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Yorkshire Water's response to "Financial resilience in the water sector: a discussion paper"

We welcome the opportunity to respond to Ofwat's Financial resilience in the water sector discussion paper published 7 December 2021, and to participate in an open dialogue on Ofwat's proposed approaches to financial resilience for PR24 and beyond.

We recognise the importance of financial resilience to our customers and both equity and debt investors, making this a subject of regular scrutiny at Yorkshire Water. We note the concerns presented by Ofwat in this discussion paper and those in the accompanying paper from Professors Wright and Mason. Generally, we do not agree or understand the basis for concerns on financial resilience and hence the justification for proposed changes, which we believe is due to insufficient evidence being presented in support.

In particular, **we see no reason to amend the existing trigger level for cash lock-up conditions**. The risk level for customers when companies have an investment grade rating is already very low and, perversely, **an increase in the trigger level could lead to increased costs being borne by customers without any tangible benefit** for them. In respect of service performance, we believe that the existing ODI regime provides adequate incentive to ensure performance levels are maintained and note that Ofwat has yet to publish its discussion paper on ODIs.

As part of our commitment to financial resilience we recently engaged an external expert to conduct a financial resilience assessment on Yorkshire Water. We are willing to share the principles underpinning this assessment in the

‘Future Ideas Lab’ for the benefit of other companies and stakeholders. We believe this will provide a more transparent and broader structured approach to assessing financial resilience, which should address Ofwat’s concerns.

Our detailed responses to the 15 questions posed by Ofwat are appended to this letter. These also incorporate relevant points from the Professors Wright and Mason report. The rest of this letter concentrates on some broader aspects of financial resilience that we believe merit further discussion ahead of Ofwat’s publication of its draft PR24 methodology later this year.

Regulatory environment

Ofwat already has the significant ability to influence the financial resilience of water companies through the existing ring-fencing licence conditions and regulatory mechanisms used to determine allowed revenues and to ensure a company can finance its functions. Particularly, the financing related parameters used for a notionally efficient company and its allowed return (“WACC”) that form part of the allowed revenues determined in a price review. In addition, the existing ODI regime, incorporating in-period rewards and penalties, provides sufficient incentive to maintain minimum performance levels.

Consequently, we see no need for Ofwat to assume ‘decision risk’, or be perceived to do so, with respect to the actual capital structure and financing arrangements adopted by a water company. We agree that these decisions should remain with companies and their management, who are better positioned to manage all risks. Otherwise, there is the potential that regulatory restrictions or interventions on such matters can have a wider than intended impact on investment.

Therefore, it is best in the long-term for the sector, that companies and their boards continue to determine the most appropriate capital structure and financing arrangements, which enable the most efficient financing solutions for customers and provide assurance that licence conditions will not be breached.

We agree that financial resilience and the related decisions taken by management are important matters for customers. We believe the key to addressing Ofwat’s concerns on financial resilience would be to review the benefit of greater transparency and to ensure an ongoing dialogue with companies, rather than mandating additional protections through licence conditions. There is already a reasonable degree of transparency in financial resilience reporting when we consider reporting requirements for going concern purposes and long-term viability assessments plus external scrutiny from credit ratings agencies and debt investors. We would however welcome discussions as to any further improvements in reporting that would benefit customers and other stakeholders.

Furthermore, we believe firmly that the current regulatory protections provide a sound basis for a resilient sector and see no compelling reason to introduce further changes in addition to those implemented at PR19. An opportunity for improvement would be the adoption of a more rounded assessment that goes beyond a collection of metrics, with an emphasis by Ofwat on gearing and selected ratings, as presented in the 2020/21 Monitoring Financial Resilience report. This should provide a framework for a longer-term basis of assessment, creating additional transparency, thereby avoiding the risk of presenting financial resilience as a binary assessment that is not necessarily credible and possibly undermining for the regulatory environment.

Principles and approach

We agree that water companies should maintain a resilient and transparent approach to their capital structures and financing arrangements, to be able to efficiently raise capital to finance operations and investment.

