

Ofwat's discussion paper on financial resilience in the water sector

Hafren Dyfrdwy response

31 January 2022

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Our response

We welcome the opportunity to respond to your discussion paper on financial resilience.

At Hafren Dyfrdwy, we have a high level of financial resilience reflected in our low level of regulatory gearing and a responsible and limited use of financial derivatives. We are delivering improving operational performance for our customers and are the best performing water company on the DWI's water quality compliance risk index (CRI).

We agree that water companies should have the financial resilience needed to meet customers' needs at all times. While we support targeted interventions on companies where Ofwat has concerns about financial resilience, we consider broad-brush approaches affecting all companies can have unintended consequences.

In relation to Ofwat's specific proposals:

- We consider your proposal for companies to maintain **two investment grade issuer credit ratings** should not apply to Hafren Dyfrdwy. We consider it would be proportionate for us to have only one credit rating given the cost of obtaining a rating and our small size. We are currently in discussions with you about Hafren Dyfrdwy obtaining a credit rating.
- We disagree with the proposal to **link the cash lock-up condition to service performance** because service performance can be temporarily affected by external factors and it would be difficult to define appropriate performance thresholds. This is particularly the case for Hafren Dyfrdwy where just a couple of incidents can have an outsized impact on our comparative performance levels. Take internal sewer flooding for example. In 2020/21, we were identified as one of the worst performers in the sector on a normalised basis off the back of just 6 incidents. Had we had only 4 events that year, we'd have landed the 5th place, whereas just 2 events would have put us out in front of the sector – 30% ahead of the year's best performer.
- We disagree with **a reduction in the notional company gearing assumption** that Ofwat is exploring further in its discussion paper on risk and return. If Ofwat is concerned about highly geared companies, we suggest taking a targeted approach to those companies, rather than reducing the notional gearing assumption that affects all companies. We are aiming to keep our regulatory gearing around 60% for AMP7 as Severn Trent agreed with you when we were created.
- We disagree with the proposal to raise the credit rating at which the **cash lock-up condition** applies. However, we agree with Ofwat's proposal for companies to be required to submit **a financial resilience plan** to Ofwat when they are one notch above the minimum investment credit rating with a negative outlook. This is a proportionate way of monitoring companies' financial resilience. It would also neatly complement Ofwat's annual financial resilience monitoring report and the associated regulatory pressure on companies to be financially resilient.
- We agree with Ofwat's view that financial resilience is a wider concept than focusing on one specific metric, such as gearing. We therefore support the proposal **not to set pre-determined limits on capital structure**, which could reduce companies' flexibility in real time to address changing circumstances and efficiently finance investment programmes.
- We agree with the proposals for companies to notify Ofwat of changes to credit ratings, increased **transparency** on the use of swaps and increased transparency on pension obligations. This increased transparency will be helpful for investors.

We look forward to working with you constructively on financial resilience over the coming months.