December 2021

Financial resilience in the water sector: a discussion paper

Ofwat

Executive summary

Water companies[1] provide essential services for customers and the environment. It is important that they have adequate levels of financial resilience to meet customers' needs at all times and under all circumstances.

Resilient financial structures should enable companies to raise capital, to finance the investment that is necessary to deliver their obligations and commitments to customers now and into the long term. It is also important that companies are able to demonstrate transparently that their financial structures enable them to deliver in the best interests of customers, not just their investors, taking account of future pressures, for example driven by less predictable weather, the effects of climate change and population growth.

Concerns arise where companies maintain high levels of debt, weak levels of financial resilience and credit ratings with little headroom in the investment grade. These circumstances can be the result of past financing choices, including where large amounts of debt have been raised or there has been a past withdrawal of equity, sometimes accompanied by dividend payments that do not reflect the levels of service delivered to customers.

As set out in our 2021 Monitoring Financial Resilience report, nine companies have gearing levels more than ten percentage points above the level of 60% used in our PR19 determinations and two of these maintained gearing levels that exceeded 80%. We referenced three companies having credit ratings that were at, or at risk of, falling to the minimum of investment grade. Two companies report mark-to-market swap liabilities that, if added to regulatory gearing, result in liabilities at, or above, 100% of RCV.

In this paper, we discuss the importance of companies maintaining resilient financial structures, and reference actions taken by some companies with less resilient financial structures, which lead to longer-term financial resilience challenges. We note, in particular, the risky use of swaps, which can mask weak underlying levels of financial resilience, can undermine existing creditor protections and defer a challenging financial resilience position to the future.

In this paper we discuss the case study of Southern Water. The case study illustrates that weak levels of financial resilience accompanied by poor operational performance, can have real consequences for customers if a company does not have the financial flexibility to turn poor operational performance around. This could lead customers and the environment to suffer the consequences of poor service for extended periods of time.

[1] In this document, a reference to a water company or company means a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991 (WIA91). The options in this document apply to the 17 largest regulated water companies (Appointees) in England and Wales.

We have already taken steps to align the ring-fencing licence conditions[2] of all companies and improve our monitoring and reporting of financial resilience. The requirement for companies to maintain financial resilience was a key focus of PR19, yet there are cases where, as yet, companies are not meeting their public commitments to strengthen their financial resilience. We continue to engage with companies with weaker levels of financial resilience and this year we sought to make better use of our Monitoring Financial Resilience report to highlight matters related to the financial resilience of each company. However, we consider that there is more that needs to be done to better protect customers from the consequences of weak levels of financial resilience.

Options for discussion

We discuss a range of options that could be adopted to strengthen the existing arrangements to protect customers from the consequence of weak financial resilience. These options are not mutually exclusive.

Placing limits on gearing

Limits on capital or financing structures have been imposed in other sectors and the Competition and Markets Authority (CMA) panel discussed it as an option in its recent redeterminations of Ofwat's PR19 final determinations. However, defining limits on gearing is unlikely to capture the full range of risks to financial resilience and fixed gearing caps may also lack flexibility to address changing circumstances and investment programmes. We are not minded, at this time, to set pre-determined limits on capital structure. Instead, we discuss below an alternative approach to strengthen the credit rating requirements. However, we are interested in views on whether this might be necessary if weak financial resilience remains an issue in the sector.

Raising the minimum standards of credit quality

An important component of the regulatory ring-fencing licence conditions is the requirement for companies to maintain an Issuer Credit Rating which is an Investment Grade Rating. While the provision does not specify which investment grade category companies should target, we have always expected companies to maintain headroom within the investment grade. In company business plans for PR19 most indicated that they were targeting a credit rating two notches above the lowest level in the investment grade.

While many companies maintain credit ratings that are well within investment grade, we have concerns where companies are at, or near to, the lowest category of the investment grade as it indicates a potential lack of underlying resilience, which is important for providers

[2] Companies' licences contain certain conditions that are designed to protect customers and the regulated business, to ensure each company has sufficient access to resources it needs to carry out its functions. The conditions constrain a company's conduct, ensuring its resources are not diverted and that it is not exposed to undue risk. We discuss these further in Appendix A1.

of such an essential public service. We want to discuss the optimal way to encourage companies to ensure that financing decisions best allow this headroom to be maintained, to protect customers and to ensure the sector is robust for the future.

One option we are considering is whether to increase the level at which the current cash lock-up licence conditions trigger – to a level higher than the existing level defined in the licence at BBB-/Baa3 with negative designation. The trigger level could be uplifted to BBB/Baa2 with negative designation. We are also interested in views on whether it could be lifted to an even higher level, reflecting that company business plans and our price determinations tend to target a credit rating of BBB+/Baa1. Furthermore, we discuss whether the cash lock up conditions could be further extended to include other triggers defined in circumstances where companies deliver poor levels of service to customers or the environment.

Other options set out for discussion include a requirement for companies to publish or provide resilience plans where a rating falls to a defined level, or to provide additional board assurance where credit ratings are maintained at levels below the level targeted in a business plan or price review.

We have previously confirmed to companies the credit ratings we monitor for licence compliance purposes. Concerns about financial resilience can arise where credit ratings are withdrawn without a clear rationale. We discuss an option that would require companies to maintain two investment grade issuer credit ratings and an option for companies to formally notify us of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned, planned rating withdrawals).

Expectations on dividends

Our approach to PR19 required companies to set out how they would meet our expectations on the design and application of dividend policies. We set an expectation that companies should be transparent about their approach to dividends, taking account of matters that include financial resilience and performance in meeting obligations and commitments to customers. As part of the PR19 price review process, companies set out a commitment to meet our expectations.

Our assessment of the 2020-21 Annual Performance Reports found that companies still need to more clearly explain how their decisions take account of performance in meeting obligations and commitments for customers. We continue to find instances where companies explain their dividend decisions on the basis of holding companies' obligations to meet debt interest payments rather than by reference to the performance of the regulated company. This is concerning as it could indicate a weakness in the regulatory ring-fence. Such explanations are also not acceptable if companies in this sector are to maintain public trust. In this paper we suggest amendments to the licence to align the dividend licence conditions with the expectations we have previously set out.

Increased transparency

We expect companies to be transparent about their financing arrangements, their ownership and group structure and their assessment of risks to their long term viability. This is essential so that risks in financial structures are clearly understood and that customers can see that companies are being run in their interest. Credit ratings give a useful perspective on company resilience, proving useful insights and potential early warning signals about a company's levels of financial resilience. However, credit ratings are intended to inform debt markets and provide an independent view of credit quality and are not in place to protect customer interests. Therefore, we see a role for us to provide an assessment from the customer perspective and we will continue to build our insights here, linking with assessments of service delivery and to continue to highlight where we see concerns.

We welcome views on the scope to increase transparency, particularly in circumstances where a small number of companies have used complex financing arrangements including swaps to mask underlying risks to long term financial resilience. We invite comments on the need for increased transparency around holding company debt, defined benefit pension deficit funding arrangements and their impact on underlying financial resilience. Finally, we invite comments on an option for companies to continue to demonstrate how they propose to maintain financial resilience and take account of customer interests in making their financing decisions, in PR24 business plans.

Regulatory incentives on capital structure

At PR19 we introduced a gearing outperformance sharing mechanism. The mechanism was introduced to address perverse incentives for companies to make risky financing choices rather than specifically to address financial resilience. We acknowledge the views expressed by the CMA panel on the gearing outperformance sharing mechanism in the recent PR19 redeterminations and views expressed by companies in response to the PR24 framework design consultation (see appendix A2). We welcome views on how the incentives framework around capital structure should evolve taking account of the other issues discussed in this paper and whether companies should consider voluntary arrangements to share financing outperformance, as South West Water is doing with its WaterShare+ arrangement.

Next steps

We welcome an open dialogue about the possible approaches set out for discussion. We will hold a series of roundtables to discuss the issues set out in this document.

Alongside this discussion paper, we have published an independent report prepared for Ofwat by Professor Robin Mason and Professor Stephen Wright, 'Mason & Wright': A report on financial resilience, gearing and price controls. The Executive Summary and Section 4 of that paper provide independent commentary relevant to this discussion paper; other sections of that paper are relevant to a forthcoming discussion paper for PR24 on Risk and Return.

We welcome comments on the issues as summarised in Box 1 by 31 January 2022.

