South Staffs Water
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By email: PR24@ofwat.gov.uk

31 January 2022

Dear Ofwat,

Ofwat discussion paper - Financial resilience in the water sector

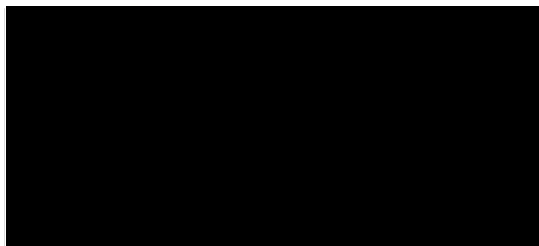
We welcome the discussion paper on financial resilience in the water sector.

We have a particular concern on the possible change to the trigger level for cash lock up which we see as disproportionate as only one company in the industry is at the minimum investment grade. In addition, Ofwat have a duty to ensure that companies are appropriately funded to finance their functions and this includes setting a WACC and capital structure commensurate with the target rating required by the sector. If this is not set correctly, even an efficient company would struggle to maintain a rating above the minimum investment grade.

We think that the current mechanisms in place are sufficient, for example a requirement to publish a Long Term Viability Statement (LTVS) and Ring Fencing Certificate (RFC) in the APR each year. These statements are signed off by company Boards and independently reviewed by the financial auditors.

Please refer to the remainder of this document for our specific responses to the questions in the discussion paper.

Yours sincerely



Strategy and Regulation Director

Financial resilience in the water sector

South Staffs Water and Cambridge Water consultation response

1 and 2. 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? 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?

It is important that companies maintain headroom in their credit rating to allow for any short-term shocks but this needs to be underpinned by the certainty and predictability of the regulatory framework. After PR19, most of the sector was placed on negative watch which demonstrates the important role that Ofwat play in influencing credit ratings.

3. 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.

We support not defining a limit on capital or financing structures. Any limit imposed could have implications for companies to invest in the future.

4. Views sought on amending the existing trigger level for the cash lock-up conditions to a higher credit rating and the potential for the trigger to be linked to measures of service performance

It is not clear what issue Ofwat are trying to address in considering an increase in the trigger level. There has been no company failures in the 30 years since privatisation and only one company currently has a credit rating at the minimum investment grade. We therefore do not think that amending the trigger level is proportionate.

Ofwat themselves have a duty to ensure that companies are appropriately funded to finance their functions and this includes setting a WACC and capital structure commensurate with the target rating required by the sector. For example, Moody's guidance for a target rating of Baa2 is at a gearing level above 72%. If this is not set correctly, even an efficient company would struggle to maintain a credit rating above the minimum investment grade.

With regards to the potential for the trigger to be linked to measures of service performance, failure for poor service levels is already penalised through ODIs.

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

As referenced in question 4, companies already stress test their plans each year as part of their Long Term Viability Statements (LTVS). This is reviewed by the financial auditors as an extension of the going concern statement and signed off by the Board of Directors. The Board also declares as part of the Ring Fencing Certificate that the company will have sufficient financial resources to enable it to carry out its activities for at least the next twelve months.

We therefore think that the current requirements in place are sufficient without the need for a separate resilience plan to be published. One possible way to strengthen the current requirements further is to require companies to consider a period of at least ten years when producing their LTVS.

The other issue with introducing resilience plans is that credit ratings cannot be improved in the short term so such plans would need to be in place for many years so would limited in its impact.

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.

We refer to our answer to question 5 above. We think the current reporting requirements and Board statements are sufficient.

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

We support the requirement for companies to maintain two investment grade issuer credit ratings.

8. 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 support this proposal

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

We have no comments

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

We do not agree that a licence change is needed and believe that the current expectations set out at PR19 are sufficient. In the APR, we already sets out the criteria we use to determine the level of dividend payment and take into consideration service

and future investment needs and look to balance future uncertainty with maintaining investor confidence. For example, in the autumn of 2020 we did not pay a dividend due to the uncertainty of the impact of Covid-19 on our business.

We are also unsure how Ofwat would determine if the condition had been met and what the remedies would be.

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

We observe that swaps can be an effective mechanism to manage risk (such as currency risk on non-sterling borrowings) albeit the focus here is on inflation linked swaps which have an accreting liability profile.

We further note that the pool of lenders willing to lend directly on an inflation linked basis, particularly CPI linked, is limited and therefore inflation swaps have been a recognised mechanism for companies to synthetically achieve a proportion of index-linked funding, as assumed by Ofwat in defining the notional company.

Companies that use such instruments will typically disclose details in the Statutory accounts about the accreted element of Mark-to-Market values and will most likely be including accretion on inflation swaps in financial covenant calculations of RCV based gearing.

12. 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.

We do not think that additional disclosures on holding company debt should be set for companies. There are sufficient governance arrangements in place for the regulated business which Ofwat should have regard to. This includes the need for a Board with the largest single group being independent non-executive Directors and the requirements of companies within their licence to meet the relevant ring-fencing provisions. We think that this should give sufficient confidence to Ofwat.

There is also a timing issue with regards to when the APR is published (mid-July) and when the holding company account are finalised which is usually several months later which would mean that the information would be unaudited.

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

We think that the current statutory disclosures on pension schemes is sufficient and that further disclosure is not necessary due to the maturity of defined benefit pension schemes.

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

We agree that there should be a Board assurance assessment of financial resilience at PR24. However, this could come at a considerable cost through the need for external assurance to give the Board the required level of comfort to make such a statement. We therefore do not think that the requirement should be made too prescriptive and Board's should be allowed to decide what level of assurance they think is appropriate.

15. 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 have no comments.