Southern Water Response to Ofwat's PR24 Risk and Return and Financial Resilience Consultations

PR24 and beyond: discussion paper on risk and return

Financial resilience in the water sector: a discussion paper

Southern Water's response to Ofwat's risk and return and financial resilience consultations

Contents

1 Key messages

Thank you for the opportunity to respond to your recent consultations, "*Financial resilience in the water sector: a discussion paper*" and "*PR24 and beyond: discussion paper on risk and return*". We felt it was important to consider these two papers together, given the impact of risk and return decisions on financial resilience.

We support Ofwat's ambition to further align the interests of water companies and investors with those of customers at PR24, and to ensure that the sector remains attractive to investors. However, in our view, the proposals set out in the risk and return paper run contrary to this objective. A suggested significant reduction of the nominal equity return would run counter to the objective of improving financial resilience, at a time when the level of risk in the industry is increasing due to substantial investment needs and uncertainties associated with climate change and less predictable weather.

The proposals for a lower cost of equity are not consistent with market evidence and rely on a narrow view of the data for each component (TMR, RfR, Beta), resulting in the downward skew. We are concerned that a substantially lower return would diminish the buffer available to manage increasing risk, leading to weaker financial resilience and reduced investor appetite, which is not in customers' best interests.

At the same time, we believe that suggested methodological changes to increase the proportion of index-linked debt and reduce notional gearing distort financeability analysis, with an impact equivalent to an uplift of 0.3x in ACICR[1] terms. These methodological changes are not sufficiently justified and do nothing to improve real world financial resilience. We recommend that due consideration is given to the financial resilience and financeability implications from the risk and return proposals.

We understand and support Ofwat's aim to ensure strong financial resilience and support its efforts towards greater transparency. With regards to Southern Water specifically, we would like to reiterate that in September 2021 our new majority shareholder Macquarie Asset Management (Macquarie) contributed over GBP1 billion of new equity to recapitalise the group and make it financially resilient. This included immediate funding of material investment beyond our Final Determination cost allowances to accelerate our continuing performance improvement. These major changes have resulted in credit rating affirmations (BBB+/Baa3) by all three credit rating agencies, with the agencies remarking that "the financial stability of Southern Water and its group has been strengthened significantly"[2] and that de-leveraging represents "a favourable shift in financial strategy" and is "credit positive and support rating affirmation" [3].

Whilst the transformation plan is taking effect, we have committed to a sustainable financing strategy and a conservative distribution policy. We welcome the recognition in the document that where investors have explicitly committed to a turnaround and improvements in company performance are being delivered, some aspects of the financial resilience

[1] Adjusted Cash Interest Cover Ratio, as referenced by Ofwat in its suite of relevant financial ratios, page 56 of PR24 and Beyond, Discussion paper on risk and return. Notional company analysis considered
[2]S&P (17th September 2021) - Southern Water Outlook Revised To Stable Following New Equity Injection; Ratings Affirmed
[3]Moody's (10th August, 2021)- Moody's affirms Southern Water's ratings following recapitalisation and environmental fine

proposals may not be appropriate. We look forward to engaging with Ofwat on this in due course.

With regards to assessing companies' financial resilience, we would suggest it is inappropriate to place excessive reliance on credit ratings and that an "in the round" board assessment should be considered instead. More broadly, there is a risk that aspects of Ofwat's financial resilience consultation might be perceived as a means for Ofwat to exert greater control of dividends and capital structures. This could be seen as an increase in regulatory risk by investors, as to date dividends and gearing are for the board and shareholders to decide on.

In proposing to tighten the minimum credit rating requirement[4] and notional gearing assumption[5], Ofwat assumes that equity injections will be available, while providing limited evidence that PR24 risk and return package would continue to be attractive to equity investors. The impact of the recent proposals on credit rating agencies' view of the regulatory framework and the implications for credit ratio thresholds has not been assessed either. The notional company structure should be reasonably achievable for most companies in the sector if it is to be meaningful, but the practical ability of companies to reach the proposed step improvement in credit ratings or in the notional gearing has not been assessed. Moreover, limited evidence has been presented to demonstrate why the new notional structure would be more efficient than the existing one. It is also important to note that it will be very difficult to achieve meaningful de-gearing in PR24 without equity injections, given the pressure on cash flows from the increasing investment requirements, lower returns, and growing risk. At the same time, equity injections may not be in customers' best interest as investors may require higher equity returns, resulting in higher customer bills. We welcome a constructive and open dialogue with Ofwat on this matter to avoid decisions undermining the sector's financial resilience.

Weighted Average Cost of Capital (WACC) parameters

In setting the WACC the overarching concern must be to ensure that that companies receive sufficient cash flows to finance their functions, manage risk and attract capital to deliver their investment programmes, as well as maintaining financial resilience. While it would be wrong to focus excessively on individual assumptions used in deriving the WACC, we would like to address some of the proposed approaches to estimating key WACC components.

We note that the methodologies for estimating the Risk-free Rate (RfR), beta, Total Market Return (TMR), and selecting a point estimate for the cost of equity and cost of embedded debt depart substantially from the CMA's final re-determination for PR19. In doing so Ofwat appears to place far greater emphasis on the outcomes of the RIIO-2 appeals, even though these don't reflect the specifics of the England & Wales water industry, and should thus be considered weaker precedent versus the PR19 CMA appeals. We discuss some of the differing approaches between Ofwat and the CMA PR19 below.

The decision not to 'aim up' when assessing the cost of equity is a deviation from the view taken by the CMA at PR19. The CMA aimed up by 25bps versus the mid-range to account for uncertainty and risk asymmetry. While it is still too early to conclude on the extent of the risk asymmetry in PR24, we remain of the opinion that relevant factors for aiming up should be considered at the later stages in the price determinations process (including, but not

[4] Amending the trigger point for the cash lock-up to BBB/Baa2 with a Negative Outlook/Watch from BBB-/Baa3 with a Negative Outlook/Watch

[5] "Lower gearing can be achieved in different ways. For example, through equity injections or adopting a lower dividend yield […]" page 41, PR24 and Beyond, Discussion paper on risk and return

limited to forward-looking risk exposures on costs, investments, ODI incentives and financeability).

Ofwat's proposed approach to rely only on index-linked gilts (ILG) to determine the RfR differs from the CMA's approach of using both AAA bond indices and ILG. It also contradicts economic theory, as the ILG rate is not available to all market participants as a lending and borrowing rate, and ultimately leads to RfR understatement. As Ofwat is minded not to index RfR and given market expectations for rate increases, there is also a significant risk that companies may be exposed to value losses during PR24. To address that risk, a forward rate adjustment to the RfR would be appropriate.

Ofwat's method of deriving a range of TMR estimates based on both forward-looking and historical evidence also departs from the CMA's approach at PR19. Given the limitations of the robustness of the forward-looking evidence, the CMA disregarded it and formed the TMR range based on historical ex post approaches. We agree with the CMA's approach and urge Ofwat to exercise caution in relying on the forward-looking evidence, which can introduce volatility and depends on the assumptions used.