Box 1: Financial Resilience: points for discussion

We invite comments and views for discussion on the following:

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?
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 welcome views on:

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.
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.
7. a requirement for companies to maintain two investment grade issuer credit ratings.
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).
9. removing dispensations from the requirement to maintain an investment grade credit rating.
10. the need to align the licence to our broader expectations for dividend policy.
11. enhancing the transparent reporting of the use of swaps and how this could be best achieved.
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.
13. the option to improve the transparency of pension deficit reporting.
14. the expectation that PR24 business plans should include a board assured assessment of financial resilience.
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.

Responding to this discussion paper

We welcome views on the emerging thinking in this paper by 31 January 2022. Please email them to OfwatPandO@ofwat.gov.uk.

We will publish responses to this document on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this discussion paper you are deemed to consent to its publication.

Information provided in response to this document, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our Privacy Policy.

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If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed and provide a redacted version of your response, which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

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Amendment: Clarification added as footnote 20 on page 14, 9 December 2021

1. The importance of financial resilience and the current customer protections

1.1 Our role in monitoring financial resilience

We define financial resilience as the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption, whether that disruption is driven internally or externally to the company. Financial resilience is important; it matters for customers and it affects company behaviour. Poor levels of financial resilience, particularly when combined with poor service performance can have real consequences for customers and the environment, because companies may not have the financial flexibility when disruption occurs to continue to fund necessary maintenance activities and service improvements and, where necessary, turn performance around.

There are a number of factors that impact on a company's financial resilience and its ability to avoid, cope with and recover from disruption. At each price review we set the revenue allowances and incentive packages for each company. Company performance in delivering against their determinations can impact on cashflows and hence financial resilience.

In the water sector, the risks to a company's financial resilience are mitigated to a large extent by the uncertainty and reconciliation mechanisms included in the regulatory framework. However, revenue recovery, operational or cost performance, the outcome of enforcement action, dividends/dividend policies and differences in debt financing costs compared to regulatory allowances can all impact on cashflow headroom and hence financial resilience. Company management has material influence on all these factors.

Consistent with the principle that risk is best left to the responsibility of the parties that are best able to manage or control that risk, our approach has been to allow companies significant discretion over their financing and capital structure arrangements within the context of price reviews, company licences and company law. The expectation is that investors bear the risks of their financing and capital decisions. These decisions can have a material impact on the ability of a company to deal with and recover from disruption; short term financing decisions potentially have long term consequences on how a company might manage its financial resilience.

In a competitive market, investors take the risks and rewards of risky or aggressive financing arrangements, and customers have the option to purchase goods or services from a competitor if a company fails. However, where a service is provided by a monopoly business and services cannot be replicated by a competitor, poor levels of financial resilience can have real consequences for customers. If poor levels of financial resilience result in an excessive focus of management attention on resolving short term issues – this may come at the expense of a detriment to long term resilience.

This is consistent with observations made by Professors Mason & Wright[3] who comment that 'it may be that a firm in financial distress does not go bankrupt, but instead cuts back on areas of expenditure that are important in the longer term, but may be discretionary in the short term'. It is consistent also with the observations of Brealey, Myers and Allen who suggest that where financial resilience deteriorates, provided a company can gather enough cash to make interest payments, it may be able to delay administration for many years but in that time, a range of sub-optimal behaviours may occur.[4] For companies providing an essential service, such behaviours can have real consequences for customers and the environment.

Maintaining resilient structures

The water sector carries a significant amount of debt finance, with 73% of the sector RCV – £56.2 billion – being financed by debt as at 31 March 2021. This debt must be refinanced as it matures, and companies must continue to raise new debt and equity to finance improvements to the asset base. Most of the companies we regulate maintain debt levels above the level used in our determinations (as measured by net debt:RCV) and there is strong evidence that the sector remains attractive to both debt and equity investors. However, some companies adopt materially riskier financing arrangements as assessed by reference to a range of financial metrics and credit ratings; we report on these metrics in our Monitoring Financial Resilience report[5].

The independent assessment of credit rating agencies provides useful information about the financial strength of the companies we regulate. Credit rating agencies take account of a wide range of factors including operational and financial performance in their assessment and this provides important signals about the risks to financial resilience. However, it is not sufficient to rely on the ratings assigned by the credit rating agencies alone to protect customers from risky financing choices.

The purpose of a credit rating is primarily to provide lenders information about the credit risk of a particular investment, providing an indication about the prospects for recovery in a distress scenario. Whereas we focus on protecting customers from risky financing choices or poor performance. Concerns arise particularly where companies with poor levels of resilience do not have the financial ability to turn around poor operational performance which could leave customers and/or the environment to suffer poor levels of service for extended periods of time. Our role extends therefore to encouraging companies to operate efficiently, while remaining resilient over the long term. Where financial resilience is at risk, we seek to encourage companies to address those risks and we seek to ensure customers are protected from the consequences of poor financing choices.

In recent years, we have encouraged all companies to appraise and where necessary improve

[3] Mason & Wright, A report on financial resilience, gearing and price controls, 3 December 2021.
[4] See also for example, Brealey, Myers and Allen, 'Principles of Corporate Finance', 10th Edition, Chapter 18.
[5] Ofwat, Monitoring financial resilience report 2020-21.

their levels of financial resilience, taking account of the revenue at risk associated with service performance. The levels of allowed returns, which, reflecting wider economic factors, have declined over time. We are encouraged that several companies maintain resilient structures, and some companies have taken steps to improve financial resilience, however weak levels of financial resilience remain a concern, as set out in our 2021 Monitoring Financial Resilience report and as discussed in this discussion paper.

1.2 Measures of financial resilience

There is no single measure of financial resilience. All else equal, high levels of indebtedness (measured as gearing and defined as net debt:RCV) can exacerbate the effects of a financial shock. That said, there are many other factors that are relevant to an assessment of financial resilience, including debt financing costs and the consequences on cashflows of adjustments for service performance.

Different credit rating agencies ascribe different weights to these metrics in their credit assessments; each of the credit rating agencies monitor gearing levels as an important indicator of credit risk. The FFO:net debt metric is a key focus of Standard & Poor's credit rating assessment. FFO:net debt is also an important metric in Moody's credit assessment, alongside adjusted interest cover; Fitch also focus on an interest cover financial ratio, referred to as the post-maintenance interest cover.

Financial metrics that measure interest cover are typically impacted directly by factors including expenditure performance, adjustments that are made to allowed revenue for service performance and actual debt financing costs and so can provide better signals of shorter-term pressures to financial resilience than financial metrics that measure debt capacity. A rounded assessment of financial resilience, should therefore take a range of factors into account, taking account of an evaluation of the capacity of a company to raise the finance it needs and the ability of a company to meet its annual financing costs.

Our Monitoring Financial Resilience reports aim to illustrate the relative financial resilience and financial positions of the water companies. We set out information that includes credit ratings, borrowings (including mark-to-market valuations of derivatives) and other reported financial metrics. We report on performance information, as measured by the return on regulatory equity metric, and other information relevant to an assessment of financial resilience, such as dividends, tax, pension liabilities and our review of long term viability statements.

1.3 Current regulatory protections

The regulatory framework already includes a number of important protections that are designed to insulate the regulated company and its customers from the risks of financial distress and the actions of group companies. These protections include the regulatory ring-fencing licence conditions (summarised in Appendix A1) and the special administration regime is designed to ensure customers benefit from continuity of service in the event of a special administration order.

We have taken several steps to strengthen customer protections as we have evolved the regulatory framework. Recent actions we have taken to ensure customers are protected, and to encourage companies to strengthen financial resilience are set out in Box 2.

Box 2: Recent steps we have taken to strengthen financial resilience

Recent steps we have taken include that we have:

- signalled a need for some companies to revisit their financing arrangements and consider the need to strengthen balance sheets well before the commencement of the PR19 process.[6]
- enhanced reporting and monitoring of financial resilience under the Monitoring Financial Resilience framework that was implemented following PR14.[7]
- set out a requirement, at PR19, for the first time, for companies to demonstrate how they intended to maintain financial resilience during AMP7 in their business plans.[8] Evidence submitted by companies was subsequently assessed and challenged by us through the PR19 process.
- through our 2018 'Putting the sector in balance' position statement, set out our expectations on a range of issues including dividends and executive pay.[9]
- published our consents guidance[10] which sets out our approach to granting derogations from ring-fencing provisions in company licences.
- set out our expectations for companies when preparing long term viability statements[11] and ring-fencing certificates[12].
- updated ring-fencing licence conditions so that licences are aligned across the sector and each company has the current most up-to-date conditions (Appendix A1).[13]
- continued to engage with companies where issues related to financial resilience or capital structure arise.

