Our Ref: [redacted]

Your Ref:

31 January 2022

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Dear Ofwat

Financial resilience in the water sector: a discussion paper

Thank you for the opportunity to respond to the above discussion paper issued in November 2021. We continue – both as a Board and Company – to take very seriously the maintenance of the financial resilience of the Company, and overall welcome many of the proposals in Ofwat's discussion paper to increase financial resilience across the sector for the benefit of customers. Our responses to Ofwat's questions are contained in the Appendix to this letter.

We also acknowledge Jonson Cox's letter to Jeremy Pelczer dated 28 January 2022, which references financial resilience matters, and to which Jeremy will reply in due course.

As Ofwat notes in the discussion paper, there is no single measure of financial resilience, and a holistic approach must be taken by Ofwat when assessing and reporting on an individual company's financial resilience. For example, external credit rating agencies' assessments provide insight into financial resilience from a debt holder's perspective, but they should not be viewed in isolation. In our Company's case, being on a Baa2 credit rating – even with a negative outlook – did not impact on our ability to deliver for customers or to maintain headroom under our debt covenants. Even with the proposed improvements to financial resilience as detailed in the discussion paper, the assessment of financial resilience in the round should be a key consideration going forward for Ofwat.

The proposed additional transparency proposed by Ofwat in this discussion paper is welcomed and we believe will aid a broader understanding of companies' financial resilience.

However, while we support the majority of Ofwat's views on this matter, we do not support the linkage in water companies' licences of dividends to in-year service performance. The latter could lead to a volatile dividend profile, would fail to consider the long-term performance of the company and would not be in the interests of investors. In addition, we would not be supportive of amending the existing trigger level for the cash lock-up conditions to a higher credit rating – and so support the current requirement that a cash lock would occur where the credit rating is sub-investment grade or is at the lowest investment grade with a negative designation.

We would be pleased to continue to discuss the above matters with your financial resilience team in the coming months.

Yours faithfully

Group Chief Financial Officer

Appendix

Q1. 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?

Response:

As noted in Ofwat's report, it is not sufficient to rely on the rating assigned by the credit agencies alone to protect customers. Credit rating status – and threat of a downgrade – cannot be looked at in isolation, and therefore stating that it is not appropriate for provider of essential infrastructure "to be at risk of falling to the lowest investment grade" is too simplistic. For example, as a Company that was placed on Baa2 negative by Moody's, this in no circumstance impacted our ability to operate or deliver our essential services for customers. In addition, even if we had been downgraded to Baa3, we would have still been able to operate effectively for our customers and – from a financial resilience standpoint – the level of borrowing under our bond covenants still provided us with significant headroom to deal with any financial shocks and market liquidity for raising funds remained strong. We would look to improve our credit rating where possible if at lower levels, but such rating levels – in isolation – do not indicate a lack of financial resilience.

Q2. 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?

Response:

Yes – we agree that a company should take actions to improve its credit rating before being downgraded to the lowest investment grade credit rating. However, this is good financial resilience and governance that companies should always perform in such circumstances. But again, as noted in the comment above, is it too simplistic to place too much emphasis on the correlation between credit ratings, operational performance and service delivery for our customers and overall financial resilience. Financial resilience can still be maintained at lower investment grade ratings.

In response to your request for views on the following items:

Q3. 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.

Response:

We agree with Ofwat's view not to define limits on capital or financing structure at this time – items such as fixing gearing caps do not take account of companies' changes in circumstances and capital investment requirements and would limit flexibility (potentially forcing immediate and unrequired actions). In that respect, we agree that financial resilience is a wider concept than focusing on one specific metric.

Q4. 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.

Response:
With respect to the above matters, we would strongly object to amending the existing trigger level for the cash lock-up conditions to a higher credit rating – and so support the current requirement that a cash lock would occur – with the use of Ofwat's consent – where a credit rate is sub-investment grade or is at the lowest investment grade with a negative designation. Changing this trigger to a higher credit grade places too much emphasis on a single measure of financial resilience. Similarly, we do not support linking 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. We consider Ofwat has tools already in place to improve service performance, in particular the outcome delivery incentive (ODI) framework.

