South West Water
Peninsula House, Rydon Lane, Exeter, EX2 7HR
www.southwestwater.co.uk

Date: 31 January 2022

Ofwat
21 Bloomsbury Street
London
WC1B 3HF

By e-mail: OfwatPandO@ofwat.gov.uk

Dear Sir,

FINANCIAL RESILIENCE IN THE WATER SECTOR: A DISCUSSION PAPER

We welcome the opportunity to respond to this discussion paper. We have included our responses to your specific questions in Appendix 1.

We agree that it is essential that we are a robust and financially resilient sector. In recent years Ofwat has placed even more focus on ensuring the water sector is financially resilient. Changes made have increased the focus and reporting of long-term viability, dividend policies which provide a direct link to the performance of the regulated business and challenged companies to consider their financing structures.

We agree that further transparency on financial structures and resilience (alongside other aspects such as pensions and dividend payments) would be beneficial, but we do not believe there is a need to change the licence or target a higher investment grade credit rating to achieve this.

In addition, we do not believe it is necessary to specifically hold a formal credit rating to secure benefits for customers or ensure our financial resilience. South West Water does not hold a formal credit rating, and this demonstrably has not impacted our financial resilience nor ability to access funding (with significant availability of debt through our Sustainable Financing Framework) at efficient rates with South West Water having one of the lowest effective interest rates in the industry. We believe our existing approach which provides significant assurance on our ability to achieve the Ofwat specified investment grade credit rating, provides a framework that underpins our financial resilience.

If you have any queries, or would like any further detail, please do not hesitate to contact us at [redacted]

Yours sincerely

[redacted]

South West Water Finance Director

APPENDIX 1

1. **Do you agree that it is not appropriate for providers of essential infrastructure to operate at, or be at risk of falling to, the lowest investment grade credit rating?**

   We believe it is essential that water companies can deliver the investment needed to deliver robust operations and service to customers. This means being financially resilient and able to attract both equity and debt investors to support the industry into the long-term.

   It is for individual companies to ensure they are financially resilient. Financial resilience to some extent depends on the financial structure that a company targets. A credit rating considers many aspects of which the financial structure is one aspect and therefore it may not necessarily be the case that a change in rating target will impact financial structures which in term impact financial resilience.

   Moreover, we think South West Water demonstrates that having a formal credit rating is not the only way of achieving financial resilience as South West Water has strong financial resilience with gearing more aligned with the notional structure assessed by Ofwat and has been able to support Green Recovery investment in advance of recovering the costs from customers.

   In addition, as we see across some companies, credit ratings can vary depending on the methodology and approach of the specific agency as well as specific company matters – therefore setting a target for overall investment grade allow for variations within these bands.

2. **Do you agree with the notion that a company should be taking actions to improve its credit rating well before it is downgraded to the lowest investment grade credit rating?**

   We think that companies should continually monitor their financial resilience and take actions where they see challenges to resilience in any area – of which a credit rating would be one aspect. However, as we have seen across companies, the differing methodologies between ratings agencies can mean that an individual company rating may not always follow the same pattern and indeed companies may not have control over external impacts that challenge a credit rating nor advance warning of such changes. There may also be short-term factors which result in a lower credit rating at a specific time – reflecting that some regulatory or political uncertainty has impacted on credit ratings in the past – but not necessarily impacted the long-term financial resilience of the industry.

We welcome views on:

3. **our option not to define limits on capital or financing structures at this time and whether it might be necessary to define limits for companies where financial resilience does not improve.**

   We believe that it is for individual companies to define their financing structures. Companies already have the licence condition to ensure they have financial resources and facilities to enable them to carry out the Regulated Activities as well as the statutory obligation to act in a way that does not jeopardise the solvency of the company.

   Ofwat clearly has a role to ensure companies are focused on financial resilience – with the existing longer-term financial viability statement a transparent way to achieving this.

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

   In recent years Ofwat has placed significant focus on ensuring the water sector is financially resilient. Changes made have increased the focus and reporting on long-term viability, targeted dividend policies (and Executive Pay) to provide a direct link to the performance of the regulated business including in many cases a direct link to service outcomes and challenged companies to consider their financing structures – through gearing mechanisms introduced at PR19.

   As a result, we do not believe there needs to be a change in the cash lock-up conditions within the licence, and in particular these should not be linked to service performance as this can be temporarily impacted by a range of external factors and may arise in only one area of the business and do not necessarily reflect an underlying issue with performance or financial resilience.

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

   We agree that companies should be taking action to improve their financial resilience and are supportive of the introduction of financial resilience plans for those that are significantly outside of the notional expectations.

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.**

   Overall, we agree that companies should be open and transparent in how dividend payments align with the dividend policies set out and how the Board has considered all factors of performance and delivery in making annual dividend decisions. However, given this requirement for clear Board scrutiny on dividend payments, there may not be a need for specific board assurance in this area – unless there is challenge to the overall financial resilience which would be covered in existing assurance statements over long-term viability.

7. **a requirement for companies to maintain two investment grade issuer credit ratings.**
8. **a requirement for companies to formally notify us of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals).**

   We agree that transparent reporting, in any area of financial resilience is important however, as South West Water demonstrates, having a formal credit rating is not necessarily reflective of a company's financial resilience.