[6] For example in CEO, Cathryn Ross's speech at Moody's 2017 UK Water Sector Conference and in our 2017 report on 'monitoring financial resilience' we were clear that 'we expect companies to be thinking about how changes to the allowed cost of capital at PR19 might impact on their financing arrangements'.
[7] Ofwat, Monitoring financial resilience reports. Ofwat, Consultation on how companies should demonstrate long-term financial resilience, January 2016.
[8] Ofwat, Delivering Water 2020: Our final methodology for the 2019 price review, December 2017 (p5, chapter 5). Board assurance that business plans were financially resilient on a notional and actual basis was also required.
[9] Ofwat, Putting the sector in balance: position statement on PR19 business plans, July 2018.
[10] Ofwat, Conclusions on guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework and the consents guidance, February 2020.
[11] Ofwat, IN 19/07 - Expectations for companies in issuing long term viability statements, April 2019.
[12] Ofwat, IN 20/01 - Requirements and expectations for ring-fencing certificates, February 2020.
[13] Ofwat, Conclusions on section 13 of the WIA91 on proposed modification to ring-fencing provisions, 14 July 2020; Wessex Water did not agree to the licence modifications we sought in 2020 and retains some differences.

1.4 Case study

Despite all of the steps set out above, we have long acknowledged that regulatory protections may not protect customers in all circumstances. The special administration regime under the Water Industry Act 1991, is designed to ensure the continued provision of water and wastewater services in the event of company failure. However, service provision to customers may deteriorate long before a process of special administration is triggered, or investors take steps to strengthen a company's balance sheet. Indeed, poor levels of performance across service, cost or financing measures, over extended periods of time, can impact on financial resilience, absent investor support.

Special administration has not been tested in the water sector, though it has been tested in other regulated sectors. It remains an important protection for customers and is available for use in appropriate circumstances. The costs of special administration to investors could be significant: investors could face the prospect of material loss to their investment and so the risk of losses through the process of special administration should encourage companies to maintain structures that are financially resilient.

The risk of loss should lead companies and their investors to resolve issues well before special administration is triggered. The case study in Box 3 illustrates the consequences that can arise where weak financial resilience combines with poor operational performance. We note that any detrimental impact to investors is likely to increase with the increased proximity of special administration; existing investors retain control of a recapitalisation or sale process where it is carried out in advance of special administration.

Box 3: Financial resilience case study: Southern Water

In August 2021, following a period of increasing pressure on the operational and financial resilience of Southern Water, an agreement was made that resulted in the managed change of a controlling stake, and the investment of new equity, into Southern Water and its holding companies. A fund managed by Macquarie Asset Management acquired a majority stake in Greensands Holdings Limited, the holding company of Southern Water via a £1.073 billion injection of new equity, including £530 million invested as new equity into Southern Water.[14]

For many years, we have engaged with and challenged Southern Water to improve its performance. The company has underperformed across many of the service standards measured by us and other regulators and has been the subject of repeated and ongoing regulatory intervention: it was placed in the lowest category of our service delivery reports in 2020-21 ('lagging behind') and 2019-20 ('poorer performance') and placed in the lowest quartile in our measures of customer service - Service Incentive Mechanism (SIM) and

[14] Investment into Southern Water: correspondence between Leigh Harrison and Jonson Cox, 9 August 2021.

Overall Performance Assessment (OPA) over many years[15]; it was the subject of our largest enforcement action (resulting in a penalty of £3 million and a reparations package totalling £123 million in 2019) due to material failures of the management, governance, operations and performance of its wastewater treatment works and associated misreporting[16] during the period 2010 to 2017; it was subject to the highest ever court-imposed fine (£90 million in 2021) of any water company for environmental pollution[17] that occurred in 2010 to 2015 and there are further investigations ongoing by the Environment Agency.

Weak levels of financial resilience have affected the credit rating of Southern Water: its senior secured credit rating was downgraded from A- to BBB+ by Fitch in December 2018, Baa1 to Baa2 by Moody's in June 2019 and from A- to BBB+ by S&P's in July 2019; the senior secured credit rating was subsequently downgraded to Baa3 (the lowest investment grade) by Moody's in September 2019.

The company had maintained a highly covenanted structure with gearing up to 80% at the level of the regulated company and up to 93% at the level of the holding company, since the financial restructuring in 2003, with debt at the holding companies financed by the regulated company. Debt to the value of £700 million was raised by the holding companies of Southern Water and injected as equity into the regulated company to strengthen its balance sheet in 2019.

Facing ongoing challenges with financial resilience, Southern Water undertook significant swap restructuring exercises in 2018 and 2020, which had the effect of improving short term cashflows. This allowed it to meet short term financial ratios and to avoid triggering financial covenants, but resulted in increased future liabilities. Including the mark-to-market valuation on derivatives of c.£1.4 billion, leverage measured c.100% of RCV as at March 2021.

Our concerns about the performance and financial resilience of Southern Water were highlighted to its board. In 2020, Southern Water announced it would not pay dividends until it was clear that to do so would not be detrimental to the company's financial resilience.[18] Also in 2020, Southern Water stated it would not seek to access future inflation linked debt through the use of derivatives.[19] Ultimately, the previous majority shareholders commenced a process that resulted in them accepting a material dilution in their shareholding and a reduction in their ownership in the company.

Based on information in the public domain, we assess that the incoming investors made

[15] Ofwat, Service and delivery: 2020-21 (p7), 2019-20 (p5), 2018-19 (pp5,10), 2017-18 (p10), 2016-17 (p7). Ofwat, Setting price controls for 2015-20. Final price control determination notice: policy chapter A4 – reconciling 2010-15 performance, December 2014, Figure A4.3 and Table A4.5
[16] Environment Agency, Ofwat announces £126 million penalty for Southern Water, June 2019.
[17] Environment Agency press release, Record £90m fine for Southern Water following EA prosecution, 9 July 2021.
[18] Southern Water Services (Finance) Limited announcement, Dividends and Financial Resilience, RNS Number: 2128L, 28 April 2020.
[19] Southern Water, Annual report and financial statements for the year ended 31 March 2020, page 113.

their investment at around par to RCV[20]; significantly below market-to-asset valuation premia observed in other recent transactions which have typically been in the range of 10-30% in the water sector.[21]

There remains significant work that will need to be done to improve the operational performance of Southern Water. The new investors will bear the risks and rewards of delivering Southern Water's turnaround in performance; it is anticipated that it will take some time to improve services to the levels customers deserve.

[20] Invested funds were retained within the group, existing shareholders receiving none of the proceeds, and diluting the collective interest of existing shareholders to a minority position.
[21] PwC, Review of the relationship between financing allowances and water company performance – a report for Ofwat prepared by PwC, October 2020, p26, figure 4.11: UK water historic market to asset ratios.

2. Issues arising and concerns

2.1 Introduction

In the paper that accompanies this discussion paper, Professors Mason & Wright identify that a potential market failure associated with a regulated company's financial decisions is an externality that creates a gap between the social and private costs of financial distress. They explain that managers of a regulated company may not consider the full social costs of the difference between the social and private costs of financial distress and illustrate the difference between social and private costs by reference to gearing. This potential market failure is the reason why regulatory arrangements need to be in place to protect customers from the consequences of risky financing decisions.

Risks from high levels of debt can be made worse if paired with a high cost of debt or a high debt maturity concentration. Concentration risks can arise where large amounts of debt are raised or mature at a specific point in time. These issues underpin the view that an efficiently financed company is one that takes a balanced approach to its financing arrangements, which diversifies risk and allows it to respond flexibly to future developments. As short term financing decisions can have long term impacts, it is important that a company's financing decisions are taken bearing in mind any consequential risks to long term financial resilience – and so it follows that companies and investors, rather than customers, should bear the risks and long term consequences of risky financing choices.

In this section we discuss some of the features we have seen where companies have adopted more risky financial structures. These issues go beyond concerns previously raised where large amounts of debt have been raised, accompanied by a withdrawal of equity or large dividend payments. One such concern has been the use of derivative financial instruments by some companies with more risky financial structures, and the consequential impacts on financial resilience.

