PR24

Financial resilience in the water sector: a discussion paper

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United Utilities response to Ofwat's discussion paper on financial resilience in the water sector

United Utilities

Water for the North West

Contents

1. **Executive Summary 3**

2. **Issues arising and concerns 4**

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? 4

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? 5

3. **Strengthening the customer protections 6**

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. 6

We welcome views on the potential approaches set out for discussion, which comprise: 6

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; 6

Q5 a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level; 7

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. 7

Q7 We welcome views on a requirement for companies to maintain two investment grade issuer credit ratings. 8

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). 8

Q9 We welcome views on removing dispensations from the requirement to maintain an investment grade credit rating. 9

Q10 We welcome views on the need to align the licence to our broader expectations for dividend policy. 9

Q11 We welcome views on enhancing the transparent reporting of the use of swaps and how this could be best achieved. 9

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. 10

Q13 We welcome views on the option to improve the transparency of pension deficit reporting. 10

Q14 We welcome views on the expectation that PR24 business plans should include a board assured assessment of financial resilience. 11

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. 11

1. Executive Summary

United Utilities Water welcomes the opportunity to comment on Ofwat's 'Financial resilience in the water sector: a discussion paper'.

We are pleased that Ofwat remains firmly focussed on the financial resilience of companies in the sector for the long-term, and this objective very much aligns with UUW's approach over many years. We consider that the initiatives introduced by Ofwat in recent years - such as the annual "Monitoring financial resilience" report and the attempt to standardise licence ring-fencing conditions across the sector – have helped provide greater transparency and strengthened the financial resilience 'envelope' for the sector. We consider such measures are important in the sector retaining the trust and confidence of its customers, investors and other stakeholders. We support Ofwat's proposals that companies, in submitting their price review business plans, should articulate their dividend policies for the Appointee company in clear terms (as UUW did at PR19), including consideration of factors which could lead to an adjustment in the level of dividend paid out. However:

- We do not see a need for an expansion in the licence of the factors which require consideration of criteria in relation to the payment of dividends, with capital structure and dividend policy remaining a matter for company boards to determine; and
- We also do not support Ofwat's proposal to further amend the existing trigger level for the cash lock-up licence condition to a higher level of credit rating. We consider that there is little distinction between ratings in the BBB band (i.e. BBB flat compared with BBB-), in contrast to the 'big red line' between investment grade (IG) and sub-investment grade (sub-IG). We therefore consider that the existing trigger level remains appropriate.

From the discussion paper, we observe that Ofwat seems keen to place increasing reliance on credit ratings, and the opinions expressed by the credit ratings agencies, in the context of long term financial resilience. UUW recognises the importance of credit ratings in facilitating efficient access to debt capital markets – and as such are influential over the cost of financing the company's activities. They also provide an 'independent' opinion of a company's or the broader sector's credit worthiness. Such opinions are used by debt investors to 'benchmark' corporates not only within the same sector but also across different industries, and also to benchmark different instruments within a corporate's capital structure. As such UUW would be supportive of a requirement to maintain two ratings.

However, credit ratings arguably have limitations in some circumstances and therefore should not be seen as the ultimate and only determinant of long-term financial resilience. A typical ratings assessment horizon for a regulated utility would generally extend to no more than three to five years – arguably far less than what Ofwat consider to be "long-term" for the purposes of financial resilience. Whilst credit ratings' three to five year perspective means that they give a good assessment in the short to medium term, the drawback is that they may not capture longer term "iceberg" risks to financial resilience. This includes risks such as "kick the can" swap restructurings and failure to responsibly fund pension schemes, e.g. on a "low dependency basis". We therefore fully support the need to supplement credit ratings with enhanced transparency and disclosure in company APR's, which can be summarised in Ofwat's "Monitoring financial resilience" report.

Finally, we agree with the option around requiring companies to maintain a minimum of two credit ratings and consider that this should be consistently applied across the sector. There should be an overarching principle of consistency of requirements across the sector - we consider that there is little evidence to suggest that licence requirements on financial resilience should not be consistent across the sector, apply to all companies and provide all customers with the same level of protection.

2. Issues arising and concerns

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?

UUW agreed with and was supportive of the current licence requirements that it must ensure that it maintains an investment grade credit rating. We were also supportive of the existing cash lock-up provisions applying if a rating falls to the lowest investment grade (IG) rating with a negative watch or outlook. We consider that these requirements remain appropriate in setting a 'floor' on the bounds of acceptable ratings for an Appointee company.