We have reviewed all previous Ofwat publications[1] to confirm our understanding of the regulatory approach for the assessment of long-term financial resilience. Throughout, resilience is defined clearly and consistently as '*the ability to avoid, to cope with and to recover from disruption'*. Financial resilience is defined similarly with an added reference to a company's financial arrangements.

There are clear principles and themes that define resilience in the round, with customers at the heart, by linking the operational, corporate, and financial aspects of a company. These aspects are assessed in the long-term by identifying and planning for the challenges and opportunities from policy initiatives and external trends. Yorkshire Water's track record in managing its long-term resilience accords with these principles and particularly the decisions taken in AMP6 to build resilience for AMP7. These were fully supported by its shareholders, including the retention of shareholder dividends for seven of the last eight years.

Therefore, we believe any assessment of financial resilience would build on these established principles and be wider than the specific points and questions in the discussion paper. Whilst there is a linkage, an assessment of financial resilience would incorporate licence protections and should not be focused solely on them. For example, all relevant credit ratings should be considered for an assessment whereas licence protections only consider a small sub-set of available ratings as a trigger for cash lock-up purposes. We believe that this would be a more appropriate approach when assessing actual capital structures as opposed to notional constructs.

Our view, and the approach at Yorkshire Water, is to take a more rounded assessment of financial resilience based on:

- operational performance and cash generation,

[1] 'Towards resilience' (Dec 2015), 'Resilience in the round' (Sep 2017), 'Delivering Water 2020' (Dec 2017), PR19 final determinations (Dec 2019) and Monitoring financial resilience report for 2019/20 (Dec 2020)

- debt servicing capability,
- debt financing arrangements, and
- other financial commitments and distributions.

This full assessment reviews performance and resilience looking both backwards and forwards in time. Given the long cycle nature of the water sector, this builds a fuller picture of management actions that cannot be judged against a single five-year price review period. Overall, we believe this is in line with Ofwat's aim of a longer-term focus on goals, plans and resilience, as well as reducing the risk of irrational decisions in the short-term.

An extremely important aspect of assessing financial resilience are the financing arrangements in place for a company and the ability to manage events that would place stress on the ability to raise debt. In a response to a CMA request, Yorkshire Water confirmed extensively the benefits of its securitised debt platform, complementing and enhancing the licence ring-fence, which provides a standard set of terms to raise debt in different international markets, or bilaterally, that is typically funded by buy-to-hold investors.

We are aware that Ofwat has previously dismissed the benefits of such debt platforms as only applicable to financial creditors and not relevant for customers. We believe this too simplistic a view; there should be consideration of the differences to unsecured debt structures, which are important when considering the risk of disruption. Therefore, an assessment of financial resilience across the water sector must take into account the different financing arrangements for companies.

Key points on Ofwat's discussion paper

The appendix to this letter contains our detailed responses to Ofwat's financial resilience discussion paper. We have summarised our main thoughts on the points raised by Ofwat and its proposals that have been presented for consideration.

Overall, **the implied scope of review for financial resilience appears unduly limited and anchored to licence protections**, which are essentially 'backstop' measures. We believe **a true assessment of financial resilience must have a wider scope**, as set out above, and Ofwat is missing an opportunity to establish a credible assessment framework that would ultimately benefit customers in the long-term.

Although it is noted that there is no single measure of financial resilience, there is **an unwarranted focus on gearing and selected credit ratings.** This is accompanied by **unsubstantiated assertions, repeated from the PR19 referrals to the CMA, that higher levels of gearing lead to weaker financial resilience, poor service, and reduced investment.** In addition, this premise does not appear to be supported by the information presented for the Southern Water case study.

The focus on gearing and, by direct association, an equity buffer is also limited in scope. We believe companies should maintain robust balance sheets; however, this alone does not translate into increased financial resilience when considering the possible impact on interest costs[2] or the ability to access liquidity during a period of stress. **Perversely, a reduction in gearing could lead inefficiently to increased costs being borne by customers without any tangible benefit for them.**

Therefore, we consider **insufficient evidence has been presented by Ofwat and Professors Wright and Mason to support the repeated reference to "risky financing" and the need for additional protection for customers.** We believe Ofwat needs to provide greater clarity on its general concerns regarding financing arrangements used by companies, which continue to include some puzzling comments on the nature and role of swaps.

