Financial resilience in the water sector: discussion paper response

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About this response

In its 'Financial resilience in the water sector: a discussion paper" dated December 2021, Ofwat asked for responses to a number of questions summarised in Box 1 of the Executive Summary.

This document sets out a full response to all questions. Given the complex nature of the topic we have provided an executive summary, which we hope helps to provide context and explain the basis on which we have provided answers to each of the specific questions.

For clarity, our response sets out each of Ofwat's questions, followed by our answer.

We would be happy to discuss this response, or any other aspect of our financial resilience with the Ofwat team at any point.

Executive summary

Ofwat is correct to take a keen interest in the allocation of risk and return, and financial resilience

Economic regulation seeks to align the interests of companies and their investors with those of customers and society by means of the allocation of risk. Ofwat's work in recent years has brought important increased scrutiny of - and challenge to - the industry on this.

Ofwat's 'Back in Balance' work has reset the regulatory framework to better align financial (and to an extent reputational) incentives with delivery of outcomes and improvements in efficiency and innovation that will benefit customers. We see Ofwat's work on financial resilience as closely linked to this. It is important to ensure that equity-type risk in the sector is appropriately borne by shareholders and that shareholders act on the incentives this creates. Risks that should sit with shareholders, and which shareholders are remunerated for, should not somehow be shunted on to customers, either financially or in terms of performance and resilience. There are circumstances in which it is appropriate for customers to bear risk, for example, where the allocation of a risk to shareholders that they are unable to manage leads to a risk premium on the cost of capital (and a cost to customers) with no attendant customer benefit through improved management of that risk. But it is important for such decisions to be made consciously and to be clear where risk sits so that it can be provided for.

Thames Water's shareholders are conscious of the risk they bear and take this seriously; Ofwat's reforms mean that today's market and regulatory mechanisms work well, and are prompting action

Ownership of a water company is a privilege. Water companies hold a monopoly position in respect of supply of life's essence service. With that privilege comes great responsibility, including to maintain the resilience of these services in the face of risk. Our shareholders are fully cognisant of this responsibility. They know that if they fall short, the regulatory regime will work – as it should – to cause them significant financial and reputational pain. In our view, the reported developments at Southern Water shows how this can play out, and demonstrates the effectiveness of existing regulatory and market mechanisms in precipitating change to protect the interests of customers.

At Thames Water, we know that our performance for our customers, communities and the environment has fallen short. The existing regulatory regime is causing our shareholders significant pain as a result. We accepted our final determination in PR19 expecting to incur more than £120 million of outcome delivery incentive penalties. Through the conditional allowances, our ability to recover from our customers the cost of improving resilience in London's water network is contingent on a £300 million contribution from our shareholders. In accepting our final determination at PR19 we also understood that our costs benchmark as inefficient against Ofwat's models, and that the poor quality of our business plan means that every pound we spend over our price control allowances costs our shareholders 75 pence.

The root causes of this poor performance will take time to address. Ofwat is aware that we have a turnaround plan of real breadth and depth in place to do this, and that it includes a review of our capital structure. This is not a quick fix, and we simply could not deliver the turnaround plan without the support of our investors throughout its duration.

The sector has proved itself to be financially resilient in the face of significant shocks

Not only have our shareholders stepped up to support Thames Water in dealing with a series of company-specific risks, but the sector has also proved to be resilient to the two biggest exogenous shocks since World War 2; the Global Financial Crisis and the Covid-19 global pandemic. This has been noted by Mason and Wright in the paper commissioned by Ofwat.

If Ofwat believes there are risks under which company financial arrangements would not prove resilient, it would be helpful if Ofwat could be explicit about what those risks might be and about the nature of its concerns.

We understand that Ofwat is concerned about the relatively high levels of gearing of some companies. And there is obviously a discussion to be had about the optimal capital structure of individual companies. This should – and does – take place within companies, taking account of the specific nature and level of risk in those businesses. Given the risks it faces – as we have set out above and about which Ofwat has been increasingly clear in recent years – it is fully in the interests of shareholders to adopt a capital structure that is financially resilient. If that requires de-gearing, then this will happen.

