south east water

Financial resilience in the water sector: a discussion paper

South East Water response

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Contents

1. Key messages on financial resilience & risk and return discussion papers

We welcome the opportunity to respond to Ofwat's recent discussion papers, *PR24 and beyond: discussion paper on risk and return* and *Financial resilience in the water sector: a discussion paper*.

Our response is structured as follows:

- Section 1 covers our overarching messages in relation to both the financial resilience & risk and return discussion papers, given the interdependencies between (1) financial resilience of the sector; and (2) the balance of risk and return
- Section 2 sets out an executive summary to our response to the financial resilience discussion paper
- Section 3 summarises our analysis of and commentary on Ofwat's proposed resilience mechanisms
- Section 4 provides more detailed commentary on the questions and proposed mechanisms set out in Ofwat's financial resilience discussion paper

We support Ofwat's focus on the long term financial resilience of the sector as well as customer service levels. However, it is not clear to SEW as to what financial resilience issue Ofwat is seeking to address in the discussion paper. Ofwat interprets the Southern Water case study cited in the discussion paper as an example of weak financial resilience driving a deterioration in customer service level. However, we consider that: (1) existing protections for customers appear to have worked well; and (2) the example is a clear case study in poor operational performance, but there is no evidence that this poor performance was caused by weak financial resilience or that is should have wider implications for other companies.

As a result, Ofwat's proposals for new regulation and changes to company licences in relation to financial resilience seek to address a problem that has not been defined or evidenced – and these changes could result in sub optimal capital structures, perverse incentives, additional costs for customers and the sector becoming less attractive to investors. We consider that this is not in the interests of customers or in accordance with Ofwat's statutory duties, particularly given the need for the sector to invest and strengthen operational resilience to factors such as climate change, population growth and additional environmental pressures.

Ofwat's definition of and approach to financial resilience does not appear to be supported by careful analysis of company risk exposure or protections implied by existing regulatory mechanisms, licence requirements and corporate structures. For example, Ofwat's proposal to increase the credit rating threshold for cash lock up to Baa2/BBB negative outlook – absent analysis of whether the current lock up threshold at the minimum investment grade rating is sufficient to protect customers – is unproven.

We are disappointed that Ofwat's focus on financial resilience has not been translated into its proposals for risk and return at PR24, which imply reductions in returns (unsupported by market evidence) and financial flexibility available to manage risk. The balance of risk and return underpins financial resilience but the implications of Ofwat's proposals for the resilience of the sector do not appear to have been explored even though they are key to protecting customers long term interests. We strongly recommend that Ofwat combines its assessment of the issues raised in both of these papers to avoid changes in regulation driving increased risk, undermining the resilience of the sector and creating a problem that did not exist prior to these unsupported proposals.

The overall calibration of risk and return and other regulatory interventions in themselves have a direct impact on the financial resilience of the water sector. However, neither discussion paper considers changes in these areas to *improve* financial resilience. There is a clear juxtaposition between Ofwat’s focus on water company financial resilience and the proposed unjustified methodological changes to cost of equity which, all else equal, will reduce returns, projected equity buffer available to manage risk and the financial resilience of the sector. In turn, this reduction discourages asset investment which is not in the interest of customers or in accordance with Ofwat's statutory duties.

Further, we consider that Ofwat should not use sector-wide mechanisms, such as a one-size-fits-all cost of capital, for a diverse group of companies. Specifically, mechanisms which create random “winners and losers” on debt financing costs. These approaches undoubtedly put a number of companies under more financial stress than others. We view this as a material consideration, which is not covered by Ofwat, when assessing financial resilience.

Financeability

Ofwat has proposed changes to the financeability test that are not in the long term interests of customers. For example, the notional gearing should be set based on the average gearing of the sector of around 70 per cent, reflecting the market level[1]*. Financeability constraints should not be artificially "resolved" by reducing gearing below the market level. This would result in inconsistencies, with companies unable to both (i) optimise gearing/financing costs at the efficient level of above 60 per cent, and (ii) achieve financeability which would require de-gearing at below 60 per cent. These changes to the notional company undermine the importance of the Ofwat's financeability duty as a cross check on allowed returns.*

The financial resilience and risk/return balance is of significant importance in the sector. This is especially true of the risks a company like South East Water faces as a business. SEW is a small water only company located in one of the most water stressed area in the UK with a network close to capacity. We face challenges arising from the imbalance of totex allowances and ODIs between the water service and wastewater service, with the industry overspending on water service totex and incurring net ODI penalties in 2015-2020, compared to the opposite performance on the wastewater service. We also have additional financing costs due to less frequent debt issuance, access to fewer sources of finance and higher cost of carry. In particular, SEW has significant investment requirements in the future due to climate change and being located in a water stressed area. These investment requirements were not considered fully by Ofwat in PR19, which resulted in an under-estimate of totex funding required for enhancements.