What is important is that companies should plan to operate above this floor – financial resilience pertains to the risk that events outside of the company's control may cause its financial headroom to be eroded (albeit temporarily). For a company to be financially resilient, then its financial headroom should be sufficient to ensure that reasonable expectations for such risks, coupled with appropriate company actions, should enable the company to not breach the floor value of investment grade, and thereafter to be able to recover its financial headroom. Such assessments of financial resilience should reflect reasonable risk assessments – it would be unreasonable to expect all companies to be at zero risk of ever falling the lowest IG rating. We also note that raising the floor would naturally raise the normal operating credit rating that a company should operate (based on maintenance of a reasonable level of headroom to maintain a financially resilient position), which would seem very likely to increase the cost of finance and hence increase the WACC.

For many years we have targeted ratings well above such a floor. UUW's own PR14 and PR19 financeability assessments targeted maintaining solid investment grade ratings at the A3 (Moody's) / BBB+ (S&P) level. Our objective was to maintain efficient access to finance through the economic cycle. As such, we do not consider that operating at the lowest investment grade is appropriate for providers of essential infrastructure with material ongoing financing and investment needs.

Further, from a statistical perspective, there is not a material distinction between ratings in the BBB band. This is in contrast to the 'big red line' between IG and sub-IG. For example, default risk does not materially increase when comparing corporate default experience at BBB+ (Baa1) versus BBB (Baa2) versus BBB- (Baa3)[1]. The Moody's study[2] shows the cumulative issuer-weighted global default rates over the 1998-2020 period at various time horizons ranging from one year to ten years (i.e. a BBB+ rated entity suffering a default in the period one year from today through to ten years from today). For a five year horizon (arguably the longest ratings horizon) default rates were: 0.85% for BBB+ (actually fractionally lower than the 0.88% for A-); 1.02% for BBB; and, 1.92% for BBB-. For a three year horizon default rates are even more compressed: 0.49% for BBB+; 0.56% for BBB; and 0.97% for BBB-.

In contrast, the difference between IG and sub-IG default rates is more pronounced, with the highest sub-IG rating – BB+ (Ba1) - having a default rate of 3.64% for a five year horizon and 1.96% for a three year horizon.

Additionally, we have found little evidence to indicate that access to debt capital markets at a BBB- rating is materially impaired compared with BBB flat with the corporate bond indices providing no granularity within a ratings band (i.e. there are no sub-indices comparing BBB- with BBB flat in the iBoxx BBB 10-year+ corporate bond index). Again, this contrasts with a material difference in credit spreads and issuance volumes when comparing IG with sub-IG. We would be happy to share our findings with Ofwat in this regard.

Finally, we are wary of attaching full reliance on credit ratings to determine financial resilience, and consider that comparative assessment of primary source data and information (as is collated in Ofwat's "Monitoring financial resilience" report) could provide better information over an extended period of time.

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[1] See Moody's Investor Services 34th annual default study, 28 January 2021

[2] Moody's Investor Services 34th annual default study, 28 January 2021, p.48, Exhibit 44

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?

We find that the current minimum threshold in UUW's licence – to maintain an investment grade credit rating – remains appropriate and that no further requirements are necessary as regards potential deterioration in credit rating. Well-run utility businesses, operating in a balanced and fair regulatory framework, should be able to maintain a sustainable and stable capital structure whilst holding ratings at the lower end of investment grade. The choice for companies around the appropriate level of credit rating (within the IG range) represents a risk trade-off – where shareholders are increasingly exposed to losses if ratings were to deteriorate to sub-IG. Company law and code requirements provide additional onus on boards to satisfy themselves they are a going concern and resilient business. In the extreme situation of company failure, company law (administration) and the regulatory regime (special administration) both provide measures to protect creditors and customers.

The Southern Water case study in Ofwat's discussion paper indicates that these mechanisms remain fit for purpose with shareholders suffering greater loss (re: announcement on dividends in 2020 and seeking out new investors) than customers or creditors. Although it is interesting that notwithstanding the equity investment made by its new majority investor, Southern Water's rating with Moody's remains at Baa3. This indicates that it might take time to restore ratings to a better level even once action to improve the capital structure has been completed.