The proposal not to re-lever raw equity betas is also different to the CMA's approach (and we understand the CMA considered an approach similar to that proposed by Ofwat and did not adopt it in its re-determination). It implies an inappropriate use of the Modigliani-Miller (MM) theorem and relies on limited evidence that listed company gearing is close to notional gearing, while resulting in a very significant reduction in allowed cost of equity (up to 58 bps).

Ofwat's approach to estimating the cost of embedded debt based on the sector average is consistent with the CMA methodology. However, the exclusion of swap costs is not consistent with the CMA position and distorts sector average financing costs. The vast majority of index-linked swaps in the sector were designed to achieve efficient inflation hedges, which reduce risk and support financial resilience. Our view is that these swaps should be included in the cost of embedded debt estimate.

The proposal to use MARs as a primary cross-check is also deviating from the CMA's approach. At PR19, the CMA did not attach any weight on the MAR when it came to a final view on the point estimate for the cost of capital and urged to exercise caution in using market prices for a final cross-check. We support this view as a reliance on a great number of theoretical assumptions around future regulatory periods for decomposing a MAR increases scope for judgement and distortions in setting allowed returns.

2 Response to the risk and return consultation

2.1 Balance of risk and return

Q2.1. Do you agree with our principles for reviewing old and new reconciliation mechanisms and do you have suggestions for further reconciliation mechanisms which could be retired for PR24?

We support Ofwat's proposal to assess the existing and the newly proposed reconciliation mechanisms based on materiality, efficiency of risk allocation, and cost-benefit analysis. We would like to re-iterate that currently there are too many reconciliation mechanisms and that a bar for including additional mechanisms should be set high. The PR19 final determination reconciliation mechanisms seek to capture ex-ante all scope of outperformance, which is contrary to the idea of an incentive-based regulatory regime. Numerous reconciliations may also distract the company's management focus away from customers and stakeholders.

While the number of the existing regulatory reconciliations is excessive, we stand behind the following core risk sharing/incentive reconciliation mechanisms: revenue, totex, ODIs, C-Mex and logging up/down for funded outputs.

We agree with the suggestion to remove DSRA for AMP8 but note that this should be supported by proper calibration of growth assumptions during the price determination process.

We do not back the elimination of the RPI-CPIH wedge reconciliation mechanism. Our view is that a compensation for the mismatch in the RPI-linked debt and CPIH-linked RCV should be considered as part of the price control transition to CPIH in PR24 (greater detail included in our response to Question 6.1). Moreover, given the limitations associated with reliably estimating long-tern CPIH, a true-up may be required to ensure the transition to 100% CPIH indexation is NPV-neutral. Overestimating CPIH at the start of PR24, which is possible as CPIH data series are only being developed, could lead to a systematic under-estimation of real WACC and a value loss, unless a true up takes place.

And finally, considering the CMA decision for PR19 to disapply GOSM for the four appellants, we think that the mechanism should be disapplied for the whole sector to ensure consistency across the companies as well as the regulatory bodies. Our views on the rationale of GOSM disapplication align with CMA.

Q2.2. Do you have any comments on our proposed approach to producing risk ranges, including but not limited to:

a. risk ranges for the efficient notional company prepared by Ofwat; and

b. company-specific risk ranges produced by companies.

RoRE risk analysis and incentive calibration represents a critical component in setting appropriate overall PR24 risk and return package. It should be used as the key tool informing the setting of the allowed equity return and should reflect any asymmetry of the ODI penalties and rewards, and totex sharing rates, consistent with the CMA's approach at PR19. It is paramount that a mismatch between the risk and return originating in the PR19 FD (reflected in observed under-performance across the sector to date) is re-considered and corrected for PR24. Moreover, company-specific data provides the most useful insight into analysis of overall risk exposure, as companies have the closest understanding of the risks pertinent to their businesses, and of the mitigants available to manage these risks.

We agree with Ofwat's proposal to complement its RoRE risk analysis for a notional company with company-specific analysis provided by the sector. Critically we consider that it is important that weight is assigned to both for price control calibration, as companies will face risks which are out of their control but specific to their business. These risks will need to be reflected in the calibration of totex allowances and company-specific ODI targets and reward/penalty rates at PR24.

Notwithstanding this, we understand the difficulties associated with developing a common reporting methodology for companies, while at the same time stress the importance of factoring company-specific asymmetric risks in the consideration of the overall risk profile and proposing some mitigants for those risks (e.g. IDoKs, adaptive pathways, etc.). We also flag the significance of robust calibration of a P50 case for a notional company.

Furthermore, we think that caution should be exercised when using historical data in estimating the risk profile for PR24. Adequate risk analysis must capture forward-looking operational risks allowing for increase in risk related to PR24 specific operational targets and accounting for interdependence between risks. Ofwat-guided increase in risks in PR24 should be appropriately factored in its own risk analysis, backed by the reliable data, objective and consistent methodology and detailed guidance for assessing risks that may be correlated.

We welcome greater clarity from Ofwat on the weight attached to and treatment of the notional and company-specific RoRE analysis in the overall determination of PR24 risk ranges.

2.2 Allowed return on equity

Q3.1. How should we reflect the period affected by Covid-19 in our approach to estimating beta?

We think that the impact of Covid should be disregarded for PR24 purpose. In our view, a comprehensive analysis needs to be carried out before deciding whether the Covid-affected data is relevant for the inclusion in estimating beta. As the pandemic is not yet over, there is still uncertainty around how it will evolve and influence the economy and exposure to systematic risk. Hence, data that is currently available is incomplete. It will be more straightforward to carry out this analysis in the following regulatory periods, in which we gain sufficient and reliable data and can conduct a systematic assessment of the pandemic.

Q3.2. Noting the impact of gearing on betas discussed in the report by Professors Mason and Wright, how should we adapt our approach to specifying beta for a company at the notional gearing?

We understand that Ofwat is considering alternative approaches to de- and re-levering of betas in light of the Mason and Wright (M&W) paper. The paper proposes a variety of ways through which this can be achieved, however, it seems from the consultation document that Ofwat focuses on one approach which uses the unadjusted raw beta estimate directly as the beta for the notional company.

We do not support Ofwat's proposal. We do not think that a deviation from the long-standing approach of de-levering raw betas from listed comparators and re-levering to the notional gearing is justified. This is because limited evidence has been presented to reliably demonstrate that listed company gearing is close to notional gearing. Additionally, insufficient methodological ground has been provided to justify the departure from the existing definition of the Enterprise Value (EV) gearing. Furthermore, conclusions arrived at by Mason and Wright (M&W) are incorrect due to inappropriate use of the Modigliani-Miller (MM) theorem.