This brings us finally to Ofwat's points on regulatory incentives regarding actual capital structures adopted by companies and Ofwat's long-held concerns regarding gearing levels well in excess of the notional level. As noted at the start of this letter, there are already sufficient regulatory incentives from the use of the notionally efficient company as a reference for allowed financing costs that determine WACC, which are underpinned by the strengthened ring-fencing licence protections.

We do not understand the continued reference to 'distorted incentives' that are inextricably linked to the introduction of GOSM during PR19. This was reviewed comprehensively by the CMA in 2020, when it considered the various reasons for its introduction by Ofwat. The CMA found this mechanism to be flawed in design, possibly exacerbating financial risks and without enough evidence to justify a break from a well-established regulatory approach.

It is clear these unproven justifications around the need for regulatory incentives continue to form part of Ofwat's considerations on financial resilience. Our detailed responses include the request for Ofwat to supply fresh evidence in support of its assertions and to support the highly theoretical assertions made by Professors Mason and Wright.

[2] "*The existence of the common terms and security package means that a company with a securitised structure may support a higher level of gearing with limited impact on interest costs than a non-securitised company while maintaining a similar investment grade credit rating.*" Monitoring financial resilience report for 2019/20 (Dec 2020)

Concluding points

We agree in principle that companies should maintain financially resilient capital structures and the key appears to be clarifying all aspects of companies' long-term approaches to financing their activities and investments.

However, the discussion paper published by Ofwat does not provide sufficient evidence for its assertions on the current financial resilience of the sector. The paper raises the prospect of some form of unprecedented intervention into the financing decisions of companies, which would erode investor confidence in the sector. We believe that there is scope for improvement in the approach taken to assess financial resilience, which is broader than that presented by Ofwat and would establish a sounder, more trusted assessment for external stakeholders.

We have completed an extensive review on what should constitute a well-rounded assessment with expert support. We are looking to share this in the 'Future Ideas Lab' to help others assess financial resilience in a fuller and more structured manner ahead of PR24, which should increase transparency and address Ofwat concerns.

This discussion paper is one of a series issued by Ofwat, including a paper issued on risk and return and another due to be issued on ODIs. This piecemeal approach means it is not possible for companies to assess fully any changes to the regulatory framework or PR24 proposals. This reflects our points noted above for financial resilience to be assessed with a wider scope and this can only be achieved once there is clarity on all of Ofwat's considerations and proposals for PR24 and beyond.

We welcome Ofwat's engagement with the sector through this discussion paper and look forward to a continuing, open dialogue on this important topic as PR24 progresses.

Yours sincerely

[redacted]

Director of Strategy and Regulation

Appendix: Detailed response

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

We believe that the current licence protection of at least one investment grade rating is appropriate for a provider of essential infrastructure and provides sufficient incentive for companies to manage their credit ratings appropriately. However, this licence protection is only one part of any financial resilience assessment of a company, which needs to be broader and look at the range of factors that underpin the continuing ability to raise capital to finance activities and investment.

When assessing financial resilience, we do not understand Ofwat's concern on investment grade credit ratings, as the risk associated with such ratings for customers is low. For example, S&P's 2020 analysis[3] shows that no company across Europe with an investment grade rating has defaulted across the last 11 years (all industries). Across the whole 30 years of data, there have only been 7 defaults (all industries) across Europe. The Utilities sector also has the lowest default rate of any sector.

At investment grade levels, a company's rating primarily impacts the cost at which it can raise debt, rather than its ability to actually raise the debt. Customer bills were set based on an assumed notional target rating of BBB+/Baa1; therefore, customers are already protected against any additional costs arising from a different rating.

In respect of financial resilience, a company's capital structure, its financing arrangements and the associated risks have always been a matter for the board of each company to decide, with shareholders bearing the risk for any changes from the notional structure, such that customers are always protected.

