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Dear P&O team

Financial resilience in the water sector – Wessex Water response

Thank you for the opportunity to comment on your discussion paper on financial resilience in the water sector.

This discussion paper sets out a number of options that would see Ofwat become increasingly involved in regulating the industry's financial structure. This is something that has historically been left to company boards. Although we agree that financial resilience should be a key consideration of the boards, we struggle to see compelling evidence of any market failures that warrant increased regulatory oversight in this area for all companies.

Any increased regulation in this area should be driven by a clear market failure and designed to protect customers' interests. The current performance commitment and incentive framework alongside other incentive packages presents a comprehensive monitoring of customer service. We struggle to see the value that further regulatory intervention here adds compared to the existing monitoring of the services customers receive. Alongside this, we are concerned that it could distract management effort away from the services that matter to customers.

In our opinion, the one example of market failure presented (the Southern Water case study), does not present a compelling case that there is any causal relationship between operational and financial resilience. Further, the hypothetical market failures discussed by Mason and Wright do not seem to have materialised in this case and so we question their relevance in justifying further changes.

The broad range of industry-wide interventions proposed here, designed to stop fringe cases of poor performers, is not a balanced approach. Instead, the focus of any changes should be on what is needed to stop these individual cases sooner, rather than changes that could have unintended consequences for all companies.

We question whether the interventions discussed here would have the desired effect in any case. One of the main levers companies have to increase financial resilience is to reduce expenditure. This will likely result in lower investment and hence lower levels of service. This will be particularly of note if the cash lock up threshold is raised, or more punitive regulatory incentives are introduced with the aim of lowering gearing levels.

Finally, for any of these interventions to make sense they must be consistent with the policy decisions informing the thinking around risk and return. Currently, we are nervous that there appears to be inconsistency around the proposals for risk and return and the proposals set out here. The decisions made informing the overall balance of risk and return directly feed through to the financial headroom of companies. These need to be considered in parallel through a consistent policy lens.

Below are our answers to the specific questions raised.

I hope you find this response helpful and would welcome further discussions on any of these points as we look to work collaboratively to deliver a progressive framework for PR24.

Regards

[redacted]

Director of Economic Regulation

<u>Detailed answers</u>

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?

The ratings received from credit rating agencies provide a useful independent view on how financeable the industry is, and therefore a useful cross check to inform and guide financeability discussions. However, they are for the benefit of lenders, not customers.

For them to be a meaningful comparison, key credit rating metrics must be calculated correctly as part of the price review process – particularly if, as the discussion paper proposes, they are seen as the litmus test for financeability. During PR19, it was established by the CMA that the interest covers used by Ofwat were not consistent with those used by the credit rating agencies – despite much more similar calculations being present in the financial model. The comparable AICR for Wessex under the notional structure gives a downward trend to 1.27x; this would put the notional company at risk of falling to the lowest investment grade. Therefore, if these are the target interest covers in the regulatory settlement, it is not inappropriate for the company to perform at that level. In this case, a failure of regulation should not be considered a failure of the company.

However, credit ratings are only a cross check. The important question is “can an efficient company efficiently finance its functions?”. The risk and return consultation claims that companies can raise debt cheaper than the costs implied by their credit rating. This suggests that companies can raise efficient finance even at lower credit ratings and thus raises the question of whether this lower credit rating would be a problem. This is just one example of the inconsistency of thinking in this area. (Note, we are using this to highlight the inconsistency rather than to agree with the assertions in the risk and return paper).

Ultimately, we think that it may be appropriate for providers to operate at this credit rating. This could arise from poor regulatory price setting, or it could arise as companies continue to invest to prioritise services to customers while under financial distress. We would however expect companies’ boards to be concerned with this and have in place plans to improve that are outlined and monitored in the company’s long-term viability statement. Therefore, we think that the current regulatory toolbox has enough tools to monitor and control this.

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?

Fiduciary responsibility sits with company boards. We expect any reasonable board to put in place measures early if trends show a deterioration of credit rating. The question needs to be asked as to whether actions that jeopardise customer service be taken – we would suggest not. Therefore, a longer, slower recovery with less impact on customer service should be preferable to a quicker financial recovery that adversely impacts service.