In its consultation, Ofwat states that listed company gearing may not be statistically different to the notional company gearing, if the definition of listed company debt is expanded to include market value of debt (rather than rely on book value), pension deficits and/or derivatives. While the expanded definition of debt will, indeed, lead to a higher EV gearing for listed comparators, it would not be consistent with how a notional gearing is calculated. There is no justification for changing the debt definition, nor is there a clear methodology for how to measure and select liabilities. This reduces transparency and predictability, as well as increases the scope for future arbitrary changes to definitions. We welcome a clear and consistent methodology from Ofwat on why certain liabilities should or should not be included in the definition of debt. Moreover, should the decision be made to expand the definition of debt to include pension deficits and derivatives, it should be reflected consistently across all other regulatory parameters.

We have reservations regarding the application of MM theorem by Mason and Wright (M&W). The 15 bps increase in WACC, as indicated by M&W, was calculated using the cost of total debt whereas to test whether WACC is invariant to gearing the cost of new debt only should have been used instead. This can be verified from MM's original paper which says - *"the firm borrows at the market rate of interest"*[6]*,* as a result the increase in WACC goes down to 6 bps when cost of embedded debt is excluded.

Secondly, the cost of new debt calculation is market-based and not CAPM-implied, which leads to a partial application of CAPM to arrive at WACC. This deviation from CAPM leads to a WACC which varies with gearing (equation below). The proof of this relationship can be found in the UKRN report[7].

$$WACC = (RFR + \beta_A * MRP) + g * (CoD - (RFR + \beta_D * MRP))$$

To derive a gearing invariant WACC, the second term in the equation above needs to be 0, in other words, the CoD should be CAPM-implied. Setting an RfR estimate solely based on ILGs could exacerbate the finding that WACC is variant to gearing as the RfR used in the calculation would be understated.

M&W have also acknowledged that CAPM is a poor model for debt returns. Therefore, in our view, it is reasonable to price in the debt premium observed in the market and hence, mild deviations from MM theorem are expected given how the regulatory regime is set up.

Q3.3. How should we convert RPI-linked yields into their CPIH-linked equivalents when deriving a RfR point estimate?

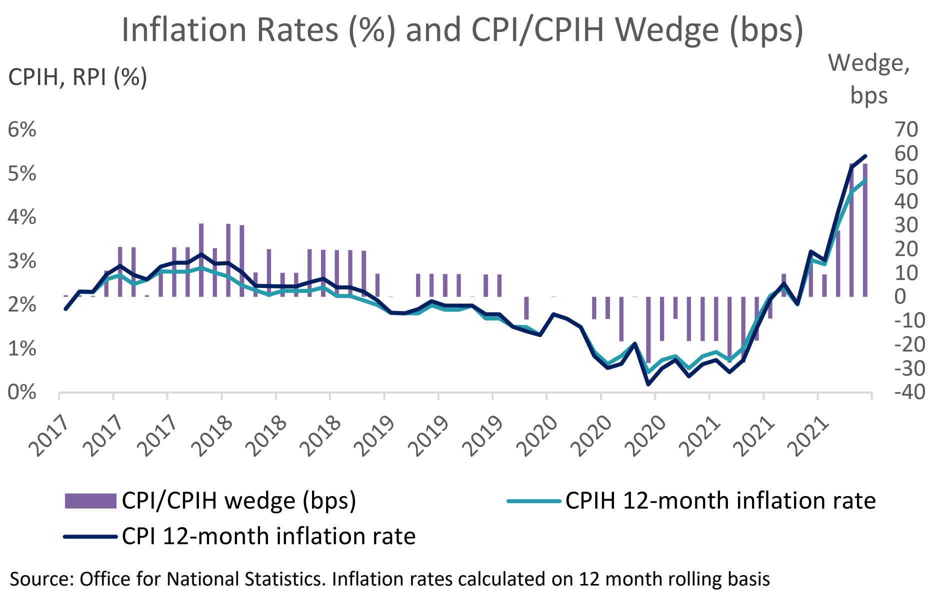
We understand the difficulty of measuring the RPI/CPIH wedge accurately, given the RPI reform in 2030, as well as the prospective Judicial Review of the reform, scheduled for mid-

[6] Modigliani, F. and Miller, M. H. (1958), 'The Cost of Capital, Corporation Finance and the Theory of Investment', The American Economic Review, 48:3, June, p. 289, footnote 48.
[7] Estimating the cost of capital for implementation of price controls by UK Regulators - An update on Mason, Miles, and Wright (2003), p. 23, [Microsoft Word - 7th draft-180305.docx (ukrn.org.uk)]

2022. The most straightforward way to address this challenge would be to index the risk-free rate. Absent that, a forward-looking adjustment to RfR could be warranted to reflect the risk of misestimating the wedge.

We disagree with using the 2% long-term CPI rate as a substitute for CPIH for the purpose of deflating nominal yields. Ofwat states that the difference between the CPI and CPIH is small and not persistently positive or negative, and so proposes to disregard the CPI/CPIH basis risk. We consider CPI/CPIH basis risk to be material, especially during the current high inflation environment and also given the limited time series of CPIH. The last 5-year (2017[8] to 2021) average CPI/CPIH wedge is 6.24 basis points,[9] while the average 6-month CPI/CPIH wedge goes up to 28 basis points in the second half of 2021.[9] At its extreme, CPI was c. 56 basis points above CPIH in both November and December 2021. Since the historical movement of CPI/CPIH wedge is not monotonic and could be substantial (see Figure 1 below), we believe CPI/CPIH basis risk is an important factor to be reflected in RfR. Caution should be exercised in converting the existing yields as to not understate the RfR, particularly considering Ofwat's proposal not to index cost of equity, which we disagree with.

Figure 1: CPI/CPIH Inflation Wedge and 12-month Rolling CPI and CPIH Inflation Rate



A proposal not to index cost of equity could have negative impact on the overall risk and return profile of PR24, as market consensus is that interest rates are likely to increase. An increase in interest rates would translate into higher cost of debt and weaker financeability if cost of equity remains static. We therefore propose a forward-looking adjustment to RfR to factor in this risk.

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[8] CPIH became the lead measure of inflation only in March 2017, after concerns over the methods and processing of the private rents data used to estimate owner occupiers' housing costs were resolved https://www.ons.gov.uk/economy/inflationandpriceindices/methodologies/consumerpriceinflationincludesall3indicescpihcpiandrpiqmi

[9] Office for National Statistics, Consumer price inflation time series data.

2.3 Allowed return on debt

Q4.1. Do you agree with our proposed role for benchmark bond indices in cross-checking a cost of debt allowance based on a balance sheet approach?

We fully agree with Ofwat's proposal to place more weight on balance sheet data than index data, as financial instrument data in companies' annual reports reflects the actual cost of debt and thus improves the accuracy in setting the allowance.

