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Dear Ofwat colleagues,

FINANCIAL RESILIENCE IN THE WATER SECTOR: A DISCUSSION PAPER – TIDEWAY'S RESPONSE

We welcome the opportunity to respond to Ofwat's discussion paper on financial resilience. In doing so, we note that the proposals are aimed at the 17 largest appointed water companies, as opposed to Tideway. While we welcome the distinction, we consider the issues raised to be fundamental to the sector and hence are sharing a response with you.

Tideway agrees with Ofwat on the importance of financial resilience for firms providing essential services. This is vital to delivering for customers and the environment and maintaining public trust in the sector both in the short and long term. We also note Ofwat's approach to regulating the sector, its existing powers and the responsibilities placed on companies and their boards, all of which have supported many positive outcomes since privatisation.

In our case, whilst we have a somewhat different purpose and regulatory arrangements, we have placed significant importance on financial resilience. We have acted in line with the principles of the Corporate Governance Code and the requirements in our debt covenants, government support package and licence. This includes, for example, securing sufficient liquidity to cover costs until the start of system commissioning, and adopting a conservative and prudent approach to the use of derivatives. We would agree with you that there does not seem to be a case to apply any changes to our arrangements.

Our detailed responses to the options in the discussion paper are set out in the annex to this letter, including comments on features of Tideway's business model and existing requirements.

We ask Ofwat to consider the following general comments:

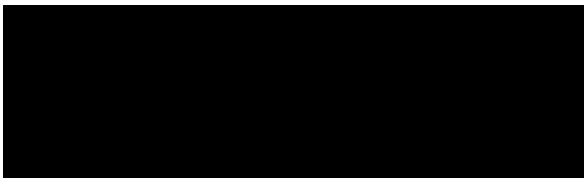
- Companies are best placed to finance themselves efficiently. Unless there are specific concerns about resilience, we do not believe that it is appropriate for the regulator to restrict the approaches that companies may wish to take, beyond the provisions already set out in their licences;
- We question whether the options presented are appropriately targeted towards less resilient companies. We see a risk that they inappropriately constrain more resilient

companies, leading to less efficient financing arrangements and increased costs to customers;

- Many of the options set out in this paper appear to represent a significant change to the regulatory settlement for the sector as determined at PR19, or in Tideway's case at licence award for the period to 2030;
- Ofwat already has extensive powers to request information from firms and to enforce against any that are not meeting regulatory obligations. It is not clear to us from the discussion paper what powers Ofwat feels it currently lacks in its work to promote financial resilience, or what new powers it is seeking; and
- We note that the regulatory ring fence was recently strengthened for appointed firms, and question why Ofwat considers that this was insufficient.

We support Ofwat's proposal for a series of roundtables to consider the issues raised in the discussion paper. It will be important at those sessions to examine the options available to Ofwat whilst ensuring the sector's financial flexibility is maintained in the interests of customers and the environment.

Yours sincerely



Director of Strategy and Regulation

ANNEX – TIDEWAY COMMENTS ON OFWAT OPTIONS

Ofwat point for discussion	Tideway comments
We invite comments and views for discussion on the following:	
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?	See general comments above
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 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	<ul style="list-style-type: none"> • We agree that there should not be a general regulatory limit on capital or financing structures. Financing is a matter for each company and regulatory limits would reduce flexibility. • For less resilient companies we question whether gearing limits would be an appropriate response given the dangers of attempting to impose a 'one size fits all' approach on different financial structures.
4. Amending the existing trigger level for the cash lock-up conditions [<i>BBB-with negative designation</i>] to a higher credit rating and the potential for the trigger to be linked to measures of service performance.	<ul style="list-style-type: none"> • This amendment would represent a fundamental change in the economic conditions faced by the sector. We do not see a case to change the existing arrangements and query what Ofwat is aiming to achieve; what problems would be ameliorated by a higher trigger level? • Whilst Tideway is less directly impacted by a link to service performance we do have concerns over the introduction of the policy to the sector. There exist questions as to how service performance would be measured which include: the identification of the measures; how the impact of external factors on performance would be considered; consideration of short or long term performance; and whether service performance would be assessed in an absolute or comparative sense. More importantly it would appear to introduce an additional and unnecessary control over the financing of companies. The proposed approach risks materially reducing equity investment in the sector, increasing the cost of equity and ultimately leading to higher bills for customers.

