstanding that two companies' Boards certify that they would be able to get an investment grade credit rating we think that with regard to financial resilience companies should be on the same footing. We would therefore support removal of these dispensations. Having explicit credit ratings for these companies also has the merits of making more meaningful comparison to targeted credit ratings per the business plan process.

In addition, we feel that the requirement to maintain an investment grade credit rating is an important customer protection. In the case of South West Water's acquisition of Bristol Water the acquirer does not have the condition but the acquired company does. From the customer perspective the continuation of the absence of this rating from South West Water's licence means a detrimental impact on the customer protections afforded to the customers of Bristol Water.

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

We would support formalisation of expectations with regard to dividend policy – that it does not impair financial resilience now and over the longer term, and that dividend policies take account of service delivery for customers and the environment including levels of performance and other obligations.

As Ofwat's monitoring financial resilience report illustrates, in some cases companies' justifications for their 2020/21 dividends were lacking. Ofwat found that only three companies' dividend explanations were in line with expectations. Our own review of APRs found that in some cases companies' simply referred to dividends being in line with their stated dividend policies

In view that companies' explanations are lacking, despite what we consider to be fairly explicit expectations, it seems to us that the transparency that we want to see with regard to dividends may only be achieved by an explicit licence condition.

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

We understand and recognise that the concern with regard to swaps, whilst recognising this as a legitimate Treasury management tool, is that companies effectively use swaps to advance cash flows to support short term liabilities but could store up problems for the future.

We would welcome more transparency about swaps and welcome the steps Ofwat has taken to include them in the monitoring financial resilience report. As Ofwat indicates, the gearing metric does not capture all a company's liabilities at a point in time so to understand financial resilience a broader understanding of liabilities is necessary. The monitoring financial resilience report shows that when all debt-like liabilities are taken into consideration both Southern Water and Yorkshire Water would have gearing in excess of 100 per cent of the RCV.

Ofwat suggests getting companies whose swap liabilities exceed a threshold of five per cent of the RCV ought to provide enhanced explanation of how they are managing their exposure on derivatives. We would support this enhanced transparency. Based on the monitoring financial resilience report this would apply to Anglian, Southern, Thames and Yorkshire with three of those companies ranking in the top four for highest gearing as measured by net debt / RCV.

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 would support more transparency of this issue particularly where debt obligations at the holding company level are financed by dividends from the appointed business. While ring fencing provisions do exist, that Moody's indicates the these only provide limited insulation from the credit quality of its parent captures the impact holding companies can have on appointee financial resilience. Transparency about where holding company debt is impacting appointed business credit rating would be a useful addition to a better understanding of financial resilience.

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

The changes that Ofwat has made with regard to pension deficits in recent times means that funding of pension deficits is a matter for companies and their shareholders. However, customers have a legitimate interest in this should the cash commitments companies make to their pension liabilities call into question the financial resilience of the company either in its own right or coupled with other policies that impact financial resilience. As Ofwat indicates it is possible for companies to report a pension asset in its statutory accounts but be funding a deficit based on a three yearly actuarial valuation. A greater understanding of cash commitments would enhance understanding of financial resilience.

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

We agree that companies should provide Board assurance of financial resilience. This should include transparency around the investment grade that the company has targeted, and how that investment grade might play out under Ofwat's downside scenarios and any response deemed necessary to maintain financial resilience in the light of those scenarios.

As Ofwat set out in the PR19 methodology, companies without good financial and corporate resilience will not achieve good operational resilience.

It would seem to be a backward step to not require this in view that at PR19 company Boards had to provide assurance on notional and actual financeability.

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 would not be supportive of companies effectively having a reward-only ODI for financial resilience. Customers may have a negative view on a company having a reward for being financially resilient. If company financial resilience is reported clearly and transparently, it would enable CCW, other stakeholders and potentially media and customers to see how secure a company is. This could add to customer trust (which we report in our Water Matters report). We would also note that financial resilience would need to be defined. We think that there is scope to take Ofwat's dashboard from the monitoring financial resilience report a step further to increase the reputational incentives around financial resilience on an annual basis. We also wonder whether financial resilience could be considered when determining whether a company is awarded fast track status for its business plan. This could be both with regard to its actual structure (where Ofwat could make an informed assessment based on companies' financial metrics and credit rating from the most recent APR and with reference to the business plan where a company demonstrates its financial resilience in the light of any standardised downside scenarios stipulated by Ofwat). It is conceivable that a less secure company could be at risk of delivering its business plan commitments, especially if its plan is ambitious.

On gearing alone it would seem logical that where companies have committed to reducing gearing that both the company in its APR and Ofwat through the monitoring financial resilience report explains companies' progress.

We continue to support companies' voluntary sharing arrangements. To further incentivise companies to consider sharing with customers Ofwat could consider this when determining fast track status.

Enquiries

Enquiries about this consultation should be addressed to:

[redacted]
Policy Manager
CCW
E-mail: [redacted]
Tel: [redacted]