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.

Capital structures should be the decision of the company's board. As long as companies are continuing to deliver high quality services to customers then there should be no need to impose any restrictions, particularly with no evidence of a market failure that this is addressing.

Customers are protected from any higher costs associated with the financial structure as revenue allowances are based on a notional company and so customers will not be paying for any additional risk taken here.

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

Credit rating scores are a reference point for lenders, not customers. Excessive reliance on them is not in customers' interests. They are one of many indicators for financial resilience and should not act as mechanistic triggers for action as proposed here. Therefore, not only is this unnecessary, but this will also create perverse incentives. We strongly oppose this measure.

As we have discussed before, when a company is in financial distress, a key lever in resolving it will be the restriction of expenditure – which is much greater in magnitude than restricting dividends / payments to associates. This means that a company will likely reduce expenditure to strengthen its financial position if in danger of falling into a cash lockup situation. This will cause pressure on service and long-term resilience. If the cash lock up is raised, this will become much more apparent and divert management time.

Fundamentally this comes back to our key point. What is the market failure that these proposals are trying to solve? If it is to maintain service levels and investment, then that is already done through the outcomes framework, and calibration of those incentives should be looked at before creating other regulatory complexity that could have unintended consequences. We believe that the Southern water example does not support this as they managed to raise additional equity to resolve their issues; this may not have been the case if the cash lock up was higher.

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

Company LTVS should set out the resilience plans where ratings are falling. We do not see the need for more regulatory burden added here.

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.

Company boards are already required to approve dividend policy and agree dividend payments consistent with their fiduciary responsibilities. These considerations will include credit rating, ability to raise finance, and financial covenants. Therefore, we do not see any justification for more regulatory intervention here.

7. a requirement for companies to maintain two investment grade issuer credit ratings.

In principle, we support this – specifically if credit rating is viewed as the litmus test for financeability. Although we note that the ratings are not independent and will tend to move in parallel, and this does incur a cost.

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).

In principle, we support this and support transparent governance. However, specifics around timescales, etc. will need to be outlined before any firm agreement.

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

We do not think that uniformity of licenses is a necessity, as companies may have differing circumstances and so do not support uniformity for its own sake.

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

We accept that company performance on aspects such as customer service and financing needs to inform decisions on dividend payments, and that the payment of dividends should not impair the business in delivering its functions. Differences from dividends assumed to those paid should be justifiable by considering the performance of the company.

However, we do not support the need for any prescriptive rules around dividends to be incorporated into the licence. This is just a further step to rate of return regulation. It will risk reducing the overall incentive power of the current regulatory framework. This is not a desirable outcome. The incentive power has led and continues to lead to significant private sector investment.

As previously, we do not see what market failure this is trying to address. With no clear failure and potential adverse impacts, we do not see the justification for this intervention.

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

Swaps can be used as part of an efficient financing structure and so we think that their consideration and treatment needs to be consistently treated across all facets of financial resilience and risk and return.

However, we have no comments on how the reporting of them could be enhanced, but it should not come at the expense of disincentivising the use of these instruments.

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

The regulatory ring fencing of the appointed company should mean that this is not required.

Even where holding companies have failed (e.g. Enron in 2002), there has been no impact on customers. Therefore, we see no evidence to suggest that imposing any additional reporting will deliver any benefit.

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

Pension scheme deficits are already heavily disclosed in the annual report and accounts and are discussed with the pension regulators. Therefore, we so no justification for additional disclosures.

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

Financial resilience should be a core part of the PR24 assessment. Consequently, we would expect company Boards to consider and offer assurances around it. Although we support this in principle, the exact scope and scenarios it covers would need to be discussed and agreed separately to this principle.

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.

In our opinion, there is no clear market failure and so moves to address it that all come with potential unintended consequences as discussed through our response cannot be justified. This echoes the finding of the CMA who removed the Gearing outperformance sharing mechanism.

Correctly calibrated long-term incentives on performance and cost not only measure the actual market failures (service and bills customers receive) but should provide the incentive to efficiently finance the company's functions.