While we fully accept Ofwat's desire to understand that these discussions are happening, we do not accept that Ofwat should or needs to be prescriptive about the appropriate capital structure for an individual business. We therefore support Ofwat's view that it should continue to calculate price limits using an industry-wide notional level of gearing. There is clearly a debate to be had about what this should be and the implications of whatever level is chosen.

Ofwat needs to provide more evidence of a causal link between high levels of gearing and poor performance, and already has tools to deal with poor performance

We read Ofwat's analysis of performance and gearing with interest. The analysis does not establish a causal link between poor performance and levels of gearing. The analysis may show some degree of correlation, but it is weak. There are highly geared companies with high levels of performance (e.g., Anglian Water) and highly geared companies with high levels of investment (e.g., Thames Water). There are companies whose performance (in absolute and industry-relative terms) has shifted significantly over time while their gearing has not changed materially and Ofwat has not considered this. Higher levels of gearing can reflect where a company is in its investment cycle, with periods of investment necessary in the short term to stimulate improvements in operational performance over the long term. We also note that Mason and Wright take the view that it is hard to establish a robust link between gearing and operational performance on the basis of the relatively little data available.

In our view, given the existing protections and incentives in the regime, there should be a high bar on direct regulatory intervention (including any penalty mechanism) in respect of a company's capital structure and the evidence base provided in this discussion paper falls substantially short of that.

We very much understand and appreciate Ofwat's concerns about industry performance and its desire to see poor performing companies improve. We believe that Ofwat's 'Back in Balance' work has improved the alignment of company interests with improved performance for customers and society. The PC and ODI framework in particular has been effective in improving the alignment of company financial performance with delivery for their customers. In its recent consultation on PCs and ODIs, we note that Ofwat has set out proposals that it believes will enhance this aspect of its regulation, and we would encourage Ofwat to channel its concerns about company performance towards that work, rather than seeing it as supporting arguments for de-gearing. In our view, for example, Ofwat should consider carefully whether the downside-skewed nature of its ODIs provide the best incentive for improved performance.

Companies are already incentivised to address high gearing where this is an issue, but the story for equity can be challenging

Where an individual company's circumstances do suggest that de-gearing would be sensible, this could be challenging to achieve.

To be clear, the story for equity in the water sector today is not always a compelling one. Ofwat's messaging, regulatory policy and decision-making over the last decade has consistently increased investor risk and driven down base returns. We recognise that this has been important in improving that alignment of investor and company interests with those of customers and society; companies need to work harder to do more of what matters for customers and society if they are to enjoy upside. Logically, there must be a limit to this; there must be a point at which Ofwat considers that the sector is 'back in balance'. But this is not apparent to investors, who observe a trend of increasing risk and lower returns.

Linked to this, we are very supportive of Ofwat's emphasis on the need to focus on the long term and will reflect this in our forthcoming business plan. It would be helpful if Ofwat could be clearer about how the regulatory regime will treat some of the large, lumpy, long term projects we need to deliver such that investors can be confident that risks will be remunerated over the long term. Furthermore, we think it is important to stand back and look across the emerging PR24 policy framework – PCs, ODIs, totex allowances, the bioresources controls – and consider the outturn balance of risk and reward this creates, and whether it adds up to an environment conducive to increased equity investment.

Ofwat's proposals for a more sensitive and broader cash lock up trigger are counter-productive

We are particularly concerned about Ofwat's proposals to introduce cash lock-up where a company's investment grade credit rating is at BBB (negative outlook), and potentially an even higher level.