We discuss the existing licence requirement to maintain an investment grade credit rating and how that links to our expectations for companies to maintain headroom in the investment grade category. High levels of dividends, and dividends paid to meet obligations of holding companies, can impact on the financial resilience of a regulated company and we discuss our issues, concerns and expectations with regard to dividend policies.

2.2 Derivative financial instruments

Derivative financial instruments (notably, swaps) are typically used by companies to hedge financial risks. Swaps can form part of a considered approach to treasury risk management, for example, where linked to underlying instruments and used to hedge interest rate, inflation or exchange rate risks. However, they can also introduce additional risks. [22]

Swaps have been used by a small number of companies with already weak levels of financial resilience to alter the profile of cash interest payments, for example, to reduce short-term effective interest costs at the expense of highly likely future cash outflows, without any improvement in long term, underlying financial resilience.[23] Where the terms of existing swaps are revised to alter the profile of interest costs, this can also result in a permanent adjustment to the real coupon and hence interest cost over the life of the swap. These arrangements can have the effect of deferring underlying financial risks to a future period – risks that would not otherwise arise for those companies that adopt less risky financing and capital structures.

Swap liabilities are not reflected in reported regulatory gearing, but can contribute to negative mark-to-market swap valuations. Such arrangements are referenced by Moody's as economically equivalent to new borrowing and as masking underlying financial weakness.[24] In some cases, credit rating agencies make adjustments to net debt to reflect these liabilities in their credit rating assessment, for instance, Fitch makes an adjustment to Yorkshire Water's gearing to reflect that tenor extensions on out-of-money swaps are equivalent to new borrowing.[25] However, the reporting of such arrangements is not transparent, meaning adjustments are not always made.[26]

Risky use of swaps in covenanted structures

In the cases of highly covenanted structures, companies have set out that the covenants attached to their structures afford additional layers of protection to lenders and subsequently customers. It is argued by some companies that the arrangements introduce certain disciplines to company management that enhance protections to customers because covenants trigger much sooner to prevent payments out of the regulated business than (for example) the special administration regime.

While swaps are widely used by companies in the water sector and by other companies more broadly, the use of certain types of swaps as described above counters the argument that covenants could be said to enhance the protections for customers. First, as cashflows on

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[22] In some instances, swap counterparties have sought to limit their credit exposure to individual issuers, for instance, by requiring that swap contracts include break clauses or pay-downs of the inflation accretion at, say, five yearly intervals. These features allow parties to manage exposures, but create additional points where a regulated company may have to pay down a liability or create additional requirements for a company to reprofile its swap liabilities.

[23] Because some swaps can move costs from the present to the future, they have been referred to as 'kick the can swaps'.

[24] Periodic Review: Moody's announces completion of a periodic review of ratings of Southern Water Services (Finance) Limited, 5 July 2021. Moody's Credit Opinion, Yorkshire Water Services Limited, 13 March 2020, pp6-7.

[25] Fitch Affirms Yorkshire, Water's Class A and B, Debt at 'A-' and 'BBB-'; Outlook Stable, 9 June 2021

[26] For example, in their 19 November 2021 credit opinion on Yorkshire Water, Moody's state: 'Although we regard the probable future payments resulting from swap restructurings as debtlike, we do not include them in Moody's-adjusted net debt because the company does not disclose them separately from the contingent mark-to-market liabilities on its other swaps'.

swaps rank senior to interest payments on debt in a default scenario, the use of such swaps can undermine the value of protections afforded by debt covenants. Second, the arrangements can potentially delay to a future period the point at which covenants might otherwise be triggered – and, in extremis, this could potentially be deferred to the point where special administration would be triggered. Finally, such arrangements may not be attractive to potential future investors – they have been cited as potentially deterring existing or potential investors from injecting equity or acquiring an interest in a company. Similar points to those set out above, though focussed on the interests of creditors, have been referenced in credit opinions.[27]

Highly covenanted arrangements are specifically aimed at protecting the interests of lenders. When such arrangements were put in place, they typically provided scope for a company to adopt a higher initial gearing level for the same target rating as the standard corporate model. The arrangements were designed to address the interests of investors, often allowing for a withdrawal of equity, rather than to protect the customer interest. Where the covenants subsequently drive management actions which lead to the adoption of increasingly risky financial policies, this can be detrimental to the interests of customers.

Highly covenanted arrangements also have the potential to act against customer interests if the covenants drive management behaviours that may not be in the long term interests of customers. Such behaviours might arise where investment or financing decisions aim specifically at meeting short-term covenanted financial ratios, for example, if maintenance or investment activities were to be delayed to boost operating cashflows. Covenants might also drive particular management behaviours and management responses to proposals for evolution of the regulatory regime, for example, if the covenants need to be amended to accommodate changes in the way we regulate.

As further evidence to support their view, companies operating with covenanted structures have argued that the benefit to creditors (and hence to customers, as explained above) from their covenant and security package is recognised by rating agencies through a rating uplift, i.e. putting forward a view that covenanted structures improve credit quality.

We agree that credit rating agencies typically do ascribe a certain benefit (or uplift) in their credit assessment to both the protections of the regulatory ring-fence and the creditor protections in the covenants. However, we observe that the uplift assigned for creditor protections has been notched down in instances where swap restructurings have taken place, and the uplift may not always outweigh the negative impact on the credit score where a company maintains a risky financial policy. Our view is supported by an analysis of the scorecards[28] reflected in the credit rating opinions published by Moody's as discussed in Box 4.

[27] See, for example, Moody's credit opinion, Yorkshire Water Services Limited, 19 November 2021 (pp6-8).
[28] Moody's publishes a scorecard for each company it rates as a reference tool that can be used to approximate credit profiles for water companies.

Box 4: Moody's scorecard assessment of financial policy and its rating uplift for structural features

In table 1 we set out the score assigned by Moody's to 'financial policy' in its scorecard assessment of the companies it rates. Financial policy is one of ten sub-factors to which Moody's assigns a 'sub-factor score'. It takes account of Moody's assessment of management and shareholder tolerance for financial risk. The 'sub-factor score' is mapped to the broad Moody's rating categories of: Aaa, Aa, A, Baa, Ba, B, Caa, or Ca, with a lower sub-factor score signalling a riskier financial policy.

The table shows that for the majority of companies with highly covenanted structures, a lower score is assigned to financial policy than companies without structural arrangements. Southern, Thames and Yorkshire Water have the lowest financial policy score, in each case, these scores have been lowered from levels more consistent with their peers due to their adoption of more credit negative financial policies.

The 'rating uplift' is an uplift applied in Moody's scorecard for structural considerations. An uplift is applied to account for structural enhancements that may be included in a company's financial arrangements. All companies are assigned at least a 0.5 rating uplift, taking account of the regulatory (ring-fencing) protections of the licence. Typically, companies with highly covenanted features are assigned an additional uplift of 1.0 (leading to an uplift score of 1.5). In the case of Southern Water and Yorkshire Water, these additional uplifts were halved to 0.5 in October 2019 and March 2020 respectively, taking account of the swap restructurings carried out by the respective companies.

The one anomaly is Welsh Water, where Moody's see limited credit value from the covenant package at higher credit ratings of A3 and above.

While we acknowledge that the Moody's scorecard methodology is not determinative of the credit rating that is ultimately assigned, the methodology provides a useful framework against which credit risks can be assessed. In our assessment, the higher rating uplift afforded to highly covenanted structures does not fully counter a risky approach to financial policy. Furthermore, the steps taken by Moody's to halve the additional uplift for the creditor security package suggests the benefits claimed from such arrangements can fall away as a result of risky financing arrangements that may not have been envisaged at the time the covenanted financing arrangements were put in place.

Table 1: Financial policy scores and rating uplift from Moody's scorecard

Financing Structure	Company Name	Financial Policy	Rating Uplift
Highly covenanted	Affinity	Ba	1.5
	Anglian	Ba	1.5
	Bristol	Ba	1.5
	Welsh	A	0.5
	Portsmouth	Ba	1.5
	SES Water	Ba	1.5
	South East	Ba	1.5
	South Staffs *	Ba	1
	Southern	B	1
	Thames	B	1.5
	Yorkshire	B	1
Standard corporate	Northumbrian	Baa	0.5
	Severn Trent **	Baa	0.5
	United Utilities	Baa	0.5
	Wessex	Baa	0.5

Source: Moody's last credit opinion for each company

* South Staffs Water maintains a hybrid structure with more covenants than a standard corporate financing structure but fewer than other companies with more highly covenanted structures.