It is imperative that the risks associated with the efficient running of our business are properly priced to ensure financial resilience in the short and long term.

Gearing Outperformance Sharing Mechanism

We are pleased that Ofwat acknowledges a number of the reasons why the Competition and Market Authority’s (CMA) March 2021 PR19 redeterminations did not include the Gearing Outperformance Sharing Mechanism (GOSM). As we stated, at the time this mechanism is fundamentally flawed and not in the customers’ interest. After careful consideration, the CMA decided in principle that the mechanism’s design is not supported by finance theory or practice. As a result, it would not be appropriate to include a reduction in AMP8 revenue due to the AMP7 GOSM at PR24.

[1] Based on 2021 APRs the average level was c.70.2%.

2. Executive summary – financial resilience discussion paper

We have reviewed and carefully considered the range of new mechanisms proposed in Ofwat's *Financial Resilience in the water sector: a discussion paper*. While a number of Ofwat's proposals on transparency and reporting could give Ofwat more clarity on the sectors financial resilience, Ofwat has provided no evidence that there is a financial resilience problem in the sector to justify the more substantive proposals for new regulation or changes to company licences.

Ofwat sets out a series of proposed new regulatory mechanisms and changes to licence conditions whilst not clearly articulating the problem it is trying to solve. While Ofwat is right to highlight customer service levels and financial resilience of the sector as two important issues as we approach PR24, it does not provide evidence to support its assumption that weak financial resilience would lead to a deterioration in customer service levels.

- First, Southern Water represents one example; there are other companies with high gearing but good service performance, suggesting there may not be general correlation between financial resilience and operational performance.

- Second, it is not clear in the Southern case whether weak financial resilience had any impact on customer service levels. There could be other variables which could lead to poor service performance and weak financial resilience (through making a company less profitable). In this case, regulating gearing and/or credit ratings would not improve customer service performance since the underlying cause is unrelated to financial resilience. Similarly, it could be the reverse sequencing and poor service performance might lead to fines and penalties, which in turn exerts pressure on financial resilience.

It is clear to us that more evidence is required to support the assumptions made by Ofwat in advance of introducing new regulation on financial resilience to support customer service levels. Specifically, more evidence is required relating to: (1) any relationship between customer service levels observed in the sector and financial resilience; and (2) the direction of this relationship, to show if financial resilience issues cause a deterioration in customer service levels, rather than the other way round.

Ofwat has not demonstrated that a company with lower gearing or stronger financial resilience would have avoided the operational issues and issues related to customer service levels highlighted in the Southern Water case study. The discussion paper implies causality without providing robust evidence.

Indeed, it is possible that a company which has lower financial resilience may wish to manage its performance to an even greater extent to avoid any additional penalties, or to gain rewards to help ease the resilience challenge. As a result, Ofwat's proposed solutions come across as *"solutions in search of a problem".*

There may be some valid reasons as to why Ofwat might need to monitor financial resilience over and above monitoring customer service levels, but these are unclear to us at this stage. Ofwat should provide clear rationale for new regulation of financial resilience and explain how the suite of existing regulatory mechanisms including the following mechanisms do not address this risk currently:

- **Ex ante mechanisms**: Such as totex sharing, caps and collars on ODIs and cost of new debt indexation, which are included within price control and are applied automatically to reduce the risk exposure companies face on individual elements of the regulatory building blocks. These targeted mechanisms are complemented by Ofwat's financeability duty and the regulatory reset every five years.

- **Intra price control reporting**: Where water companies are required to report financial and operational information to Ofwat each year in addition to the publication of the annual report. This reporting provides Ofwat with visibility of company performance throughout the price control.

- **Mechanisms applied under material changes in circumstances**: These mechanisms provide additional protections in the event of severe downside shocks, are independent of price reviews and can be triggered at any point in time. These mechanisms include cash lock up at Baa3 (negative outlook) as well as special administration.