We support Ofwat's use of credit ratings as an indicator of financial resilience and support the licence requirement to maintain investment grade. But, as Ofwat appreciates, directors are under a legal obligation to take a much broader set of parameters into account when assessing financial resilience. Furthermore, credit ratings reflect both objective and subjective factors, including the ratings agencies' views of how Ofwat may operate the regulatory regime. To give an example, when Ofwat initially introduced the ODI regime at PR14, rebalancing returns substantially away from base returns through the allowed WACC and towards more performance-driven returns, the ratings agencies were unsure of how the regime would be operated in practice and did not take ODIs into account in their ratings. There is a significant risk that companies will be placed into cash lock-up as a result of some such subjective judgement, which could even be a consequence of regulatory changes.

We are also concerned about Ofwat's idea of amending the existing trigger for cash lock-up to include levels of performance and other obligations. Ofwat is aware that measures of service performance are not fully accurate or consistent across companies, even where their performance and incentives are determined on a comparative basis. Measures of service performance also change over time, specifically as part of the price review process. In addition, there are several service performance measures that are very vulnerable to events beyond a water company's reasonable control (such as high impact, low frequency rainfall events). These imperfections can be accommodated in the round in the current regime. But if any of these measures individually or collectively were to trigger a cash lock-up they would need to become much more accurate and comparable, and would need to be more focussed on aspects of performance within reasonable management control. Attaching the possibility of a cash lock-up to these measures would place more weight on them than they can bear.

Given all of these concerns, there is no doubt that increasing the risk of being in cash lock-up as a result of Ofwat's proposed changes would negatively impact investor perceptions of the sustainability of yield and consequently equity returns. This in turn would make it harder to attract equity into the sector (unless it was reflected in the WACC), while effectively increasing protection for bond holders. As Ofwat is aware, the debt provided to water companies often comes with covenants designed to protect bond holders by placing restrictions on what companies can do (e.g., in the form of requirements to maintain certain ratios), and we have argued that these act to protect customers too. In previous discussions, Ofwat has accepted this, but has also noted the potential for these protections to create rigidities in company governance structures that could be unhelpful. It therefore seems to us counter-intuitive that Ofwat is now contemplating the introduction of further such rigidities.

Overall, we are therefore concerned that Ofwat's proposals for a more sensitive cash lock up trigger could have unintended consequences, by making it more challenging to attract equity should they need to address financial resilience concerns.

Ofwat should instead take a strict 'comply or explain' approach to financial resilience

We are supportive of increasing transparency to ensure that financial structures and risks to long term viability are clearly understood. If Ofwat wants to achieve this and encourage companies to ensure that sufficient credit rating headroom is maintained above existing licence conditions, we see benefit in adopting a 'comply or explain' regulatory mechanism. This approach is well-established and one of the key foundations of UK corporate governance best practice. We therefore request that Ofwat considers the following proposals:

- On a periodic basis, companies with a credit rating (or basket of metrics) below the designated credit ratings threshold (or for the associated basket of metrics) could be required to explain, via a board-assured statement, why their level of financial resilience is considered sufficient. This statement could be published within the annual performance report or alongside viability statements in the annual report and accounts. We believe there is value in Ofwat taking account of board's existing going concern and viability statement obligations when determining any additional assurance requirements. We also suggest that consensus be reached as far as possible on the designated thresholds to ensure that only material issues for financial resilience are highlighted and focused on.

- In the event of a "Lock-Up" and "Trigger" covenant being breached under a company's debt financing arrangements, the company would be required to notify and engage with Ofwat (on a confidential basis), disclosing the causes of the breach and any remedial plans being agreed with the security trustee (or equivalent). We consider this as a way for market-based debt protections to complement regulatory protections to improvement visibility and provide assurance for Ofwat that appropriate actions are being taken on a timely basis to protect customer interests.

