July 2022

Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers

About this document

This paper invites comments on our proposals to modify certain ring-fencing provisions in each water company's[1] Instrument of Appointment (**licence**). The modifications proposed relate to Condition P of all companies' licences, apart from Wessex Water's licence, which we propose to make modifications to Conditions A, I, K and P of.

Under section 12A of the Water Industry Act 1991 (WIA91), we are able to modify the conditions of an English water company's[2] licence subject to the procedural requirements set out in sections 12A-12I WIA91. Under section 13 of the WIA91, we are able to modify the conditions of a Welsh water company's[3] licence if the company consents to the modifications. Before making modifications under sections 12A and s13 WIA91, Ofwat must give notice. In respect of each English company this document constitutes a statutory notice under section 12A of the WIA91 and in respect of each Welsh company this document constitutes a notice under section 13 of the WIA91, in particular sections 2, 3, and 4.1 to 4.3 and appendices A3 and A4. Proposed modification drafting for all companies' licences apart from Wessex Water's is shown in Appendix A3, and proposed modification drafting for Wessex Water's licence is shown in Appendix A4.

[1] For the purpose of this document, a reference to a water company or company means a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991. The proposals in this document do not apply to apply to new appointments and variations.

[2] In the context of this document English water companies means companies appointed as water and/or sewerage undertakers whose areas of appointment are wholly or mainly in England. The companies whose licences we propose to modify pursuant to s.12A WIA91 are Anglian Water Services Limited, Affinity Water Limited, Bristol Water plc, Northumbrian Water Limited, Portsmouth Water Limited, Severn Trent Water Limited, South East Water Limited, Thames Water Limited, South Staffordshire Water plc, Southern Water Limited, South West Water Limited, Sutton and East Surrey Water plc, United Utilities Water Limited, Wessex Water Services Limited and Yorkshire Water Services Limited.

[3] In the context of this document, Welsh water companies means companies as water and/or sewerage undertakers whose areas of appointment are wholly or mainly in Wales. The companies whose licences we propose to modify pursuant to s.13 WIA91 are Hafren Dyfrdwy and Dŵr Cymru.

Executive summary

Financial resilience is the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption, whether that disruption is driven internally or externally to the company. In a long-term sector, providing an essential service, such as water, it is vital that companies have access to the financial resources necessary to deliver their obligations and commitments to customers at all times, both now and into the future. We expect companies to be on a sound financial footing with robust and transparent financing arrangements that are clearly aligned with the interests of customers.

Water companies and their investors are responsible for ensuring that the regulated company remains financially resilient. We monitor companies' financial positions and engage with companies where we have concerns about their financial resilience. Though, as we would expect, many companies in the sector show good levels of financial resilience, we have concerns that some do not and that the current regulatory protections we have are not sufficient to protect the interests of customers. Weakened financial resilience can lead to reduced levels of operational performance and erode a company's capacity to cope with financial pressures or shocks without compromising service to customers.

In some instances, companies have been slow to acknowledge that their financial position needs to be improved when we have raised concerns and have been unwilling to engage openly on these issues. In addition, we have seen recent cases of companies stepping back from public commitments to improve financial resilience.

These experiences have indicated to us that backstop financial resilience protections across the sector need to be improved. This consultation sets out our targeted proposals to strengthen regulatory protections to incentivise companies to be financially resilient. Our proposals are part of a proportionate regulatory approach, which should not have a material impact on financially resilient companies. This consultation builds on significant work we have carried out on financial resilience, in recent years, and seeks to support this work and the engagement we have with companies where we have identified financial risks. This consultation also reflects the discussion paper that we published in December 2021[4] and our consideration of the 32 responses we received to it as well as extensive engagement with respondents, sector stakeholders[5], and a range of debt investors. It also takes into account, the wider and ongoing risks to financial resilience.

This paper focuses only on proposals that we intend to progress (as set out in box 1); we are not progressing with all of the suggestions set out in the discussion paper (see appendix A1). We consider it appropriate to bring the regulatory ring-fencing framework of all companies to

[4] Financial resilience in the water sector: a discussion paper, December 2021

[5] Engagement was through roundtable discussions as well as direct discussions with companies, investors and the consumer interest groups CCW and Citizens Advice.

the same standard to ensure that all water customers have the same level of protection regardless of which regulated water company is supplying them with services. We therefore propose to modify the licence of Wessex Water to also incorporate changes made in July 2020 to all other companies' licences.

Our proposals to strengthen the regulatory ring-fence[6] licence conditions across the sector are to:

Modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, effective from 1 April 2025.

We have always expected companies to maintain headroom within investment grade credit ratings – and the majority of respondents to our discussion paper agreed that they would not expect a regulated utility to hold a credit rating of BBB-/Baa3 or below. Despite this we have become concerned about the general decline in credit quality in the sector over time. The present minimum standards in company licences allow companies' financial resilience to deteriorate too far before distributions outside of the regulatory ring-fence are restricted and they have to engage in meaningful corrective actions or in discussions with us on the mitigants being planned and executed. This proposal seeks to encourage companies to ensure the decisions they make allow them to maintain long term financial resilience, to maintain headroom well within the investment grade and to take early corrective action where it is required, including engaging with us effectively at an earlier stage. As with the current licence condition there will continue to be the opportunity for companies to request consent from us to make distributions, even if they are in cash lock up.

Modify the dividend policy licence condition to require that dividend policies and dividends declared or paid should take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term.

Currently all companies have an existing licence condition that requires them to only pay a dividend if it does not impair the company's ability to finance its activities and to reward efficiency and the management of economic risk. The licence also requires companies to publish information in accordance with our principles including that they should explain how their dividend payments and policies take account of delivery for customers.

Despite this, in recent reporting to us, many companies did not meet our expectations in explaining their dividend payments and/or policies. This has raised concerns (detailed in our 2020-21 monitoring financial resilience (MFR) report) that the majority of companies were not explaining things clearly enough and should do a lot more to show how the levels of

[6] The 'regulatory ring-fencing framework' or the 'regulatory ring-fence' or simply the 'ring-fence' refers to the ring-fencing licence conditions in Condition P of companies' licences (or Condition I, in the case of Wessex Water). The ring-fence provides an important protection for regulated companies and their customers. Its purpose is to ensure that the regulated company maintains sufficient financial and management resources which enable it to carry out its functions in a sustainable manner. It protects the regulated company from the activities of other entities such as other group companies.

dividends paid or declared reflect the levels of service delivered. Therefore, we are proposing to modify the existing dividend policy licence condition to directly reflect our principles and to align them with expectations that we set and which companies agreed to meet at PR19 on ensuring dividends take account of delivery for customers and the environment. Our proposal will strengthen the regulatory ring-fence in the licence and improve protections for customers and the regulated company. It also ensures consistency, removes the potential for ambiguity and promotes the importance of explaining dividend decisions clearly and as issues that matter for customers and the environment.

Additional licence modifications and other mechanisms

There are also other modification proposals in section 4 of this paper related to a licence requirement for companies to maintain investment grade issuer credit ratings with at least two credit rating agencies and to notify us of changes to credit ratings.

We also set out how we are pursuing improved transparency on swaps and pensions, outside the licence.

All the proposals set out in this paper are designed to support our discussions with companies. By strengthening the provisions of the regulatory ring-fence, including aligning the dividend provision with current expectations, we are increasing the minimum standards companies need to uphold but this is not a replacement or alternative for the need for ongoing dialogue and engagement with us on financial resilience which will continue to be a key focus for us.

We welcome comments on the modification proposals as summarised in box 1 by 29 September 2022.

Box 1: Financial resilience proposals

We welcome views on our proposals to:

1. modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, as set out in section 2, box 3, proposed to take effect from 1 April 2025.
2. modify the dividend policy licence condition to require that dividend policies and dividends declared or paid should take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term, as set out in section 3, box 4.
3. modify the licence to require companies to hold two issuer credit ratings, or to seek our agreement to an alternative arrangement, if proportionate, as set out in section 4, box 5.
4. modify the licence to require companies to notify us about any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating

withdrawals), with reasons for the change, where applicable, as set out in section 4, box 6.

5. bring other ring-fencing provisions in Wessex Water's licence up to the current industry standard as set out in appendix A4 and as explained in our 2020 consultation on regulatory ring-fencing licence modifications[7].

The rest of this paper is structured as follows:

Section 1 sets out our role in financial resilience including the reasons why we consider it necessary to strengthen financial resilience across the sector at this time.

Section 2 sets out why we consider it important for companies to maintain headroom within the investment grade and therefore why we consider it necessary to pursue an increase in the credit rating level that triggers the cash lock-up licence condition, our proposed modifications to address these issues and the effect of the proposed modifications. We also respond to issues raised in response to our discussion paper.

Section 3 sets out why we consider it important for companies to meet our expectations that dividend policies and dividends declared and paid should take account of service delivery for customers and the environment over time, and current and future investment needs and financial resilience over the long term, our proposed modifications to address these issues and the effect of the proposed modifications.

Section 4 sets out why we consider it important for companies to maintain investment grade issuer credit ratings with at least two credit rating agencies and to notify us of changes to credit ratings, our proposed modifications to address these issues and the effect of the proposed modifications.

We also set out how we are pursuing improved transparency on swaps and pensions, outside the licence, in section 4.

[7] Conclusions on section 13 of the WIA91 on proposed modification to ring-fencing provisions, Jul-2020

Responding to this consultation and next steps

We welcome views on the proposals outlined in this paper by 29 September 2022. Welsh water companies should also indicate their agreement or otherwise to the proposed modifications to their licences by this date. Please email responses to financial.resilience@ofwat.gov.uk.

Subject to our consideration of responses, we propose that the modifications to each English water company's licence will take effect from a date no less than 56 days from publication of our decision to make the modifications, except for the modification to the cash-lock up licence condition which we propose will take effect from 1 April 2025 to give companies time to adapt, if required.

We will publish responses to this document on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this consultation paper you are deemed to consent to its publication.

Information provided in response to this document, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our Privacy Policy.

If you would like the information that you provide to be treated as confidential, please be aware that under the FoIA there is a statutory Code of practice which deals, among other things, with obligations of confidence.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed and provide a redacted version of your response, which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

Contents

1. Our role in financial resilience and protecting customers

In a long-term sector, providing an essential service, it is vital that companies have access to the financial resources necessary to deliver their obligations and commitments to customers.

The incentive-based regulatory framework we operate aims to align the interests of investors and management with the interests of customers through the use of mechanisms that reward companies for delivering high quality services, at an efficient cost. Debt and equity capital are both important to ensure the sector has sufficient access to the financial resources needed to deliver services to customers. The regulatory framework assumes that companies maintain an equity buffer so that investors have sufficient capital at risk to be strongly motivated to encourage companies to be efficient. This ensures companies deliver strong performance for customers and the environment, including the investment necessary to fulfil their obligations, taking account of any additional or unplanned costs, such as financial penalties or other payments incurred as a result of underperformance.

Our long standing approach is that companies are best placed to make decisions over their financing and capital structure arrangements, including a target credit rating which provides them with a robust level of headroom to allow for financial flexibility, within the boundaries set by our regulatory controls, their licence and company law. Therefore, investors should bear the risks and consequences of decisions made for and by the company and an equity buffer is a necessary part of this.