There are also a series of additional mechanisms which we have not had to use to date. These include the Interim Determination of K (IDoK)[2], the shipwreck clause and the special administration regime. These additional protections are there to ensure any decline in financial resilience would not result in a detriment to customers.
A number of the substantive resilience proposals do not meet Ofwat's legal duties applicable to the introduction of new regulation or licence condition modifications and appear likely to result in additional costs to customers or provide the wrong incentives. In particular we are concerned about the following:

- **Incentive mechanism for financial resilience –** such a mechanism could closely mirror the GOSM and would suffer from its flaws including worsening the financial resilience of companies with higher gearing.

- **Cash lock up linked to higher credit rating** – this mechanism could have unintended consequences and achieve the opposite of Ofwat's stated objectives. In particular, the proposed changes to cash lock up thresholds could incentivise under-investment in service levels at an earlier stage *before* a company enters into financial distress to avoid cash lock up, with no corresponding benefit. Companies would be incentivised to retain greater cash in the business to maintain credit metrics, cutting costs and expenditure which would impact customer service

- **Licence conditions for link between dividends and customer service delivery for customers and the environment** – a direct link would ignore the multiple factors which drive dividend profiles including smoothing dividend profiles over time, timing mismatches between performance and cashflows, investment requirements and macroeconomic conditions, and could deter equity investment at this critical time for the sector

- **Reporting of HoldCo financing arrangements –** again, it is unclear what issue Ofwat is aiming to solve as HoldCo financing is not relevant to customers (who are protected by the regulatory ringfence). It is not clear on what legal basis Ofwat believes it is entitled to create new regulatory obligations that extend beyond the activities of the regulated company.

[2] Excluding in period ODIs.

3. Key evidence and arguments – financial resilience discussion paper

3.1 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?

Ofwat has highlighted that it is inappropriate for providers of essential infrastructure to provide poor customer service, which we support. Regulation should focus on that problem – not on credit ratings which are unrelated.

We are pleased that Ofwat is considering credit ratings to assess financial resilience as they represent a more robust basis for the assessment of financial resilience than just gearing. However, a credit rating does not represent a sufficient measure in isolation and currently there is no evidence for a deterioration in ratings on average across the sector.

Our financing structure has allowed us to finance substantive investment over AMP6 and AMP7 to date and maintain a stable investment grade credit rating, despite downward ratings pressure for the sector caused by Ofwat's decisions following the PR19 determination and a challenging operating environment due to external factors such as Covid-19.

We provide regular reporting in our annual reports and the Annual Performance Reports (APRs) which summarise our financial position, operational performance, and include a forward-looking assessment of risk in the Long Term Viability Statement (LTVS) and Board assurance (for example on the financeability of business plans). This provides transparency to Ofwat on our financial resilience and confidence that we closely monitor and manage our financial position.

Importantly, our financing structure is only one input into our company's, and the sector's, financial resilience over the long term. Additionally, financial resilience is contingent on appropriate calibration of the regulatory framework – Ofwat has primary duties to ensure that companies are able to finance their functions (in particular through securing reasonable returns on their capital and robust financeability tests) and to secure long-term resilience. As a result, Ofwat has its own responsibility to ensure that the regulatory regime is well calibrated to support financial resilience.

We are concerned that Ofwat's analysis of resilience is focussed on the corporate structures and financing but (1) does not consider the role of calibrating risk and return in supporting financial resilience, and (2) is being implemented in parallel with changes to financeability testing which will weaken financial resilience analysis as a cross check at PR24. Ofwat's proposals therefore risk creating contradictory results that would not be consistent with the responsibilities implied by Ofwat's finance duty.

In particular, penalising companies for a downgrade of credit rating will encourage short-term actions to avoid being downgraded, e.g. under-investment. This could act against the interests of customers as it increases companies' focus on their credit rating, potentially to the detriment of customer service.

The "obligation" to maintain a certain credit rating is similar to the obligation to pay out interest. Companies would be incentivised to maintain financial ratios that allow them to maintain a credit rating higher than the cash lock up threshold set. This could in turn – where there is pressure on projected metrics – incentivise companies to avoid downgrade which could be achieved through reduction or deferral of investment, adopt sub optimal, short term solutions or use of synthetic financial instruments to accelerate cashflows. Such an obligation would be likely to have unintended consequences and risks distracting management, against the long term interests of customers.

There is already a mechanism in place whereby if a company falls to Baa3/BBB- (negative outlook) there will be a cash lock up. No evidence has been provided to show that this mechanism is insufficient or needs to be enhanced to improve customer protection. Accordingly, the case for new regulation in this respect has not been made.