We note that Ofwat appear to be concerned about the use - and lack of transparency - around "risky" swaps. We understand your concerns are driven by the use of derivatives to reprofile cashflow, increasing near term cash inflows by creating a larger marked-to-market liability which consequently increases gearing and cash outflows in the future. Whilst Ofwat are justified in exercising caution around such transactions, derivatives remain an important and established tool for treasury risk management provided they are used in a bona fide manner for hedging purposes. As such, the underlying intention is relevant. We believe it is important that Ofwat does not take a 'one-size-fits-all' approach that could unintentionally penalise the legitimate use of swaps, or overly constrain a company's ability to manage treasury risks in a prudent, proportionate and efficient manner. Derivatives will be intensively relied upon following a full transition to CPIH for regulatory capital value indexation, given the lack of liquidity in CPIH based funding markets. Therefore, we encourage Ofwat to adopt an approach that facilitates open dialogue with companies about the nature of the derivatives being used to manage risk.

A high bar should exist for any licence modifications

It is important that a high bar is applied to changes to company licences. Licences are the bedrock of regulatory stability and transparency, which underpin the sector's ability to continue to attract the capital required to secure current and future customers' water and wastewater services.

In an environment where neither the precise nature of the problem to be solved is clear, nor the transmission mechanism between any policy change and an actual improvement is clear, it does not feel appropriate to write such a policy change into licences. Neither do we believe this is necessary. Rather Ofwat should make any changes that it considers are needed to improve financial resilience trough PR24. This will also have the benefit of enabling Ofwat, companies and investors to stand back and consider their impact in the round, against the overall balance of risk and reward in the review.

Any changes to the regime should aim to improve outcomes for customers

We understand and are supportive of Ofwat's work continually to review its regulatory framework and to strive to improve its effectiveness in aligning the interests of companies and their investors with those of customers and society. There is always scope to learn and improve. But it is important only to make changes where they would result in better outcomes, and to make that assessment holistically. In our view, today's regulatory regime and markets have done a good job in both allocating risk to drive improved outcomes and to maintain financial resilience.

There may be scope to improve the performance incentive framework. But this is not linked to gearing.

There may be a need for some companies to adjust their capital structure to better reflect the risk profile of their business. Evidence today suggests that companies are fully incentivised to examine these issues and act; no further regulatory intervention is required there. Where regulation can help is by enabling a more compelling proposition for equity, and by supporting better transparency. Changes in these areas would, in our view, be completely aligned with customer interests and would help to secure the changes that Ofwat wishes to see.

We would be happy to discuss and work with Ofwat further on any of these issues.

Response to questions

Question 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 note from the Mason & Wright paper[1] that there is not compelling evidence of harm to customers of lower credit ratings, but we acknowledge that this, equally, does not provide evidence that there is no harm to customers of lower credit ratings. Given the limited empirical dataset, we consider the overarching principle to be that providers of essential infrastructure should be seeking to provide high levels of service in a sustainable and financially resilient manner. We see the well-established licence condition in the water sector requiring the maintenance of an investment grade credit rating as being central to financial resilience and helping to protect customers' interests.

Our investors (equity and debt) are supportive of maintaining a prudent level of headroom to the minimum investment grade requirements as the consequences of breach would be so severe that they (particularly equity) stand to suffer significant loss. In practice, this is a key driver for ensuring appropriate corporate governance arrangements are in place, which include Board-approved financial and risk management policies, regular going concern and viability statement assurance, and debt covenants (financial and non-financial). The appropriate level of headroom will be bespoke to each company (and even to particular circumstances for a given company) and must be assessed on a case-by-case basis. For example, it would be quite reasonable for a company to step up investment to improve service to customers, which may reduce its free cashflow and result in a credit downgrade in the short term, knowing that this was a temporary and planned consequence. It may also be appropriate for it to maintain its dividend during this period, especially if equity has been contributed in the form of reinvestment or new capital. Additional regulatory constraints on credit ratings may therefore have unintended consequences with adverse impacts on customers.

Question 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?