The balance sheet approach is consistent with the CMA's approach, as it is based on the sector average costs. However, there is lack of detail on how the balance sheet approach (as well as the cross checks based on iBoxx) will be applied. We welcome greater clarity in setting out ex ante principles for calibration of the cost of debt allowance, including:

- The length of the sector average calculation (the trailing average period used) and a specific decision on the inclusion of debt issued before the global financial crisis;
- The sample of companies used in the calculation;
- The debt mix – what instruments need to be included in the embedded debt;
- The averaging method (e.g., CMA used median to reduce the effect from outliers); and
- Other specification (other instruments, debt mix, potential adjustments required, etc).

Additionally, we note that the exclusion of swap costs from the cost of embedded debt is not consistent with the CMA position and could distort the underlying principles of the policy, which is to match sector average financing costs. In RIIO2 appeals, CMA also recognised that vanilla swaps used to synthetically replicate index-linked debt instruments are useful inputs into the calculation of sector's debt costs. We therefore propose to include vanilla index-linked swaps in the estimate for cost of embedded debt. For the avoidance of doubt, we do not propose to include more sophisticated derivative trades, such as swap re-couponing referred to as "kick the can" swaps, in the calculation.

Q4.2. Given the persistent issuance discount of water company bonds against the iBoxxx A/BBB index, how should this be reflected in our new debt allowance-setting?

We note that the CMA rejected Ofwat's outperformance wedge of 15 bps on the cost of new debt at PR19, on the basis that there was insufficient evidence of material or sustained outperformance, as the sample size drawn by Ofwat was too small to reach a statistically significant conclusion, and there was no evidence to support outperformance on an expected basis for AMP7. In line with the CMA's decision, we oppose the application of any outperformance adjustment to the cost of new debt on the grounds of it not being supported by robust evidence. There is lack of analysis which part of the 55 bps outperformance quoted by Ofwat stems from higher credit ratings, shorter tenors, or company size – and hence no clear rationale or evidence to support an adjustment from the market benchmark at the target credit rating for the notional firm.

Additionally, CMA identified the following issues, which we think are still applicable today and which we agree with:

- Competitively priced EIB debt is no longer available after Brexit

- It is not reasonable to expect sustained outperformance for the sector with the target notional rating at Baa1/BBB+ in line with the market benchmark selected (above)
- Ofwat's new debt 'true-up' mechanism ensures that companies' outturn allowance reflects movements in the benchmark across the AMP.

Consequently, CMA concluded that the only potential to justify any adjustment is lower tenor in the water sector, which, by itself, is not sufficient to justify any adjustment.[10] Moreover adjusting the cost of new debt in PR24 for any perceived outperformance would incentivise shorter debt tenors, which in turn would increase refinancing risk and hurt financial resilience. We propose that Ofwat carefully considers knock-on effects of any such decision.

Q4.3 Do you agree with our proposal to restrict company specific adjustments to reflect only factors due to small size, and to remove the benefits test?

We would advocate collaboration between Ofwat and the industry to take notice of the CMA's recent determinations. This approach is best suited to promote market stability.

Should there be a need to adjust either the cost of equity, or cost of debt, we would anticipate the need for extensive industry consultation and a minimalist approach to implementation.

2.4 Notional capital structure

Q5.1. Do you agree with the framework we have set out for determining an appropriate notional structure for PR24 and beyond?

We note that Ofwat has not provided any evidence that the current 60% gearing is inefficient and a reduction to, say 55%, is more optimal. Furthermore, Ofwat does not point to a specific market failure or market distortion that the change in notional gearing is needed to remedy, as required by the principles of regulatory economics. A proposed notional gearing of 55% departs even further from the sector average (of c. 70%) than the current notional gearing of 60%, and is inconsistent with Ofwat' other proposal to align the proportion of index-linked debt with sector average for financeabilty assessment.Therefore, we disagree with Ofwat's proposal to reduce notional gearing to 55% in PR24 from 60% in PR19. Such a drastic change of 5% RCV is not practically achievable for the sector without equity injections, which may not be available given low level of allowed equity return and increased capital spend.

Ofwat is assuming that equity will be readily available to reduce companies' gearing by explicitly stating its expectation of equity injections. This assumption, however, is not reflecting the reality of sector attractiveness to equity investors, given the expectation of increased risk exposure and reduced allowed returns. In our view, PR24 risk and return proposition is likely to deter equity investment in a period when the sector requires increasing investment to meets its Net Zero commitments.

As equity injections may not be readily available for the reasons explained above, the use of lower notional gearing of 55% for the assessment of financeability appears artificially constructed and may not be seen as a meaningful cross-check by investors.

[10] CMA PR19 Final Determination, para. 9.825

Also, as explained in the answer to Q7.1 below, this level of notional gearing (55%) corresponds to Moody's' A2 rating level, which requires a significantly higher AICR of 2.0x. Similarly, ratio guidance of other CRAs, such as Fitch, shows that a gearing of 60% would correspond to the 'A' rating category, with an expected minimum cash PMICR of 2.2x and nominal PMICR at 2.5x[11]. Should notional gearing go down to 55%, notional company financeability assessment should also be based on the higher thresholds for interest coverage ratios for consistency with market outcomes and rating agency assumptions.

The duty of the regulator is to ensure that efficient companies remain financeable. In our view, this should be achieved through appropriate calibration of the risk and return package rather than an arbitrarily reduction in notional gearing or other changes to the notional capital structure.

We also would like to express a view around Ofwat's treatment of the regulatory precedents. In the consultation, Ofwat refers to the Firmus appeal as a precedent that the CMA has expressly recognised that a regulator could in certain circumstances reasonably assume that a financeability constraint could be addressed by raising equity finance. We disagree with this interpretation of the Firmus decision, as it reflected company specific factors that do not apply in the current context. Similarly, company-specific factors apply to NATS whose actual gearing was significantly lower than notional gearing, coupled with an asset light business model.

Q5.2. Do you agree the proportion of index-linked debt should be increased and what are your views on the composition of index-linked debt for PR24?

We note Ofwat's proposal to increase the proportion of index-linked debt for PR24, however, we disagree with it as it is not consistent with the definition of debt for the purpose of setting the cost of embedded debt allowance. The sector average index-linked debt position is 38% excluding index-linked swaps and 50% including them. In fact, achieving a 50% hedge is impossible without the use of index-linked swaps, as is explained in the answer to Q11 of the financial resilience paper. Since the allowance for the cost of embedded debt excludes swaps, their inclusion in the calibration of the proportion of index-linked debt would be inconsistent.

It is important to point out that an increase in the proportion of index-linked debt significantly improves notional company financeability assessment, while moving further away from the sector's actual position, excluding swaps.

2.5 RCV indexation

Q6.1. Do you agree with our proposed framework to evaluate the transition to CPIH indexation, and our proposal to transition fully at the start of PR24?