3.2 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 consider that setting a threshold above the current minimum investment grade is counter-productive as it means that a company could take action to maintain a rating through reducing investment which adversely impacts customer service levels.

We believe the sector is already incentivised to maintain credit ratings to support the efficiency of debt issuance, manage existing covenants and avoid cash lock ups set out in licences. As a result

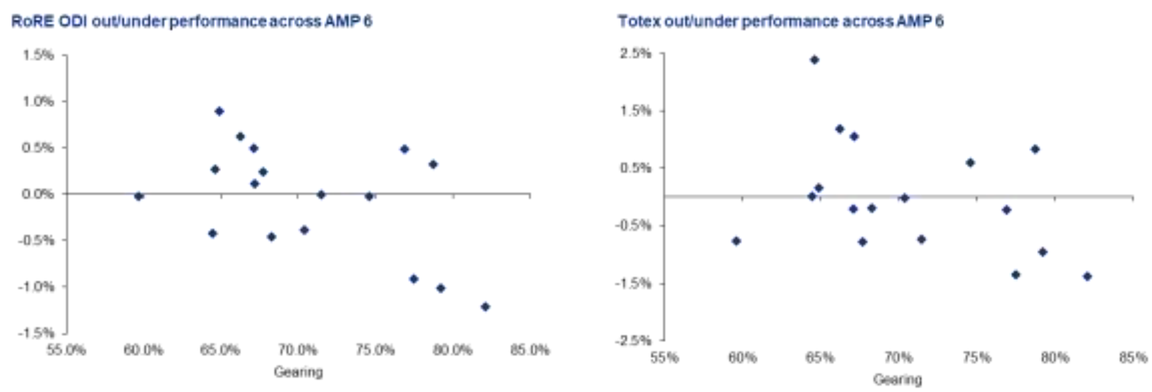
additional regulation is not required.
We agree with Ofwat on the importance of companies taking appropriate actions to ensure an investment grade rating is maintained. In this context, we have always maintained two credit ratings and maintained headroom to minimum investment grade. Subject to this, it is unnecessary and likely to be counterproductive for Ofwat to seek to impose more intrusive and inflexible regulation relating to credit ratings.

There have been no observed water company failures over the last fifteen years (despite a global financial crisis and a worldwide pandemic, as recently recognised by the CMA). This is evidence that appropriate actions are being taken prior to companies falling sub investment grade and there is no obvious market failure which necessitates additional regulatory intervention.
Instead, we consider Ofwat should focus on maintenance of customer service levels *irrespective of* the credit rating and that additional cash locks ups or licence conditions could *deter* companies from prioritising investment in customer service levels at an early stage.
Imposing a tighter credit rating is contrary to established regulatory practice that gearing is an issue for companies to manage, aside from the requirement to maintain an investment grade credit rating. If the requirement is set above the current level, companies must be compensated for any costs from the implied change to capital structure

3.3 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.

We agree that limits should not be imposed on capital or financing structures, and to do so would result in limited financial flexibility. A cap on gearing would also result in a mechanism predicated on a narrow definition of financial resilience and could over- or under-state whether there is a resilience problem.
We have performed analysis of the observed relationship between gearing levels in the sector and performance on ODIs and totex. This analysis, shown in
Figure 1, does not indicate a correlation between gearing and performance levels, with both relatively high and low geared companies out- and under-performing on these key measures of investment and customer service levels.

Figure 1: Gearing and performance measures



Source: APRs

This is reflected in the Mason and Wright report, which states that "*there is still relatively little data on which to base an assessment of whether there is a robust relationship between measures of financial resilience and operational performance*".[3]
As there is no evidence of a relationship between gearing and customer service levels, any new regulatory mechanism in this area would not be justified. Furthermore, new regulation would need to be supported by a robust impact assessment. The assessment should evaluate if the mechanism promotes economically efficient market outcomes and remedies potential distortions in the long term interests of customers.
A mechanism that limits gearing could in practice become inflexible and presents the risk that

[3] Mason and Wright (2021), A report on gearing, price controls and financial resilience, para 4.17

companies become unable to provide sufficient liquidity to manage downside risk or to finance new investment due to reaching the cap.
In summary, we agree with Ofwat's position to not introduce a cap on gearing.

3.4 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.

There is no rationale or clear evidence to support amending the cash lock up conditions to a higher credit rating. This could result in reduced equity investment in the sector which is required for ongoing investment in the network to maintain customer service levels.