Our shareholders seek a stable ratings environment, and this is supported by maintaining prudent levels of headroom against minimum licence requirements as well as against credit ratings and financial covenant thresholds. For reasons similar to those set out in our response to Q1, investors would, in general, be in agreement with this notion, but any additional rigid regulatory requirements may have unintended consequences and restrict the flexibility of, and incentives for, companies to put in place actions for the longer-term benefit of customers, communities and the environment. Specifically:

[1] Mason and Wright, 'A report on financial resilience, gearing and price controls', 3 December 2021, paras 4.17-4.18

- Our corporate governance arrangements, including debt covenants, ensure appropriate management actions are taken at appropriate times to avoid breach of minimum requirements.
- Factors driving a deterioration in credit ratings (e.g. higher opex and ODI penalties) are likely to be correlated to a reduction in headroom in financial covenants. A typical debt package includes an array of lender protections and early warning signals based on a sliding scale of thresholds that are likely to be triggered well before the licence condition is triggered. These credit-enhancing protections are aligned to customer interests in compelling management to take remedial action in a timely manner.
- A deterioration of credit ratings towards sub investment grade can start to disproportionately increase pricing for new debt issuances and refinancing risk, which provides a strong economic incentive for shareholders to ensure management is taking action to protect existing ratings.

That there have been no observed water company failures over the last 15 years, despite a global financial crisis and a worldwide pandemic, provides evidence that the existing regulatory arrangements, alongside debt covenants and corporate governance arrangements, have been working effectively in the round to ensure appropriate controls are in place and appropriate actions are being taken on a timely basis. We have, however, given due consideration to additional mechanisms which could be in customers' interest (refer to our proposals in response to Q5 and Q6).

Question 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 agree with not defining limits to gearing on the basis set out by Ofwat, and also consider these to be too a narrow measure and not sufficiently flexible to accommodate changing circumstances and investment needs. We note gearing-based controls are already typically included as a debt covenant and are rigorously used by rating agencies in their assessments.

Although far from perfect, we consider credit ratings are better than gearing (or any other individual metric) as a proxy for financial resilience and as a basis for any regulatory tools such as the minimum investment grade licence condition. But, as Ofwat appreciates, directors are under a legal obligation to take a much broader set of parameters into account when assessing financial resilience. Indeed, there are risks to using any single proxy and we would therefore encourage Ofwat to factor in a wider set of relevant factors such as strength of corporate governance arrangements, headroom to debt covenants, debt maturity concentration and the type of equity investors.

It is not clear to us why gearing-based (or similar) limits would become more appropriate or effective where financial resilience does not improve if the primary concern is customer harm. We would consider scrutiny on service performance, investment levels and remedial plans – using existing enforcement powers – to be a more direct, proportionate and recognised form of regulatory intervention.

We also find the CMA's statements in relation to the Gearing Outperformance Sharing Mechanism ("GSM") to be of strong precedential value and, for these reasons, would not expect any similar economic penalties linked to any single metric (including credit ratings) to be reintroduced. Punitive regimes in this context do not provide incentives for increasing equity in the sector (as skewing strongly to the downside has the effect of raising the cost of capital and therefore, other things being equal, increases the risk that an individual company will not achieve its cost of capital) and reduce financial resilience if levied through a reduction in revenues, which are not in the customer's interest.

Question 4

We welcome views 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.

Raising credit ratings requirements and/or imposing new criteria based on service delivery for setting the cash lock-up threshold would represent a significant departure from established sector precedent, given the relative stability in this area of the licence over many AMPs. A sudden change in policy could be considered by rating agencies and investors as introducing material regulatory uncertainty and instability. This can have unintended consequences of:

- Disincentivising investment by redistributing funds towards de-gearing (to improve the rating and exit the lock-up) away from accelerated investment to improve service to customers, communities and the environment (as shareholders may not be able to afford both).
- Creating rigidity in companies by incentivising a short-term focus on managing credit ratings to the detriment of managing performance and investment levels whereby issues might arise only in the medium-longer term, with a detrimental impact on customer service and the environment.
- Disincentivising investment where shareholders are seeking to invest in a long-term turnaround proposition (and deliver an eventual uplift in ratings) for the benefit of customers and looking to have discretion over a progressive level of yield from delivering performance improvements, but are prevented by rigid service and credit rating thresholds.
- Penalising companies through no fault of their own. Regulatory publications could result in a rating agency to downgrade the sector rating or outlook, reasonably or unreasonably, absent any change in company-specific factors. This would allow Ofwat or a single rating agency to put companies into lock up through their own actions. For example: Moody's putting the sector on negative outlook during the PR19 process due to anticipated changes to regulation and a reduction in regulatory transparency and consistency[2].
- If a one-size-fits all approach is taken, not reflecting underlying differences between companies (e.g., size and complexity) as legitimate factors when assessing the merits of a dividend payment.

