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

Severn Trent Water response

31 January 2022

WONDERFUL ON TAP

SEVERN TRENT

Contents

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31 January 2022

Dear [redacted],

SEVERN TRENT'S RESPONSE TO OFWAT'S DISCUSSION PAPER ON FINANCIAL RESILIENCE IN THE WATER SECTOR

I welcome the opportunity to contribute to the development of the approach to financial resilience in the water sector.

At Severn Trent we pride ourselves in maintaining a high level of financial resilience. This is reflected in our low level of regulatory gearing (one of the lowest in the sector in Ofwat's Financial Resilience Report 2020-21), our stable credit rating two notches above the investment grade threshold and a responsible and limited use of financial derivatives. Ofwat also recognised us as industry leader on financial resilience in its latest Financial Resilience Report.

We are delivering sector-leading operational performance for our customers. Ofwat recognised our service performance in December 2021 by placing Severn Trent in the sector-leading category in its Service and Delivery Report. The Environment Agency awarded us 4-star status (the top grade) in July 2021 for environmental performance for the second year in a row. We are also the best performing water and sewerage company on the DWI's water quality compliance risk index (CRI).

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

In relation to Ofwat's specific proposals, we disagree with the following:

- We fundamentally disagree with the proposal to **link the cash lock-up condition to service performance** because service performance can be temporarily affected by external factors and it would be difficult to define appropriate performance thresholds. Such an approach would make dividends more volatile, when stable dividends are one of the reasons listed company investors accept the low cost of equity in the water sector. We consider Ofwat has other, more appropriate, tools to improve service performance, in particular the outcome delivery incentive (ODI) framework.

- We fundamentally disagree with **a reduction in the notional company gearing assumption** that Ofwat is exploring further its discussion paper on risk and return. If Ofwat is concerned about highly geared companies, we consider Ofwat should take a targeted approach to those companies rather than reducing the notional gearing assumption, which affects all companies including the best performers. We consider any reduction in notional gearing is unjustified but suggesting a five-percentage point reduction to 55% in one price control period is unprecedented. It cannot be right that Ofwat's proposals imply that a sector leading company on service performance and financial resilience, such as Severn Trent, would have to raise equity in 2025-30. Listed companies raising equity is usually taken as a sign of financial distress by the financial markets, except in exceptional circumstances such as the need for the Green Recovery from the Covid-19 pandemic. Our investors value a stable regulatory framework and reducing the notional gearing assumption without evidence that it is needed for financial resilience undermines this stability.

- We fundamentally disagree with the proposal to raise the credit rating at which the **cash lock-up condition** applies. We consider the cash lock up condition should remain unchanged at the lowest investment level credit rating with a negative designation. Raising the cash lock up condition would require responsible companies, such as Severn Trent, to re-establish their headroom. The costs involved in increasing credit ratings would eventually feed into customers' bills or result in lower investment.

We agree with the following proposals in the discussion paper:

- We agree with Ofwat's view that financial resilience is a wider concept than focusing on one specific metric, such as gearing. Gearing can vary from year to year due to factors such as inflation and timing differences between raising funds and investment spending. We therefore support the proposal **not to set pre-determined limits on capital structure**, which could reduce companies' flexibility to address changing circumstances and efficiently finance investment programmes.

- We agree with Ofwat's proposal for companies to be required to submit **a financial resilience plan** to Ofwat when they are one notch above the minimum investment credit rating with a negative outlook. This is a proportionate way of monitoring companies' financial resilience. It complements Ofwat's annual financial resilience monitoring report and the associated regulatory pressure on companies to be financially resilient.

- We agree with the proposal for companies to maintain **two investment grade issuer credit ratings**. However, in the case of Hafren Dyfrdwy, we consider it would be proportionate for it to have only one credit rating given the cost of obtaining a rating and its small size.

- We agree with the proposals for companies to notify Ofwat of changes to credit ratings, increased **transparency** on the use of swaps and increased transparency on pension obligations. This increased transparency will be helpful for investors. We only use swaps for sound financial management reasons such as currency swaps, switching between fixed and variable debt to manage risk and moving from nominal to index-linked debt.