We agree that full transition to CPIH would significantly simplify the regulatory regime, increasing transparency and reducing the risk of error. This must, however, be balanced with companies' exposure to RPI, given its long-standing use as the regulatory index.

There is a high proportion of RPI-linked debt (approx.45% on average) in the sector, so the exposure to RPI/CPIH basis risk and CPI/CPIH basis risk is significant. It is unlikely to be sufficient to only refer to Ofgem on their basis risk management approach, as the proportion of RPI debt is materially lower in the energy sector. Companies need to enter into swap

[11] EMEA Regulated Networks: Ratings Navigator Companion (fitchratings.com), p.7

agreements matching RPI-linked debt payment to CPIH-linked revenue stream to hedge the exposure. Besides, the CPI and more importantly the CPIH market is not likely to have sufficient market depth for large size debt issuance, as it is relatively nascent and illiquid. Therefore, the costs to hedge basis risks need to be compensated for. If these costs are not appropriately compensated for, we would favour a more phased transition to CPIH to avoid the asset liability mismatch. We note that even under a phased transition, the PR19 assumption that all debt is RPI-linked would need to be updated to a hybrid RPI/CPIH mix.

2.6 Financeability

Q7.1. Do you agree that financeability is likely to be less constrained at PR24 than at PR19?

We view financeability assessment as an important cross-check for the overall process and a binding constraint on the price control calibration. We do not agree with Ofwat that financeability is likely to be less constrained at PR24 than it was at PR19. On the contrary, we expect financeability to be under pressure from the lower capital return implied by the risk and return discussion paper. We anticipate that a reduction in the embedded cost of debt would be insufficient to offset the pressure from lower equity return in combination with expected increases in risk and uncertainty at PR24 and also over the longer term, as recognised by Ofwat in its Long-Term Delivery Strategies paper.

Proposed changes to the notional capital structure – including the proportion of index-linked debt and the choice of notional gearing – impart a false sense of headroom which ultimately results from an inconsistent application of the financeability tests and unsupported changes to and specification of the notional capital structure.

Should a decision to set notional gearing at 55% be made, to maintain consistency of approach, the AICR thresholds in the financeability cross-check should also be moved up to 2.0x. This move will align both ratios within the same rating level of A2 (by Moody's). The ratio guidance for each rating level is presented below, based on Moody's 2018 report[12]. Similarly, Fitch's methodology[13] can be used for guidance on gearing and cash PMICR.

	A2	A3	Baa1	Baa2
Minimum AICR	2.0x	1.7x	1.5x	1.3x
Maximum Gearing	55%	65%	72%	80%

Source: Moody's Investor Services (May 2018)

	A	BBB	BB
Minimum FFO Int Coverage	4.5x	3.5x	2.0x
Maximum Gearing	60%	70%	80%
Minimum Nominal PMICR	2.5x	1.8x	1.4x
Minimum Cash PMICR	2.2x	1.6x	1.2x

Source: Fitch (2021)

Ofwat is also considering the use of revenue advancement to manage a shortfall in cash flows on a case-by-case basis. In response to similar proposals during PR19, Fitch noted[14]

[12] Regulated water utilities - UK: Regulator's proposals undermine the stability and predictability of the regime, p.5
[13] EMEA Regulated Networks: Ratings Navigator Companion (fitchratings.com), p.7
[14] Fitch (26th July, 2019) Ofwat Price Review Intensifies Pressure on UK Water Sector (fitchratings.com)

that they would adjust the cash PMICRs to align the accounting treatment of Opex with the regulatory treatment, if companies use the PAYG rate above the accounting level. Moody's also responded similarly[15] suggesting that they would continue to remove the regulatory depreciation as well as excess PAYG to calculate company-specific AICR ratios. The CMA also acknowledged the fact that revenue advancements do not improve credit quality from a rating agency perspective[16]. CMA also stated that appropriately calibrated risk and return package should not require the use of PAYG lever to enhance financeability.

We also note that nominal PMICR, which is an important credit metric used by Fitch, is currently missing from the list of metrics proposed by Ofwat. It should also be included for financeability assessment as the holistic measure of debt serviceability that does not depend on the timing of cash flows.

We would welcome re-consideration of the current proposals by Ofwat in the next iteration of this consultation, in line with the approach to financeability assessment applied at PR19.

Q7.2. Do you agree that real RCV growth should be funded through a combination of debt and equity such that gearing of the notional company remains consistent with the notional gearing set at the start of the control period?

We agree that nominal RCV growth should be funded through a combination of debt and equity, as it always has been, according to the capital structure selected by the Board and shareholders. This was reflected in the maintenance of a constant gearing, such that dividends were flexed based on the need to finance nominal RCV growth.

We do not fully understand the relevance of real RCV growth in the context of funding. Companies maintain nominal capital structures and make their decisions on funding new investments in nominal terms.

We disagree that the equity funding of RCV growth, whether real or nominal, should comply with arbitrarily selected notional gearing, especially if the overall return package proposed by the regulator is unattractive for shareholders.

It also remains crucial that the dividend assumption used by Ofwat is in line with the pay-out ratios of the market benchmarks. Ofwat itself[17] has previously acknowledged that utilities characterise a dividend yield that is at the top end of the range compared to other sectors, and that they are income or dividend-paying stocks.

2.7 Other key points not covered above

RfR

Ofwat proposes to rely solely on evidence from ILGs in deriving an RfR estimate. This is a departure CMA's PR19 final determination where both ILGs and AAA-rated corporate bonds were given equal weight. We note that CMA recognised the pros and cons of both these instruments separately and concluded that none of them can solely be used as a proxy for RfR. While AAA-rated bond yields include some undesirable risk factors, the primary reason for including information from AAA-rated bond yields is that these bonds represent the lowest borrowing rate available to all the market participants, which is one of the

[15] Moody's Investor Services (26th July 2019) – Regulated Water Utilities UK: Ofwat tightens the screws further, p.5
[16] CMA PR19 FDs, pp. 1092,1119
[17] Ofwat (2018), 'Putting the sector back in balance: Consultation on proposals for PR19', April, p.25

requirements of CAPM RfR. AAA bond yields could be adjusted for embedded illiquidity and default risk, before using them as RfR proxy.

An alternative to AAA-rated bonds is the use of ILGs with an uplift for '*convenience yield'*. We welcome Ofwat's acknowledgement of the existence of such a premium. There have been domestic as well as international precedents for uplifting the ILG yields. For instance, the Competition Commission referred to it in the 2008 inquiry of Stansted Airport[18], and estimated a 30 bps discount for the '*extra liquidity*' of ILGs, which forms just one component of the convenience yield. Similarly, ARERA, the Italian regulator, included a 100 bps uplift over ILGs, for the energy sector.[19]

Ofwat proposes to remove the forward rate adjustment. CMA disapplied this uplift citing research which suggested that the current spot rates provide a better forecast of the future spot rate than current forward rates. We also note that Moody's has recently published a report[20] which indicates that the rates are expected to rise to the pre-crisis levels in the coming 6 to 7 years. Given the possibility of a significant rise in rates during PR24 – which is a period where we need to incentivise large investments –it is appropriate to consider either a forward rate adjustment or the indexation of RfR.