[2] ibid

- Undermining the scope and legitimacy of a board's remit in deciding on, and applying, dividend policy. Concurrently, it risks undermining Ofwat's own stated principle of not regulating the dividend. As a comparison, the market for FTSE-listed companies tends to recognise a fixed pay-out ratio for dividends, meaning that lagging performance does not necessarily disqualify the payment of a small level of dividend (provided the company is not in financial distress).
- Ultimately, making the sector appear more risky and less transparent[3], which could cause a sector downgrade and drive up the cost of capital for actual and notional capital structures, which would ultimately increase costs to customers.

Many of these consequences cause harm to customers, communities and the environment in a backdrop of affordability and encouraging investment for the longer term being key priorities for PR24.

Stopping dividends in a wider range of circumstances simply accumulates cash in the business, but does not address how the cash will be used to improve service and asset health (as shareholders may still choose not to reinvest). We believe it is more effective for regulation to directly target the incentivisation of service delivery and investment levels if Ofwat consider these are the most salient areas of concern. We consider the current regulatory mechanisms, including the outcomes based regime and Ofwat's enforcement powers, to be appropriate, proportionate and effective in providing incentives for performance. If Ofwat wishes to do more in this area we would suggest refining the outcomes framework in PR24 to provide for more ODI upside to incentivise 'frontier shifting' levels of performance, which Ofwat could then use to challenge all companies in future price reviews.

Question 5

We welcome views on a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.

See response to question 6

Question 6

We welcome views on 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 consider the questions 5 and 6 to be similar in essence and seek to provide a consolidated response. In-line with our response to Q4, a credit rating falling is not necessarily a bad outcome if service and investment levels are maintained, and so focusing on regulating these areas would be the most effective most way of protecting customer interests.

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[3] During PR19, Moody's published a report ('Regulator's proposals undermine the stability and predictability of the regime', 22 May 2018) highlighting that the proposals, driven by political forces, undermined "stable and predictable" regulation and concluded a sector downgrade was appropriate

However, we also recognise[4] that as credit rating headroom is reduced, this can be correlated to a reduction in financial covenant headroom and/or liquidity, which are both relevant for assessing financial resilience. We therefore see benefit in adopting a 'comply or explain' approach as a matter of principle, noting that this approach is established in other key regulatory institutions in the UK, such as the corporate governance code, and therefore is one of the key foundations of UK corporate governance best practice. We welcome further clarity as to the desired contents of these additional resilience plans and board assurance statements.

We note that many sector companies are already subject to "Trigger Event" covenants which, if breached, put the company into lock-up and require additional disclosure and remedial plans to be agreed with the security trustee to try to recover from the breach as expediently as possible. These credit-enhancing protections are designed to be an early warning signal and compel management to improve performance and financial resilience before the company becomes financially distressed; to this extent, these lender protections are aligned to the customer interest. It is important that regulatory intervention is kept to a minimum in this situation (and that quasi-Special Administration procedures are not initiated early) as it could unduly interfere with established contractual arrangements and prolong the breach, which would not be in the customer's interest.