It is a key element of the regulated frameworks in the UK that companies are free to choose their capital structure and their associated target ratings, as long as they maintain at least one investment grade rating.

Whilst boards will seek to manage credit ratings appropriately, to maintain an efficient debt raising capability, it is important to recognise ratings agencies have independent and divergent views on common issues that would impact ratings assessments. On this basis we believe it is more appropriate when assessing financial resilience to consider all published ratings for a company rather than focus on any individual rating which could be considered an outlier.

As noted above, there is a risk of selecting particular ratings that place too much reliance on the views of individual credit rating agencies whereas financial resilience must be assessed against a broader framework.

[3] https://www.spglobal.com/ratings/en/research/articles/210707-default-transition-and-recovery-2020-annual-european-corporate-default-and-rating-transition-study-12012930

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 do not understand the concern that Ofwat has with a company potentially operating at the lowest investment grade credit rating. As noted above in our response to Question 1, analysis from the credit rating agencies shows that the risk of default with an investment grade rating is incredibly low.

There is already an obligation to maintain at least one investment grade rating per the licence protections, but it is feasible for a company to operate at the lowest investment grade rating without disruption to customers or hindering investment for the future. This is because company financing arrangements can have inbuilt protections and credit ratings are just one data point considered by seasoned debt investors who will conduct their own assessment.

A company's rating primarily impacts the cost at which it can raise debt, rather than its ability to actually raise the debt. In PR19, customer bills were set based on a notional target rating of BBB+/Baa1; therefore, if a company is actually operating at a lower rating than this then it will be their shareholders that bear this additional cost, not customers.

It is also critical that actual ratings are not conflated with notional targets. A financial resilience assessment of a company needs to consider a range of factors relevant to that company's actual capital structure (e.g., financing arrangements, investment requirements) that have not been considered as part of any notional assessment. Financial resilience needs to be assessed on a company specific basis, not a one size fits all, notional style approach.

We believe each company's choice of target rating for each ratings agency is a matter for the board of that company. As noted in Question 1 above, it is important to recognise ratings agencies have independent and divergent views on common issues. On this basis we believe it is more appropriate to consider all published ratings, rather than focus on any individual rating which could be considered an outlier.

In summary, we believe that a company should be left to determine the actions to be taken regarding the maintenance of all its credit ratings, whilst acknowledging the incentive to do so when considering licence protections and that shareholders will bear the financing risk of actual ratings being lower than the notional target used as a basis for setting customer bills.

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

We believe that there should be no defined limits on capital or financing structures, either now, or if financial resilience concerns were identified.

It has been a key element of the regulated framework that companies and their boards have been free to choose their own capital structure, with shareholders bearing the risk for any deviations from the notional structure so that customers are protected. Any subsequent change to this key principle would have a significant impact on investor confidence in the sector, which would not be in the ultimate long-term interest of customers.

As noted above capital structure, or gearing, is just one of many factors to consider when assessing financial resilience. Therefore, imposing potential remedies to address any perceived financial resilience issues based purely on one measure, such as gearing, would be inappropriate as it would not necessarily provide the optimal solution for customers or investors.

This can be illustrated by the example of Southern Water that Ofwat has provided. Despite recently reducing gearing by c.10% and subsequently receiving further equity injections, Southern Water's credit rating with Moody's has remained at the lowest investment grade rating.

We also remain concerned that Ofwat continues to suggest that there are "distorted incentives" associated with high gearing given the CMA concluded that Ofwat had been unable to provide any evidence there were any benefits for companies that were associated with high gearing. Further comment on this is provided in our response to Question 15 below.

We also note that Ofwat makes repeated references to financial instruments being "risky" particularly in relation to derivatives, without providing any evidence to support these assertions. These views also carry across to the risk and return consultation. Therefore, it is critical that these two important consultations are considered together.

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.**

We see no reason to amend the existing trigger level for cash lock-up conditions, which only reference ratings selected by Ofwat from those published for a company. As noted in our responses to Question 1 and Question 2 above, the risk level for customers at the lowest investment grade rating is already very low.