We disagree with the proposed use of SONIA rates either as a benchmark instrument or as a cross check for the RfR estimate. SONIA swap rate is based on the evolution of overnight rates, while cost of equity estimates are long term. The use of swaps for adjusting the tenor may not be reliable due to lack of market liquidity.

TMR

Ofwat proposes to derive a range for the TMR estimate using historical approaches (ex-post and ex-ante) and employ forward-looking approaches in order to select a point estimate from that range.

We are concerned about using the forward-looking approach as there are assumptions involved that are subjective and may not necessarily be robust. As a result, the point estimate could materially differ from the mid-point of the range implied by robust historical ex post approaches which CMA relied on at PR19. For example, forward-looking cross checks using the Dividend Growth Model could produce a wide range of TMR estimates (and we note Ofwat has typically focussed on the lower end of this range and not attached weight to equally plausible higher estimates implied by these models). The different assumptions and basis used by fund managers in market return forecasts could add another layer of volatility to the year-on-year returns.

At PR19, the CMA used the mid-point of the historical range when selecting the point estimate. It did not include the forward-looking evidence given its reservations about its robustness and the preference to maintain its assumption of a constant TMR over time. We do not think that there is significant basis for departing from the methodology applied by the CMA.

Ofwat also proposes to deflate historical returns using CPIH rather than adjusting RPI (with a forward-looking RPI-CPIH 'wedge'), given the simplicity and accuracy of a CPIH-based TMR

[18] CC (2008), Stansted Airport Ltd Q5 price control review, Appendix L
[19] Criteria for determining and updating the rate of remuneration of the invested capital in the infra services of energy sector, [614-21alla.pdf (arera.it)](arera.it), p. 9
[20] Moody's (2022), Regulated Water Utilities – UK, 2022 outlook stable as regulatory certainty balances environmental and social risks, p. 6

following the proposed full CPIH indexation. This is subject to passing a review of suitability of ONS's CPIH back series to deflate the historical returns (impending publication).

This is a significant departure from CMA's approach at PR19, which put equal weight on both RPI and CPI. While CPI is a more reliable measure of inflation, the series is modelled which brings inherent uncertainty. On the other hand, RPI values are available for a longer historical window. At PR19 the CMA considered that exclusion of RPI series could introduce biases resulting from omission of relevant data. Including both the indices is expected to increase the accuracy of the inflation series. We do not see a robust basis for departing from the CMA's approach.

Ofwat does not comment on the proposed approach to averaging historical returns. At PR19, the CMA preferred to use the arithmetic mean due to its simplicity and transparency. In order to reflect the long holding periods of UK water investors, the CMA considered both overlapping and non-overlapping estimators of returns over 10 and 20-year holding periods. We do not think that there is any rationale to diverge from CMA's approach.

Cross-checks for cost of equity

Ofwat proposes to use MAR analysis only to cross check CAPM-derived returns. Ofwat acknowledges that listed companies tend to display above-average performance but considers that it is possible to control for this factor in the analysis.

MARs as the primary cross check

We do not think that MAR analysis is the most appropriate cross-check for the cost of equity. We strongly believe that there are more robust and reliable cross checks (that we discussed above and below), which should be preferred to MAR analysis. Furthermore, we think that MAR analysis is the least reliable cross check on CAPM evidence. We set out our rationale for below.

First, Ofwat would need to apply a high degree of judgement and make a number of assumptions to decompose a MAR such that it might provide a useful input into the calibration of allowed returns. For instance, Ofwat would need to make assumptions around future price control periods costs, such as opex and capex, ODIs, tax, macroeconomic factors, risk, etc. and then come up with a range of out- and under- performance for each one of them. All these assumptions would be very theoretical given the uncertainty of future regulatory periods, which means that isolating the contribution from assumed outperformance on cost of equity would be very difficult. Furthermore, the ambiguity in forecasting becomes greater the longer the period covered by the analysis.

We note that at PR19, the CMA did not put much weight on the MAR when it came to a final view on the point estimate for the cost of capital. The CMA said that it remained "*cautious about using market prices to determine the point estimate for the cost of equity or overall cost of capital*". The CMA also noted how difficult it would be to draw correct conclusions from the MAR data. On balance, the CMA concluded that MARs did not represent a suitable cross-check for the cost of equity for the entire water sector.

Alternative cross checks

We agree that the CAPM model has its limitations and recognise that over the years, the suitability of the CAPM model has been greatly scrutinised and challenged by academics and industry experts.

We also note that various academics have, over the years tried to come up with more suitable alternatives to CAPM. Some of these newer models (such as the Stambaugh and Yuan (2016) 4-factor model, the Hue, Xue and Zhang (2015) q-model, and the Fama-French 5-factor model, amongst others) were found to have greater explanatory power than CAPM and could potentially be applied as a cross-check for the cost of equity

Aiming-Up

Ofwat proposes not to 'aim up' at PR24. We note that in its PR19 Final Determination, the CMA allowed 25 bps to account for investment incentives, parameter uncertainty and asymmetric risk on ODIs. Our views are fully aligned with those of the CMA at PR19.

Ofwat's arguments are that the PR24 package will be designed in a way that does not require an allowed RoE above the midpoint and that 'aiming up' will not be necessary because the circumstance that would give rise to the need to aim up would be already addressed at source.

Overall, at this stage of the price review process it is too early for us to comment on the extent to which aiming up might be appropriate or not. We welcome the opportunity to have further constructive dialogue with Ofwat on this matter to reach a mutually suitable resolution.

3 Responses to financial resilience consultation

3.1 Issues and concerns

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?

Credit ratings can play an important role in assessing a company's financial resilience. However, it is important that credit ratings are not used as the only relevant measure, given the narrow purpose they serve to measure the probability of default on debt obligations. Other appropriate factors must be considered, such as the strength of cash flows, operational performance, corporate governance, access to debt and equity finance, shareholder mix and strategy. In our view, a broad assessment of financial resilience provides a rounded perspective on this matter.

Ofwat considers that it is never appropriate for essential infrastructure providers to operate at, or be at risk of falling to, Baa3/BBB- (the lowest investment grade credit rating). We do not necessarily agree with this view. Investment grade rating is an indicator of very strong credit quality, with average cumulative 5-year historical default rate of under 3%[21]. Moreover, the difference in historical default rates between Baa2 and Baa3 is minimal (less 1 percentage point), so a more onerous requirement to operate at the Baa2 credit rating level is unlikely to provide a meaningful benefit to customers but may increase the administrative burden on companies, divert managerial resources away from operational delivery, disincentivise new equity capital from entering the sector and inadvertently harm financial resilience.