We would suggest Ofwat considers the following proposals:

- On a periodic basis, companies with a credit rating (or basket of metrics) below the designated credit ratings threshold (or for the associated basket of metrics) could be required to explain, via a board-assured statement, why their level of financial resilience is considered sufficient. This statement could be published within the annual performance report or alongside viability statements in the annual report and accounts. We believe there is value in Ofwat taking account of board's existing going concern and viability statement obligations when determining any additional assurance requirements. We also suggest that consensus be reached as far as possible on the designated thresholds to ensure that only material issues for financial resilience are highlighted and focused on.
- In the event of a "Lock-Up" and "Trigger" covenant being breached under a company's debt financing arrangements, the company would be required to notify and engage with Ofwat (on a confidential basis), disclosing the causes of the breach and any remedial plans being agreed with the security trustee (or equivalent). We consider this as a way for market-based debt protections to complement regulatory protections to improvement visibility and provide assurance for Ofwat that appropriate actions are being taken on a timely basis to protect customer interests.

Question 7

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

We do not see this as a key concern for Thames Water given the benefit of having two ratings for our market access. We note that this may have the effect of a regressive tax on smaller water

[4] Refer also to our response to Q2

only companies in terms of the marginal cost of, and resource requirements for, maintaining an additional rating versus the marginal benefit.

Question 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 consider this to be a sensible requirement.

Question 9

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

We do not consider this to be currently applicable to Thames Water, which is subject to certain ratings maintenance requirements under its debt financing arrangements. As a large debt issuer in utilities, maintaining investment grade credit ratings helps us to secure low cost of financing. However, if Ofwat pursued the option of raising level at which lock-up would be activated, it would be important that there were dispensations available to reduce the risk of unintended consequences.

Question 10

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

The assessment of financeability (as illustrated through the risk and return discussions during a price review) and ratings environment tend to be highly cyclical and dependent upon the prevalent issues surrounding each price review. This is a key reason why rating agencies generally do not look beyond the current AMP for their assessment, unless the price review process is nearing a conclusion in determining the financial profile for companies for the upcoming AMP.

To avoid creating undesirable rigidity into the system, we suggest that any changes arising from the financial resilience consultation are more appropriately implemented through PR24 rather than through licence amendments. We also advise against implementing any regulatory interventions to dividend policy via the licence as it risks further undermining the scope and legitimacy of a board’s remit in deciding on, and applying, dividend policy. In particular, placing binary controls on dividend payments being used to service HoldCo debt obligations risks distorting and undermining the operation of dividend policy within legitimate corporate governance arrangements. This further risks reducing regulatory stability and transparency and, for the above reasons set out in our response to Q4, incentives for additional equity to be invested into the sector.

Licences are the bedrock of regulatory stability and transparency, which underpin the sector’s ability to continue to attract the capital required to secure current and future customers’ water and wastewater services. In an environment where neither the precise nature of the problem to be solved is clear, nor the transmission mechanism between any policy change and an actual improvement is clear, it does not feel appropriate to write such a policy change into licences. This is particularly pertinent given all the potentially unintended and damaging consequences of Ofwat's proposed licence modifications.

Question 11

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

We would welcome clarity of what Ofwat are seeking beyond existing disclosures by companies and how transparency could be improved to assist their assessment of financial resilience. We would be happy to assist Ofwat by discussing the nature and purpose of our existing disclosures, which often go beyond statutory requirements.

Disclosure in relation to swaps is provided in companies' annual reports and annual performance reports, as well as existing rating agency assessments. We note that, for example, Moody's takes a generally negative view towards 'kick the can' swaps and, amongst other things, exclude the near-term cashflow benefit of these in calculating their adjusted interest cover ratio. We also observe that near-term accretion paydowns and mandatory swap breaks (on which companies provide transparency as part of their dialogue with rating agencies) are factored in credit ratings metrics and agencies' assessment of financial policy, where relevant.