Within this framework it is still important that as a regulator of an essential service we have a clear ongoing assessment of the financial resilience of companies and have the right regulatory tools to protect customers.

1.1 How we assess financial resilience

Our assessment of financial resilience takes account of a range of information and the specific circumstances of each company. We consider a range of financial measures (e.g. interest cover, gearing, liabilities not reflected in gearing such as swap mark-to-market valuations and pension obligations) as well as other information, such as disclosures published in annual performance reports (APRs), operational performance and the potential consequences of enforcement action. Information published by third parties, such as credit opinions published by credit rating agencies also provide useful insight that may be used to assess risks to a company's financial resilience. We explain how we assess risks to each company's financial resilience more fully in box 2.

There is a degree of judgement to an assessment of financial resilience and the sometimes diverging views between rating agencies on the same company highlight the challenges of assessing a company's financial resilience. This is why we do not rely on any single source of information and, in turn, assess all information that is available to us to inform our own view of financial resilience which we share through our annual MFR report.

Box 2: How we monitor and engage with companies on financial resilience

We use a range of information including disclosures made in annual performance reports (APRs), statutory accounts, interim reports (where available), credit rating reports and other public information. APRs include a range of quantitative and qualitative information as well as statements of assurance from each company's board[8]. We can also ask companies for additional information where we consider it necessary to understand their financial position. Each company also publishes a long-term viability statement (LTVS) within the APR or statutory accounts. The LTVS is a board assessment of each company's long term financial viability. In making that assessment companies prepare and stress test forward looking plans which reflect the key risks that they face. They also consider any mitigating actions that would be taken if an identified risk occurred.

Since 2015-16 we have published an annual MFR report based on information and data provided by the companies in their APRs. The MFR report allows easier comparison of key financial metrics across companies and over time. We use the MFR assessment and other information to reach a view on the areas where a company may have heightened levels of risk to financial resilience enabling us to identify those companies where additional engagement is necessary or where we would expect them to be taking action.

Where we identify companies as higher risk, we engage with them directly to understand their position and, where necessary, the steps that are being taken to improve financial resilience. Our engagement is targeted and proportionate to our assessment of the issues and also seeks to understand how the board and shareholders are considering and acting to solve the issue(s) in question. Such engagement commences well before a company's credit rating is at risk of falling to the lowest investment grade.

Where we identify potential risks to a company's financial resilience, then it is appropriate for us to engage with the affected company in order to a) understand how the company is assessing and addressing the risks we have observed and b) secure that the company is taking appropriate steps to continue to deliver for customers and the environment. As the sector's economic regulator, we expect companies (and where necessary, their investors) to engage openly and transparently with us about their financing arrangements and any issues

[8] Board assured statements in APRs include the ring-fencing certificate (RFC) and long-term viability statement (LTVS). In an RFC a company confirms it has sufficient resources (including financial, non-financial and management resources plus systems of planning and internal control) to maintain its regulated activities for the next 12 months. An LTVS assesses the company's viability over a longer period, minimum 5 years.

relevant to their financial resilience. Indeed, there was significant support for improving transparency in responses to our December 2021 financial resilience discussion paper, as long as it is proportionate.

Going forward, we will continue to use this engagement as an essential part of our regulatory approach to financial resilience and companies should continue to expect that we may request that they provide further evidence in support of their long term viability assessment, or any other disclosures made in their APRs or other published information. This may include additional details of the assumptions, outcomes (e.g. outputs of stress testing) and details of mitigations (i.e. corrective actions the company is considering) to provide us with confidence that company boards have identified, assessed and are managing the risks.

This approach is aligned with those respondents to our December 2021 discussion paper that said our approach should be targeted and should rely on existing regulatory processes to strengthen financial resilience, if possible, rather than introduce new mechanisms. We would expect, in many cases, that companies are already engaging with their own boards on plans to address any issues and improve financial resilience.

1.2 Current position of the sector

While most companies in the water sector are able to demonstrate that they are financially resilient, we have become increasingly concerned about the impact of the financing decisions made by some companies on their long term financial position, including available financial headroom, and how this could affect service to customers. This is a particular issue where companies need to finance a turnaround plan or to improve performance. We welcome the steps taken by a number of companies to strengthen their balance sheets (through equity injections or restricting dividends), in some instances, we remain concerned about risks to company resilience as explained in our MFR report. The credit ratings we monitor for licence compliance purposes across the sector have fallen over time, indicating a reduction in financial headroom[9]. Several companies have ratings below the notional company target of at least BBB+/Baa1.

While we are not seeking to dictate a single capital structure for the sector, companies need to operate with robust levels of headroom so our aim is to set a backstop, with effective minimum standards for financial/capital structures below which companies should not drop. Many of the current financial structures in the water industry were put in place before the 2007-08 financial crisis. In putting these structures in place, a number of companies paid significant dividends or made loans to shareholders to achieve a higher target gearing. This led to an overall increase in gearing across the sector and the higher levels of debt reduced the flexibility in company structures. Since then, there have been changes in wider economic conditions and consequent reductions in the level of returns that companies can earn. This

[9] Some companies have withdrawn their lowest credit rating, if they hadn't, average ratings would be even lower.

reflects changes in financial markets, as well as changes in the regulatory regime over time, for example, an increased use of outcome delivery incentives and so, a greater proportion of allowed revenue is now at risk. Consequently, there is a greater need for companies to ensure that they have adequate financial headroom and elements of some structures established 15 years ago may no longer be appropriate.

It is therefore necessary for us to look at our approach to regulating companies, the mechanisms that are available to us to protect customers and the operation of the regulatory ring-fence of regulated companies.

Our proposals are targeted to only impact less resilient companies and should have no impact on well-run companies with resilient structures. However, we consider that the proposals are aligned with our duties in respect of all regulated companies because of the potential for circumstances to change over time; they provide a clear signal to companies and their management about our financial resilience expectations. The proposals will also further encourage all companies to consider their financing decisions in the context of maintaining financial resilience in the long term and encourage them to take steps early where risks to financial resilience might arise.

1.3 Operational resilience and financial resilience

A number of respondents to the discussion paper suggested that we were drawing a direct link between operational performance and financial resilience and that if we were concerned about operational resilience, we should focus on honing performance incentives rather than financial resilience metrics.

To be clear, we are not suggesting that poor financial resilience automatically leads to poor operational performance. Our concern is that when challenges to financial resilience arise, for example, as a result of an internally or externally generated cost shock, companies need sufficient equity backing to respond adequately without losing a strong investment grade credit rating. In addition, we observe cases where companies which we have identified as carrying greater financial resilience risks[10] have also been identified as carrying operational challenges or as lagging behind in our service delivery report[11]. In addition, there are reasons to consider that financial resilience problems can exacerbate other challenges, for example, where a focus on the short term might result in a company seeking cost savings or satisfying near-term financial obligations such as interest payments or deferring spend rather than a focus on necessary investment. Indeed, in recent months we have seen companies consider deferring key expenditure, which customers have funded, when faced with pressures on their finances. We have been clear that this approach is not acceptable.

[10] Monitoring financial resilience report, 2020-21, page 5
[11] Service delivery report, 2020-21, page 7

2. Cash lock-up and credit ratings

Our December 2021 discussion paper proposed amending the existing trigger level for the 'cash lock-up' licence condition[12] to BBB/Baa2 with negative outlook or to a higher credit rating (from the current trigger of BBB-/Baa3 with negative outlook) and requested views on the potential for the trigger to be linked to measures of service performance. All companies have an existing cash lock-up licence condition except Wessex Water as the company did not consent to sector-wide licence modifications made in July 2020[13].

Based on further work and engagement with stakeholders, including representatives of debt investors, we propose to raise the trigger for cash lock-up to BBB/Baa2 with negative outlook. Distributions can only be made with our approval if the rating hits that trigger. We propose that the modification of the cash lock-up licence condition, as set out in box 3, should take effect from 1 April 2025 to give companies time to strengthen their financial resilience, if necessary.

Our experience and available evidence suggests that operating at the lowest investment grade of BBB-/Baa3 exposes a company to unnecessarily higher levels of risk and potentially leaves it insufficient headroom to absorb unexpected shocks including, for example, outcome delivery incentive underperformance payments and enforcement penalties (such as fines for breaches of environmental law) or to fund any major turnaround plans, if required. The cash lock-up licence condition should support the regulatory protections already in place to encourage companies to maintain financial resilience and engage early with us on financial resilience issues. Our experience suggests that the existing trigger for the cash lock-up licence condition is at a position that is too low to operate as an effective backstop as financial resilience issues have typically crystallised well before a company is at BBB-/Baa3 with negative outlook. As such we propose updating the wording as set out in box 3 below.

We propose not to link the cash lock-up trigger directly to measures of service performance, at this time. Our view is that a simple trigger would be more effective and better address our concern that companies need to engage proactively with us where we identify risks to a company's financial resilience.

In practical terms, triggering the cash lock-up licence condition does not constitute a licence breach; it simply means that our approval is required for certain payments out of the regulated company. We intend to retain that ability in the revised licence condition as there may be limited circumstances in which distributions might still be acceptable in a cash lock-

[12] The cash lock-up condition places restrictions such that a company 'must not, without the prior approval of Ofwat, transfer, lease, licence or lend any sum, asset, right or benefit to any Associated Company' (except in limited circumstances) where a credit rating is sub-investment grade, or is at the lowest investment grade, BBB-/Baa3, with negative outlook.

[13] As explained 'Conclusions on section 13 of the WIA91 on proposed modification to ringfencing provisions', Jul-2020, Wessex Water did not consent to modifications made to all other companies' licences at that time.

up situation. We recognise there have been circumstances where companies have had credit ratings that would trigger lock-up at this proposed new level. To seek our approval for distributions, companies need to make a request for approval in accordance with our consents guidance[14] and demonstrate that they are financially resilient or are taking appropriate actions to secure their financial resilience. We would want to understand the actions that the company is taking to address its issues including financial forecasts and the expected timeframes before actions are expected to feed through into improved outcomes. We will consider each case on its own merits.

2.1 The importance of headroom in the investment grade

Water companies need to finance significant investment programmes in order to deliver the obligations and commitments to customers and the environment. To enable this, they need to be able raise debt efficiently at all times in the economic cycle.

Each company currently has a licence condition requiring it (or any Associated Company which issues corporate debt on its behalf) to ensure it maintains, at all times[15], an Issuer Credit Rating which is an Investment Grade Rating (as defined in the licence). This requirement enables companies to maintain efficient access to capital. In addition, the cash lock-up condition ensures that, should a company's investment grade credit rating be at risk, certain distributions are restricted from leaving the company without our prior approval.

Together, these requirements seek to protect the interests of customers and the regulated company and increase the likelihood that a company has sufficient headroom to continue to meet its statutory and licence obligations and to absorb cost shocks without losing its investment grade rating.

Our position has always been that companies should maintain headroom within the investment grade; as such, we have never expected any water company to operate with little headroom in the investment grade category. Our view is supported, for example, by the PR19 price determinations which targeted a BBB+/Baa1 credit rating for the notional company, and the PR24 methodology sets an expectation that companies should adopt this target or better for the purposes of the notional company in their business plans. We would expect companies to consider carefully, and, where necessary, take mitigating steps to improve financial resilience where a credit rating is poorly positioned.