** In the case of Severn Trent, we include the uplift as Moody's state the company 'benefits from 0.5 notches of uplift from regulatory ring-fencing provisions, embedded in its licence, but the scorecard-indicated outcome for the operating company is also A3, in line with the group as a whole. The uplift for regulatory licence protections does not apply to the holding company.'

2.3 Credit ratings

Credit rating agencies provide an opinion of a company's long term capacity to meet its financial obligations as they become due in the form of a credit rating. Credit ratings are important to companies as lenders place significant weight on them when deciding whether, and how much, to lend to a company; in turn, credit ratings affect the cost of debt finance.

Table 2 sets out the credit ratings stated by companies as the targets for their actual financial structure, together with the credit ratings as at 30 November 2021 that we monitor for licence compliance purposes.[29] Currently, 7 water companies[30] hold credit ratings that are either at the lowest investment grade or one notch above (and hence lower than the level all companies signalled as reasonable for the notional structure at PR19). In addition, several companies maintain credit ratings that are lower than was stated by the relevant company as

[29] For monitoring purposes we are guided by the licence definition of 'Issuer Credit Rating' to determine which credit ratings we accept for purposes of monitoring against the licence. Broadly speaking we accept as an 'issuer credit rating' the rating from an agency considered to be most reflective of the creditworthiness of the regulated company as a whole. Companies were informed of which ratings we monitor for regulatory purposes in July 2020 when we modified condition P of their licence; these ratings are periodically updated to reflect any changes.

[30] Not including Yorkshire Water's corporate family rating (CFR) of Baa2 negative as it was withdrawn.

the target for the actual financial structure in PR19 business plans.

Between May 2020 and May 2021, credit ratings were withdrawn for four water companies,[31] including the corporate family rating maintained by Yorkshire Water which, at the time, was Baa2 with negative designation. Where credit ratings are withdrawn, particularly in circumstances where that credit rating has been stated by us as one that is monitored for licence compliance purposes, and there is a lack of transparency about the reasons for that withdrawal, this can further underpin any existing concerns about financial resilience.

Table 2: Credit ratings targeted in PR19 business plans for the actual financial structure and credit ratings as at November 2021

	Target credit rating for the actual financial structure			Credit rating for the actual financial structure as at November 2021		
Water company	Fitch	Moody's	S&P	Fitch	Moody's	S&P
Anglian Water		Baa1		–	A3	A–
Dŵr Cymru	BBB+	Baa1	BBB+	–	A3	A–
Hafren Dyfrdwy		Baa1	BBB+	–	–	–
Northumbrian Water		Baa1	BBB+	–	Baa1	BBB+↓
Southern Water		Baa1	A–	BBB+↓	Baa3	BBB+
Severn Trent Water		Baa1	BBB+		Baa1	BBB+
South West Water				–	–	–
Thames Water		Baa1	BBB+	–	Baa2	BBB+↓
Wessex Water	BBB+	Baa1		BBB	Baa1	–
United Utilities		A3	BBB+	BBB+	A3	BBB+
Yorkshire Water		Baa2			*	A–
Affinity Water		Baa1		–	Baa1	BBB+
Bristol Water		Baa2		–	Baa2↑	–
Portsmouth Water		Baa2		–	Baa1↓	–
SES Water		Baa1		–	Baa2	–
South East Water		Baa2	BBB	–	Baa2	BBB
South Staffs Water		Baa1		–	Baa2	BBB+↓

Source: Ofwat PR19 final determinations[32] and credit rating agency reports.
↓/↑ means the rating is on negative/positive outlook or watch. The ratings shown for the actual capital structure as at 30 November 2021 are those monitored by us for licence compliance purposes – some of the ratings are entity level 'issuer' ratings, some are 'corporate family ratings' and some are senior secured debt ratings. *Yorkshire Water held a Baa2 corporate family rating assigned by Moody's that we monitored for licence compliance purposes until it was withdrawn on 12 May 2021.
South West Water and Hafren Dyfrdwy currently have a dispensation from the licence requirement to maintain an investment grade issuer credit rating.

[31] Rating Action: Moody's withdraws Yorkshire Water's corporate family rating, 12 May 2021; S&P Global Ratings – Research Update: Portsmouth Water Ltd. 'BBB' Ratings Affirmed; Ratings Subsequently Withdrawn At The Company's Request, 13 November 2020; Rating Action Commentary –Fitch Affirms Affinity Water's Ratings; Withdraws IDR, 27 October 2020; London Stock Exchange announcement, Withdrawal of Credit Rating – Wessex Water Services Finance plc, 21 May 2020.
[32] Ofwat, PR19 final determinations: Aligning risk and return technical appendix; December 2019, p78, Table 6.1 for target credit ratings. Rating agency reports and announcements.

While no company maintains credit ratings that contravene the licence requirement to maintain an investment grade issuer credit rating, we would not expect them to because this requirement is included in company licence conditions as a backstop. Our expectation has always been that as providers of essential infrastructure, who must provide services to customers in all circumstances, companies are best able to serve the interests of customers where headroom is maintained within the investment grade.[33] Our perspective is supported by companies' own view from PR19 where each targeted a credit rating of at least Baa1/BBB+ for the notional company structure, which is two notches above the lowest investment grade. This target credit rating is consistent with the current average of the credit ratings we monitor.

There are many reasons why headroom above the lowest investment grade is important: as providers of an essential service, companies must be able to raise finance if they are to deliver their obligations. Companies with lower credit ratings carry a greater probability of default and greater risks associated with raising debt, or of being impacted by widening debt spreads at times of market disruption, as seen during the 2008 financial crisis. Furthermore, headroom is necessary as it enables companies to respond flexibly to a wide range of shocks., We, therefore, expect companies with credit ratings that are at, or at risk of falling to, the lowest investment grade credit rating to already be taking steps to strengthen financial resilience.

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?

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?

2.4 Expectations on dividend policies

As part of PR19, we set out that in a sector where customers cannot choose their supplier, it is important that customers and wider stakeholders can understand how decisions about dividends relate to overall performance. Equity investors have an important role to play in financing water company investments and driving efficiency and innovation in the sector. However, where dividend payments do not align with the long term financing needs of a company and levels of service provided to customers and the environment, dividends paid

[33] These views have been expressed in past regulatory determinations and for example, when we have consulted on company proposals to amend capital structures. See for example , Thames Water Utilities Whole Business Securitisation (2007, p2), Yorkshire Water Services Limited – Whole Business Securitisation (July 2009, p3), The acquisition of AWG plc by Osprey Acquisitions Limited and its impact on Anglian Water Services Limited (2006, p6), The completed acquisition of Southern Water Services Limited by the Greensands Consortium (2008, p13)

can erode financial headroom and public trust.[34]

At PR19, all companies set out their proposals for their dividend policies for 2020-25. In doing so, companies sought to align with our expectations that dividend policies and dividends declared or paid should take account of company performance in meeting their obligations and commitments to customers, and take account of other factors, including the need to maintain financial resilience and matters such as pension obligations.

We reported on our assessment of company dividend policies in our [2021 Monitoring Financial Resilience report] for the first year of the current price control. Across the sector, our assessment found that where companies made reference to delivery of service to customers, often only general statements were made and, in some cases, companies explained dividend payments were based on obligations at a group level rather than by reference to the performance of the appointed company. The payment of dividends by reference to group obligations is concerning as it could indicate a weakness in the regulatory ring-fence. In some instances, we were unable to see that companies had taken forward the actions identified at PR19 to align their dividend policies with our expectations.

From a customer perspective any dividend represents an outflow of cash from their water company, whether the dividend is used to fund holding company costs or paid to ultimate shareholders. And as it is the regulated company that holds the licence, public trust is served best where the level of dividend is explained in relation to performance of the regulated company, irrespective of the obligations of the wider group.

Reliance on dividends from the regulated company to pay the interest costs of holding companies means there could be a degree of pressure for a company to pay dividends regardless of its performance in delivering service to customers. Furthermore, investor expectations could lead to pressure being brought to bear on financing or dividend decisions that are made by the regulated company.[35]

We do not regulate the level of dividends and so we have not specified the terms on which dividends should be paid, nor have we sought to place controls or caps on dividends. Decisions about the declaration and payment of dividends are the responsibility of the board of each company. It is important, therefore, that company boards are held to account for

[34] We set out our expectations for transparency on performance related executive pay at PR19 (see Ofwat, PR19 Final Determination – Aligning risk and return technical appendix, December 2019, section 9.2), where we were clear that companies should demonstrate a substantial link to stretching performance delivery for customers. These expectations are also reflected in our board leadership, transparency and governance principles, which we most recently reported on in our February 2021 report.