We were surprised to see proposals to make further changes to our licence conditions in the financial resilience discussion paper. Our operating company, SEW Ltd, sits within the regulatory ringfence which already includes mechanisms and arrangements to maintain financial resilience and protect customers.

These arrangements, alongside our corporate governance arrangements and Whole Business Securitisation (WBS), ensure we have strong mechanisms in place to protect customers and support financial resilience of the regulated business.

Our OpCo Board, whose single largest group is independent directors, approves each dividend payment having regard to all stakeholders' interests, including customers. No dividends would be paid from SEW Ltd should the operating company be under financial distress. Ofwat has signalled that further information on the debt at the holding company level might inform its analysis of the financial resilience of the regulated business. However, this debt sits outside the regulatory ringfence and is not relevant to Ofwat's analysis of financial resilience of the regulated company. The consideration of holding company debt is not consistent with Ofwat's statutory function to regulate activities within the regulatory ring fence, and would also depart from regulatory practice applied in other sectors and by the CMA.

As agencies look at more than just gearing, we welcome Ofwat's expansion and consideration from gearing to include credit ratings. The obligation to maintain a certain credit rating is similar to the obligation to pay out interest. Companies would be incentivised to maintain financial ratios that allow them to maintain a credit rating higher than the cash lock up threshold set. This could in turn – where there is pressure on projected metrics – incentivise companies to avoid downgrade which could be achieved through reduction or deferral of investment, reduce customer service levels, adopt sub optimal, short term solutions or use of synthetic financial instruments to accelerate cashflows. This mechanism could have unintended consequences and side effects which are not in the customer interest.

In any event our actual dividend yield (2.1% in 2020/21) is currently *lower* than the notional level set by Ofwat at PR19. This dividend yield illustrates that we set our dividends based on a range of factors.

The proposal to link operational performance and dividends paid implies that dividends typically have a direct, negative impact on investment in customer service levels – but this is not the case. As a result, the restriction of dividend payments water companies make could deter equity investment in the sector which is needed to deliver capital programmes and improve customer service levels. Dividend decisions take into account multiple factors, not limited to, but including:

- financing policy;
- scale of investment;
- totex performance and efficiency;
- macroeconomic variables; and
- customer service levels.

We already have a range of incentives which ensure that we maintain headroom against a minimum investment grade credit rating. These incentives include, a lower cost of debt associated with a higher credit rating, our debt covenants and the existing license conditions, which include a cash lock-up mechanism should certain financial ratios be breached.

Cash lock-up at a higher credit rating would require compensation for the change in capital structure, in particular for water only companies that cannot easily change their capital structure over a short timeframe given the long-dated debt they hold. Achieving a higher credit rating will in all likelihood mean that the Board will direct funds towards achieving the rating outcome rather than towards the investment plan.

Credit ratings are not comparable across the industry. For example, SEW has a BBB credit rating with S&P whereas many of its peers have a BBB+ credit rating. This is because SEW only has one class of debt in its OpCo and S&P choose to apply the credit rating in line with the class B debt of its peers. Ofwat applies the credit rating to the majority of OpCo debt when assessing the credit rating. As a result SEW could be disadvantaged due to its debt structure, not its underlying credit quality. *Ofwat does not evidence how an increase in rating requirement to BBB improves financial resilience or customer service levels. Rating agencies also react to any changes in regulation introduced by Ofwat therefore any stricter requirements in terms of gearing or rating or weakening of financeability testing are likely to have a negative impact on the sector outlook as a whole. For example Moody's downgraded the sector following PR19 methodology, noting credit rating "…downward pressure could result from a significant increase in business risk for the sector as a result of legal and/or regulatory changes leading to a reduction in the stability and predictability of regulatory earnings, or the company facing unforeseen funding difficulties."*[4]

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

We are not opposed *per se* to the publication of resilience plans but require further information from Ofwat to understand what might be included within the plans and the *"defined level"* at which the plans will be required.

Where companies are maintaining customer service levels *and* have an investment grade credit rating above the minimum investment grade, we are not clear that a focus on financial resilience by Ofwat would be in the interest of customers.

As detailed above, regulatory focus on financial resilience could be counter-productive where it incentivises companies to under-invest in service levels or reprofile cashflows over time.

As a result, any regulatory obligations for resilience plans should be proportionate and not overly onerous.

An alternative, where a companies disclose covenant breaches to Ofwat, provides an explanation of the breach and an outline of appropriate remedial action, might be more appropriate than the publication of a resilience plan.