It is critical that there is a reasonable level of headroom between the published ratings for a company and the minimum investment grade rating that acts as a cash lock-up trigger (currently two rating notches) to enable a company to manage any unforeseen exceptional events and to avoid finding itself on a ratings "cliff edge".

If the cash lock-up ratings trigger was to be increased, then in order to maintain a reasonable level of headroom, the ratings targeted by a company would have to be increased, which would have a number of knock-on impacts, including potentially higher bills for customers. We do not believe the extra costs associated with raising the target rating level would provide sufficient additional benefit to customers to be considered an efficient option worthy of further consideration.

Yorkshire Water notes that the notional financeability analysis conducted by the CMA showed that the non-appellant companies would effectively have had the lowest investment grade rating under reasonable downside scenarios, being one notch lower than the appellant companies (further details provided in response to Question 6 below). On this basis, raising the cash lock-up trigger would clearly provide insufficient headroom.

In respect of service performance, we believe that the existing ODI regime provides adequate incentive to ensure performance levels are maintained. We note however that Ofwat has yet to publish its discussion paper on ODIs for PR24. We will therefore comment as necessary when this is published.

We will shortly be presenting our response to Ofwat's PR24 and beyond: Discussion paper on risk and return. In our response we note that it is critical that all aspects of risk and return, including financial resilience and ODIs, are considered together 'in the round'. At this point in time however is not possible to provide a rounded view due to the piecemeal approach taken on the release of discussion papers at this early stage.

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

We note that there are already significant levels of public disclosure on financial resilience through the annual publication of long-term viability ("LTV") statements in Annual Performance Reports (APRs) and the board assurance of financial resilience completed as part of the price review business plan submission.

For Yorkshire Water, these assessments are particular to its circumstances, including its annual business plans and the terms of its financing arrangements. All credit ratings are included in the matters considered by the board at Yorkshire Water for financial resilience reviews, but they are not the sole defining criteria for assessing financial resilience.

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.

We request further clarification as to the rationale to link distributions to credit ratings given published dividend policies and the fiduciary duties of board directors. Yorkshire Water believes it is incorrect to conflate credit ratings targeted for the notional capital structure with decisions relating to a company's actual capital structure and its financial resilience. This can be perceived as clear regulatory intervention in a company's decisions on its actual capital structure. We do not understand the need for additional board assurance statements in relation to dividends, as dividend policies are already board assured.

In addition, ratings originally targeted in company price review business plans for a notional capital structure are not an appropriate comparison since they are based on the risk and reward assumptions included within a company's business plan. They are not adjusted subsequently for the final determination, which may be notably different as was clearly the case for the sector in PR19.

For example, in PR19 Ofwat applied material downward movements to the balance of risk and return in its final determinations, through a material reduction in WACC and enhanced cost and performance challenges. The impact of these changes equated to a one notch ratings downgrade; illustrated by the fact that all non-CMA appellant companies were downgraded by at least one ratings agency following their acceptance of their final determinations.

Finally, as with the other responses above, any financial resilience assessment needs to be based on a broad framework of measures, not solely credit ratings.

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

We do not see the benefit of licence protections being amended to maintain two investment grade ratings.

A full financial resilience assessment should consider all the ratings published by credit ratings agencies. For example, Yorkshire Water has six debt ratings maintained and published by three ratings agencies that support its ability to maintain its capital structure and efficiently raise debt.

We note that Ofwat has taken a selective approach on ratings to be monitored for licence purposes, which is not necessarily appropriate for a financial resilience assessment. Credit ratings are subject to the specific methodologies and views of individual agencies and, as a result, there can be a range of different ratings issued by different agencies for a company.

Given this disparity between the individual assessments of different ratings agencies, Yorkshire Water believes all published ratings should be considered when assessing the financial resilience of a water company. This is distinct to ring-fencing licence conditions, which clearly serve a different purpose.