Ofwat's notion, that a company should take pre-emptive action, makes the presumption that:

- All possible risk events are predictable by companies, and/or that in the incidence of a risk event that company actions can always be sufficient to counteract the risk event without a temporary loss of financial headroom.
- Also, deterioration in credit ratings does not always lie solely within the company's control. As can be evidenced by the sector-wide downgrades by Fitch and Moody's in 2018, such downgrades are sometimes precipitated by regulatory, rather than company, action and are not always foreseeable let alone within the hands of companies to counter.

Where adverse ratings actions are in the gift of companies to mitigate, companies can find that the action is taken before the company has been able to put in place and execute their remedial plans.

3. Strengthening the customer protections

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 with Ofwat's option not to define limits on capital or financial structures. From a pragmatic perspective, the action in itself of defining such a limit would not be sufficient to fix legacy positions which some of the more highly leveraged companies may find themselves in. In the specific case of companies with greater financeability challenges, it is unclear whether limits would really work, for the many reasons which Ofwat identifies in the paper.

Rather, such caps on gearing could have an unintended and destabilising effect, presenting an immediate compliance issue for any companies with gearing above the prescribed level. Whilst that would seem unlikely to be the case for UUW (given our relatively low gearing versus the sector as a whole) such action could lead to broader loss of confidence from investors in the regulatory model and perhaps introduce systemic risk.

Credit rating agencies have a role to play in this space. They form a judgement in the round on all aspects of the company that affect the medium to long term credit risk profile. To support that process, and improve information transparency, any action by Ofwat should be focused on improving the quality of information disclosed to better enable Ofwat to monitor performance, which in turn may also assist rating agencies. Examples of greater transparency and information disclosure which we consider would be helpful could include holding companies and debt, swaps and pension obligations which we expand on in our responses to questions 11-13.

Raising the minimum standards of credit quality: Cash lock up licence conditions and resilience plans

We welcome views on the potential approaches set out for discussion, which comprise:

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;

We do not support amending the existing trigger level for the cash lock-up conditions to a higher credit rating. As mentioned in our response to Q1, we do not see any material distinction with regard to ratings in the BBB band, in contrast to the differences between IG and sub-IG. We therefore believe that the licence conditions in respect of credit ratings have been appropriately calibrated.

The existing trigger level already operates on a company's lowest rating, thus offering some degree of contingency and protection, particularly if the requirement to maintain two ratings is implemented, as quite often a company will be split rated. It is therefore possible that a company could be faced with a lock-up on the back of one agency taking ratings action whilst maintaining stronger ratings with another agency. In such circumstances, we would contend that there is no easy way to determine which agency's opinion may be correct, and therefore the trigger has been prudently set with the objective of a company avoiding a downgrade to sub-investment grade.

We also disagree with the linkage of any such trigger to service performance opposite customers or the environment (Mason & Wright proposals). Such a mechanism could lead to investors reassessing regulatory risk particularly the risk of regulatory interference of a subjective nature. We believe that companies acting responsibly would consider such factors more broadly 'in the round' with regard to a company's ongoing obligations. As illustrated by recent company action on the restriction of dividends, these elements are already part of the 'in-the-round' considerations, which companies already make when assessing potential dividend payments.

However, it is disappointing that company licences do not contain consistent cash lock-up conditions (e.g. certain companies being currently exempt from procuring ratings and Wessex Water does not have the cash lock-up licence condition). We consider that there is little evidence to suggest that licence requirements on financial resilience should not be consistent across the sector, apply to all companies and provide all customers with the same level of protection.

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 to prepare resilience plans on the basis that responsible, well-run companies should put such plans in place, as part of any board's assessment around sustaining their financial performance. It therefore appears reasonable that, should companies find their financial resilience tested, they should share with Ofwat their plans to strengthen their financial resilience. As a listed entity though, UUW's parent company would find the extended proposal – publication of such plans – problematic as, by their nature, such plans will include financial forecasts, publication of which may contravene listing requirements. We consider that the trigger level for companies to share their plans with Ofwat must be set appropriately and should not merely have regard to credit ratings downgrades as the sole determinant of financial resilience, including an assessment of what factors have led to any ratings downgrade (e.g. has it been a change in ratings methodology or a change in the agencies' view of the regulatory environment (as per Moody's and Fitch in 2018).

Here, we would see the trigger for such a resilience plan to be shared with Ofwat as being aligned with having a lowest rating at BBB- stable outlook – i.e. just above the existing cash lock-up trigger level of BBB- negative watch/outlook.