A clear understanding by Ofwat of individual companies' relationships with their shareholders should also be considered where options exist that may impact potential distributions, such as the above cash lock-up triggers. Within SES Water, our shareholders continue to work very closely with the Board and management and continue to prove to be an investor focused on the long term. From a financial resilience perspective, this level of support has been demonstrated in the past, through our de-gearing exercise (where preference shares were also converted into ordinary shares) in 2018 and adherence to a dividend policy aligned to Ofwat's recent guidance. Altering of licence conditions has not been required in the past for us to ensure our shareholders' continued support, and we would not support any future amendments as proposed in Q4. or Q10. of this response.

Q5. A requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.

Response:
We support companies being required to submit a financial resilience plan to Ofwat when they are one notch above the minimum investment credit rating with a negative outlook as a proportionate way of monitoring companies' financial resilience.

Q6. 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.

Response:
We agree with providing this additional level of assurance where minimum actual credit ratings have been reached – and that this should be incorporated into the additional dividend disclosure that Ofwat have also recommended as part of its recent Monitoring Financial Resilience (MFR) report.

Q7. A requirement for companies to maintain two investment grade issuer credit ratings.

Response:
While we do not strongly object to further external data points to assess financial resilience, such as further credit ratings if there is clear justification for such additional requirements, as a smaller company in the sector we would be concerned with the additional cost such additional requirements may incur.

Q8. 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).

Response:
We support the requirement for companies to formally notify Ofwat of changes to credit ratings, including changes in rating and outlook. However, companies should still be allowed the ability to state whether they believe this change materially effects their ability to deliver its regulated activities.

Q9. Removing dispensations from the requirement to maintain an investment grade credit rating.

Response:
We agree with view that all companies should hold at least one external credit rating.

Q10. The need to align the licence to our broader expectations for dividend policy.

Response:
We agree that the alignment of the licence text to clarify that "dividends declared or paid should not impact the ability of the appointed business to finance the business considering current and future investment needs and financial resilience over the long term". This makes explicit what we do as a Company and is a key component of our dividend discussions with the Board and our long-term viability statement. With respect to the potential licence text amendment to clarify that "dividends declared or paid take account of service delivery for customer and the environment, including levels of performance and other obligations" we would not support a short-term linkage in the licence of dividends to in-year service performance. The latter could lead to a volatile dividend profile, would fail to take into account the long-term performance of the company (which should be the basis of stable dividend payments) and would likely not be in the interests of investors. Ultimately it should be for boards to decide on the level and timing of dividend payments.

Q11. Enhancing the transparent reporting of the use of swaps and how this could be best achieved.

Response:
While we do not currently utilise swaps or other similar financial instruments in our Company, in line with good governance and transparent financial reporting, we support further transparency of such matters, such as being clear on exposure on mark-to-market positions.

Q12. 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.

Response:
We do not object to increasing the transparency of debt obligations at the holding company levels in the Annual Performance Report – we already have increased the level of transparency of our Group structure, although we do note that this is technically outside of Ofwat's remit of the regulated business – it is the regulatory ring-fenced business that is prime importance, not necessarily debt issued at higher group entities.

Q13. The option to improve the transparency of pension deficit reporting.

Response:
We support – where required – additional disclosure with respect to pension deficit reporting, given the relationship with a company's cash commitments.

Q14. The expectation that PR24 business plans should include a board assured assessment of financial resilience.

Response:
We agree that it should be a key requirement for each company to provide assurance from its board setting out the steps it has taken to determine that it will remain resilience for the AMP period and beyond into the long-term viability statement period.

Q15. 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

Response:
We would not support an expansion of the incentives framework around capital structure further at present and care will be required within PR24 to ensure that flexibility is maintained for smaller companies such as ourselves to allow capital structures that suit our particular requirements.