Ofwat asks for suggestions about reputational, procedural and financial **incentives around capital structure**. We hope the following suggestions are helpful: a common performance commitment for financial resilience; Ofwat using reputational incentives in its annual reports; Ofwat including financial resilience as part of the business plan incentive at PR24; and a procedural incentive to require more financial reporting for highly geared companies. Taken together these suggestions would provide reputational, procedural and financial incentives for companies to be financially resilient. We also discuss in our response The Pensions Regulator's (TPR) approach of targeted actions on pensions schemes with resilience issues.

We look forward to working with you constructively on financial resilience over the coming months as you progress towards Ofwat's final methodology for PR24.

Yours sincerely,

[redacted]
Director of Strategy and Regulation
Severn Trent Water

Response to questions

Comment on Ofwat's executive summary

The discussion paper did not ask a question about it, but we are interested in Ofwat's comment in the executive summary (page 4) that:

> "credit ratings are intended to inform debt markets and provide an independent view of credit quality and are not in place to protect customer interests. **Therefore, we see a role for us to provide an assessment from the customer perspective** and we will continue to build our insights here," (emphasis added)

We are happy to support Ofwat in building its insights, if that would be helpful.

Chapter 2.3 - Credit ratings

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?

We agree with Ofwat's view that water companies should have adequate levels of financial resilience to meet customers' needs at all times.

Credit ratings allow water companies access to financial markets to make sure we can raise funds to deliver services for our customers and the environment.

At Severn Trent we are targeting and are operating at two notches above the lowest investment grade credit rating. We consider this is an appropriate level of financial resilience for a listed company to ensure we can deliver for our customers and the environment. It also provides a proportionate amount of headroom over the cash lock up condition linked to the licence requirement for water companies to maintain at least the lowest investment grade credit rating.

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?

At Severn Trent we are targeting and are operating at two notches above the lowest investment grade credit rating. We consider this is an appropriate level of financial resilience to ensure we can deliver for our customers and provides a proportionate amount of headroom above the licence requirement.

As we discuss in our response to question 5, we agree with Ofwat's proposal for companies to submit financial resilience reports to Ofwat if they are one notch above the lowest investment grade credit rating and on a negative outlook.

Chapter 3.2 - Should we place limits on capital or financing arrangements?

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.

We agree that financial resilience is a wider concept than focusing on one specific metric, such as gearing. Gearing can vary from year to year due to factors such as inflation and timing differences between raising funds and investment spending. We therefore agree with Ofwat's proposal not to set pre-determined limits on capital structure, which could reduce companies' flexibility to address changing circumstances and efficiently finance investment programmes.

The discussion paper draws a distinction between limits, rules and definitions of acceptable use. We will work constructively with Ofwat on any proposal for rules for risks to financial resilience or definitions of acceptable use. Ofwat will need to be cautious that these do not effectively become limits with the unintended consequence of reducing flexibility to address changing circumstances and to efficiently finance investment programmes. In addition, as the discussion paper says, such an approach could end up shifting the decision risk to the regulator instead of the company, when it is the company and its management that are better positioned to manage their risks.

Chapter 3.3 - Raising the minimum standards of credit quality

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.

<u>Cash lock-up conditions set at a higher credit rating</u>

We fundamentally disagree with the proposal to raise the credit rating at which the cash lock-up condition applies. We consider the level for the cash lock-up condition should remain unchanged at the lowest investment level credit rating with a negative designation. Raising the level would apply the cash lock-up condition to a company that is meeting its licence condition and is not considered at risk of a downgrade.

Raising the cash lock up condition would require responsible companies, such as Severn Trent, to re-establish their headroom. The costs involved in increasing credit ratings would eventually feed into customers' bills or result in lower investment.

That said we do agree with companies being required to submit financial resilience plans to Ofwat when they are one notch above the minimum investment credit rating with a negative outlook as a more effective way of pressuring companies to justify and potentially improve their credit rating (for more detail please see our response to question 5).

It is worth being aware that the credit rating agencies calculate the credit metric "Funds From Operations" (FFO) to debt before the payment of any dividends. Therefore, applying a cash lock up that stops dividend payments will have no immediate effect on FFO/debt and a company's credit rating.