[35] A feature of some of the structures maintained by some highly covenanted structures is high interest shareholder loans that have been made to holding companies. In some instances, interest is accrued at rates of up to 12%, well in excess of the nominal allowed returns (5.02% at PR19). We do not know how investors report on these shareholder loans to their investment committees. However, the fact that these loans continue to be stated in the accounts of the holding companies, raises questions as to whether the rates at which interest is accrued is a signal of expected investor returns or drives investor expectations that may not reflect the underlying circumstances within which the regulated companies operate.

their decisions, and it is vital that there is a full and transparent explanation as to why dividends are justified. The need for transparency to engender trust and accountability is incorporated into our BLTG principles.

We are clear that is it our expectation that investor returns should reflect underlying company performance and resilience. Dividends should be restricted where companies underperform or where underlying financial or resilience concerns need to be addressed, and investors should expect to receive reasonable dividends where companies perform and are resilient. We acknowledge that across the sector, several companies have reduced dividends to strengthen balance sheets in 2020-21.

We will continue to call out poor practices where they are observed, monitoring whether companies are meeting our expectations and we will keep our expectations and our role in this area under review. We discuss further our option to strengthen customer protections on dividends in section 3.3.5.

3. Strengthening the customer protections

3.1 Introduction

We aim to maintain a clear and transparent regulatory framework that holds companies to account for their performance and ensures long term corporate, financial and operational resilience. This helps to ensure the sector remains investible and delivers the best outcomes over the long term.

There remains strong appetite for both debt and equity investment in the sector. The consistency of the regulatory framework is recognised as important to ensuring the sector remains attractive, providing confidence to investors. However, the aim of maintaining consistency does not mean our regulatory approaches should remain static; the framework should evolve to meet changing circumstances and risks.

In this section we set out the possible approaches that could be taken to strengthen customer protections and encourage companies to maintain resilient financial structures. The options we discuss are not mutually exclusive; it is possible a number of these options could be taken forward in combination. We discuss the options under four categories:

- Limits on capital or financing arrangements.
- Raising the minimum standards of credit quality.
- Increased transparency.
- Regulatory incentives on capital structure.

3.2 Should we place limits on capital or financing arrangements?

In its decision of the PR19 redeterminations, the CMA panel suggested that one possible approach to address financial resilience concerns was to introduce licence modifications that could be defined to directly limit gearing.[36] Limits have been imposed in other sectors to curtail the use of risky capital structures, promote capitalisation and ensure companies are more resilient to episodes of financial stress. For example, capital adequacy requirements apply in the banking sector and the licence conditions of NATS (En Route) plc (NERL) were amended in December 2010 to introduce a gearing cap of 65% and a gearing target of 60%.

A rules-based approach to financial resilience such as defining limits on certain financial ratios or placing restrictions or limits on financing arrangements such as the acceptable use of swaps, could have the benefit of being simple for companies and stakeholders to

[36] CMA, 2021, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorskhire Water Services Limited price determinations – Final report paragraph 9.1224.

understand.

However, there are problems with such an approach. Defining limits on individual financial metrics alone may be an imprecise protection and is unlikely to capture the full range of risks to financial resilience. Fixed gearing caps may also lack flexibility to address changing circumstances and investment programmes and it may be necessary also to set additional protections or expectations, reflecting for example that there is no single measure of financial resilience. It may be necessary to define the acceptable use of swaps and other rules on financial structure to capture the impacts on financial resilience of matters such as operational underperformance or the risks that may arise from other group companies.

To capture the full range of risks to financial resilience, it may also be necessary to consider and define rules for other risks to financial resilience. Such an approach could end up shifting the decision risk to the regulator instead of the company, when it is the company and its management that is better positioned to manage its own risks.

We do not propose to define limits on acceptable capital or financial structures at this time. Consistent with other areas of the regulatory framework, our preferred approach is to continue to use, or where appropriate amend, existing approaches to encourage companies to maintain financial resilience which we discuss in this section. However, the adoption of risky financing arrangements, albeit by a limited number of companies, underlines the importance of a reappraisal of the existing protections in place and we are interested in views on whether it might be necessary to define limits on capital or financing structures where financial resilience does not improve.

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.

3.3 Raising the minimum standards of credit quality

3.3.1 Cash lock up licence conditions and resilience plans

We consider it is reasonable to expect that regulatory requirements placed on companies progressively increase as the credit quality of a company declines. We already engage more frequently with companies with lower levels of financial resilience, however, there may be scope to formalise these arrangements, and to consider whether existing protections should be strengthened.

An important protection of the regulatory ring-fence is the 'cash lock-up' licence conditions. These conditions place restrictions such that a company must not 'transfer, lease, licence or lend any sum, asset, right or benefit to any Associated Company without our prior consent where a credit rating is sub-investment grade, or is at the lowest investment grade, BBB-/Baa3, with negative designation'.

Given our expectation that companies should not operate at the lowest investment grade rating, or be at risk of downgrade to that level, there is a strong case for reconsidering the point at which cash lock-up provisions should trigger. And, to uphold financial resilience, it may be reasonable for a company to restrict transfers or distributions out of the regulated business well before its lowest credit rating is at risk of falling below the investment grade.

There may be a rationale therefore for amending the trigger point for the cash lock-up conditions such that no distributions should be made, without our consent, where a company holds a credit rating that is at risk of falling to the lowest investment grade rating (i.e. where a credit rating is at BBB/Baa2 with negative designation or lower). Potentially, the trigger for cash lock-up could be lifted to an even higher level, reflecting that company business plans and our price determinations tend to target a credit rating of BBB+/Baa1.

There might be limited circumstances where it is appropriate to grant an exception to this, for example, where investors have committed to delivering a turnaround in company performance, together with evidence that a turnaround in performance is being delivered and the commitment has been backed up with an injection of equity, creating some capacity for distributions.

Additionally, Professors Mason & Wright suggest a tigger point for the cash lock-up licence conditions could be set by reference to levels of service, such that no distributions should be made where specified service performance levels to customers or the environment are not met. These service levels could, for example, be specified in a price review, or in the licence.

An additional or alternative approach could be a requirement for companies to publish or submit resilience plans where credit ratings fall to a set threshold. For example, in its RIIO-2 Final Determinations, Ofgem set out a requirement for licensees to provide the regulator with a financial resilience report if their issuer credit rating falls to BBB/Baa2 (or equivalent) and is on negative designation (or is downgraded directly to a lower rating without first being placed on negative watch).[37] There may be merit in adopting similar arrangements for the water sector, where a company with a credit rating that falls to or below a defined level should publish or provide us with a resilience plan. The expectation would be that companies would formally and openly engage with us in setting out their plans and the steps being taken to strengthen financial resilience.

[37] Ofgem, 'RIIO-2 Final determinations – Finance annex (revised)', December 2020, p87, section 6.

Finally, a requirement or expectation could be set to require additional board assurance statements to be provided in defined circumstances. This would place a requirement to confirm how the board has ensured it is comfortable that the company remains financially resilient when it approves a dividend or other distribution, where any credit rating is maintained that is below the level stated as the target for the notional capital structure in a company's business plan, or in a price review.

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.

3.3.2 Number of credit ratings held

The ring-fencing licence conditions currently require companies to maintain at least one investment grade issuer credit rating.

Credit rating agencies operate independently and adopt different methodological approaches. Therefore where companies maintain an investment grade credit rating with more than one credit rating agency, stakeholders benefit from the credit assessment and commentary of more than one independent party.

We referenced in section 2.3 that credit ratings have recently been withdrawn in some circumstances, and that where this is done without a transparent explanation, this can lead to questions about a company's financial resilience, particularly where the credit rating with the lowest rating assessment is withdrawn. One option to help address such concerns is to require companies to maintain two investment grade credit ratings that satisfy the licence definition.

In practice, the majority of companies (13 out of 15 companies that hold ratings) already maintain ratings with two or more credit rating agencies and so such a regulatory requirement presents little additional burden. We also understand that where companies retain a covenanted structure, their covenants tend to require two or more credit ratings to be maintained.

