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Response to Financial Resilience in the Water Sector: A Discussion Paper

This letter sets out Corsair Capital's views on Ofwat's recent *Financial Resilience in the Water Sector* discussion paper. We are writing in our capacity as investment advisor to funds that own 30.3% of Kelda Holdings Limited, provider of water and sewerage services to domestic and business customers across Yorkshire.

In addition to the points made in this letter, Corsair fully agrees with those set out in the Global Infrastructure Investor Association (GIIA) response to Ofwat's two recent discussion papers – Financial Resilience and Risk and Return.

We would give particular emphasis to one overarching point made by the GIIA. It is imperative that water companies, investors and Ofwat work together to create an environment in which transformational investment can be made in the near future. Significant amounts will be required to meet known challenges, including Net Zero and resilience to ongoing climate change. These investments need to be made with confidence. The proposals under discussion by Ofwat have a destabilising effect on confidence at a critical time.

Ofwat's discussion paper

In its discussion paper on Financial Resilience, Ofwat sets out options which it believes could be used to strengthen existing requirements related to financial resilience. While we accept that Ofwat's consideration of the implications of financial resilience for consumer outcomes is legitimately in keeping with its duties, we have strong concerns about some of the proposals made in the discussion paper. We are particularly concerned about the proposals for a possible tightening of the credit rating related aspects of the existing 'lock-up' condition in UK water and sewerage company licences.

It is of course incumbent on Ofwat to be mindful of its relevant duties as set out in the Water Industry Act. Although not referred to by Ofwat in the discussion paper, the primary duties of relevance in this context would seem to be furthering the consumer objective while securing that the company can finance its functions.

In its discussion paper, Ofwat explores the link between consumer outcomes and financing choices. Ofwat's hypothesis is that a meaningful link exists. In support, it places significant emphasis on a case study based on the recent experience at Southern Water in which poor performance coincided with high gearing. Linked to this, Ofwat discusses potential changes to regulation (specifically, possible licence modifications) that would address this apparent failing and avoid similar problems in future.

We do not agree with Ofwat's inference from the evidence or the proposals under discussion. Change to existing regulation is needed only in light of clear and robust evidence. Here, the evidence is vague and weak. The proposals are neither justified nor supported by appropriate impact assessment.

Rather than adopting a robust model which attempts to explain consumer outcomes by reference to a wider set of causal factors, including factors such as this, Ofwat chooses only to look at one.

There is no need for Ofwat to intervene

With regard to the evidence, anecdotal references to a single company (Southern Water) which has exhibited poor performance and has high gearing do not support the general hypothesis that there is a causal link between high gearing and poor performance.

In considering the more general relationship, Ofwat's own advisors (Professor Robin Mason and Professor Stephen Wright) articulate this point very clearly in their supporting report, published by Ofwat alongside the discussion document[1]:

> *"The fact of the matter, however, is that 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."*

This view is based on the authors' simple analysis of the correlation between financial structure and operational performance (a proxy for consumer outcomes). Within this model – the evidence of the link between consumer outcomes and financing choices is weak.

Additionally, however, Ofwat fails to consider other – potentially more plausible – drivers. For example, there is extensive literature linking business performance to metrics of consistency and stability of management and leadership. An unbiased model that attempted to identify the drivers of good consumer outcomes would properly explore these and other potential drivers within a wider assessment of such relationships (akin to the approach adopted in Ofwat's econometric cost efficiency models).

It is not, in our view, surprising that Ofwat has not been able to find robust evidence. First, its analysis is mis-specified as it fails to reflect properly the drivers of operational performance. And second, the lack of evidence of a link between high gearing and operational performance suggests that the existing special administration and other regulatory measures are both effective and sufficient. In particular, they have provided the right incentive to support new equity financing where needed (as recently observed with Southern Water and Thames Water).

The CMA concurs: in the PR19 appeals, it cited the cases of Wessex Water and Dŵr Cymru as examples of where Ofwat's interventions, enabled by the existing special administration procedure, were in both cases proportionate and effective in driving a transfer of ownership and associated operational and investment obligations without adverse consequences for customers. The special administration procedure, and Ofwat's actions, have been successful in protecting the consumer interest.

[1] Para 4.17, "A report on financial resilience, gearing and price controls", Report prepared for Ofwat by Professor Robin Mason and Professor Stephen Wright, 3/12/2021

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The general evidence, across the sector, of adverse consumer outcomes associated with balance sheet events is therefore missing and Ofwat's (effective) assumption of market and/or regulatory failure misplaced.

Given the lack of evidence of a problem, the potential proposals under discussion are both unwarranted and premature. Rather than seeking to amend the regulatory regime in this area, Ofwat should take comfort from the way the market operates under the current regime.

Even if there were a need to intervene, Ofwat's proposals are disproportionate

Even if a causal relationship were identified between capital structures and customer outcomes, the changes proposed by Ofwat are severe and their proposed imposition through a speedy change to the licence would be unreasonably and unduly disruptive. It is striking – and concerning – that Ofwat has not carried out any assessment of the impact of its proposals. From our perspective, they are patently disproportionate.

The focal point of Ofwat's discussion paper is a potential change to the licence condition related to 'lock-up'. The changes discussed would involve a potential upgrading – by up to two 'notches' – of the credit quality threshold that a company must maintain to be able to make dividend payments (inter alia). The impact this would have on the existing and required capital structures across the sector would be significant and come with major cost implications. Ofwat's discussion paper undertakes no meaningful assessment of this.