[14] Guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework, Feb-2020
[15] Wessex Water's licence requires it to use 'all reasonable endeavours' to maintain such a rating.
South West Water has the condition in its licence but currently has our agreement to comply with an alternative requirement: annually the company submits a certificate confirming that, in the opinion of the board, it would be able to maintain an Issuer Credit Rating which is an Investment Grade Rating.

2.2 Evidence to support the view that a rating of BBB-/Baa3 is not sufficient for an essential public service

Probability of downgrade to sub-investment grade

It is a licence requirement that water companies must maintain a credit rating that is in the investment grade. Empirical evidence suggests that there is a heightened risks of downgrade to sub-investment grade for companies operating at BBB-/Baa3. Credit transition data shows a significant increase in the probability of a company being downgraded to a sub-investment grade rating over 5 years if its initial rating is Baa3 rather than Baa2 or stronger.

Table 1 below shows that the probability of being downgraded to a sub-investment grade level over 3 years, is 0% if the starting rating is Baa1, 3% if the starting rating is Baa2 and 30% if the starting rating is Baa3 (i.e. 10 times higher than at Baa2) – and the risk of transitioning to a sub-investment grade level increases with each passing year. This suggests that 1 in 3 companies rated Baa3 would be sub-investment grade within 5 years.

Table 1: Probability of credit rating being downgraded to below investment grade over the course of a five-year period (based on Moody's credit transition model)

Starting rating	Year 1	Year 2	Year 3	Year 4	Year 5
Baa1	0%	0%	0%	0.3%	0.8%
Baa2	0%	0.4%	3.0%	5.6%	8.0%
Baa3	5.0%	17.9%	30.1%	31.7%	33.9%

Source: compiled using SGN's RIIO GD2 Business Plan Appendix, Financeability, Dec-2019, pages 10-13.

Further, a 2019 Barclays[16] research piece references that the likelihood that a BBB- rated company will be downgraded within a year is five times greater than a BBB+ rated company; and that many large institutional investors are forced to sell bonds that fall out of the investment grade category due to investment restrictions, meaning a downgrade to sub-investment grade can increase the effective interest rate of debt instruments substantially. The finding on forced selling aligns with some of the discussions we had with debt investors (appendix A2). This evidence supports our view that we should expect water companies, as providers of an essential public service, to maintain credit ratings that are well within the investment grade.

Threats to capital access at lower investment grades

Companies need to maintain stable access to capital to finance their functions and the investment that is necessary to deliver their obligations and commitments to customers and the environment, now and in the long term. A downgrade to a sub-investment rating threatens that capital access. Our discussions with debt investors (see appendix A2) also confirmed their reduced willingness to invest in water companies rated BBB-/Baa3 for the

[16] Barclays Private Bank – Market Perspectives, BBB-rated bonds: a cause of concern? 6 September 2019.

long term.

Companies with stronger credit ratings are also better able to maintain stable access to debt markets at times of economic disruption. While water companies continued to raise finance during the 2007-08 financial crisis, time-series spread data from Moody's[17] shows that during times of crisis, there is a much greater impact on the cost paid for debt financing for companies with lower credit ratings, even within the investment grade, as spreads widen to a greater degree for lower rated investment grade credits. We note also that credit ratings across the regulated companies were, on average, stronger in 2007-08 than they are now.

Higher cost of debt at lower credit ratings

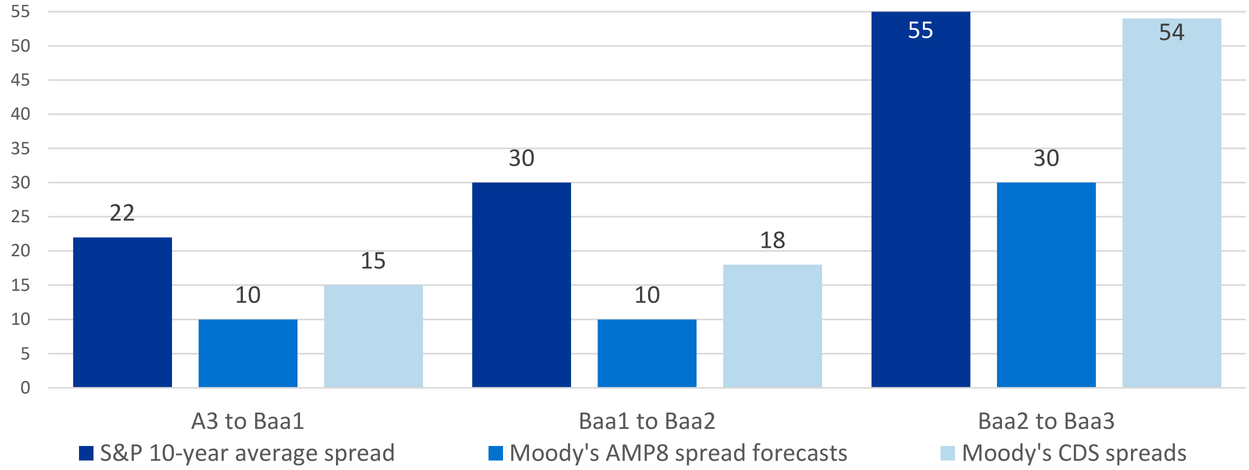
At PR19 all companies proposed a notional credit rating of BBB+/Baa1 and that was the basis of our allowances. The PR24 draft methodology proposes companies should target a credit rating of at least BBB+/Baa1 for the notional company.

Spread data shows there is an increased cost of debt at lower credit ratings, with a more pronounced increase in spreads at BBB-/Baa3 than at downgrades at higher credit ratings. In Figure 1 we illustrate the following:

- A 2019 report from Standard & Poor's[18] based on the period 2003 to 2019 (looking at instruments with a 10-year maturity) assessed that spreads increased by approximately 30bps when a rating fell one notch from BBB+ to BBB and increased approximately by a further 55bps with a fall from BBB to BBB-.
- Moody's forecasts for AMP8 (2025-30), published in October 2021, set out a 10bps increase in spreads over gilts in moving from a credit rating of Baa1 to Baa2 and a further 40bps increase with a fall from Baa2 to Baa3. [19]
- Moody's credit default swap (CDS) spread[20] data shows an 18bps increase in spreads between Baa1 and Baa2 and a further 54bps increase between Baa2 and Baa3.[21]

[17] Moody's Analytics, Cross-sector: Market Data Highlights – Data Report, fig 1, 14-Jul-2022 (published weekly).
[18] S&P Global Research Insights, The Cost of a Notch, 26-Mar-2019
[19] Moody's, Companies could face another cut in allowed returns in AMP8, 5-Oct-2021, Exhibit 15, p12
[20] Investors can buy CDS as 'insurance' against a given credit defaulting. A higher CDS spread reflects a higher premium or cost for that insurance.
[21] Moody's Analytics, Cross-sector: Market Data Highlights – Data Report, fig 13, 14-Jul-2022 (published weekly).

Figure 1: Increase in spreads (in basis points) for rating categories in the investment grade



Note: A-, BBB+, BBB and BBB- are the S&P/Fitch equivalents to A3, Baa1, Baa2 and Baa3 at Moody's, respectively.

2.3 Views on the proposal to lift the cash lock-up trigger

In its response to our discussion paper, the Consumer Council for Water (CCW) supported the proposal to raise the trigger for the cash lock-up licence condition such that it is triggered for any company with a credit rating lower than BBB+/Baa1, the level targeted for the notional company. No water company or equity investor that responded to the discussion paper expressed support for raising the trigger to at BBB/Baa2 with negative outlook; although, one company indicated that a notch up to BBB-/Baa3 could be acceptable, rather than at Baa3 with negative outlook.

Half of the respondents as well as the debt investor representatives we spoke to (see appendix A2) considered that a public utility should not operate at BBB-/Baa3 or below over the long term.

Respondents set out what they see as the risks or potential impacts of our proposal to lift the trigger for cash lock-up. The main concerns expressed were that:

- the proposal would undermine investor trust and confidence (20 of 32 responses), due to dividend uncertainty/instability and could lead to reduced investment. There were also concerns that amending the trigger could constitute a control on dividends particularly if cash lock-up were to be linked to measures of service performance. Two respondents added that the proposed approach is inconsistent with UK Government investment policy.
- existing regulatory protections are adequate;
- the case study of our work with Southern Water as set out in the discussion paper showed that the regulatory regime worked as intended;
- we have not adequately evidenced or justified the need for change.
- other regulatory approaches, such as outcome delivery incentives, are more targeted at improving resilience.

- it was inappropriate to place excessive reliance on credit ratings as this puts companies at risk of potential changes in credit rating methodology and/or that an “in the round” assessment should be considered instead.
- there is a more significant boundary between investment grade and sub-investment grade than between categories in the BBB band so shifting the lock up trigger level wouldn't meaningfully change underlying resilience.
- about a third of companies in the FTSE100, representing over 20% of its market capitalisation, have credit ratings of BBB/Baa2 or below and that almost 75% of these paid dividends in 2020; indicating that lower ratings are adequate for a resilient company.
- lifting the position of the cash lock-up trigger would require companies to maintain increased levels of headroom unnecessarily and that it would potentially require a higher allowed return on capital.
- the proposal is unprecedented, or a material change in the regulatory contract that it is disproportionate or overstepping our statutory duties.

In response to the proposal that cash lock-up could be triggered by reference to measures of service performance, 13 respondents suggested that the service metrics and thresholds to use would be hard to choose or that they are complex or subjective; or that it would lead to excessive dividend volatility or too much regulatory control over dividends - which was viewed as the board's role at each company.

Engagement with debt investors

Debt investors form the largest source of investment in regulated water companies. As no debt investor responded to the discussion paper, we engaged with the representatives of 11 debt investors with significant holdings in water, to ensure their views were captured. A summary of those discussions is in appendix A2.

Of the 11 we met, nine (including eight that are also invested in the debt of water holding companies[22]) were supportive of the proposal to amend the trigger for the cash lock-up to BBB/Baa2 with negative outlook and one was indifferent to it. This was driven by the view that given the need to protect water supply and services into the future, operating at BBB-/Baa3 into the long-term was considered not to provide sufficient headroom to absorb shocks so companies should be taking action to avoid a downgrade to that level. That said, four of the nine supportive debt investors emphasised that the sector needs to remain attractive to equity and said our final decision on whether to amend the trigger should be balanced between the views of both debt and equity investors.

Several debt investors said that they looked to the regulatory framework to mitigate the risk of a company falling to a sub-investment grade level and to push lower-rated companies to improve their rating. This suggests that having appropriate levels of regulatory oversight and

[22] Debt investors with exposure to holding company debt would be directly affected by a cash lock-up as the lock-up would lead to a loss of dividends which are partly used to pay interest on holding company debts.

intervention is also positively helpful in encouraging efficient access to debt finance.

2.4 Our view on responses to the proposal

Consistency with our statutory duties

We consider that modifying company licences to increase the cash lock-up trigger is in line with our statutory duties[23]. In particular, we consider it aligns with our duties to further both the consumer objective and the resilience objective as it reduces the likelihood that a company loses its investment grade rating thereby securing its ability to meet the need for water supplies and wastewater services into the long term for the benefit of its customers and the environment. It also aligns with our duty to secure that water companies can finance the proper carrying out of their functions. For example, encouraging companies to maintain headroom within the investment grade, to the extent this aligns with the basis on which price controls are set, should help to assure continued, stable access to finance at a reasonable cost, allowing efficient companies to finance their statutory functions and licence obligations. Further, such protections should help to minimise the risks of contagion, so that the financing costs of resilient companies should not be adversely affected by the crystallisation of risks to companies with weaker levels of financial resilience.