Linking cash lock-up conditions to measures of service performance

We fundamentally disagree with the proposal to link the cash lock-up condition to service performance because it could lead to more volatile dividend payments as follows:

- First, operational performance can vary from year to year, e.g. due to a cold winter, a drought or a storm, such as Storm Arwen in November 2021 which was the worst in two generations. It would create uncertainty for investors if distributions were effectively linked to weather conditions rather than underlying performance.
- Second, it will be difficult to define the operational performance levels that would trigger the cash lock up conditions, creating uncertainty for investors. Large water companies have more than thirty performance commitments and no company has achieved more than 88% in a single year, reflecting their stretching nature. As a result, Ofwat will need to define what proportion of commitments a company needs to achieve, whether near misses count the same as large misses and whether a materiality threshold should be applied to overall performance. This would involve a complex system. The alternative is a more flexible system involving judgment, but this would create Ofwat discretion over payments to investors, undermining the stability of returns for investors.

More volatile dividend payments are likely to lead to investors requiring higher equity returns from water companies.

We agree with Ofwat's view that decisions about dividends are the responsibility of the Boards of water companies. We consider water companies should continue to manage the balance between reinvesting profits into the business and distributing to shareholders, as we have done over a long period of time, while always maintaining a sustainable level of gearing and service quality for our customers.

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

We agree with the proposal for companies to submit a financial resilience plan to Ofwat at a certain credit rating. This seems to be a proportionate approach given companies should manage their financial risk and it would codify the discussions Ofwat has with companies in such positions.

We consider adopting Ofgem's threshold for the financial resilience report of a credit rating falling to BBB/Baa2 (or equivalent) and on negative designation is appropriate. The trigger point for this additional reporting requirement is proportionate because it is one notch and a negative outlook above the lowest investment grade credit rating, which is the requirement in the licence.

We consider the required contents of the financial resilience report should reflect what a prudent licensee should be considering and discussing internally if they were in this position.

We do not support publishing the financial resilience reports because they will contain financially and commercially sensitive information. In addition, a prudent company will want to consider a range of scenarios including downside scenarios that might concern external stakeholders who did not fully understand the purpose and context for the scenarios.

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.

We agree with Ofwat's view that decisions about dividends are the responsibility of the boards of water companies. Our Board already makes sure it is comfortable that the company remains financially resilient when it approves our dividend payments, so we do not object to the proposal in question 6. At PR19, we aligned our dividend policy for 2020-25 with Ofwat's latest expectations.

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

We agree with Ofwat's proposal for companies to maintain two investment grade issuer credit ratings.

In the case of Hafren Dyfrdwy, we consider it would be proportionate for it to have only one credit rating given the cost of obtaining a rating and its small size. We consider there should also be funding for the additional cost of the credit rating for Hafren Dyfrdwy.

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 Ofwat's proposed requirement for companies to formally notify Ofwat of any changes to credit ratings, including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals.

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

We consider that a dispensation should only be used in exceptional cases where there is a clear benefit to customers.

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

We support Ofwat's view that decisions about dividends are the responsibility of the boards of water companies. As a responsible, financially resilient company our Board considers our long-term investment needs, our long-term financial resilience and our long-term service delivery for customers and the environment when deciding our dividend policy.

At PR19, we aligned our dividend policy for 2020-25 with Ofwat's latest expectations. Therefore, we do not consider Ofwat needs to put its expectations on dividends into the licence. Keeping Ofwat's expectations outside the licence gives Ofwat more flexibility to evolve its expectations as circumstances change.

Chapter 3.4 - Increased transparency

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

We agree with enhancing the transparent reporting of swaps. We already report publicly on our derivatives in our Severn Trent Plc and Severn Trent Water annual report and accounts.

We make a responsible and limited use of swaps, which can provide benefits for customers. For example, we use currency swaps, which Ofwat supports in its discussion paper. We also use swaps to manage risks in our debt portfolio, for example by converting floating rate exposures to fixed to hedge against rising interest rates and by converting RPI liabilities to CPI ones to match the regulatory assumptions more closely.

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.

As a listed company our holding company debt levels are already in the public domain. However, we do not agree with requiring the reporting of holding company debt levels because these are not regulated entities.