As part of UUW's PR19 business plan, we stated that we would share our resilience plans with Ofwat if gearing exceeded 70%.

Again, we consider that consistency of licence conditions across companies is essential.

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 that additional board assurance statements should be required if a company board approves a dividend when its credit ratings are below the level stated for the notional company in the business plan.

Company boards are accountable for the decisions which they make, such as the declaration or payment of a dividend. Responsibly governed boards should always consider their financial resilience when making dividend decisions. This process should be subject to further scrutiny when the company's credit ratings are below targets stated in the business plan. In addition, there are already existing legal and corporate governance requirements that provide responsibilities for directors to appropriately consider when making dividend assessments.

However we consider that credit ratings targets stated for the notional capital structure at a price review may not always be the appropriate trigger for such additional assurance requirements. There are valid reasons as to why actual ratings might subsequently differ following the years in which business plans were submitted and/or the price review determination was made. By illustration, if a price review financeability assessment is made to only 'just' meet ratio thresholds thus positioning the notional company on a ratings 'cliff-edge', and/or should Ofwat's ratios be calculated out of line with those of the ratings agencies, and/or should ratings agencies' metrics ignore future impacts such as regulatory true-up mechanisms – then it is logical for deviations to arise between a company's current ratings versus the notional price review position.

Further, as seen with Fitch and Moody's in 2018, ratings agencies might change their ratings methodologies or assessment of the regulatory environment or sector risk profile. This has the potential to immediately tighten credit metrics and potentially lower ratings through circumstances outside a company's control. Related to this, it will be useful to understand the ratings agencies' assessment of Ofwat's proposals for Bioresources at PR24.

Without appropriately addressing such factors, UUW is unlikely to support additional requirements relating to dividends or distributions where credit ratings are below the targets stated for the notional capital structure at the applicable price review.

Raising the minimum standards of credit quality: Number of credit ratings held

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

We agree with the proposal that companies should maintain two investment grade issuer credit ratings provided this was a requirement for all companies.

Procuring two ratings reflects market best practice. UUW has long recognised the benefit in terms of debt market access of having two ratings, and this also provides additional information to credit investors (who themselves may favour or seek out one agencies ratings opinions over another). However, companies should be free to choose which agency they procure their ratings from with the freedom to change between providers, providing that they maintain at least two ratings. Such freedom should help to maintain competitive tension between ratings providers, thus keeping down the not insubstantial costs which companies must incur.

Given the costs in procuring and maintaining credit ratings, we would be reluctant to endorse an approach which meant that we were ‘bound-in’ with one or more credit ratings agencies as, on cost-benefit grounds, periodically we would reasonably want to review which ratings we procure (provided we continue to comply with the minimum number of ratings providers).

Again, we consider that consistency of conditions across companies is essential and therefore we support this proposal provided it is applied consistently across all companies.

Raising the minimum standards of credit quality: Timely notification of credit rating changes

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 that companies should be required to formally notify Ofwat of any changes to credit ratings, once the change has been announced by the applicable ratings agency. We would expect that most companies would inform Ofwat of such action anyway – as UUW did in 2020. Ofwat could also efficiently monitor the sector for ratings changes themselves, by reviewing the summary ratings assessments published by the credit agencies.

However, UUW would not be supportive of notification <u>in advance</u> of any planned rating withdrawals. As mentioned, there are costs to procuring and maintaining credit ratings and commercially we would be reluctant to endorse an approach which meant that we were ‘bound-in’ with one or more credit ratings agencies as, on cost-benefit grounds, periodically we would reasonably want to review which ratings we procure. Provided that companies maintain two ratings then Ofwat should not need to be informed should the providers change or, say, its third rating be withdrawn.

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Raising the minimum standards of credit quality: Dispensations from the requirement to maintain a credit rating

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

We agree with this proposal.

We strongly advocated for this at the time of the 'strengthening the ring-fence' consultation in 2018, arguing that it was not a level playing field if all companies did not have a requirement to maintain an investment grade rating and did not have the same cash lock-up provisions.

We therefore advocate again that it is essential that all companies have consistent licence conditions as regards credit ratings and cash lock-up provisions. We consider that there is little evidence to suggest that licence requirements on financial resilience should not be consistent across the sector, apply to all companies and provide all customers with the same level of protection.