We believe that actual capital structure is a matter for company Boards and their investors to decide on because an optimal position may vary depending on many factors, including investor risk appetite. Moreover, there are many examples of utilities, transport companies, telecom providers and infrastructure assets operating sustainably at BBB-/Baa3 credit rating levels[22]. Additionally, we note that Ofwat is supportive of higher gearing for DPC projects, which are also delivering essential infrastructure. Southern Water's existing ratings with Fitch, S&P, and Moody's span BBB- to BBB+.

With that said, the water sector is best served through targeting significant headroom to BBB- via a robust calibration of notional company's risks and returns at each price review. It is appropriate to target the A-/BBB+ range assuming notional gearing of 60%, which would be broadly consistent with rating agencies current methodologies and ratio thresholds. The notional "financeability" analysis, largely defined by the allowed WACC, is the single biggest driver of water company financial resilience. It is notable that four companies appealed their PR19 final determinations, including concerns regarding risk and return, and financeability. While CMA addressed some of these concerns, it appears that Ofwat's risk and return

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[21] According to Moody's (Annual Default Study: Corporate Default and Recovery Rates, 1920 – 2017, Exhibit 35); https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1112754

[22] For example Madrilena Red de Gas (Spain-Based Gas Distributor Madrilena Red de Gas, | S&P Global Ratings (spglobal.com)), Galp Gas Natural Distribuicao (https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2548536), Stagecoach (https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2724290), Eesti Energia (https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2746216), Abertis Infraest (https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2553391), Indigo Group (https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2687183).

consultation continues to run contrary to CMA's conclusions on PR19 financing package and contrary to its own financial resilience aims.

Finally, serious consideration should be given to the attractiveness of the sector to new equity investment, given increased risk exposure due to supply-side or demand-side shocks, as well as substantial investment needs over PR24 and beyond. Credit ratings, while driving cost of debt, do not drive equity returns directly. If Ofwat aims to encourage additional equity into the sector, interventions in setting attractive equity returns should be considered as opposed to debt. Ofwat's risk and return consultation is likely to reduce potential equity returns and deepen the imbalance between risk and return.

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?

As mentioned in Q1, we believe that credit ratings should form part of a broader assessment of financial resilience. In addition, we would expect companies to be considering their operational and environmental performance, and customer service levels. If credit rating downgrade was part of a wider picture indicating weakening performance and potential concern, we would advocate companies take early mitigating action. There may, however, be instances where credit ratings are downgraded due to circumstances outside of companies' control. These include changes to rating agency methodologies, revision of sector business risk due to less favourable assessment of the regulatory framework or severe weather events. In such cases, it would be unreasonable to place the burden of improving ratings solely on companies.

In case of Southern Water, when credit rating downgrade was indicating a concern over weakening performance, we proactively adapted our capital structure to ensure investment plans can be delivered. Our actions have always been to ensure continued delivery of our day-to-day operations and FD investment plans. These actions were not always viewed favourably by credit rating agencies but were consistent with the best interests of our customers. As an example, the restructuring of our inflation linked swaps mitigated operational underperformance and ensured this did not adversely impact business plan delivery.

3.2 Strengthening the customer protections

Q3. 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

The sector needs a well specified notional company that exhibits a strong investment grade credit rating. Since privatisation, actual capital structure choices, including whether to use structural or covenanted protections, have been the remit of companies' Boards and shareholders. A departure from this position, with unrealistic expectations on the pace of de-leveraging and/or credit rating improvement could be perceived by market participants as a decrease in predictability and transparency of the regulatory regime. This, in turn, could lead to weaker financial resilience as the perceived level of risk in the regulated water sector would increase.

Many aspects of a company's performance could cause weak financial resilience, with the choice of capital structure being only one of them, so it is important that Ofwat engages in a constructive dialogue to identify the root cause of the problem, rather than trying to cure it with "*one size fits all*" balance sheet regulation. That said, we support Ofwat's desire for both transparency and resilience of actual company structures. Companies' Boards, in adopting their chosen capital structure, must be aware of and address risks in a manner consistent with the duties of an essential infrastructure provider.

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

We do not support either of these proposals. These changes, if implemented, would likely have the opposite impact on financial resilience than originally intended as they would undermine investor trust and increase the level of compensation investors require for the regulatory risk. They could also lead to an unnecessary business disruption and take management's focus away from improving operational performance. A trigger linked to service performance would increase uncertainty and be counter-productive, as service levels may be impacted by one-off events and severe weather. We welcome Ofwat's explicit acknowledgement that where investors have specifically invested to deliver an operational turnaround, there could be an appropriate exception.

Credit ratings have a very specific purpose to serve debt investors and are entrenched in the investment processes. However, ratings carry little relevance to customers unless there is a danger of operational disruption due to insolvency. At investment grade, customers are well-protected against such events. As the difference in historical default rates between BBB and BBB- is very small (less than 1 percentage point for 5-year cumulative rate)[23], customers will see no benefit from a higher cash lock-up trigger. At the same time, this proposal would likely be interpreted as means to control dividends and capital structures, which would do significant harm to the sector's ability to attract new equity.

Furthermore, credit ratings could and have historically changed due to events outside of companies' direct control. For example, sector-wide downgrades in PR19 were driven by the cut in allowed return and tightening of credit ratio guidance caused by the perception of reduced transparency and predictability of regulation. This happened despite de-leveraging efforts of the sector. Based on Ofwat's recent consultations, it is reasonable to expect similar pressures in PR24, so a cash lock-up could be triggered without companies doing anything wrong.

A step-up in the cash lock-up rating trigger to BBB/Baa2 would leave many companies with limited lock-up headroom, which would be undesirable from a risk management perspective. To increase the headroom to the proposed BBB/Baa2 trigger, companies would need to de-lever. Any requirement of de-leveraging or improvement in credit quality should be realistic, practically achievable, and appropriately priced in through the cost of equity considerations. It is unrealistic to expect investor appetite to contribute fresh equity if the level of allowed return does not appropriately compensate for the risk embedded in the overall price control package. We note that these proposals, assessed in combination with the risk and return consultation, discourage potential investors.

We understand that Ofwat targets to address poor financial resilience by proposing a cash lock-up linked to service performance. However, the relationship between service performance and financial resilience is not sufficiently evidenced. An independent report prepared for Ofwat by Professor Robin Mason and Professor Stephen Wright 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'*. At the

[23] According to Moody's (Annual Default Study: Corporate Default and Recovery Rates, 1920 – 2017, Exhibit 35); https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1112754

same time, service levels are already linked to financial outcomes through the ODI regime, impacting the ability to make distributions.