3.6 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.

Our Board reviews and assesses the impact for financial resilience of any proposed dividend prior to payment and provides annual LTVS and Going Concern statements. It is not clear what benefit additional reporting or assurance would provide to customers.
The largest group of directors on our Board is independent directors, in line with Ofwat's requirements. We consider that Ofwat should attach weight to these existing corporate governance arrangements and the independent oversight these arrangements imply, rather than introducing additional regulation and oversight.

Our dividends are set and paid at a level that is consistent with the company to maintain its long term financial resilience in the interest of shareholders, customers, employees and other stakeholders and subject to the company (i) having adequate resources to meet its financial obligations and (ii) being able to comply with its obligations under the Companies Act 2006 relating to the declaration and payment of dividends. All dividends paid by SEW Ltd are approved by the OpCo Board and the independent directors make up the largest group on the Board.

[4] Moody's Investor Service (2020), South East Water (Finance) Limited Credit Opinion, page 2

In relation to the requirement for Board statements or assurance where ratings are below the target rating for the notional capital structure:

- The notional capital structure needs to represent a robust, predictable and stable structure which is supported by market evidence and corresponds to water company financing. We are concerned that this is not the case as the changes are not proven and move notional company away from market evidence. We set out additional detail in our response to the risk and return discussion paper.
- As recently as PR19 Ofwat included both BBB+/Baa1 and BBB/Baa2 target ratings when setting the price control.

We are not clear what the rationale is for the Board to provide assurance in relation to the target credit rating. Target credit ratings are not correlated with customer service levels, and there is no evidence of a causal relationship between these two factors. As noted in response to question 3.3, Ofwat's advisers Mason & Wright note that there is limited evidence in either direction of a relationship between measures of financial resilience and operational performance.
During our annual reporting process we provide an LTVS and Going Concern statement to demonstrate our financial resilience and ability to maintain an investment grade credit rating, even under downside scenarios.
It is unclear that additional assurance or Board statements will further protect customers interests.

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

We hold credit ratings above investment grade from Moody's and S&P and welcome the challenge to our financial position that two different independent rating assessments brings. However, we note there is no evidence provided by Ofwat to suggest that two credit ratings *improve* financial resilience.
We are already incentivised to hold an investment grade credit rating, and headroom to the minimum investment grade, as maintaining a robust credit rating supports our efficient cost of debt and access to a wide pool of investors and capital markets. This incentive exists independently of Ofwat's requirement to hold an investment grade credit rating – no evidence has been provided to demonstrate that any additional regulatory requirements in this respect would improve financial resilience.

3.8 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).

Our rating reports and any changes to our credit ratings are publicly available. We are happy to notify Ofwat of these changes.
Our rating assessments are available publicly and formalising reporting to Ofwat could support more robust and timely regulatory monitoring.

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

We meet this requirement and hold credit ratings above investment grade based on both Moody's and S&P rating methodologies.
Overall we support the requirement to remove any dispensation from the requirement to maintain an investment grade credit rating.

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

We oppose Ofwat's proposal to modify our licence to include additional financial resilience mechanisms. Equity investment is critical to meet our capital investment requirements and this proposal could act as a deterrent for equity investment which would not be in customers' interests.

Our dividend policy recognises the responsibilities we have as a water company and when selecting the level of dividend, the Board ensures the company will have adequate resources to finance the appointed business. Our dividend policy also takes into account the need for future investment, the environment and performance for customers.[5]

However, there is no evidence that it is necessary or proportionate to translate this dividend policy or Ofwat's dividend expectations to a licence modification. The overarching objective of our dividend policy is *"that dividends should provide a* ***suitable return to shareholders for their investment in the Company*** *whilst ensuring that the Company is* ***able to finance its functions*** *and* ***meet its obligations*** *as a water undertaker without impairing its long-term financial resilience."*[6]

We set dividends taking all of these factors into account 'in the round'. It should be noted that our dividend yield (2.1% in 2020/21) is below the notional benchmark yield Ofwat applied at PR19. There is no basis to assume that new regulation of dividend policy – for example to explicitly link it to customer service levels and the environment – would positively impact on investment or customer service. Accordingly, we do not believe that Ofwat has provided sufficient evidence that new licence obligations regulating dividend policy would be in accordance with Ofwat's statutory duties.