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

We welcome Ofwat's reaffirmation that funding pension deficits remains the responsibility of companies and their shareholders and there is no intention for Ofwat's established policy on the treatment of pensions deficit costs to change.

We agree with improving the transparency of pension deficit reporting.

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

We agree with PR24 business plans including a Board assured assessment of financial resilience, building on the assessment we produced for PR19. We look forward to working with Ofwat on what the contents of that assessment should be.

Chapter 3.5 - Regulatory incentives on capital structure and performance

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 fundamentally disagree with a reduction in the notional company gearing assumption that Ofwat is exploring further its discussion paper on risk and return. If Ofwat is concerned about highly geared companies, we consider Ofwat should take a targeted approach to those companies rather than reducing the notional gearing assumption, which affects all companies including the best performers. We consider any reduction in notional gearing is unjustified but suggesting a five-percentage point reduction to 55% in one price control period is unprecedented. It cannot be right that Ofwat's proposals imply that a sector leading company on service performance and financial resilience, such as Severn Trent, would have to raise equity in 2025-30. Listed companies raising equity is usually taken as a sign of financial distress by the financial markets, except in exceptional circumstances such as the need for the Green Recovery from the Covid-19 pandemic. Our investors value a stable regulatory framework and reducing the notional gearing assumption without evidence that it is needed for financial resilience undermines this stability.

However, we recognise Ofwat's concerns about financial resilience and consider there are alternative solutions without the damaging side effects of lowering the notional company gearing assumption.

We consider there is value in considering the following options on incentives around capital structure:

- **A common performance commitment (PC) for financial resilience** with performance potentially determined by the outcome of a form of financial resilience "audit" against a pre-defined set of measures and criteria. This could be linked to the dashboard in Ofwat's annual Monitoring Financial Resilience (MFR) report. We recognise that Ofwat would prefer this to be a reputational incentive, but making it a common PC would mean it would count towards Ofwat's assessment of what proportion of PCs each company has achieved.

- **Using reputational incentives in Ofwat's annual reports.** This could build on the dashboard in the MFR.

- **Taking account of financial resilience when assessing business plans at PR24.** This could cover past performance during AMP7 as well as current and future plans. Ofwat could also consider companies' proposals for sharing outperformance with customers on a voluntary basis. Financial resilience could be included as part of the business plan incentive at PR24, which would strengthen the incentives on financial resilience. Ofwat could also make financial resilience a requirement for "fast-track" status at PR24.

- A procedural incentive for financial resilience would be to require **more financial reporting for highly-geared companies**. This would encourage companies to become more financially resilient to reduce the amount of reporting they have to provide.

Taken together these suggestions would provide reputational, procedural and financial incentives (via the business plan incentive) for companies to be financially resilient.

We have also mentioned in conversation with Ofwat the approach of The Pensions Regulator (TPR). TPR focuses its actions on pensions schemes with resilience issues, rather than all pension schemes.

TPR seeks to ensure the resilience of pension schemes, so that they can deliver all their promised pensions to their beneficiaries. The main legal requirement that supports this is a triennial actuarial valuation, followed by the submission of a recovery plan.

TPR has increasingly tightened up its expectations on valuations and recovery plans, including:

- expecting schemes to undertake detailed scenario testing on their financial robustness, within an integrated risk management framework that links funding, investment and sponsor covenants;

- expecting that schemes do not take on more risk than their sponsor covenant can support;
- expecting that schemes develop clearly actionable contingency plans, should there be adverse developments in the future; and
- expecting that pension schemes are treated fairly alongside other stakeholders, particularly shareholders.

TPR requires submission of recovery plans and has various powers to then investigate and impose additional requirements on schemes, targeted where they are not satisfied with the recovery plan. These requirements can include “supervision”, replacing a Trustee and calling for or imposing requirements for companies to contribute to schemes. TPR’s powers are being strengthened by regulations that are under development following on from the Pension Schemes Act 2021.

We consider TPR’s approach emphasises the importance of all schemes / companies demonstrating their financial resilience, but the regulator only targeting actions on those schemes / companies with weaker levels of resilience.