Response to 'Financial Resilience in the Water Sector' Discussion Paper published by Ofwat on 7th December 2021

1. **Do you agree that it is not appropriate for providers of essential infrastructure to operate at, or be at risk of falling to, the lowest investment grade credit rating?**
   - We are aware that there has been a trend towards companies, and utilities in particular, moving public credit ratings from single or double A territory into triple B territory over the last ten years or more. In reference to the table on page 20 of the Ofwat's Financial Resilience discussion paper, we see that the triple B category dominates the volume of issuers, we believe this is partly the result of rating agencies' reaction to increased pressures on water companies' business models and partly a corporate decision by shareholders. Irrespective of historical rationale, it is now accepted that triple B category ratings are considered "solid investment grade" by the debt and equity capital markets. Being at the lowest end of triple B does not leave much margin for a business to absorb shocks in performance or other exogenous factors and it would not be GLIL Infrastructure's preferred strategy; we have encouraged Anglian Water to implement a reduction in leverage at the operating company level in order to ensure access to a competitive cost of debt and financial resilience. We believe the requirement for licence holder to maintain minimum investment grade rating has protected consumers from facing the risk of a business being unable to fund its capital expenditure requirements, we see no reason to impose additional restrictions on licence holders.

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?**
   - Given the answer to (1) above we believe it should be up to the Board and the shareholders to determine the most appropriate capital structure for the licenced entity. We believe that Ofwat has the tools in its existing mandate to provide a stimulus to companies to maintain conservative capital structures which would not result in a business operating at weak investment grade over a sustained period of time. Ultimately it is up to the shareholders to ensure that there is sufficient equity buffer in the business, or they will face a risk of material equity loss.

3. **What are your views on our option not to define limits on capital or financing structures at this time and whether it might be necessary to define limits for companies where financial resilience does not improve?**
   - We are supportive of the approach Ofwat has adopted to-date, which is to not define limits on capital or financing structures, and to allow water companies discretion over their financing and capital structure arrangements. We believe that the Boards of the water companies should remain responsible for ensuring they can fulfil their duties as licence holders. If Ofwat intervenes to set financial metrics or sets more restrictive measures then it may be assuming the responsibility of director duties, which seems a risky path for the regulator to adopt. The water sector debt and equity capital markets are mature and sophisticated, offering a high degree of pricing transparency; in this efficient capital market the capital structure and the credit ratings will reflect the wider company performance and operating decisions, as well as the financial structure itself. In our view, Ofwat should keep detailed capital structure decisions, and restrictions, within the remit of the company Boards rather than impose an incomplete set of financial metrics as a further buffer for financial resilience. We would be concerned about the potential for unintended consequences.

4. **What are your views on amending the existing trigger level for the cash lock-up conditions to a higher credit rating and the potential for the trigger to be linked to measures of service performance?**
   - We believe that Ofwat's current proposals for PR24 returns are depressing the implied credit rating for a notional company compared to prior reviews. At the same time the proposal to increase the credit rating threshold at which triggers should be applied, through either financial ratios or through public credit ratings, would remove decision-making flexibility from management teams, Boards and shareholders. In addition, introducing lock-up measures based upon annual service performance would introduce unnecessary volatility. The public listed water companies do not set their dividend policy on the basis of annual service performance levels, and it is not clear why this measure would improve their performance. The same is true for privately owned businesses. We believe service performance is already adequately measured through ODIs and performance commitments.

5. **What are your views on a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level?**
   - We consider this to be part of the ongoing responsibility of the Board and the companies' management teams. We believe that Ofwat has sufficient measures within its current mandate to ensure that companies are delivering the investment and service performance required. It is not clear what additional protections would be achieved by having further disclosure.

6. **What are your views on 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?**
   - This measure seems to duplicate director duties under the Companies Act. A director is on the board to act in the best interests of the company and not to represent the interests of particular stakeholder. Directors should not be authorising distributions unless they are confident the business will remain a going concern and, more importantly in a licenced entity, ensuring that the business can meet its current and future commitments. It is not clear why duplicating assurance for matters that directors should be reviewing is relevant and important for the economic regulator. On the point regarding a credit rating threshold for distributions which applies to a notional company, this appears to cut across the concept of notional versus actual gearing. If Ofwat is retaining the concept of setting returns based upon a notional capital structure then it should avoid linking measures related to returns, such as dividends and distributions, with actual observed capital structures.