We note that Ofwat appear to be concerned about the use - and lack of transparency - around "risky" swaps. We understand your concerns are driven by the use of derivatives to reprofile cashflow, increasing near term cash inflows by creating a larger marked-to-market liability which consequently increases gearing and cash outflows in the future. Whilst Ofwat are justified in exercising caution around such transactions, derivatives remain an important and established tool for treasury risk management provided they are used in a bona fide manner for hedging purposes. As such, the underlying intention is relevant. We believe it is important that Ofwat does not take a 'one-size-fits-all' approach that could unintentionally penalise the legitimate use of swaps, or overly constrain a company's ability to manage treasury risks in a prudent, proportionate and efficient manner. Derivatives will be intensively relied upon following a full transition to CPIH for regulatory capital value indexation, given the lack of liquidity in CPIH based funding markets. Therefore, we encourage Ofwat to adopt an approach that facilitates open dialogue with companies about the nature of the derivatives being used to manage risk.

Question 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 would welcome clarity of what Ofwat are seeking beyond existing disclosures by companies and how transparency could be improved to assist their assessment of financial resilience. We would be happy to assist Ofwat by discussing the nature and purpose of our existing disclosures, which often go beyond statutory requirements.

Disclosure in relation to holding company ("HoldCo") debt is driven by reporting requirements and investor relations good practice. Thames Water provides a high degree of transparency already via our annual report, HoldCo accounts and HoldCo investor reports, which includes information such as debt balances.

Question 13

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

We would welcome clarity of what Ofwat are seeking beyond existing disclosures by companies and how transparency could be improved to assist their assessment of financial resilience. We would be happy to assist Ofwat by discussing the nature and purpose of our existing disclosures, which often go beyond statutory requirements.

Disclosure in relation to pension deficits is already factored into rating agency assessments. We are also cognisant that there are established market-based processes between a company and their pension trustee (which is regulated by The Pensions Regulator) to agree triennially an appropriate actuarial valuation of the deficit (or surplus) and cash repair profile (where relevant). We welcome clarity from Ofwat as to whether they consider there to be any acute issues with the existing process or disclosures.

Question 14

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

We understand the ongoing importance of financial resilience in a company's business plan and agree it needs an appropriate degree of board assurance. We welcome clarity as to whether Ofwat considers there to be gaps in PR19 board assurances and therefore how assurance requirements might differ at PR24.

Question 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.

In our view only limited changes to the incentives framework at PR24 are needed and should be carefully considered to avoid unintended consequences. The current arrangements are resulting in equity being rewarded for good performance and taking substantial pain where performance needs to be improved. Taking our own example:

- There has been significant expenditure (£1.3 billion p.a. since 2015/16), which is in excess of regulatory totex allowances to increase service performance and longer-term asset health as part of our turnaround plan.

- We are making a significant shareholder contribution of up to £300 million to release conditional allowances.
- At the time of accepting the PR19 final determination we anticipated over £100 million of ODI penalties and in 2021/22 incurred £51.4 million of penalties including C-Mex.
- At our current gearing level, shareholders would incur a substantial penalty from the AMP7 GSM and have not taken a dividend since 2016/17.

Thames Water remains financially resilient despite these substantial penalties and higher levels of gearing. Shareholders are bearing the associated risks as contemplated under the final determination and remain committed to its turnaround plan and improving services to customers, communities and the environment.

We believe that the design of any voluntary sharing arrangements should place customer interests at its heart. In Thames Water's context, we consider regulatory support for investment as critical to delivering our turnaround plan as well as delivering the best outcomes for customers in a financially resilience manner. To this end, we ask Ofwat to consider the potential customer benefits of not applying any accrued GSM penalty from AMP7 as a revenue reduction in AMP8, as the bill impact is likely to be relatively insignificant[5], but instead that the accrued penalty is ringfenced to fund investment in schemes agreed with Ofwat that are targeted at improving service delivery.

We will continue to give thought to potential voluntary sharing arrangement as we progress with our PR24 programme. This will need to take into account the overall balance of risk and reward in the overall regulatory framework. Clearly companies will be more likely to introduce voluntary sharing arrangements if the overall package is more balanced than at PR19.

[5] As an illustrative example, an assumed £200m penalty accrued over AMP7 that equates to ~£40m revenue reduction per annum in AMP8 would reduce customer bills by ~2%, or ~£8 per average HH dual service bill

Thames Water