At the current cash lock up trigger of BBB-/Baa3 with negative outlook the risks of downgrade to sub-investment grade are significantly higher as shown in section 2.2; a trigger at BBB/Baa2 with negative outlook balances the need to minimise these risks with retaining financial flexibility.

Reducing investor appetite in the sector

Overall, most water companies are able to demonstrate that they are resilient; they have sufficient revenue allowances to allow them to meet their obligations and commitments to customers while maintaining credit ratings well within the investment grade. As such, we are not persuaded that lifting cash lock-up by one notch to BBB/Baa2 with negative outlook will reduce investor appetite for the sector as it would not lead to any risk of dividend restriction where companies maintain financial resilience. We consider that improving credit quality and financial resilience will strengthen companies' ability to access debt markets at efficient cost. Furthermore, we observe, for example, that in some cases, existing borrowing covenants place more restrictive conditions on companies.

We consider that the sector remains attractive to responsible, long-term equity investors; and, that strengthening the regulatory protections will have little to no impact on investors in companies that are resilient, ensuring the sector remains attractive to investors seeking investments in resilient companies. Furthermore, current market-to-asset ratios (MAR) of

[23] Water Industry Act 1991, General duties with respect to water industry.

listed companies –in the range of 1.25-1.3 of asset value[24] (well above the long term average of about 1.1) – continue to support our view that there remains strong investor appetite for the sector.

To the extent the proposed amendments more clearly signal our expectations about credit quality and financial resilience, this improves the predictability of the regulatory framework and improves the investability of the sector. Furthermore, resilient companies may be motivated to take steps to ensure financial resilience allowing them greater financial flexibility. For example, resilient companies may be in a better position to maintain reasonable dividend payments where risks might otherwise arise from cost shocks. Our proposals do not cut across the key features of the regulatory regime that are valued by investors and the sector should also continue to be attractive as a hedge against inflation given index-linked cash flows and RCV growth.

Our incentive regime means high-performing companies continue to have opportunities to earn higher returns, commensurate with the levels of performance delivered to customers. We see it as important that company boards remain responsible for determining the level of dividends and for justifying their decisions to stakeholders. However, it may be appropriate for dividends to be restricted or withheld in certain circumstances, for example, where there is a need to support resilience or where returns are low due to poor performance or poor historical financing choices or where equity must contribute to significant investment growth.

Finally, our view that the proposal is positive for equity investors in regulated water companies is consistent with Moody's view that a 'stronger regulatory ring-fence may benefit operating companies', we note however Moody's comments that the proposals could be detrimental to the credit quality of holding companies[25]. We regulate only the regulated company as the licenced entity and our long held position is that companies and investors must choose their own financing arrangements within the context of their licence and the price determination. We have been clear that interest obligations of holding companies should not be determinative of the level of dividends declared or paid by the regulated company if companies are to meet our expectations (as explained further in section 3). In this context, we note that in 2021 Anglian Water restructured its financing arrangements and introduced arrangements designed to support holding companies to meet costs in circumstances where dividends are restricted by the regulated company.

Requirements for headroom

We understand that company boards may be concerned about the need to maintain headroom against the triggers in the licence. However, we do not expect resilient companies

[24] Five transactions since Mar-2021 (three in energy, two in water) have had an average equity multiple greater than 2.1 and a MAR exceeding 1.4.

[25] Moody's – Sector in depth – Ofwat focuses on financial resilience as regulatory regime evolves, 14-Feb-2022

to be impacted by our proposal and we are not convinced that they need to increase levels of headroom to accommodate this proposal, given that we targeted BBB+/Baa1 at PR19 for an efficient company with the notional capital structure. Moreover, 12 out of 16 rated companies targeted BBB+/Baa1 or higher for their actual company structure at PR19 and currently, two[26] out the 17 companies that we regulate have ratings of A-/A3 (or stronger) from all three rating agencies in the current price control.

Given allowances already provided, we do not expect any company to operate at, or be at risk of falling to the lowest investment grade – and where a company is at risk, we would expect it to be taking steps to improve financial resilience well in advance of a downgrade.

Comparison with FTSE100 companies

A respondent set out that about a third of companies in the FTSE100 have credit ratings of BBB/Baa2 or below and set out a view that almost 75% of these paid dividends in 2020 therefore showing lower ratings within the investment grade don't mean lower financial resilience. We don't consider this point addresses the issues relevant to a monopoly provider of essential infrastructure, nor does it justify the licenced entity operating at BBB-/Baa3 for the following reasons:

- We are not convinced that FTSE100 listing should be taken as a proxy for the most resilient companies in the long term. Most companies in the FTSE100 are in competitive sectors unlike water companies. We observe that only 13% of these companies held at least one rating of BBB-/Baa3 or lower. Importantly, the FTSE100 is not a constant and companies that don't remain resilient[27] and maintain their market position fall out and are replaced by other companies.
- we do not consider the FTSE100 to be the best comparator for the credit rating of a regulated water company because listed entities are frequently a holding company and, by nature, tend to have a lower rating than their operating companies, whether it is regulated or not. We monitor the credit ratings of regulated companies (or their dedicated financing company) which typically carry a higher credit rating as seen in Table 2 below:

Table 2: Example – Moody's holding company vs regulated company ratings (May 2022)

	Holding company		Operating / regulated company	
		Rating		Rating
	Anglian Water (Osprey) Financing plc	Ba1*	Anglian Water Services Ltd	A3
	National Grid plc	Baa2	National Grid Electricity Transmission plc	Baa1
			National Grid Gas plc	Baa1

[26] Anglian Water (at return levels determined by the CMA following appeal of the PR19 determination) and Welsh Water.
[27] FTSE 100 Historic Additions and Deletions are regularly updated at ftserussell.com. The list of former FTSE100 companies that have fallen out the index for one reason or another is in the hundreds. Centrica was added to the FTSE100 in June 2022 after dropping out from the index in June 2020.

	Holding company		Operating / regulated company	
		Rating		Rating
			WPD East Midlands	Baa1
			WPD West Midlands	Baa1
			WPD South Wales	Baa1
			WPD South West	Baa1
	Severn Trent plc	Baa2	Severn Trent Water Limited	Baa1
	Thames Water (Kemble) Finance plc	B1	Thames Water Utilities Ltd	Baa2
	United Utilities plc	Baa1	United Utilities Water Limited	A3

*This Ba1 rating was withdrawn in 2021

Over-reliance on credit ratings in assessing financial resilience

In response to points made that our proposal places too much reliance on credit ratings and the views of the credit rating agencies, we note that our approach to assessing financial resilience has always considered a range of factors covering both quantitative metrics and qualitative data. We use all available information to reach our own views about the financial resilience of the companies we regulate. We expect to have engaged with a company on its financial resilience well in advance of any cash lock-up licence condition being triggered, and it is us, rather than the credit rating agencies, that is in the position to agree to distributions once the cash lock-up condition has been triggered.

We also understand the risks associated with methodological changes made by credit rating agencies. We confirm that if a company approaches us for consent to make distributions while in cash lock-up we will take account of all relevant matters when making our decision, including any evidence put forward in respect of the comments or views of a rating agency.

The adequacy of current regulatory mechanisms

As to the view that current regulatory mechanisms provide adequate protection (with some respondents referencing that the equity injection in the case of Southern Water is evidence that a strengthening of the ring-fence is not required), we welcome the significant injection of equity to stabilise the balance sheet of Southern Water and to help fund its improvement plan. However, we do not think it's acceptable that monopoly companies providing an essential service should get to such a weakened financial position in the first place. In the case of Southern Water and in other instances where companies maintain weak levels of financial resilience, we consider the amendment to the position of the cash lock-up licence condition should encourage companies with weaker levels of financial resilience to engage with us at an earlier point in the process, thereby encouraging companies and investors, where necessary, to take steps to improve financial resilience sooner and particularly before risks crystalise and service performance becomes affected.

Our view that current mechanisms are not working as they should is also underscored by the range of financial resilience concerns that we identified in our 2021 MFR report. In addition, our ongoing targeted engagement with companies where we have identified risks, shows it is reasonable that controls should be in place to restrict distributions – knowing equity injections may not be available in a timely manner.

Proportionality of changes

A range of views were expressed in response to our proposal to amend the trigger for the cash lock-up licence condition. Various views were expressed that the proposals we presented were unprecedent, represented a material change in the regulatory framework, were overstepping our duties or were disproportionate. The views expressed referred to both the proposal to raise the credit rating trigger for cash lock-up and the proposal to link it to measures of service performance. As we are not proceeding with a link to service performance, some of these concerns fall away.

Our proposal is only to amend the existing licence condition to a level where it would trigger in a more timely manner, in order to better protect the interests of customers. We do not consider that the proposal oversteps our duties, as a matter of principle. Given all companies except one already have a cash lock-up condition, and as we only propose raising the trigger for cash lock-up by one notch, to a level we consider ought to provide companies with a greater motivation to act and engage more quickly, we consider our proposal to be proportionate. All companies targeted a rating stronger than 'BBB/Baa2 with negative outlook' for their actual structure at PR19 – with 12 out of 16 targeting BBB+/Baa1 or stronger – so our proposal does not cut across the targeted rating on any company's actual structure.

Difference within the BBB band

Three companies responding to our discussion paper suggested that, based on historical default rates, a company operating at BBB-/Baa3 does not warrant concern. The company views (see appendix A1.2) do not align with our recent experience of regulating companies in this sector, especially in circumstances where risks to financial resilience have been identified.

We consider that the risk of default is not the primary metric to be concerned about, given the protections of the licence; we consider the propensity of BBB-/Baa3 rated entities to fall to a sub-investment grade rating (as demonstrated in Table 1 above) to be the more relevant data to look at because if a company does not hold an investment grade credit rating it is in breach of its licence. Nevertheless, we observe that average default rates[28] (over the period Moody's looked at of 1998-2021) approximately double when the starting credit rating is BBB-/Baa3 compared to BBB/Baa2.

[28] Moody's Annual default study, 8 February 2022, Exhibit 36 and Exhibit 43; S&P Global Ratings – 2020 Annual Global Corporate Default and Rating Transition Study, 7 April 2021, Table 26

2.5 Alternative options considered

We considered alternative options to strengthen the regulatory protections and to motivate companies to act responsibly to improve financial resilience:

- **Gearing limits.** As set out in our December 2021 discussion paper, we considered placing limits on capital or financing arrangements, for instance, by introducing licence modifications that could be defined to directly limit gearing. For the reasons set out in that paper we do not consider this is the best approach at this time. All respondents to this question in the discussion paper agreed that we should not set limits on capital or financing structures at this time (see appendix A1.3).
- **Higher lock-up trigger.** We considered raising the lock-up trigger to a higher level than BBB/Baa2 with negative outlook but concluded that this may not be proportionate.
- **Smaller increase in lock-up trigger.** We considered the alternative proposed by a respondent to the discussion paper to lift the cash lock-up licence condition marginally to BBB-/Baa3, that is, by removing reference to 'negative outlook' in the licence. We consider that this proposal would not go far enough to achieve the desired outcome. The evidence set out in section 2.2 above shows a much higher risk of BBB-/Baa3 rated entities being downgraded to sub-investment grade than BBB/Baa2 rated entities; in addition, most respondents to the discussion paper said BBB-/Baa3 is not appropriate for an essential utility. For these reasons we consider it reasonable for the cash lock-up condition to trigger just before a company is at this rating.
- **Reliance on resilience plans.** We considered setting a licence requirement for companies to prepare resilience plans and to submit them to us when their credit rating falls to BBB/Baa2 with negative outlook, or lower (see appendix A1.5). We also considered a variation of this suggested by a respondent to the consultation (in follow-up discussions), in which, if we were not satisfied with the resilience plan, we could then place the company in cash lock-up.