While not used as the primary focus of Ofwat's argument, broader adverse implications of corporate failure would also appear to be a potential source of regulatory concern. Notwithstanding Ofwat's effective historic deployment of the special administration regime, the relationship between the likelihood of corporate failure and credit rating is also not evidenced by Ofwat.

A more proportionate approach, which would adequately seek to address the hypothetical concerns suggested by Ofwat would be to take steps to improve transparency as suggested in the paper. This could be coupled with a requirement for an open and constructive dialogue with Ofwat, setting out resilience plans, in light of any possible downgrade.

Ofwat's proposals break the regulatory contract and undermine investor confidence

Ofwat's proposals would mark a fundamental change to the regulatory contract that has been in place for many years. This has formed an important foundation for the significant investment that has been made in the water sector and other UK regulated industries over the last three decades.

Across UK regulation, financing performance (the ability to raise capital at an efficient rate) has historically been viewed as a legitimate driver of investor outcomes. The incentives within the regulatory framework are aligned to this principle. In response, the water sector (along with other UK regulated sectors) has evolved to adopt innovative approaches to financing (e.g. whole business securitisation). These innovations have reduced the effective cost of capital and allowed customers to benefit from lower prices than would otherwise have prevailed. Ofwat has, in the past, been supportive of the outcomes this approach has delivered.

The proposals now under discussion mark an inappropriately swift reversal of this position. These demonstrated benefits would be jeopardised and potentially adverse unintended consequences may follow. The risk of regulatory failure is high:

- First, the proposals would represent a disruptive fracture of an important foundation of the regulatory contract. They would have important implications for trust and confidence in the system of regulation – with inevitable consequences for the cost of capital and willingness on the part of investors to maintain the required levels of capital expenditure. At a time of critical need for infrastructure enhancement this would put good consumer outcomes at risk – the opposite effect to that intended by Ofwat.

- Second, they would give rise to a change to the nature of returns expected from the sector and expectations of how these might crystallise for investors. Lock-up arrangements of the type discussed would create uncertainty over the potential cash returns associated with sector investment. Within its broadly theoretical framework Ofwat has not engaged with this very real risk. The likely outcome (and apparent intention) is that Ofwat's proposals will 'force' companies to recapitalise to avoid these consequences. The resulting 'forced' recapitalisation has important practical effects on distribution of value and the cost of capital:
    - The enforced recapitalisation would result (as with any recapitalisation) in a significant transfer of value from existing equity holders to debt holders.
    - This transfer of value (loss) could not reasonably have been foreseen at the time of investment by today's equity holders.
    - It would stem directly from a regulatory action, not subject to robust impact assessment, implemented with undue haste and based on weak evidence.
    - Moreover, the consequences of Ofwat's action would be a reduction of the 'pool' of investors for whom equity in the UK water sector would remain an appropriate and attractive asset. Again, this would have potential significant and adverse consequences for the cost of capital.

- Third, and alongside these effects, the explicit costs of adapting to potentially changed licence conditions may be material. For example, the potential transaction costs associated with recapitalisation, and direct/indirect costs for investors who would – in effect – be pushed to exit the sector or be left with investments that were no longer appropriate to the liabilities they faced (e.g. pension funds). Such costs are real and substantial. They would be causally linked to any potential change implemented by Ofwat and cannot be ignored.

All of these considerations must form part of an overall impact assessment of Ofwat's proposals. The timing and means of implementation of any proposed changes may have an impact on the costs – but will not eliminate them.

The lack of a robust assessment of this type, subject to proper and transparent consultation and considering a wide range of potential implementation options – including those that explore different timing and types of measure – would represent a significant procedural failing.

In this regard we also note similarities to the cumbersome and ineffective process that accompanied the S13 licence change proposals in 2011 and 2012. Those proposals caused significant industry (and Government) unrest and raised major implementation challenges. Ofwat was forced to modify its

proposals substantially. We are keen to avoid a similar experience at a time when this would distract from other important challenges.

Conclusion

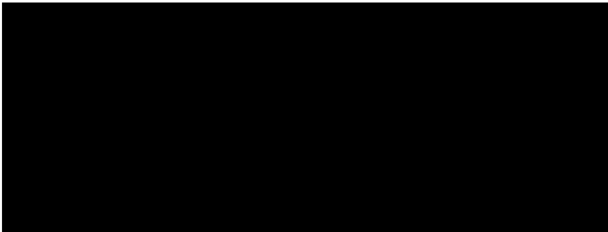
In summary, the proposals under discussion in Ofwat's paper are not supported by the available evidence. They would have the opposite effect to that intended – reducing investor confidence and trust, raising the cost of capital in the sector, restricting the pool of potential investors, leading to higher future prices and potentially reduced capacity for future investment. The costs of transition are high and are additive to this.

Serious further consideration should be given to the necessity of the proposals in Ofwat's paper. Should Ofwat plan to proceed with any change, the form and implementation of this requires critical consideration. In this case, we would strongly favour measures to increase transparency in order to give Ofwat the comfort it needs in a proportionate manner which does not risk the significant unintended consequences highlighted above.

A fair, objective and transparent impact assessment should be properly conducted, reflecting the effects highlighted above alongside other evidence, which must meet appropriate standards of relevance and robustness.

We would, of course, welcome the opportunity to meet with Ofwat to discuss and elaborate on any of these points.

Sincerely,



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