We acknowledge that the procurement of a credit rating involves some cost, however, it is possible this could be outweighed by the benefits gained from the additional insights from additional objective opinions.

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

3.3.3 Timely notification of credit rating changes

We expect companies to notify us of any changes to credit ratings, however, currently, this is not an explicit licence requirement and changes have not always been notified to us. Companies have an obligation under licence Condition P to notify us of changes that materially affect the ability of the company to carry out its regulated activities, but this may not capture all changes to credit ratings.

Given the importance of credit ratings as a signal of a company's financial resilience, the current expectation could be strengthened by making it a requirement for companies to notify us of any changes to credit ratings. This could include a requirement to notify us where there are (i) changes in issuer credit rating grades or outlooks; (ii) additional issuer credit ratings are obtained; or (iii) there are plans to withdraw an issuer credit rating that has been identified for the purposes monitoring compliance with licence provisions related to credit ratings, clearly setting out reasons for the withdrawal.

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).

3.3.4 Dispensations from the requirement to maintain a credit rating

Table 2 referenced that two companies currently carry a dispensation from the requirement to maintain an investment grade credit rating. Instead, an obligation applies that requires the Board of each company to annually certify that it would be able to obtain such a rating, together with the main factors supporting its opinion, including financial ratios and other relevant information. We have set out previously that we consider these arrangements to be exceptional and that their continued use warrants further consideration.[38]

[38] Ofwat, Consultation on strengthening the regulatory ring-fencing framework, November 2018, pp9-10; Conclusions on strengthening the regulatory ring-fencing framework, July 2019, pp12-13

However, an internally assessed or private credit rating opinion cannot carry the same weight in any assessment of credit quality as a public and dynamically updated one carried out externally by a rating agency.

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

3.3.5 Dividends

The existing dividend licence conditions were inserted across most company licences between 1996 and 2012, and require companies to declare or pay dividends in accordance with a policy that complies with the principles that (i) dividends declared or paid will not impair the ability of the Appointee to finance the appointed business and (ii) under a system of incentive regulation dividends would be expected to reward efficiency and the management of economic risk.

While these provisions remain important, there may be merit in aligning the licence text with more recent expectations, to clarify that dividends declared or paid should not impair the ability of the Appointed business to finance the business considering current and future investment needs and financial resilience over the long term, and clarify that dividends declared or paid take account of service delivery for customers and the environment, including levels of performance and other obligations.

We have already consulted on our expectations regarding the factors that it is reasonable to expect companies to take into account in their dividend policies for 2020-25 and when explaining the application of those policies. We have also updated the Regulatory Accounting Guidelines for company reporting in Annual Performance Reports to align with these expectations. The proposed licence revisions would therefore be consistent with the expectations, however, if as referenced in section 2.4, companies across the sector fail to meet our expectations, this is an issue we may wish to consider further.

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

3.4 Increased transparency

We have already taken steps to increase transparency of reporting in Annual Performance Reports and in the Monitoring Financial Resilience report. We are considering further how the financial resilience dashboard, first introduced in the 2021 Monitoring Financial Resilience report[39], could evolve to provide an improved assessment from the customer perspective. We have also engaged with companies to seek improved transparency around decisions made on dividend payments and disclosures around long term viability assessments. In this section we welcome views on whether there is a need for additional transparency, specifically on swaps, disclosure of liabilities at group level, pension obligations and financial resilience assessments in PR24 business plans.

3.4.1 Transparency on swaps

We have already sought to increase the level of transparency on derivatives, with revisions made in recent years to tables 4B and 4I in Annual Performance Reports. Table 4B provides a detailed summary of each company's borrowings, including relevant financial derivatives; and table 4I provides an analysis of the valuation of a company's financial derivatives, including the mark-to-market loss or gain. We understand that stakeholders have valued the improvements in transparency that we have made in this area.

Transparency could be further improved, for example, with an enhanced explanation of how companies are managing their derivative exposures where exposures exceed a defined mark-to-market valuation, of say, 5% of RCV. Disaggregated reporting of swaps, particularly where the restructuring of swaps leads to a future liability that is not captured in gearing (sometimes referred to as 'kick the can swaps', discussed in section 2.2) would also improve transparency, and will require further engagement with companies and other stakeholders to consider how our reporting requirements could evolve to ensure the desired improvement in transparency could be achieved.

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

3.4.2 Transparency on debt obligations of holding companies

Our duties extend only to the regulated company as the entity that holds the licence. Regulated companies are required to transact with associates and non-appointed businesses on an arm's length basis (as per licence conditions P and R and regulatory accounting guideline, RAG 5). However, a regulated company's financial resilience can be impacted negatively by its group structure: high levels of debt in holding companies, for example, can impact on the credit quality of the regulated company, particularly in circumstances where there is limited or no capacity among investors or in the holding companies to support the financial resilience needs of the regulated company. Moody's reference, for example, that a

[39] Ofwat, Monitoring financial resilience report 2020-21, p5 ('Key metric dashboard')

company's credit rating can be constrained because the 'regulatory ring-fencing provisions provide only limited insulation from the credit quality of its parent'.[40]

We already expect companies to be transparent about their group ownership structures, however there may be scope for companies to increase transparency about debt obligations at holding company levels in Annual Performance Reports, where interest is ultimately financed by dividends from the regulated company.

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.

3.4.3 Transparency on pension obligations

Defined benefit pension schemes introduce obligations on companies which, where material and in deficit, can introduce adverse impacts on a company's financial resilience. Defined benefit obligations impact on a company's balance sheet and deficit repair obligations impact on a company's cashflows.

Companies report on their pension scheme(s) in their statutory accounts on an accounting basis. Companies' pension cash commitments, however, are not driven by the outcome of financial reporting, they are driven by a separate actuarial valuation process (typically conducted every 3 years and in negotiation with pension trustees in line with relevant pension legislation and regulation). It is not unusual for the pension position reported in a company's balance sheet to differ from the pension position that is driving cash contributions, as liabilities are valued on different bases e.g. it is possible for a company to report a pension asset in its statutory accounts but be funding a deficit (see for example page 22 of our 2021 Monitoring Financial Resilience Report).

Consequently, without further detail being either provided or disclosed in companies' financial reporting, commitments made by companies to fund their pension schemes and the full extent of those obligations may not be apparent.

For a full understanding of the impact of pension deficit obligations on financial resilience, it is important to understand companies' cash commitments. Therefore, while we make clear that funding pension deficits remains the responsibility of companies and their shareholders and there is no intention for our established policy on the treatment of pensions deficit costs

[40] See, for example, Moody's confirms ratings of Northumbrian Water, outlook negative, 18 December 2020

to change,[41] there may be a case for companies to increase the transparency around their pension obligations and commitments.

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

3.4.4 Financial resilience assessments in PR24 business plans

At the PR19 price review we placed significant weight on the importance of companies being able to demonstrate how they would maintain financial resilience. We required companies to assess a common suite of downside scenarios as part of their assessment of financial resilience in business plans, and additionally, we encouraged companies to identify and model downside scenarios based on their specific circumstances. We reviewed these assessments as part of the PR19 process and commented on our assessment of each company's financial resilience in our PR19 final determinations.

A requirement for each company to provide assurance from its board setting out the steps it has taken to determine that it will remain resilient through 2025-30 and beyond is likely to remain an important component of the PR24 business plans. This could include a requirement for each company to demonstrate how it has assessed its financial resilience, the credit ratings targeted for the duration of the price control and the steps it will take to maintain financial resilience.

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

3.5 Regulatory incentives on capital structure and performance

The gearing outperformance sharing mechanism (GOSM) was introduced at PR19 to address the distorted incentives that exist for companies to adopt high levels of gearing.[42] Specifically, the GOSM was introduced to address a long-held concern that companies and their investors enjoy the benefits of financial structures where gearing levels are well in excess of the notional level without bearing the full risk of the structures. Meanwhile,

[41] As set out in IN13/17, Treatment of companies' pension deficit repair costs at the 2014 price review.
[42] We note that our policy approach to taxation for the purposes of price review determinations already addresses the incentive for companies to increase levels of indebtedness to benefit from a lower tax charge. Our regulatory approach is to set tax allowances by reference to actual capital structure where gearing levels exceed notional gearing and where a company increases gearing as a result of financial restructuring, we claw back the tax benefits for customers at the next price review. This removes the incentive for companies to increase gearing simply to benefit from a lower tax bill.

customers are exposed to the risk of poorer service and reduced investment through the impact of higher levels of gearing on financial resilience.[43] The mechanism was introduced to address these perverse incentives but was not intended to solve financial resilience issues overall.