  While we may ask companies to provide a resilience plan as part of their engagement with us, where we have financial resilience concerns, we consider that a requirement for resilience plans on its own is not helpful if the plan does not address our concerns or if companies don't follow through with stated plans. Our experience is that companies have not always been willing to engage openly in such circumstances or to put forward an appropriate plan. And, in a few cases, companies have stepped away from public statements about intentions to improve financial resilience. For these reasons we do not agree that the alternatives of resilience plans, or cash lock-up being triggered only after consideration of a resilience plan, are sufficient to address the issues identified; they could lead to greater complexity and potential delays in triggering cash lock-up, thus eroding its effectiveness as a backstop.
  The onus should be on companies to demonstrate they are resilient rather than on us to determine that they are not. If a company in cash lock-up wants to pay a dividend, it can seek approval to do so, and we can approve the request if considered appropriate. Our

decision on whether to approve the dividend would necessarily involve assessing a company's plans to resolve its issues, among other things, as explained earlier in this document. However, if prior to a cash lock-up we consider it is appropriate to request a resilience plan, because of financial resilience issues that we observe a company is facing, we could make a request for a plan under condition M of the licence.

- **Comply or explain.** One respondent suggested that, on a periodic basis, companies with a credit rating (or basket of metrics) below a designated threshold could be required to 'comply or explain' – through a board-assured statement – why their level of financial resilience is considered sufficient. Ultimately, we were doubtful of the extent to which additional reporting requirements would drive companies to act, and to address concerns if we did not agree with the board assessment. We consider that rather than putting resources into boosting headroom and avoiding the lowest investment grade credit rating, companies may focus on developing arguments to justify their current financial position which is not the desired outcome.
- **Use of performance commitments and outcome delivery incentives.** Some companies proposed that performance commitments or outcome delivery incentives could be set by reference to measures of financial resilience with financial rewards earned for maintaining financial resilience (e.g. as measured by a high credit rating or low gearing). We consider it is inappropriate to reward companies for maintaining financial resilience when this is a basic expectation for a water company. CCW and two companies responding to our discussion paper were of the same view.

Our proposal on cash lock-up

Box 3: Cash lock-up provision

Current cash lock-up trigger in licences[29]:

P27 The "Cash Lock-Up" provisions set out in paragraph P28 apply in any circumstances:

P27.1 where neither the Appointee or any Associated Company which issues corporate debt on its behalf holds an Issuer Credit Rating which is an Investment Grade Rating; or

P27.2 where the Appointee or any Associated Company which issues corporate debt on its behalf:

P27.2.1 holds one or more Issuer Credit Ratings and one or more such Issuer

[29] Precise paragraph numbering may vary between companies' licences. Wessex Water does not currently have a cash lock-up provision in its licence as it did not consent to industry-wide licence upgrades made to water company licences in 2020. For so long as Ofwat agrees, South West Water has a dispensation to the investment grade credit rating requirement: annually the company submits a certificate confirming that, in the opinion of the board, it would be able to maintain an Issuer Credit Rating which is an Investment Grade Rating. As such, cash lock-up in South West Water's case would trigger if its board was not able to provide this certificate.

Credit Ratings is not an Investment Grade Rating; or

P27.2.2 holds an Issuer Credit Rating which is the Lowest Investment Grade Rating and:

P27.2.2.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P27.2.2.2 otherwise where the rating outlook of the Lowest Investment Grade Rating has been changed from stable or positive to negative.

Proposed cash lock-up trigger in licences:

Modifications are shown in bold (additional wording) or strikethrough (deleted wording).

P27 The "Cash Lock-Up" provisions set out in paragraph P28 apply in any circumstances:

P27.1 where neither the Appointee or any Associated Company which issues corporate debt on its behalf holds an Issuer Credit Rating which is an Investment Grade Rating; or

P27.2 where the Appointee or any Associated Company which issues corporate debt on its behalf:

P27.2.1 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is not an Investment Grade Rating; or

P27.2.2 holds an Issuer Credit Rating which is **one notch above** the Lowest Investment Grade Rating **(i.e. BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent)** and:

P27.2.2.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P27.2.2.2 ~~otherwise where~~ the rating outlook ~~of the Lowest Investment Grade Rating has been changed from stable or positive to~~ **is** negative.

1. **We welcome views on our proposal to modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, as set out in box 3, proposed to take effect from April 2025.**

3. Updating the dividend provision in company licences

It is important that investors in the water sector can achieve a reasonable return on their invested capital, and dividends are an important part of the equity return. In the water sector, the regulatory incentive mechanisms, which are designed to align the interests of companies and their investors with customers, impact on the returns each company generates over the period of a price control and this should also impact on a company's dividend decisions.

All companies have an existing licence condition that (in summary) requires them to pay a dividend only in accordance with a policy that embodies the principles that dividends declared or paid do not impair the company's ability to finance its activities, and that dividends declared or paid reward efficiency and the management of economic risk.

The guidance we have set out has evolved over time and at PR19 we have strengthened our expectations in respect of what companies should be considering when declaring or paying dividends. We have also updated our Board, Leadership, Transparency and Governance Principles in respect of dividends. We have guided companies to explain dividend decisions more transparently with clearer links to how dividends reflect matters such as company performance in delivering its obligations and commitments to customers and the need to remain financially resilient. While there has been some improvement in how companies explain dividends declared or paid in APRs, as set out in our 2020-21 MFR report, we consider that dividend decisions could be much more clearly explained and better linked to performance outcomes.

As part of PR19 we set out our expectations for the 2020-25 period, companies accepted this approach and these expectations have broadly been incorporated into company dividend policies for that period. The PR24 draft methodology sets out our proposals for the 2025-30 period. Our expectations for PR24 are set out in the draft methodology, chapter 9, section '9.5 Expectations on dividends' and in Appendix 10 of the PR24 Draft methodology.[30]

Our December 2021 discussion paper proposed that it is appropriate to bring the existing licence text on dividends into line with the expectations we have set out for a reasonable dividend policy. We proposed that the existing licence text should be modified to align with our expectations that dividend policies and dividends declared or paid should take account of delivery for customers and the environment and should take account of current and future investment needs and financial resilience. We therefore propose to modify the existing licence text to broaden the principle regarding financing the Appointed Business to also include these factors as set out in box 4 below.

[30] Creating tomorrow, together: consulting on our methodology for PR24, Jul-2022 – chapter 9. Section 9.5 'Expectations on dividends ' and appendix 10, section 8 'Dividend policies'.

Modifying the existing dividend policy licence condition to reflect these more up-to-date principles both sends a strong signal to the industry and stakeholders about our expectations on dividend policy, and better enables us to act where companies declare or pay a dividend in circumstances that may not promote the long term success of the company as a whole, or may have an adverse impact on the long-term financial resilience of the regulated company and its customers, the community or the environment. Our proposal will strengthen the regulatory ring-fence in the licence and improve protections for customers and the regulated company.

Most respondents to our discussion paper did not support updating the licence text on dividend policy (see appendix A1.10). The primary reasons for this were: it is already covered by existing requirements in the regulatory accounting guidelines and board leadership, transparency and governance (BLTG) principles; or it would lead to too much regulatory intervention on dividends; or that it could constrain board judgements.

We consider it best practice to align licence conditions with the expectations which companies have agreed to meet, as this ensures consistency, removes the potential for ambiguity and promotes the importance of explaining dividend decisions clearly and as issues that matter for customers, the environment and financial resilience.

Some respondents to our discussion paper raised concerns that our proposed amendments could lead to increased year on year volatility dividend payments where dividend decisions reflect levels of service to customers. We clarify the following:

- Dividends should reflect a company's overall assessment of performance at the time dividends are declared and paid, taking account of overall service delivery over time. This is consistent with the position that there are some performance metrics that are measured annually, others that are assessed across a longer timeframe such as over the period of the price control, some that impact multiple control periods and some that are unrelated to the financial year or price control periods (e.g. fines for environmental failures). Companies need to assess their performance / service delivery 'in the round' and should also consider financial resilience and the future investment needs of the business, among other things, before a dividend is declared or paid.
- Companies must remain accountable for their decisions and are expected to justify and provide a thorough and accessible explanation for any dividend payment. It is important for companies to explain how their dividend decisions reflect overall levels of performance, over time, including how and whether past out/under performance is being taken into account.
- We do not expect dividends to be based on expected, but yet to be delivered, service improvements. There may be circumstances where it is reasonable for dividends to be withheld in full, for example, as a result of significant service failures or investigations into suspected failures or where there is a need to strengthen financial resilience. However, we do recognise that there may be circumstances in which a dividend could be

reasonably paid despite performance levels not being universally at target levels.

Decisions about the declaration and payment of dividends remain the responsibility of the board of each company, taking account of relevant legal and licence obligations including but not limited to company law, the most-up-to-date accounting standards and guidance from the Financial Reporting Council (FRC).

In addition, each Ultimate Controller of a regulated water company (as defined in licences) gives an undertaking that it will not take any action which may cause the Appointee to breach any of its licence obligations or obligations under the Water Industry Act 1991. An Ultimate Controller would likely be in breach of its Ultimate Controller undertaking if it were to take action to approve or facilitate payment of a dividend that was declared or paid out of line with the company policy or if that policy was not in line with the licence condition.

We consider that modifying the dividend policy condition in company licences, to reflect our expectations, is in line with our statutory duties. In particular, we consider it aligns with our duties to protect the interests of customers and to further the resilience objective to secure the long-term resilience of water companies' water supply and wastewater systems. This is because any dividend would need to take account of financial resilience over the longer term and service delivery for customers and the environment over time. We consider that it does not cut across our duty to secure that water companies can (in particular through securing reasonable returns on their capital) finance the proper carrying out of their statutory functions, as we continue to consider that dividends are an important part of an incentive-based regime, and our proposal enables the payment of a dividend in line with a policy that takes account of these central elements of our regulatory framework.

We are proposing to update the licence provision wording on dividends to reflect principles that align with our current expectations and duties. Indeed, all company dividend policies already broadly align with our expectations as we assessed our 2020-21 MFR report (page 31), and we expect directors to already be taking these matters into account when making dividend decisions, in any event. However, we also referenced areas where companies should do more to show how levels of dividends declared/paid reflect levels of service delivered. We consider it important to reflect these principles in the licence for consistency, to further encourage companies to meet our expectations and to enable us to act when needed.

By modifying company licences to include our expectations on dividends we also expect that companies will include a more focused explanation in annual performance reports (APRs) of all the relevant factors that were considered to justify dividends declared or paid and will more clearly tie dividends declared or paid to their dividend policy – which embeds our expectations – for the benefit of all stakeholders.