8. **A requirement for companies to formally notify us of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals).**

We do not understand the need for additional notification of any changes to credit ratings. Any such changes are determined and published by ratings agencies. Ratings 'outlooks' are also regularly reviewed by the ratings agencies and provide an 'early warning' on possible ratings action.

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

We support the removal of any dispensations in relation to the requirement to maintain an investment grade credit rating in order to strengthen licence protections. It would mean a consistent standard being applied to the sector as well as giving greater confidence due to the rating being published by an independent ratings agency and their continual scrutiny, as opposed to an annual certification.

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

We do not understand the need to amend the licence given the recent refresh of dividend policies during PR19 and Ofwat's published review of them for the sector. The application of the additional transparency and disclosure from this PR19 refresh should be assessed over the full AMP7 period to 2025.

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

We do not see the need for additional reporting on swaps given the recent changes to APR reporting requirements, in addition to disclosures within annual financial statements and six-monthly investors reports that are available publicly.

Ofwat refers to 'kick the can' swaps and Yorkshire Water requests a clarification as to what is exactly meant by this description as it is not one recognised by Yorkshire Water from its extensive experience of the UK swaps market. In addition, we note the mistaken reference to mark-to-market valuation as gearing to be considered today, which we believe represents a fundamental misunderstanding of the difference between debt and derivative instruments in respect of their valuation and recognition in financial statements.

Swaps are a legitimate financing instrument, used to manage exposures of water companies to interest rates, inflation, energy costs and other market derived prices, as recently referenced by Ofwat itself in the roundtable discussions. They should be considered as part of a company's overall financial strategy and it is fundamentally flawed for Ofwat's proposals to seek to treat them separately or exclude them in any way.

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

We do not agree there is any need for disclosures in APR's on holding company debt levels. This reflects the recently strengthened regulatory ring fence, refreshed dividend policies and that such debt, and its servicing, is clearly a risk borne by shareholders.

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

As contingent liabilities, pension deficits would be a relevant consideration in a financial resilience assessment, particularly where funding in allowed revenues has ceased, or is due to cease, or there are concerns raised by the Pension Regulator.

There is already extensive reporting on pension schemes within annual accounts. However, we support any perceived need to increase pension scheme disclosures to ensure better understanding of scheme liabilities for companies.

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

We support a financial resilience assessment similar to that conducted at PR19.

As noted in responses to the questions above, the financial resilience assessment will need to be based on a broad framework of measures that assesses the risk of disruption and not solely gearing or selected credit ratings.

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.**

Following the CMA conclusions on the PR19 redeterminations, we do not believe that it is appropriate for Ofwat to continue to imply that there are distorted incentives linked to high levels of gearing, nor that there is risk of poorer service and reduced investment. We refer to the body of evidence considered by the

CMA and ask Ofwat to draw to our attention any fresh evidence that it believes supports the comments in its discussion paper.

Likewise, we request substantive evidence to support the assertions made by Professors Mason and Wright regarding the increased social cost of financial distress, its sole link to gearing levels and some indication as to quantum of any gap between social and private costs, as currently we do not believe these assertions have been appropriately evidenced.

We also believe it is important that "financial outperformance" is appropriately defined. At present, Ofwat appears to be conflating two separate elements, namely gearing and interest, which need to be considered separately.

The CMA confirmed that there is no benefit from higher gearing; therefore, we are concerned that Ofwat continues to refer to "perverse incentives" and suggest that outperformance arises from gearing when they have been unable to provide any evidence to support this view.

On this basis, we see no need for any incentives framework in relation to capital structure. In particular, any rewards associated with financial resilience would appear inappropriate, given it is a base requirement that any company should be financially resilient. Any rewards associated with financial structure would also present outside the sector as another intervention into the key regulatory principle that companies have been free to choose their own capital structure, where shareholders bear financing risk rather than customers.

Where financial outperformance does occur, it is in relation to a company's cost of debt compared to the notional allowance. As noted in past submissions and our response to the risk and return discussion paper the current embedded debt policy creates an arbitrary set of winners and losers, based more on timing rather than efficiency or any "risky" choices as perceived by Ofwat.