The GOSM was not applied by the CMA panel in its recent redeterminations for Anglian, Northumbrian, Yorkshire and Bristol Water. The GOSM does however continue to apply to the 13 companies that did not appeal their PR19 determinations.

Professors Mason & Wright identify that a potential market failure associated with a regulated company's financial decisions is an externality that creates a gap between the social and private costs of financial distress. The fact that a gap exists between social and private levels of financial resilience is a reason why we should consider whether customers are sufficiently protected from risky financing choices, as referenced throughout this discussion paper.

In Appendix A2, we summarise the responses to our May 2021 consultation 'PR24 and beyond: Creating tomorrow, together', which included a question on how we should take forward incentives on companies to incentivise financial resilience in the price review process. We note that two respondents to our PR24 design consultation[44] (United Utilities and Severn Trent Water) suggested an alternative approach such that outcome delivery incentives could be defined for financial resilience, potentially allowing outperformance rewards to be earned by resilient companies. Such an approach raises questions about the acceptability to customers of a company earning such enhanced returns. However, it is possible we could make better use of reputational incentives, for example, in our annual reports or when assessing business plans to take account of an assessment of financial resilience.

At PR19 we encouraged companies to share outperformance with customers on a voluntary basis. A number of companies proposed arrangements that were referenced in our final determinations, including, for example the WaterShare+ scheme introduced by South West Water[45] and commitments made by United Utilities to its Community Share scheme. We continue to welcome the use of such voluntary sharing arrangements.

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.

[43] Ofwat, Reference of the PR19 final determinations: Risk and return–response to CMA provisional findings, October 2020.
[44] Ofwat, PR24 and beyond: Creating tomorrow, together, 27 May 2021 (see high level summary of responses in Appendix A2).
[45] South West Water, What's WaterShare+?

A1 Evolution of the ring-fence and its key provisions

Companies' licences contain certain conditions that are designed to protect the regulated business, to ensure each company has sufficient access to resources it needs to carry out its functions. The conditions constrain a company's conduct, ensuring its resources are not diverted and that it is not exposed to undue risk. These protections are collectively known as 'the regulatory ring-fence' and they help to limit the extent to which value can be extracted from companies ensuring that sufficient resources are available in all circumstances.

In 2020 we strengthened and aligned the ring-fencing licence conditions[46] of all companies[47] so that, to the extent reasonable, they are consistent across companies. We also adjusted the definition of Issuer Credit Rating to clarify which ratings will be used as regulatory markers for the purposes of triggering cash lock-up.

The key provisions of the regulatory ring-fence are summarised as:

- Operate as though the Appointed Business were substantially the Appointee's sole business and a public limited company separate from any other business carried out by the Appointee;
- Procure undertakings from its Ultimate Controllers committing them not to take any action which may cause the Appointee to breach its obligations under the licence or the WIA 1991. The Appointee must enforce the undertaking if Ofwat so directs;
- Inform us if the company becomes aware of arrangements which may lead to a change of control;
- Ensure it maintains at least one investment grade credit rating;
- Not to make any payments or transfers other than previously agreed financial and operational payments, if the credit rating falls low enough to trigger cash lock-up[48];
- Certify to us, annually, that it has sufficient financial resources and facilities, management resources and systems of planning and internal control to carry out the Regulated Activities for at least the following twelve months;
- Maintain at least one listed financial instrument unless Ofwat has agreed otherwise;
- Maintain a dividend policy which rewards efficiency and management of economic risk and does not impair the ability of the company to finance the Appointed business;
- Transact with associated companies on an arm's-length basis; and,
- Report any issues to Ofwat that could materially affect the Appointee's ability to carry out its Regulated Activities as soon as possible.

[46] Conclusions on section 13 of the WIA91 on proposed modification to ring-fencing provision, 14-Jul-2020
[47] Wessex Water did not agree to the licence modifications we sought in 2020 and retains some differences.
[48] Wessex Water's licence applies a lower threshold to use 'reasonable endeavours' to maintain an investment grade credit rating and does not contain the cash lock-up licence provisions.

The ring-fence also prohibits the following actions without the prior approval of Ofwat:

- Guaranteeing the liabilities of an Associated Company;
- Making a loan to an Associated Company;
- Entering into financial agreements that incorporate cross-default obligations; and
- Transferring to any Associated Company any right or asset other than financial resources that a special administrator would require if a special administration order were made.

A2 Financial resilience and PR24

Our May 2021 consultation 'PR24 and beyond: Creating tomorrow, together' we asked Q11.7: **"Do you have any suggestions for mechanisms which could incentivise financial resilience within the price control process?"**

Nine out of 17 companies said that there are enough mechanisms to ensure financial resilience.[49] In general, companies do not recognise there is a risk from poor financial resilience. We identified the following points in responses:

- **Narrow vs broad perspective on financial resilience**: Anglian Water, Southern Water, Thames Water, and Yorkshire Water disagreed in their responses with financial resilience being assessed exclusively through the capital structure. They suggest we could adopt a broader view by including operational risk, capital investment delivery risk and the stability of the regulatory environment. Yorkshire Water also suggests looking at historical financial performance and companies' strategies on resilience.
- **Future of the Gearing outperformance sharing mechanism (GOSM)**: United Utilities, South Staffs Water and Yorkshire Water welcomed the CMA's decision to remove the GOSM. They said there is a lack of evidence to prove its positive impact on financial resilience. However, South West Water's response supported the mechanism. United Utilities and Severn Trent Water suggested a positive incentive mechanism to reward companies with gearing close to the notional gearing level.
- **Whether to adopt a more tailored approach**: Northumbrian Water, Severn Trent Water and Yorkshire Water suggest we use a tailored approach for companies with high levels of gearing, to address their specific issues.

Emerging thinking

Narrow vs broad perspective on financial resilience

As we set out in this discussion paper, there is no single measure of financial resilience. While high levels of indebtedness can exacerbate the effects of a cost shock, there are many factors that are relevant to an assessment of financial resilience, including debt financing costs and the impact on cashflows of a company's service performance. Our Monitoring Financial Resilience (MFR) reports aim to illustrate the relative financial resilience positions of the water companies, and the dashboard included in our 2021 MFR report makes specific use of key metrics in recognition of the fact that an assessment of financial resilience must be broader than a focus exclusively through capital structure.

[49] Anglian Water Services, Bristol Water, Sutton and East Surrey Water, South East Water, South Staffs Water, Thames Water, Dŵr Cymru, Wessex Water, Yorkshire Water.

Gearing outperformance sharing mechanism

The gearing outperformance sharing mechanism (GOSM) was introduced at PR19 to address the distorted incentives that exist for companies to adopt high levels of gearing. Specifically, the GOSM was introduced to address a long-held concern that companies and their investors enjoy the benefits of financial structures where gearing levels are well in excess of the notional level without bearing the full risk of the structures. Meanwhile, customers are exposed to the risk of poorer service and reduced investment through the impact of higher levels of gearing on financial resilience. The mechanism was introduced to address these perverse incentives, and as referenced in this document, was not intended to solve financial resilience issues overall.

Professors Mason & Wright identify that a potential market failure associate with a regulated company's financial decisions is an externality that creates a gap between the social and private costs of financial distress. The strong likelihood that this gap exists supports the need to consider whether customers are sufficiently protected from risky financing choices, as referenced throughout this discussion paper.

We note suggested approaches referenced by United Utilities and Severn Trent Water in section 3.5 of this discussion paper. We note that these approaches raise particular questions about the acceptability to customers of a company earning enhanced returns on account of capital structure and question whether it is possible we could make better use of reputational incentives, for example, in our annual reports or when assessing business plans to take account of an assessment of financial resilience. 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.

A tailored approach

At the PR19 price review we placed significant weight on the importance of companies being able to demonstrate how they would maintain financial resilience. This included a common suite of downside scenarios that we expected companies to test as part of their assessment of financial resilience, and additionally, we encouraged companies to identify and model downside scenarios based on their specific circumstances.

We note that some of the options set out in this discussion paper, would ultimately result in an approach to financial resilience that is tailored to individual company circumstances, while acknowledging a need to ensure customers are protected in the event any company we regulate were to fall into financial distress.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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