Box 4: Dividend provision

Current dividend provision

Companies have broadly similar but slightly different wording in their licences. At present the dividend provision in the majority of company licences reads:

> P30 The Appointee shall declare or pay dividends only in accordance with a dividend policy which has been approved by the Board of the Appointee and which complies with the following principles:
>
> > P30.1 the dividends declared or paid will not impair the ability of the Appointee to finance the Appointed Business; and
> >
> > P30.2 under a system of incentive regulation dividends would be expected to reward efficiency and the management of economic risk.

Proposed dividend provision

To align the licence with the expectations that have already been set, we propose the dividend text in the licence is updated to state:

> The Appointee shall declare or pay dividends only in accordance with a dividend policy which has been approved by the Board of the Appointee and which complies with the following principles:
>
> i. that dividends declared or paid will not impair the ability of the Appointee to finance the Appointed Business, taking account of current and future investment needs and financial resilience over the longer term;
> ii. that dividends declared or paid take account of service delivery for customers and the environment over time, including performance levels, and other obligations; and
> iii. that dividends declared or paid reward efficiency and the effective management of risks to the Appointed Business.
>
> For the purpose of this licence condition, dividends refers to any distributions declared or paid in respect of any ordinary shares or preference shares.

2. We welcome views on our proposal to modify the dividend policy licence condition to require that dividend policies and dividends declared or paid should take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term, as set out in box 4.

4. Additional licence changes and other mechanisms that support financial resilience

This section sets out other proposals to strengthen financial resilience as also outlined in our December 2021 discussion paper.

4.1 Maintaining two investment grade credit ratings

Each credit rating agency has its own methodology for assessing credit risk and each agency focuses on different metrics and attaches different weights to various factors to inform its independent assessment of credit quality. While primarily designed to inform lenders, credit ratings provide important information to many stakeholders including regulators, and it is useful to have commentary on company performance from multiple independent parties.

Having a range of alternative views on financial resilience is especially helpful where rating agencies hold diverging views. It also avoids situations where a company might be incentivised to hold only one credit rating over another because a specific rating agency holds a particularly favourable or unfavourable view of the company.

Our discussion paper (and our 2020-21 MFR report) expressed some concern that low credit ratings had, in some circumstances, been withdrawn without a transparent explanation; we set out that this can lead to questions about a company's financial resilience. We proposed that requiring companies to maintain two investment grade issuer credit ratings (from two different rating agencies) rather than one, as is currently required, would help to address such concerns and would provide useful extra information to stakeholders.

15 respondents to our discussion paper proposal were either supportive or neutral. 10 did not support the proposal on the basis there was insufficient evidence to suggest that holding two credit ratings is necessary or beneficial to financial resilience and that costs need to be considered (appendix A1.7).

Several respondents (including eight out of 11 debt investors that we engaged) said maintaining two investment grade credit ratings is best practice. We agree and propose to implement this as a licence modification. We disagree with the suggestion that there is no benefit to holding two credit ratings and consider information about a company's credit ratings from a second credit rating agency provides additional information that is relevant to an assessment of financial resilience.

We consider that updating the licence requirement so that companies must maintain at least two investment grade issuer credit ratings (as set out below) would not represent a significant increase in regulatory burden; most companies already maintain ratings from at least two credit rating agencies, so, for these companies, there should be no cost impact.

We acknowledge that the costs of maintaining two credit ratings may be disproportionate for smaller companies. We may consider alternative arrangements where companies provide convincing evidence that it would be disproportionate for them to obtain two credit ratings.

Box 5: Credit rating provision

Current credit rating provision

All regulated companies except Wessex Water have the following credit rating requirement [31]. Section 4.3 sets out how we are proposing to update Wessex Water's licence to align the ring-fencing provisions with other companies. This includes the proposed amendment to the credit rating provision.

> P26 The Appointee must ensure that it or any Associated Company which issues corporate debt on its behalf maintains, at all times, an Issuer Credit Rating which is an Investment Grade Rating.

Proposed credit rating provision

> P26 The Appointee must ensure that it or any Associated Company which issues corporate debt on its behalf maintains, at all times, two Issuer Credit Ratings which are Investment Grade Ratings from two different Credit Rating Agencies, other than where Ofwat provides its written agreement for the Appointee to maintain only one Issuer Credit Rating which is an Investment Grade Rating.

3. **We welcome views on our proposal to modify the licence to require companies to hold two issuer credit ratings, or to seek our agreement to an alternative arrangement, if proportionate, as set out in box 5.**

4.2 Notifying us of changes to credit ratings

Given the importance of credit ratings as an indicator of a company's financial resilience, our discussion paper set out that we expect companies to notify us of any changes to credit ratings. However, currently this is not a licence requirement and changes have not always been notified to us; we therefore propose setting an explicit requirement for companies to

[31] Precise paragraph numbering may vary between companies' licences. Wessex Water's licence requires it to use 'all reasonable endeavours' to maintain an Investment Grade Credit rating. The company would therefore also need to adopt the more up-to-date licence provision.

formally notify us of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals) with reasons for the change, where applicable, as set out below.

22 out 27 respondents to this issue were generally supportive of the proposal (see appendix A1.8), with only one of the 22 stating they supported the proposal but not as licence change. Five did not support the proposal primarily because they did not understand the need for additional notification requirements as the information is already publicly available.

We consider that timely notification of any changes to ratings supports timely engagement between companies and us on issues of financial resilience and effective operation of the cash lock up, where necessary. We don't perceive there to be a significant increase in regulatory burden as some changes in credit rating are already notifiable to us under the material issues licence provisions (e.g. if the rating impacts the cash lock-up trigger).

In addition, while we acknowledge that credit ratings data is publicly available, we do not always get notification directly from the rating agencies when a rating changes. We therefore propose to make it an explicit licence requirement for companies to inform us of all credit rating changes.

We considered executing credit rating notifications as either a licence requirement or a requirement in the regulatory accounting guidelines (RAGs). We consider that a requirement for notifications of ratings changes is better suited to being a licence requirement on the basis that it should be an on-going, rather than annual, obligation on companies. We propose that the below provision is added as a new requirement below the condition to maintain an investment grade credit rating. We would generally expect to be notified within 5 business days after a credit rating agency announces a change in credit rating.

Box 6: New credit rating notification provision

{P27} The Appointee must inform Ofwat as soon as reasonably practicable when the Appointee changes or becomes aware of a change in any of its Issuer Credit Ratings including reasons for the change in rating. A notification would be expected within a maximum of 5 working days of:

(i) a change in Issuer Credit Rating grade or outlook;
(ii) a new Issuer Credit Rating being obtained;
(iii) the withdrawal of an Issuer Credit Rating.

4. We welcome views on our proposal to modify the licence to require companies to notify us about any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals), with reasons for the change, where applicable, as set out in box 6.

4.3 Wessex Water

In July 2020 we made modifications to all company licences apart from Wessex Water, who did not agree to the changes, to bring their regulatory ring-fencing licence conditions up to the industry-leading standard[32]. As Wessex Water did not consent to the July 2020 ring-fencing modifications, we were unable to modify its licence. However, we continue to believe that having consistent regulatory ring-fencing protections included in each company's licence is an important safeguard for customers, and we consider the reasoning set out in our July 2020 consultation and conclusions documents remains valid in the case of Wessex Water. As such, we consider that the July 2020 ring-fencing modifications should be applied to Wessex Water's licence alongside the other modifications proposed in this paper.

While we do not currently have any concerns about the financial resilience of Wessex Water, we recognise that the financial position of any company can change over time. We therefore consider it appropriate to update Wessex Water's licence now so that its customers will benefit from the same level of protection that exists for all other customers in England and Wales.

The purpose of the modifications we propose for Wessex Water's licence is to improve the protections for customers by bringing Wessex Water's licence up to the industry leading standard and to achieve a broadly consistent regulatory ring-fencing framework across England and Wales. In order to do this, in addition to the other modifications proposed in this paper we propose to draw together all of the ring-fencing provisions currently in Conditions K and I of Wessex Water's licence into an updated Condition P, and add or update certain relevant definitions in Condition A. Our proposed modifications for Wessex Water align with the conventions we developed during our 2018 licence simplification process to make the licence easier to follow and understand for all stakeholders[33].

[32] Details of these modifications and their purpose are set out in our May 2020 consultation document (Consultation under section 13 of the Water Industry Act 1991 on proposed modification to the largest licences for ring-fencing) and subsequent July 2020 conclusions document (Conclusions on section 13 of the WIA91 on proposed modification to ringfencing provisions)

[33] Details of our licence simplification modifications are set out in our 2018 consultation documents on our website here: Consultation under section 13 of the Water Industry Act 1991 on proposed modification to simplify various conditions of all undertakers' licences - Ofwat

In particular, our proposals include changing Wessex Water's existing credit rating requirement from a "reasonable endeavours" standard to a “must ensure” standard. We also propose to insert the cash lock-up provisions in Wessex Water's licence, which the company does not currently have, which will ensure that if the company's credit rating were to fall to BBB/Baa2 with negative outlook, resources could only be extracted from the company in certain specified circumstances or with our approval. Similarly, our proposal to insert a provision enabling us to direct Wessex Water to enforce its Ultimate Controller undertakings, which Wessex Water does not currently have, will protect the company and its customers from demands which might endanger the services being provided. Our proposed modifications for Wessex Water's licence are intended to ensure the long-term viability of Wessex Water and its services, and thus have a positive impact for customers, the company and shareholders in the longer-term.

The drafting we are proposing for Wessex Water's licence is set out in appendix A4.

5. **We welcome views on our proposal to bring other ring-fencing provisions in Wessex Water's licence up to the current industry standard, as set out in appendix A4, and as explained in our 2020 consultation on regulatory ring-fencing modifications.**

4.4 Dispensations from the requirement to maintain an investment grade credit rating

At the time of our discussion paper, both South West Water and Hafren Dyfrdwy had dispensations from the licence requirement to maintain an investment grade issuer credit rating.[34] We asked for views on removing these dispensations.

Only three respondents did not support the proposal, particularly one company impacted by the proposal. All others that responded to the issue were either supportive or neutral.

In March 2022 Hafren Dyfrdwy gave up their dispensation from the requirement to maintain an investment grade credit rating and have now procured a credit rating. We welcome this as positive for monitoring and maintaining financial resilience. We are in active discussions with South West Water about them obtaining a rating.

4.5 Transparent reporting

Transparent reporting is important as it allows stakeholders to understand companies' financial position and to challenge companies and raise questions where appropriate.

We welcome the strong support given by respondents to our discussion paper in relation to our call for greater transparency on swaps (appendix A1.11) and pension liabilities (appendix A1.13) and we are taking forward work to improve transparency in these areas. We will be engaging with companies on updated reporting requirements on swaps and pension liabilities for inclusion in future annual performance reports (APRs) shortly. We will issue draft reporting guidance in due course setting out what additional information is needed and how existing tables in APRs may need to be updated to improve transparency. We will engage with companies separately for their input and views on our proposed changes before proposals are added to the regulatory accounting guidelines.

As requested by respondents, any additional information we request will be proportionate and limited to the data we consider will best support our work to monitor financial resilience and understand risks. We continue to support the legitimate use of swaps to manage financial risks.

[34] Instead, an obligation applied that required the Board of each company to annually certify that it would be able to obtain such a rating, together with the main factors supporting its opinion, including financial ratios and other relevant information.