Instead, Ofwat should focus on clearly defining the problem it is seeking to address and regulating this at source. Our understanding of Ofwat's consultation is that it is primarily seeking to improve customer service levels, which should be addressed through calibration of totex allowances and the existing outcome delivery framework. These measures are capable of being directly targeted at improving customer service without any wider adverse consequences for companies or consumers.

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

We consider transparent reporting on swaps could be beneficial and (1) support clear understanding of risks implied by swaps (2) allow swaps to be better captured in calibration of Ofwat's balance sheet approach for setting cost of debt allowances.

Swaps are a standard part of financing structures in the sector and it is important Ofwat has sufficient information to understand and evaluate these instruments, both when assessing financial resilience and when setting the cost of debt allowance. Relatedly, swaps are included in rating agency assessments. Providing additional information on swaps could allow Ofwat to perform a more accurate assessment of financial resilience in line with market practitioners.

We would welcome engagement with Ofwat to develop a methodology for assessing whether individual swaps warrant inclusion in the sector average cost of debt that will not result in undue regulatory burden.

3.12 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.

The level of holding company debt in our group structure is not relevant to Ofwat's assessment of financial resilience of the licensed company. The inclusion of additional reporting of holding company financing and how equity investment in the sector is financed represents an attempted extension of Ofwat's role beyond the activities of the regulated business without any legal authority.

We are concerned with Ofwat's proposals to extend reporting requirements to group companies outside the regulatory ringfence. This assumes that the existing regulatory framework protections are not effective – but there is no evidence to support this.

The Water Industry Act confers powers and duties on Ofwat relating to the regulation of water undertakers who are granted an Instrument of Appointment pursuant to the Act. Ofwat's powers and duties are in respect of that regulated business and do not extend to the regulation of activities of other companies in a corporate group that are not subject to the Instrument of

[5] SEW (2020), Dividend policy, page 2
[6] SEW (2020), Dividend policy, page 1

Appointment. These proposals appear to seek to extend Ofwat's regulatory role beyond those provided for in the Water Industry Act without any clear legal basis to do so.

The existing ringfencing arrangements provided for in the licences of regulated companies make provision for extensive existing protections – they require companies to conduct business as if the regulated business were the sole endeavour and operate as a separate entity, have adequate financial, facilities and management resources and confirm it every 12 months, ensure that the dividend policy does not affect the company's financeability, maintain an investment grade credit rating, and not to allow for cross-defaults by increasing or accelerating financial liabilities because of default of another related entity. In addition, companies are subject to cash lock-up licence conditions, which prevent the transfer of funds outside of the regulated business. Ofwat as part of its regulatory ringfence consultation notes, "*regulated company maintains sufficient financial, management and other resources to enable it to carry out its water and sewerage services in a sustainable manner, and it protects the regulated company from the activities of other entities such as other group companies.*"[7] If the regulatory ringfence provides protections from other group companies we do not consider, and Ofwat has not explained why, it should be necessary to include additional reporting relating to the group companies.

In addition our WBS provides additional protections over and above the regulatory ringfence arrangements. Furthermore, our WBS conditions are in several instances *stronger* than the ones imposed by ringfencing mechanisms, e.g. requirements to avoid debt maturity concentrations. It is not clear how Ofwat has taken these protections into account.

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

We are happy to improve the transparency of reporting we provide relating to our pension deficit.

We already publish information relating to our pension deficit each year in our annual report and APR. We support Ofwat's view that there should be greater transparency around companies' pension obligations and commitments. It would be useful to understand what additional reporting Ofwat considers might be useful.

3.14 The expectation that PR24 business plans should include a Board assured assessment of financial resilience.

Throughout the PR19 price review process, our Board reviewed, challenged and approved our business plan. This provided important challenge and independent input throughout the development of our plan.

At PR19, we included a statement from our OpCo Board alongside our business plan submission, IAP response and DD response. These statements included reference to key considerations for financial resilience including financeability, dividend policy, executive pay, gearing and credit ratings.

Annually, we also produce our LTVS, which considers the principal risks we face over the medium to long term and how these could influence financial resilience. These assessments are also reviewed by the OpCo Board.

We agree that financial resilience is a key consideration for PR24, and this should be addressed primarily through the calibration of allowed returns and robust financeability testing. Our Board will consider the financial resilience of Ofwat's proposals as they evolve and provide a statement on their assessment of financial resilience alongside our submissions.

3.15 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.