Raising the minimum standards of credit quality: Dividends

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

We do not agree that Ofwat's broader expectations for dividend policies should be, nor do they need to be, codified in company licences. It is right that the actual company structure and associated dividend policies remain matters to be set by company boards and not the regulator. Detailed interventions in the licence in relation to the dividend policy risks giving the impression that the regulator is actively intervening in decisions which are rightly reserved for the company's Board of directors.

It is questionable whether enforcement through the licence is actually required to solve the identified issues. In AMP7, we are already seeing examples of companies withholding dividends and instead choosing to reinvest into the company to improve performance and service to customers. This 'softer' form of regulatory intervention; specifically the threat of action, can clearly be an effective enforcement tool without the need for Ofwat to seek to formalise it through the licence. Additionally, associating performance and dividend would also be problematic as it would likely be highly subjective, which could lead to scrutiny and challenge from companies amidst heightened uncertainty for investors. We believe that it would also raise investor concerns if Ofwat had the power to link cash lock-up to performance, particularly given the risk of undue political pressure.

As part of PR19, we set out in our AMP7 dividend policy our approach and conditions for when we would pay dividends. We believe that this represents the best approach, whereby the price review provides an opportunity for companies to set out how their dividend policies are congruent with the commitments made in the business plan and act to reinforce trust and confidence that the company is delivering for all stakeholders. Ofwat should look to incentivise companies to set out their commitments in this regard through positive reinforcement and by highlighting best practice. We believe there was scope for this at PR19. This is a more appropriate approach which recognises the role and responsibility of the Board in taking dividend decisions than use of the relatively blunt instrument of licence enforcement.

Increased transparency: Transparency on swaps

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 the use of swaps.

Through the enhanced APR reporting we think that Ofwat already receives a lot of useful information on companies' debt and hedging positions. For example, a particularly good source is table 4B of the APR. We therefore consider that the solution could lie rather in how Ofwat can make better use of what information they already receive to inform its assessment of financial resilience. This could also provide better information for credit rating agencies to use in any ratings assessment.

As a company which makes use of swaps for legitimate hedging purposes and which clearly articulates its hedging policies in its Annual Report and the APR, UUW would be happy to support Ofwat in defining what this might look like and the benefits of such disclosures, increasing Ofwat's understanding of each company's hedging policies and how swaps are used.

We see little merit in providing 'line-by-line' swap data but an understanding of how swaps impact the effective interest rate (and over what duration), along with the impact on the overall mix of nominal and index-linked debt could be useful. This should help to reveal the true economic position of the company's debt holdings.

Ofwat could also perform a periodic exercise to ascertain from each company whether swaps have been entered into to defer obligations (so called "kick the can" swaps), and or whether swap breaks or pay down mechanisms are a feature. This could be a targeted 'information request' exercise if certain concerns about specific companies have been raised by the credit ratings agencies for instance.

Increased transparency: Transparency on debt obligations of holding companies

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.

We are generally very supportive of increased transparency that would allow Ofwat to be better informed for its monitoring role and provide better information for credit rating agencies to use in any ratings assessment.

Whilst additional disclosures could be added to APRs we remain unconvinced as to how useful holding company gearing levels are in assessing the Appointee's financial resilience. For example, a group could legitimately have additional holding company debt (over and above the Appointed company gearing) to support other group businesses or activities.

We can see that for certain capital structures that this could be a useful indicator, particularly where Appointed company gearing has been improved by way of equity injections from companies higher up the corporate chain and funded by holding company debt.

Similarly with swaps, Ofwat could use an ad hoc targeted 'information request' rather than require such additional disclosures annually in APRs.

Ofwat raises a further concern about the transparency of holding company loans which are financed by dividends from the regulated company. Whilst we do recognise the concerns, rating agencies factor these into their ratings – along with any mitigation (e.g. regulatory ring fence and, where relevant, structural covenants). Additionally, it is worth remembering that customers ultimately remain protected because shareholders suffer equity losses if the company were to fail.

Increased transparency: Transparency on pension obligations

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

UUW would strongly endorse improving the transparency of companies' pension deficit reporting, and we consider that this should be included in APRs.