A1 Responses to our December 2021 discussion paper

This appendix summarises the responses received to the financial resilience discussion paper published in December 2021. The full set of responses is on our website. We asked the following questions in the discussion paper:

We invited comments and views for discussion on the following:

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

3. our option not to define limits on capital or financing structures at this time and whether it might be necessary to define limits for companies where financial resilience does not improve.
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.
5. a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.
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.
7. a requirement for companies to maintain two investment grade issuer credit ratings.
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).
9. removing dispensations from the requirement to maintain an investment grade credit rating.
10. the need to align the licence to our broader expectations for dividend policy.
11. enhancing the transparent reporting of the use of swaps and how this could be best achieved.
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.
13. the option to improve the transparency of pension deficit reporting.
14. the expectation that PR24 business plans should include a board assured assessment of financial resilience.
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.

A1.1 Operating at the lowest investment grade credit rating

Our discussion paper set out our view that we should not expect providers of essential public infrastructure to operate at credit ratings that are at, or at risk of falling to, to the lowest investment grade. We set out an expectation that water companies with credit ratings at risk of falling to the lowest investment grade should already be taking steps to strengthen financial resilience. The discussion paper asked specifically whether respondents considered it appropriate for providers of essential infrastructure to operate at, or be at risk of falling to, the lowest investment grade issuer credit rating.

24 respondents commented on this issue (eight provided no comment):

- Twelve respondents agreed that water companies should not operate at the lowest of the investment grade. Out of these twelve respondents, seven agreed water companies should not be at risk of falling to that level, two did not comment and three expressed a view that a risk of falling to the lowest investment grade category should not be a regulatory concern.
- Ten respondents did not agree with our view. Several respondents expressed views that credit ratings are narrow in scope with other measures of financial resilience also being important. One respondent suggested credit ratings are a useful cross-check but are of benefit to lenders rather than customers. Two respondents suggested we should focus on the root causes of poor performance and investment, rather than focus on credit ratings.
- Two respondents did not express agreement, suggesting financial resilience can be measured by other means. One of these respondents is currently not required to maintain an investment grade issuer credit rating.

A1.2 Taking actions to improve well before downgrade to BBB-

The discussion paper set out our expectation that companies with credit ratings that are at, or at risk of falling to, the lowest investment grade credit rating, should be taking steps to strengthen financial resilience. The paper asked whether respondents agreed with this notion.

22 commented on this question (10 provided no comment).

- 14 agreed with the notion, however, some of these said no further regulation is needed to secure this, as incentives are strong enough.
- 8 did not agree with the notion. Of these,

    - Four said credit ratings may be impacted by factors outside company control, e.g. due to changes in rating agency methodology, regulatory or political uncertainty, so there

  may be a temporary loss of financial headroom – another three that agreed with the notion also said this.
- Four also said, whether or not a company should be taking actions is dependent on its own specific circumstances or ought to be decided by the board.
- Three said existing mechanisms are enough, including one who said: 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.

Respondent view that, 'There's little difference within the BBB band'

Three companies responding to our discussion paper suggested that, based on historical default rates, a company operating at BBB-/Baa3 does not warrant concern:

- One said from a statistical perspective, there is not a material distinction between ratings in the BBB band in contrast to the 'big red line' between investment- and sub- investment grade. However, the same respondent said they 'do not consider that operating at the lowest investment grade is appropriate for providers of essential infrastructure with material ongoing financing and investment needs' and agreed that a company should be taking actions to improve its credit rating well before it is downgraded to the lowest investment grade issuer credit rating.

    - Using Moody's cumulative issuer-weighted global default rates over the period 1998-2020, the respondent said for a five year horizon default rates were: 0.85% for BBB+; 1.02% for BBB; and 1.92% for BBB-. For a three year horizon default rates were: 0.49% for BBB+; 0.56% for BBB; and 0.97% for BBB-. In contrast, the respondent said the difference between investment grade and sub-investment grade 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.
    - The same respondent also said they have found little evidence to indicate that access to debt capital markets at a BBB- rating is materially impaired compared with BBB flat but they did not provide any data to support the second point.

- Another said they do not necessarily agree that it is never appropriate for essential infrastructure providers to operate at, or be at risk of falling to, BBB-/ Baa3. The respondent said the difference in historical default rates between Baa2 and Baa3 is minimal, so a more onerous requirement to operate at the Baa2 credit rating level (rather than Baa3) is unlikely to provide a meaningful benefit to customers but may increase the administrative burden on companies, divert management away from operational delivery, disincentivise new equity capital from entering the sector and inadvertently harm financial resilience. That all said, the respondent said the sector is best served through targeting an A-/BBB+ rating for a notional company.

- The other said 2020 analysis from S&P showed that no company across Europe, with an investment grade rating, has defaulted across the last 11 years (all industries). Across the 30 years of data analysed, there have only been 7 defaults (all industries) across Europe.

A1.3 Defining limits on capital or financial structures

Our discussion paper proposed that we should not define limits on acceptable capital or financial structures at this time. Respondents were asked for their views on this proposal and whether it might be necessary to define limits for companies where financial resilience does not improve.

26 commented on this question (six provided no comment) and all agreed that we should not define limits on capital or financing structures at this time.

Seven respondents commented on whether it might be necessary to define limits for companies where financial resilience does not improve:

- Five did not support defining limits on companies that have weak financial resilience;
- One expressed support for remedial action on capital structure, if necessary, if a company contravenes the licence agreement;
- One said they would support a limit definition if there was a consistent medium term issue where the credit rating is at the lowest investment grade level.

A1.4 Cash lock-up trigger

Our discussion paper set out that, given our expectation that companies should not operate at the lowest investment grade rating, or be at risk of downgrade to that level, there is a strong case for amending cash lock-up to trigger at the point where a credit rating is at BBB/Baa2 with negative outlook or lower; or by reference to measures of service performance as suggested by Professors Mason & Wright. Respondents were asked for their views on these proposals.

All 32 respondents commented on this issue. All except CCW disagreed with amending cash lock-up to trigger at a higher credit rating or linking it to measures of service performance.

- CCW expressed that linking cash lock-up to service merits more consideration as it is perverse for companies with poor performance to be paying dividends. CCW also said it would be helpful if companies provided an explicit explanation in annual performance reports linking dividends to both financial and operational performance.

A wide range of reasons were provided for disagreeing with the proposal, the main ones were:

- 20 respondents said the proposal would undermine or destabilise investor trust/ confidence in UK regulated utilities (by introducing uncertainty/instability to dividends);
- 16 said the proposal was unnecessary as existing mechanisms are adequate;
- 13 said it was not clear what market failure or issue we are trying to solve or that there was no robust evidence and justification or systematic analysis;
- 13 said performance commitments and/or outcome delivery incentives are a more targeted or appropriate way within the existing regulatory framework of achieving the desired outcomes for customers and the environment.
- 13 suggested that the service metrics/thresholds to use are hard to choose or that they are complex or subjective or not accurate;
- 11 said that service performance naturally changes over the AMP and is affected by external factors (such as weather) which would lead to more volatile dividends.
- 10 said it was inappropriate to place excessive reliance on credit ratings and/or that an "in the round" board assessment should be considered instead.
- 10 said the proposal would increase the level of compensation or return investors require for the regulatory risk (this was related to dividend uncertainty and instability).
- Seven said the proposal reduces flexibility or headroom (or leads to the need to build in more headroom leading to higher bills).
- Six said the proposal is unprecedented or a material change in the regulatory contract;
- Five said the proposal is disproportionate or that we are overstepping duties.
- Four said that the case study of Southern Water as set out in the discussion paper showed that the regulatory regime worked as intended.
- Another four said that resilience plans and/or board assurance statements have more merit as they are better targeted.

A1.5 Prepare and potentially publish resilience plans

Our discussion paper set out that, given our expectation that companies should not operate at the lowest investment grade rating, or be at risk of downgrade to that level, an additional or alternative approach could be a requirement for companies to publish or submit resilience plans where credit ratings fall to a set threshold. In its RIIO-2 Final Determinations, for example, Ofgem set out a requirement for licensees to provide the regulator with a financial resilience report if their issuer credit rating falls to BBB/Baa2 (or equivalent) and is on negative outlook (or is downgraded directly to a lower rating).

We proposed that there may be merit in adopting similar arrangements for the water sector. The expectation would be that companies would formally and openly engage with us in setting out their plans and the steps being taken to strengthen financial resilience. Respondents were asked for their view on a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.

26 respondents commented on resilience plans (six provided no comment).

- 15 supported the proposal to prepare and submit resilience plans to Ofwat. Of these:
  - One respondent supported the proposal to also publish resilience plans;
  - Three did not support the proposal to publish resilience plans due to confidentiality;
  - One said they were not against publishing plans but would like more information on what would be published and the defined level at which it would be required.
  - 10 did not provide a view on whether or not they support publishing plans.
- 11 did not support the proposal to prepare or publish resilience plans.
  - Seven respondents did not support resilience plans on the basis that they already provide a lot of / sufficient information, e.g. long-term viability statements (LTVSs) in annual performance reports (APRs), board assurances, business plans at the price review and further details in the APR. So, they considered that resilience plans would add limited extra value.
  - Two respondents suggested that increasing engagement and open dialogue would be more effective.
  - One said they would support disclosing covenant breaches to Ofwat and remedial actions in place.
  - One respondent suggested that focusing on financial resilience could be counter-productive where it incentivises companies to underinvest or reprofile cash flows.
  - Another respondent suggested that Ofwat should use its current powers instead of introducing new ones to address financial resilience concerns.

Of those that commented on the trigger for resilience plans:

- One supported the threshold of BBB/Baa2 with negative outlook;
- Three supported a trigger level of BBB-/Baa3;
- Four suggested the trigger should not be based on a specific credit rating as it is only one measure of financial resilience, a rounded view should be taken by Ofwat with justification for plans based on a broad basket of factors.

A1.6 Board assurance statements at low credit ratings

Our discussion paper proposed that a requirement or expectation could be set to require additional board assurance statements to be provided in defined circumstances. This would place a requirement to confirm how the board has ensured it is comfortable that the company remains financially resilient when it approves a dividend or other distribution, where any credit rating is maintained that is below the level stated as the target for the notional capital structure in a company's business plan, or in a price review. Respondents were asked for their views on the proposal.

24 respondents commented on this issue (eight provided no comment):

- Six supported the proposal; of these, three questioned the trigger point.

- Two were semi-supportive of the proposal – one suggested it was potentially already covered by existing requirements given the current need for clear board scrutiny on dividend payments; the other said the proposal potentially put too much reliance on credit rating agencies but that it was okay to push for better explanations from the board on the basis for approved dividends.
- 16 did not support the proposal. The primary reason given was that responsible dividend payment is already adequately covered by existing requirements and obligations including: licence requirements, regulatory accounting guidelines (RAGs), long-term viability statements, going concern statements, dividend policies and requirements under the Companies Act.

A1.7 Maintaining two investment grade issuer credit ratings

Our discussion paper expressed concern that credit ratings had, in some circumstances, been withdrawn without a transparent explanation; we set out that this can lead to questions about a company's financial resilience, particularly where the credit rating with the lowest rating assessment is withdrawn. We proposed that one option to help address such concerns is to require companies to maintain two investment grade issuer credit ratings from two different credit rating agencies that satisfy the licence definition. Respondents were asked for their view on this proposal.