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

We support Ofwat's proposals that companies submit resilience plans in certain circumstances indicating weakening financial resilience. However, we do not agree that a specific credit rating is the right trigger, as it is only one of measures of financial resilience. We would like to work on the detail of these proposals with Ofwat and the industry further. While we support early engagement with the regulator, we do not support the proposal to oblige companies to publish their resilience plans. Companies manage their own capital structures, and their investor relations should be in control of these types of communications to ensure optimal execution of any capital structuring transactions.

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.

Regulators and customers are entitled to full transparency around dividend policies and their application. However, we do not support mandatory Board assurance based on a credit rating. It is also inconsistent to link actual dividend payments with the rating and gearing of the notional company. If Ofwat is concerned that dividends are being paid (or could be paid) inappropriately, then company Boards should be asked to justify their actions.

When approving a dividend payment, Southern Water's Board considers a wide range of parameters, including financial resilience. Dividends would not be paid should such payment compromise our financial resilience.

Q7. We welcome views on a requirement for companies to maintain two investment grade issuer credit ratings.

As we have three credit ratings, this proposal does not represent any additional financial or administrative burden. Generally, having more than one credit rating would provide a more balanced view of credit quality, as credit rating agency methodologies and approaches differ. At the same time, it is important to consider that credit rating maintenance involves a substantial investment of time and money and might not be appropriate for all companies.

Additionally, if more than one credit rating is required, it would be inappropriate to base regulatory action solely on the weakest rating.

Q8. 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).

We agree with the proposals for notification in the circumstances of changes to ratings or outlook – these represent a proportionate request given credit ratings are an important factor in determining financial resilience. We also support the proposal to notify Ofwat about planned rating withdrawals for information purposes, as long as the decision on which rating agency to choose remains with the company.

Companies should be free to make their own choice of rating agencies, given that they bear the cost. It is inappropriate for the regulator to control the choice of rating agencies, as this could lead to rating distortion and may be viewed as an intervention in the free markets.

Q9. We welcome views on removing dispensations from the requirement to maintain an investment grade credit rating.

As a company with three credit ratings, we are not impacted by this suggestion. More than 30 years post privatisation, all companies have had robust and sustained access to finance. Credit ratings provide one view of financial resilience, but Ofwat did not provide a clear justification as why it needs credit ratings to become mandatory, given the alternative approaches that are in place (e.g. Board certification).

Q10. We welcome views on the need to align the licence to our broader expectations for dividend policy.

A licence modification could be perceived as a way to control dividends and create additional regulatory risk for equity investors as well as deter new investments. Any type of dividend control would mean that equity investors are losing the rights that they previously had, without their explicit agreement, and therefore should be avoided. Hence, we do not support a licence modification. Ofwat's existing approach to dividend policy and governance has been successful, and it is not certain that the proposed language will deliver a practical change. We support ongoing dialogue between Ofwat and the sector around best practice dividend disclosures and suggest Ofwat addresses any specific concerns with the company in question.

Q11. We welcome views on enhancing the transparent reporting of the use of swaps and how this could be best achieved.

We welcome Ofwat's continued improvement of regulatory reporting and associated disclosures. Whilst generally supportive of increased transparency, we note that it must be weighed against the increasing regulatory burden. From a Southern Water perspective, we would be pleased to engage with Ofwat further on the transparency of our swap portfolio. We would also be delighted to help Ofwat develop a methodology for understanding the swaps.

We are concerned that inflation linked derivatives are unfairly viewed as negative due to the "mark to market" (MTM) accounting. This might derive from an incomplete understanding of swaps and MTM. Inflation and nominal bonds have similar "mark to markets" that are not reported due to an alternative accounting treatment.

The use of index-linked debt or index-linked swaps is a legitimate way to hedge against the risk of low inflation, one of the major risks that creditors and shareholders of water companies bear[24]. There may not always be sufficient market demand for index-linked debt, or the pricing may be uncompetitive, so companies use index-linked swaps overlayed on top of fixed rate debt as a synthetic way to achieve the same final position as the use of index-linked debt. It is important to note that companies have to use index-linked swaps if they are to achieve a high degree of hedging (over 50% of debt portfolio and over) based on risk management policy, as there is not enough investor demand to secure sufficient amount of index-linked debt.

MTM represents the net present value of a swap's future cash flows, the majority of which is index-linked accretion, a component that serves as a hedge against index-linked RCV. While the MTM of newly arranged swaps is usually close to nil, it can change significantly over

[24] For example, Fitch wrote in their report "What investors want to know: UK water in AMP7", p.13: "Companies generally follow conservative derivative policies and aim to swap a fixed coupon of a specific bond into an index-linked coupon by entering into a swap that precisely matches the fixed coupon and bond maturity. This type of hedging only creates exposure to inflation and is effective"

time, depending on inflation and interest rates. Many index-linked swap portfolios entered into pre-2008 now have negative MTM. That is because of a significant drop in interest rates, which are used as a discount factor for arriving at the MTM. Negative MTM is a derivative obligation, which changes over time and includes the value of future accretion, so the extent of a future repayment is never certain. Additionally, negative MTM is not expected to crystallise unless a default occurs, which is an unlikely scenario for an investment grade rated entity.

Presentation of the index-linked debt in financial statements is different to that of swaps: it only includes the liability related to historical accretion, while the MTM includes future accretion as well, which needs to be factored into any judgement calls.

Q12. 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.

Overall, Ofwat's focus should remain on the regulated company. If Ofwat has concerns that the regulatory ring-fencing provisions are not sufficient, that dividends might be improperly paid or declared, or that transactions are not arms-length, this should be address via the regulated entity.

As for the disclosure requirements, most of the companies already publish the information related to their holding companies either through their annual or investor reports. At Southern Water, we publish all the relevant group information, including holding company debt levels, on our website.

Q13. We welcome views on the option to improve the transparency of pension deficit reporting.

As per prevailing regulatory methodology, Southern Water's customers will no longer contribute towards pension deficits from 1st April 2025. The deficit repair payments will have to be funded by the shareholders, which removes any link between customer bills and these costs.

Moreover, Southern Water's accounting statements include information about pension cash commitments agreed with trustees. The purpose of additional disclosure is therefore unclear.

Overall, we do not resist a requirement to publish our actuarial pension valuation and associated recovery plan on a triennial basis if customer benefits are sufficiently justified.

Q14. We welcome views on the expectation that PR24 business plans should include a board assured assessment of financial resilience.

Consistent with PR19, we support the need for robust Board assurance of both notional and actual financeability. We would reiterate our concern, at this early stage, that Ofwat's financial resilience ambitions are inconsistent with the direction of travel signalled within the risk and return discussion paper.

Q15. 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.

We agree with the views of the CMA on the Gearing Outperformance Sharing Mechanism (GOSM). We do not support any further incentives in this area. Insufficient evidence has been produced by Ofwat to show that higher levels of gearing cause poorer performance, customer detriment, or windfall gains. These proposals could also harm financial resilience making the sector less attractive to equity investment. We believe capital structure should remain firmly the choice of companies' Boards and shareholders.