This would allow Ofwat to be better informed for its monitoring role whilst also providing better information for credit rating agencies to use in any ratings assessment. We consider ourselves to have long practised and advocated a financially resilient and transparent approach in this area. Use of optimistic or risky pension valuation assumptions might push pension deficit contributions out down the timeline with effects similar to "kick the can" swaps. Both actions result in potential financial "iceberg" risks where stakeholders may not be properly sighted on the longer term resilience issue. We would be happy to support Ofwat defining what such requirements might look like and the benefits of such disclosures. We suggest that this could also include explanation of the company's pension scheme risks, such as those relating to the: nature of investment; hedging of interest rates; hedging of inflation; and, hedging of mortality.

We also note Ofwat's particular focus in the discussion paper on pension schemes that are material and in deficit, which may result in deficit repair obligations that could be disclosed. We would be supportive of increased transparency around the amounts and profile of deficit repair contributions, for example.

We would also advocate that Ofwat seeks advice from the Pensions Regulator (TPR) on this matter. The TPR recently consulted[3] on what it described as a "low dependency" basis of valuation for pension schemes. The TPR's approach enables the liabilities of a scheme to be assessed on the basis of "low dependency" from the sponsor, meaning that the pension liabilities are likely to be met without further reliance on the sponsor. The Pensions Regulator sees this as the long term financially resilient position for companies and pension schemes to achieve. This is not as prudent as a "buy out" basis but more prudent than an accounting (and possibly many funding) basis. It is important to recognise that a funding basis is just a stepping stone to the end point that the TPR is expecting schemes to reach – "low dependency". Requiring companies to submit both accounting and 'low dependency' valuation information as part of the APR process could provide the basis for a robust assessment of each company's respective pension legacy position, and progress on improving financial resilience in this area over time.

In addition we would also advocate that, as a minimum, pension deficits on an accounting basis should be included in any debt/RCV gearing, FFO to debt, and debt to EBITDA calculations.

Increased transparency: Financial resilience assessments in PR24 business plans

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

We agree with Ofwat's expectation that PR24 business plans should include a board assured assessment of financial resilience. Such an assessment should set out what evidence the board has used and the conclusions which it has drawn as regards the financial resilience of its own business plans. This assurance statement can only be given by the board - rather than say, a third party - the board's duties in this respect cannot be divested.

The board should not be required to extend their assurance to also cover Ofwat's determinations, for instance, such as by offering assurances as to the financeability of Ofwat's determinations. Accepting the FD is a matter of judgement for the board - whether they consider that they can achieve a better outcome from the CMA, or whether they accept the challenge of an FD that may appear un-financeable and commit to finding efficiencies and improving performance.

Additionally, in a persistently low interest rate and returns environment, it can be difficult to 'solve' to meet all key credit metric financial ratio tests. For example, FFO to debt is difficult to fix without increasing revenues (and adjusting dividends has little impact), which could lead to a need to use PAYG/RCV run off adjustments to solve. This is not something that the CMA supported (and may have therefore come into its WACC assessment) and nor are Moody's and Fitch accepting of this approach. Likewise, other ratios such as adjusted interest cover can be difficult to fix without adequate cash flows. So, if financeability assessments are conducted to only 'just' solve for targeted ratios then other adjustments might mean that such ratios are not actually achieved. If ratios are approaching the middle or upper quartile of the relevant thresholds for a given rating then this might make the targeted ratings more attainable.

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.

In Ofwat's May 2021 PR24 consultation we raised the following as potential incentives and consider there remains merit in exploring these further alongside the options that Ofwat has under consideration.

[3] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation.ashx "Consultation document - Defined benefit funding code of practice", The Pensions Regulator, March 2020

In particular, we consider there could be merit in establishing positive incentives in relation to: a) retaining listed equity in the sector; and b) demonstrating robust financial resilience.

Listed equity incentive:

The benefits of retaining listed equity in the sector are threefold.

(1) Maintaining broad and diversified equity investor participation in the sector reinforces the sectors credentials as an investment proposition and acts as an effective and easily observable 'barometer' as to the sector's relative attractiveness to other sectors. Such broad based equity participation should also help in terms of longer-term financial resilience.

(2) Listed companies reinforce the sector's ESG credentials and advances in Corporate Governance can be directly evidenced by Ofwat so that such requirements can be set across the sector for the benefit of customers as a whole. UU and UUW have led the way on corporate reporting being early adopters of the Long-Term Viability Statement (LTVS) and the Taskforce for Climate Related Financial Reporting Disclosure (TCFD) in recent years. Further, developments in UK corporate governance and controls for listed companies will follow on the back of the recently published BEIS report aimed at restoring trust in audit and corporate governance (so called UK SOX).