We do not think it is appropriate to introduce an incentive based mechanism related to capital structures. This would likely be similar to the GOSM at PR19, which the CMA found to not improve financial resilience but may also be harmful to a company's financial

[7] Ofwat (2020), Conclusions on section 13 of the WIA91 on proposed modification to ringfencing provisions, page 1

resilience.

We fully support the CMA's decision to remove the GOSM at PR19 and agree with its conclusions that there is no evidence that the GOSM supports financial resilience in the sector. The CMA's decision was consistent with SEW's position through PR19 that GOSM was not grounded in any financial theory.

An incentive mechanism targeting financial resilience is unlikely to stimulate investment in customer service levels and hence to meet Ofwat's stated objective. A gearing or resilience-based incentive could reduce projected cashflows on an expected basis, and result in unintended consequences including lower investment in customer service levels under certain scenarios.

Indeed, the CMA concluded during the PR19 redetermination that there was no evidence that the GOSM improved financial resilience and that it may in fact be *detrimental* to financial resilience.[8]

In this context and further to the decision made by the CMA, we consider that any GOSM penalty relating to AMP7 should not apply in AMP8.

The CMA has also recognised that the GOSM was not well designed in principle and did not address any clearly evidenced problem. After careful consideration, the CMA decided in principle that the mechanism's design is not supported by finance theory or practice. As a result, it would not be appropriate to include a reduction in AMP8 revenue due to the AMP7 GOSM at PR24.

Finally, the CMA concluded that there were no benefits relating to higher levels of gearing[9] that could be shared with customers. In the absence of any benefits there is no rationale or need for a voluntary sharing arrangement.

[8] CMA (2021), Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited Price Determinations, para 7.i.

[9] CMA (2021) , para. 102

4. Our assessment of Ofwat's proposed financial resilience mechanisms – summary

Table 1: Our assessment of Ofwat's proposed financial resilience mechanisms

Ofwat proposed mechanism	Our assessment
Cap on gearing	A cap on gearing would result in a mechanism predicated on a narrow definition of financial resilience based on one measure of financial resilience. A mechanism that limits gearing could in practice become inflexible and presents the risk that companies becoming unable to provide sufficient liquidity to manage downside risk or to finance new investment due to reaching the cap. A cap on gearing could under certain scenarios constrain investment where a company does not have flexibility to raise additional debt although it might be resilient at gearing levels above the prescribed cap on gearing. As a result we agree with Ofwat's position to not introduce a cap on gearing.
Cash lock up	There is already a cash lock up set out in company licences. Changing the threshold for cash lock up (either to reflect a specific credit rating or customer service) would not be appropriate. There is no evidence that the existing protections are insufficient. An excessive focus on credit ratings can lead to short-termism that is not in customers' interest. The restriction of the dividend payments water companies make could deter equity investment in the sector which is needed to deliver capital programmes and improve customer service levels.
Incentive based mechanism	An incentive mechanism targeting financial resilience is unlikely to stimulate investment in customer service levels and hence to meet Ofwat's stated objective. A gearing based incentive could reduce projected cashflows on an expected basis and result in unintended consequences including lower investment in customer service levels under certain scenarios. The CMA concluded during the PR19 redetermination that there was no evidence that the GOSM improved financial resilience and benefit customers and that it may in fact be detrimental to financial resilience. This core concern would also hold true of the mechanisms considered by Mason & Wright which assume price based measures such as contributions from highly geared or less resilient companies to a special administration fund.
AMP7 GOSM	We welcome the CMA's removal of the GOSM during the PR19 redeterminations as well as Ofwat's minded position to not apply this mechanism at PR24. Such a mechanism might reduce financial resilience, rather than improve it. In this context we consider the revenue adjustment for the AMP7 GOSM should not be applied in AMP8.
Additional reporting and transparency	We understand that Ofwat may require further information, such as on swaps and pensions, to fully assess financial resilience across the sector. We support this in principle where additional transparency and reporting supports enhanced monitoring of financial resilience by Ofwat and the sector.
Holding company reporting	The level of holding company debt in our group structure is not relevant to Ofwat's assessment of financial resilience. The inclusion of additional reporting of holding company financing and how equity investment in the sector is financed represents an extension of regulation beyond the ringfence and as such it is not clear on what legal basis Ofwat believes it is entitled to create new regulatory obligations that extend beyond the activities of the regulated company.
Requirements for ratings from at least two issuers	We currently hold two ratings, from S&P and Moody's and support this proposal. We do not believe that credit ratings should be used as the sole measure of financial resilience, but should be considered in a wider suite of measures.

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