7. **What are your views on a requirement for companies to maintain two investment grade issuer credit ratings?**
   - It appears only two companies in the sector would not meet this criterion. Equally, it is not clear whether Ofwat has substantial concerns about their ability to access capital to meet their obligations. While credit ratings can be a helpful metric to provide comparison across companies, they are not the only means of measuring creditworthiness. This appears to have limited benefit to customers.

8. **What are your 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)?**

- Given that public credit ratings are used for the benefit of credit investors generally, this information is in the public domain. It does not appear controversial that Ofwat should want to see when ratings and their outlooks may change. The question remains for how many agencies would this apply? Given that some companies use multiple credit rating agencies, some for accessing the global capital markets, would Ofwat require reporting from each one, or just from a shortlist of the larger rating agencies?

9. What are your views on removing dispensations from the requirement to maintain an investment grade credit rating?

- While companies are able to evidence their ability to access capital markets, we believe this should be of less concern to Ofwat.

10. What are your views on the need to align the licence to our broader expectations for dividend policy?

- In our view this matter cuts across director duties and the wider responsibility of the Board at the licenced entity. It is part of director duties to consider the current and future investment needs of the business, this requirement does not need restating. The concept that dividends should be linked to short-term performance measures is flawed when considering shareholder responsibility to consider a long-term financial structure within wider considerations; the management and the Board should be able to determine the timing of any distributions. For example, if a business retained earnings from prior years for prudence, or reflecting observed volatility or uncertainty in the capital markets, but then determined to pay out a portion of those earnings at a later date it would not be reasonable to restrict such payments based upon a current year. This may produce unintended consequences. It is not clear what problems this measure is intending to solve.

11. What are your views on enhancing the transparent reporting of the use of swaps and how this could be best achieved?

- This is a highly complex area. However, there are existing accounting principles on reporting the use of derivatives which hedge the liabilities of a company which may be borrowed in a different currency or between fixed and floating exposures. If Ofwat is concerned that companies may be creating financial liabilities that affect the financeability of the licenced entity then this remains an issue for the directors and, ultimately, for the shareholders to manage that risk, and to accept that risk. It is not clear what benefit may emerge for Ofwat or for customers in trying to review specialist financial instruments as an indicator of financial strength. The burden remains with the management, the Board and the shareholders, reflecting the capital structure holistically, to ensure the delivery of the required investment and performance.

12. What are your 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?

- It is not only holding company debt which creates financial obligations. Ofwat should recognise that public listed companies announce dividend targets and the shareholders consider those to be firm obligations. All investors expect well managed utilities to pay dividends to shareholders. As stated previously, it is the obligation of the directors of the licenced entity to ensure that it can fulfil its duties irrespective of the demands of another holding company or a shareholder. Ofwat has recognised that it does not regulate the holding companies. As a shareholder in Anglian Water Group, GLIL Infrastructure does not recognise the assertion from Ofwat that holding company debt impacts negatively on the licenced entity.

13. What are your views on the option to improve the transparency of pension deficit reporting?

- Given that Ofwat considers these the liability of the companies and their shareholders, it is not clear how additional disclosure will assist in understanding companies' positions. The mismatch between accounting and actuarial methods demonstrates that there is volatility in how these liabilities are measured, which will make additional disclosure potentially more confusing rather than more transparent.

14. What are your views on the expectation that PR24 business plans should include a board assured assessment of financial resilience?

- As with previous price reviews, it is expected that the Boards of water companies are asked to approve any submission for PR24, having scrutinised the plan. It is not clear how they can offer any assurance for a period beyond AMP8 (2025-2030) when Ofwat can change future determinations in such a way that may undermine financial resilience. We are not clear if what Ofwat is proposing is a substantial change from prior periodic reviews.

15. What are your views on how the incentives framework around capital structure should evolve at PR24 taking account of the other views set out in this paper and the scope to which companies should provide voluntary sharing arrangements at PR24?

- We consider the gearing outperformance sharing mechanism (GOSM) to be a flawed mechanism. It was rejected as an effective tool following the CMA's independent review. It is not clear why Ofwat continues to pursue this option when the benefits to customers are not clear. There is little evidence to suggest that there is risk to customers from companies maintaining levels of debt which are above the level assumed for a notional company.

16. Other views and comments

- N/A.