   We support the approach of requiring companies to explain changes in financial resilience which may include credit ratings – however, in some circumstances this may be outside of a company's control and therefore the impact of such notifications needs to be carefully considered. This transparent approach to explaining changes in company ratings may seek to reduce the need for two separate ratings to be held.

9. **removing dispensations from the requirement to maintain an investment grade credit rating.**

We think that it is important that companies are financially resilient and able to access debt and equity investment in an efficient way to fund their operations and continued capital investment.

As the sector has developed with some companies having more highly geared capital structures it has been appropriate for greater focus on financial resilience with the requirement for some companies to have a credit rating, however having such as rating does not necessarily guarantee the financial resilience of the company nor alignment with notional gearing levels.

Whilst South West Water has a dispensation from maintaining a credit rating, it does have the licence condition to confirm annually, through a Board statement, that South West Water would be able to maintain an investment grade credit rating. In making this statement we undertake an extensive review including external independent assurance over this assessment taking into account many factors which are all fully disclosed within our Annual Performance Report.

South West Water's approach to producing a quality certificate is to perform an internal assessment which is externally assured and an independent credit assessment with a recognised credit rating agency. In addition, in meeting the specific licence condition the Board Assurance process provides a wider assessment of financial resilience than an issuer credit statement alone.

As outlined in our response to the Section 13 consultation in June 2020 we believe that retaining the Director certification which takes into account internal as well as external assessments are robust and have an extended remit (over and above reliance on a credit rating) is in the best interests of our customers.

South West Water has not to date required a credit rating to access efficient debt finance to support its operations. South West Water has a diversified portfolio of debt through a range of counterparties developed through several bilateral relationships since privatisation to raise efficient debt funding.

As a result, South West Water has been an infrequent issuer to into the debt capital markets as the size of required tranches of debt funding has been traditionally lower than 'benchmark'. Where we have had debt capital issuances, we have not required a credit rating to access the market.

Given our overall efficient financial position and the cost of maintaining a credit rating, we believe it is not in the interest of customers and stakeholders to obtain a public rating and we see no reason why any existing dispensations should be removed.

10. **the need to align the licence to our broader expectations for dividend policy.**

In recent years there have been significant changes in the dividend policies of companies across the industry – with many transparent policies which already link the dividends paid to the overall performance of company (many with reference to the Final Determination). In addition, many policies also include reference to long-term financial resilience when making dividend decisions.

Ofwat has previously noted that whilst the dividend policies were robust and transparent, the recent Annual Performance Reports for 2021 did not include sufficient disclosures on how the dividend decisions aligned with the overarching policy and the decisions taken for the year. We agree that there is room for improvement in the disclosures made within the annual reporting but given existing checks and balances in regard to dividend policies and financial resilience there is no need to amend the licence.

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

We are supportive of open and transparent reporting and agree that where swaps potentially impact on the financial structure and resilience of a company that additional disclosure may be appropriate.

South West Water utilises vanilla interest rate SWAPs, converting floating rate debt to fixed rates over a defined period – it does not hold any index-linked SWAPs.

12. whether disclosure requirements should be set for companies to increase the reporting of holding company debt levels (for example to state holding company gearing levels) in their Annual Performance Reports.

We believe that water companies should be open and transparent about their financing structure and payments made between Group companies. These disclosures (which should include financing arrangements) are already disclosed within the Annual Performance Report and as a ring-fenced company the level of debt or gearing at the holding company may not be relevant to the water company if there are significant other non-regulated activities.

13. the option to improve the transparency of pension deficit reporting

We understand that servicing pension deficit liabilities could be a factor is a company's financial resilience and additional reporting in this area may be beneficial, however with considerable disclosures required in company Annual Reports and Financial Statements any further disclosure requirements should be proportional and avoid duplicating existing disclosures.

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

Board Assurance was a requirement across the whole of the PR19 business plans – including financial resilience. The need to balance investment, service and risk & returns is fundamental to developing a business plan where companies needed to ensure they are able to finance their operations and future plans.

In addition, companies provide assurance annually through the long-term viability statements.

Therefore, we do not believe there needs to be a change in this approach at PR24 – but further guidance of expectations from Board Assurance statements might beneficial if Ofwat has concerns over the consistency of assurance given over financial resilience.

15. **how the incentives framework around capital structure should evolve at PR24 taking account of the other views set out in this paper and the scope to which companies should provide voluntary sharing arrangements at PR24.**

South West Water has always been supportive of the approach which enables companies to decide their own financing strategy and corporate structure. For this reason, we have been supportive of Ofwat's previous proposals for companies to share financing outperformance from higher gearing. Companies should be incentivised to make efficient financing decisions and as a result, they should bear the responsibility for their decisions and where companies choose to do something different, we do not believe it should be to the detriment of customers.

South West Water showed our support for this by being the only company to share outperformance on debt (from efficient financing) in PR14 and the only company to commit to sharing historical embedded debt outperformance at PR19 – all through efficiency of financing and not high gearing.

We believe voluntary sharing arrangements allow companies to tailor their approach to the areas which are most relevant to their customers and individual company circumstances.