<p>5. A requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level</p>	<ul style="list-style-type: none"> • It would be helpful to discuss these proposals further at the suggested round tables, in particular the anticipated scope of the plans and under what circumstances they would be published. • Under our Government Support Package and financing agreements, Tideway would already be required to prepare such plans.
<p>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.</p>	<ul style="list-style-type: none"> • Financially resilient companies may choose to target a rating below that stated by Ofwat as the target for the notional capital structure. We do not think they should be penalised for this. • Similarly to other companies in the sector, Tideway is already required by its licence to have (and comply with) a dividend policy which effectively embodies the principle that dividends declared or paid should not impair the ability of the regulated company to finance the licensed business. • Companies' Boards must also follow the Corporate Governance Code, which requires them to promote the long-term sustainable success of the company. Determining whether a proposed dividend/distribution is consistent with financial resilience is an important element of this. • Additional fixed assurance requirements could have undesirable consequences, for example making it more difficult for companies to meet timescales for distributions. • We question what value a requirement for additional assurance would bring in light of the above. • Tideway reports regularly to key stakeholders on its performance and faces a high level of stakeholder scrutiny throughout the year thanks to provisions in its core project documents.
<p>7. A requirement for companies to maintain two investment grade issuer credit ratings.</p>	<ul style="list-style-type: none"> • Tideway has bespoke arrangements in relation to the IGCR requirement. In principle we would not be opposed to a requirement to maintain two such ratings but would want to discuss any proposal in detail with Ofwat to ensure it avoided imposing unnecessary costs.
<p>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).</p>	<ul style="list-style-type: none"> • We see limited benefit in such a requirement. This information is already published by rating agencies and there is a high level of engagement and dialogue between companies and Ofwat in the event of any changes.
<p>9. Removing dispensations from the requirement to maintain an investment grade credit rating.</p>	<ul style="list-style-type: none"> • Dispensations should always be robustly justified. We recommend however that Ofwat does not limit its own

	<p>flexibility to grant or maintain dispensations where circumstances mean that this is an appropriate option.</p> <ul style="list-style-type: none"> • We recognise that this option is not targeted at Tideway. We consider it appropriate for us to retain our current wording that requires ‘all reasonable endeavours’ to maintain an investment grade credit rating rather than the ‘must ensure’ wording applied to other companies. <p>Tideway’s licence was left unchanged following the last round of discussions on ring fencing in 2018/19, with Ofwat stating that, “We agree that the updated provisions may not be fully appropriate for Tideway and do not intend to amend their licence as part of this exercise. Their credit rating and other provisions are different in nature to those held by other regulated companies because they reflect the activities and risks of that company, which is construction of an infrastructure asset rather than the delivery of water and sewerage services.”¹</p>
<p>10. The need to align the licence to Ofwat’s broader expectations for dividend policy.</p>	<ul style="list-style-type: none"> • When determining a dividend/distribution, companies’ Boards are bound by the licence condition mentioned in point 6 above and must follow the principles of the Corporate Governance Code which require them to promote the long-term sustainable success of the company. • We question what the additional suggested wording would add to the above. We would be concerned if the market were to view the proposal as Ofwat being seen to have an ability to control or oversee company decisions.
<p>11. Enhancing the transparent reporting of the use of swaps and how this could be best achieved.</p>	<ul style="list-style-type: none"> • It is reasonable for Ofwat to require further information in circumstances where swap arrangements have the potential to negatively impact financial resilience. • There is a need to define appropriate conditions so as not to burden companies that use swaps to reduce risk. We would welcome information on how Ofwat developed the suggested measures/metrics. • APR Table 4B requires companies to report on their use of swaps. Tideway also voluntarily publishes quarterly information on its use of swaps (most recent update: https://www.tideway.london/media/5364/debt-summary-q3-fy-2021-22.pdf) • Tideway’s use of swaps is limited by our Government Support Package.
<p>12. Whether disclosure requirements should be set for companies to increase the reporting of holding company debt levels (for example to</p>	<ul style="list-style-type: none"> • Regulated water companies are required by their licences to meet Ofwat’s objectives on Board leadership, transparency and governance (BLTG). These include that the company must have an effective Board with full

¹ <https://www.ofwat.gov.uk/wp-content/uploads/2019/07/Decision-document-on-strengthening-the-regulatory-ring-fencing-framework....pdf>

<p>state holding company gearing levels) in their Annual Performance Reports.</p>	<p>responsibility for all aspects of the regulated company's business for the long term.</p> <ul style="list-style-type: none"> • The associated guiding provisions set out the expectation that the board of the regulated company will, among other things: <ul style="list-style-type: none"> • have full responsibility for all aspects of the regulated company's business, including the freedom to set, and accountability for, all aspects of the regulated company's strategy; • be fully focused on the activities of the regulated company; • take action to identify and manage conflicts of interest, including those resulting from significant shareholdings; and • ensure that the influence of third parties does not compromise or override independent judgement. • Holding companies provide undertakings that they will not take any action which may cause the regulated company to breach the above, or any other regulatory obligation. • An approach by a regulated company's Board that focused on servicing holding company debt to the detriment of the regulated company's interests would clearly not comply with this obligation. An attempt by the holding company to compel it to do so would breach its undertaking. • We consider that these obligations provide a powerful set of constraints on companies and recommend that Ofwat look at how best to use its existing powers to enforce against any companies that fail to meet these obligations. In our view this approach would be more effective than seeking to introduce additional requirements in relation to companies that Ofwat does not regulate.
<p>13. The option to improve the transparency of pension deficit reporting.</p>	<p>No comment</p>
<p>14. The expectation that PR24 business plans should include a board assured assessment of financial resilience.</p>	<p>No comment</p>
<p>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.</p>	<p>No comment</p>