(3) Having listed companies enables Ofwat to observe directly relevant 'benchmarks' in assessing an appropriate Allowed Return using sector listed company market data as a key 'input' into the CAPM equity pricing model, which helps to set an appropriate Cost of Equity and WACC.

There are real costs to maintaining listed company status, and UUW considers that given the importance of the above benefits to customers, **a positive listed company incentive in the form of an uplift to the Cost of Equity** would be beneficial in providing incentives to existing publicly listed companies to maintain this status, and potentially provide incentives for a relisting of private companies.

Gearing incentive:

With regard to setting incentives for demonstrating robust financial resilience, this could be linked to companies' actual gearing relative to the gearing assumption for the notional company. The Southern case study provides clear evidence of the shareholder loss when gearing is excess and a company comes close to failure. This stands in contrast to the assertions made by Mason & Wright.

UUW considers that a positive incentive mechanism could be more effective than the GOSM, whereby companies that maintain regulated company gearing close to the notional gearing assumption are rewarded with an uplift in the Cost of Equity. This will provide a direct incentive to align gearing more closely with the notional company, and it could be tiered to provide greater incentive to reduce gearing - e.g. [+25]bps on the Cost of Equity if gearing is maintained, say, within plus or minus [5]% of the notional company central gearing assumption, and [+10]bps on the Cost of Equity if gearing is maintained outside of [5]% but within plus or minus [7.5]% of the notional company gearing assumption, on average across the AMP. This could be prospective, based on company business plan submissions with an ex post adjustment to reflect outturn, or retrospective at the end of the AMP.

We consider that any incentive in respect of maintaining gearing at around the level assumed for the notional company should also **take account of any companies' pension deficit position** as part of the debt position (see response to Question 13). This reflects how the credit ratings agencies treat such obligations. Further, given that no regulatory allowance for pension deficit repair contributions will be provided to companies at future price reviews, we consider that the obligations for companies in respect of pensions deficit funding should be explicitly recognised as part of any incentive to promote financial resilience for the longer term.

Any such incentive mechanism must also be adjusted to exclude any adverse impact that DPC has on a companies' gearing position (noting Ofwat's intentions to remove DPC from such metrics as derived from regulatory returns).

Explicit allowance for equity issuance costs:

Depending upon PR24 investment requirements and recognising the need for robust financial resilience for the long-term, there might be a need to attract additional equity into the sector (e.g. to maintain a stable gearing

profile or in some cases reduce gearing). We note that in RIIO-2 Ofgem has provided a 5% equity issuance allowance to fund its view of issuance costs associated with additional equity required, and we consider that such allowances are appropriate to reflect 'real world' equity issuance costs.

Other considerations and options:

We also consider that the CMA's principle of 'aiming-up' in setting the Cost of Equity and the Allowed Return as part of the PR19 final determinations could be an appropriate principle to follow, if material investment requirements/additional equity are identified at PR24.

Further, there should be explicit allowance to reflect the impacts of DPC on companies' actual gearing. Moody's has indicated that in relation to the HARP DPC project the lease liability created when the asset comes into use will be recognised as debt with a corresponding addition made on a notional basis to UUW's RCV. This will have the effect of increasing UUW's debt:RCV ratio compared with the position had the DPC asset not been in existence and/or funded via the conventional debt:equity mix.

With regard to the use of revenue advancement via PAYG and/or RCV run-off, notwithstanding the CMA's position (which mirrors that of the ratings agencies, Moody's and Fitch), we do think this tool could remain beneficial to customers at PR24 in managing 'in-period' revenues and cash flows. In particular, from a 'real world' financeability perspective the use of such a tool might be beneficial to maintain FFO/debt at acceptable levels (S&P's prime credit metric) and/or improve dividend cover thus aiding equity financeability. However, such tools should not be over-used such that they are detrimental to longer-term financial resilience.

Voluntary sharing arrangements at PR24

UUW was a strong supporter of introducing a voluntary sharing mechanism at PR19 and has implemented the UUW CommUnity Share approach, making available £71m over the five year AMP7 period, supporting customers who are the most impacted in society by deprivation. Furthermore, UUW committed to contributing more where outperformance exceeded a certain level and additional dividends exceeded this level.

We consider that it is important that such sharing mechanisms capture the totality of any outperformance earned during the relevant price control, rather than focus on one specific element.

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