25 respondents commented on this issue (seven provided no comment):

- Seven supported the proposal; of these, one expressed they were only supportive if the requirement extended to all companies and provided they would not be 'bound in' with one or more agencies as they need the ability to review which ratings to procure.
- Eight were neutral on the proposal. Of these six considered that given the investment of time and money needed to procure ratings, the proposal may not be appropriate for all companies e.g. smaller companies; one said as the proposal only impacted two companies, they did not view this as a major concern given credit ratings are not the only means of measuring creditworthiness; and one said the proposal places a lot of reliance on credit rating agencies when, in their view, the problem is ownership styles.
- 10 did not support the proposal on the basis there was insufficient evidence to suggest that holding two credit ratings is necessary or beneficial to financial resilience and that costs need to be considered.

A1.8 Formally notify us of any changes to credit ratings

Our discussion paper expressed that credit ratings are an important signal of a company's financial resilience. Given this, we set out that we expect companies to notify us of any changes to credit ratings. However, currently this is not an explicit licence requirement and changes have not always been notified to us; we therefore proposed setting 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).

27 respondents commented on this issue (five provided no comment):

- 22 supported this proposal, of these:
  - One expressed that they would not support as a new licence requirement;
  - Two supported the proposal if the requirement is to notify us after the event.
  - One supported the proposal but needed detail around timescales to be confirmed before they could provide firm agreement;
  - One expressed support for transparent reporting and notification of changes in financial resilience. However, the company does not hold a credit rating and said a formal credit rating is not necessarily reflective of financial resilience.
- Five did not support the proposal primarily because they did not understand the need for additional notification requirements as the information is already publicly available.

A1.9 Removing investment grade credit rating dispensations

Our discussion paper referenced that two companies currently carry a dispensation from the requirement to maintain an investment grade credit rating; an alternative qualification applies to these companies instead. We proposed removing these dispensations and asked respondents for their view.

22 respondents commented on this issue (10 provided no comment – including one company affected by the proposal as they were already in the process of procuring a credit rating):

- 11 were supportive of the proposal; of these three supported dispensations if they were well justified and there was a clear benefit to customers;
- Five expressed a neutral viewing suggesting a case-by-case approach is needed;
- Three respondents said the proposal was not relevant to them;
- Three did not support the proposal. The company most affected by this proposal was strongly opposed on the basis that (1) a formal credit rating does not guarantee financial resilience or alignment with notional gearing levels; (2) the company has not required a credit rating to access capitals market to-date; (3) given the company's financial position and the cost, a rating is not in the best interest of their customers.

A1.10 Align the licence to our expectations for dividend policy

Our discussion paper proposed that there may be merit in aligning the licence text with more recent expectations, to clarify that dividends declared or paid should not impair the ability of the Appointed business to finance the business, should consider current and future investment needs and financial resilience over the long term, and should take account of service delivery for customers and the environment, including levels of performance and other obligations.

25 respondents commented on this issue (seven provided no comment):

One respondent supported the proposal and 24 did not support the proposal.

- 15 said our expectations are already covered by existing requirements in regulatory accounting guidelines and board leadership, transparency and governance principles.
- 10 respondents said this would lead to too much regulatory intervention on dividends.
- 10 said the proposal would constrain commercial judgements made by the board and decision on dividends should be left for the board of directors.
- 20 (12 of whom made their comments under questions 4) said linking dividends to service would be complex, subjective or inaccurate leading to more volatile dividends. Several explained that dividend decisions reflected more than just in-year performance.

A1.11 Enhancing the transparent reporting of the use of swaps

Our discussion paper proposed enhancing the transparent reporting of the use of swaps. We asked respondents for their view on this including how this could be best achieved.

26 commented on this question (six provided no comment).

- Of the 26, 19 supported the proposal to increase transparency on swaps where this would be helpful to understand risk or is reasonably required to monitor financial resilience.
- Seven did not support the proposal primarily because disclosures on swaps were thought to be sufficient or because they did not see the need, value or benefit this would bring.

Many expressed that any policy on swaps should be proportionate and not limit (or denigrate) the responsible use of swaps. 12 respondents said derivatives including swaps play a legitimate and important role in management of financial risk and treasury management, which supports resilience.

A1.12 Reporting of holding company debt levels

Our discussion paper expressed that a regulated company's financial resilience can be impacted negatively by its group structure. We therefore asked respondents 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.

27 respondents commented on this issue (five provided no comment):

- 5 supported the proposal. Of these, one also stated that it is outside Ofwat's remit.
- 22 did not support increased reporting of holding company debt for three main reasons:
  - 10 said there was no need for this given all the protections in place for the regulated company. A few added that clarity was needed on what this would achieve.
  - Eight (including one that supported the proposal) said this is outside our remit; and
  - Six said sufficient and appropriate detail is already available from holding company accounts.

Note that we do not accept that holding company arrangements are all beyond our remit as: in some cases, companies have made intercompany loans and rely on dividends from regulated companies to meet interest costs; credit ratings of the regulated company can be affected by holdco arrangements; and some companies have, in the past, justified dividend payments by reference to holding company obligations.

However, we accept that most of the information we want on holding companies is in the public domain. We encourage companies to be as transparent as possibly about holding company arrangements.

A1.13 Transparency of pension deficit reporting

Our discussion paper expressed that, for a full understanding of the impact of pension deficit obligations on financial resilience, it is important to understand companies' cash commitments. We therefore asked respondents for views on the option to improve the transparency of pension deficit reporting.

27 respondents commented on this issue (five provided no comment):

- 21 supported the proposal. One set out that this was based on benefits being justified.
- 6 did not support improving transparency of pension reporting on the basis that they do not see the justification or benefit, or do not think it is necessary.

While there was general support, six also said it is not clear what more can be reported above the accounting standards, or what we might find useful, with some explaining that they already go beyond statutory reporting requirements. Three said increased reporting/ disclosure needs to be proportionate and not burdensome. Three respondents said that pension scheme deficits are already heavily disclosed in annual reports and accounts and are discussed with the pension regulator.

A1.14 Board assurance in PR24 business plans

Our discussion paper asked respondents for views on the expectation that PR24 business plans should include a board assured assessment of financial resilience.

24 respondents commented on this issue (eight provided no comment), and all agreed with the proposal, some with the following provisos:

- Six expressed that there should be no change in approach at PR24 compared to PR19; or that any change in scope from PR19 should be agreed separately;
- Two said the assurance should not be extended to cover Ofwat's determinations;
- Two said assurance should not extend beyond PR24 as financial parameters for future regulatory reviews are unknown.
- Two expressed that stress testing should cover both actual (i.e. company-specific) and notional structures.
- Another two respondents said financial resilience should be addressed through adequate revenue allowances and robust financeability testing.
- One expressed that the assurance requirement should be proportionate and related to the business. Another expressed concerns regarding the cost of external assurance, stating that Ofwat should not be too prescriptive and allow the board to decide what level of assurance it thinks is appropriate.
- One respondent said that if the assurance highlighted areas of concern or caveats, rather than a 'clean bill of health', Ofwat should engage in constructive discussion.

Our expectations on Board Assurance of business plans at PR24 are set out in the PR24 Draft Methodology. Our response and views to the main points above are set out in the PR24 Draft Methodology: Appendix 10 – Aligning risk and return, section 6 'Financial resilience'.

A1.15 Incentives framework around capital structure at PR24

Our discussion paper asked respondents for views on how the incentives framework around capital structure should evolve at PR24 taking account of the other views set out in the paper and the scope to which companies should provide voluntary sharing arrangements at PR24.

24 respondents commented on this issue (eight provided no comment):

- Three agreed that there should be incentive mechanisms on capital structure;
- 21 disagreed with incentive mechanisms on capital structure.

Of those disagreeing: nine referenced that the gearing outperformance sharing mechanism is ineffective or not appropriate or disincentivises new equity; five said the existing regulatory framework already provides strong incentives to maintain a resilient capital structure; four said they do not believe that there should be incentives for specific capital structures as it requires Ofwat to determine an optimal capital structure when we are rightly neutral, in a similar vein, one respondent said rewards are not in agreement with the regulatory principle that companies are free to choose their own capital structure.

Of those that agreed with incentive mechanisms on capital structure, two proposed reward systems for resilient structures, strong ratings or conservative gearing. On the opposite end of the spectrum, three respondents that disagreed with incentive mechanisms on capital structure said they do not consider it reasonable that customers should incur higher costs simply because a company is resilient when this is a base requirement for any company.

A2 Views of debt investors – anonymised report

We published a Financial Resilience discussion paper in December 2021. The discussion paper looked at the options available to strengthen our regulatory framework in order to better protect customers and secure long term financial resilience.

We received 32 responses to the financial resilience paper from water companies, private equity investors and CCW. We received no responses from debt investors. As debt investors form the largest source of investment in regulated water companies, we engaged with representatives from 11 debt investment firms to understand their views, ensuring they are represented. This anonymised report sets out the views we received; given the verbal discussion, we acknowledge that views may not always reflect the institution's position but may be the views of the representative we talked to.

Conversations with the 11 debt investors focussed on the questions set out in Appendix 1. In total, the firms we spoke to have billions invested in debt instruments across a range of WaSCs and WoCs, the lowest total investment was £300m. All the debt investors we spoke to expressed that they were mostly driven by mandates to invest on behalf of their clients. Many of their clients, e.g. pension funds, seek and are attracted to stable and consistent returns, not volatility and risk.

Most investors were primarily invested in investment grade debt as required by the mandates, but some had exposure to high yield debt (i.e. sub-investment grade debt rated BB+/Ba1 or lower) in water holding companies.

Role of external credit ratings in debt investment

All debt investors explained that external credit ratings are a significant input into their investment decision making process and formed a core part of their analysis. However, in all cases credit ratings were only an input into each debt investor's own credit assessment process which was the ultimate decider of debt positions taken. Each said they look at a broad range of other factors, such as, their own assessment of key metrics, projections, cash flow modelling, ESG (environmental, social and corporate governance), sustainability and climate scores.

All debt investors said a BBB- rating would not be considered appropriate for a UK water company over the long-term. Five debt investors said Baa1/BBB+ is a reasonable target credit rating for a regulated UK water company, three said A-/BBB+ and two said mid-BBB or higher is appropriate over the long-term. One debt investor that has traditionally focused on high yield debt investments did not state a specific level but expressed that water companies have to stay at a good investment grade level given the utility nature and that they are monopoly players.

Further, several expressed that they do not tend to invest in BBB- rated entities or debt issues as a starting point, however, some added that the relative value of the investment is considered alongside the trajectory of the rating. This means they are willing to invest in BBB- rated water companies, for example, if the return is determined to be good compared to the risk and if they assess that the BBB- rating is transient (i.e. where the company is seen to be working to improve its credit rating) – this is especially true if the investor's internal assessment is more favourable than the external rating. Importantly, many of these added that they looked to the regulatory framework to mitigate the risk of a company falling to a sub-investment grade level and to push lower-rated companies to improve their rating.

Given client mandates to invest in strong investment grade bonds, all 11 debt investors expressed that as ratings migrated lower, they would increase scrutiny and engagement with the affected company, especially if they were maintaining a large debt position in the company, to understand what is being done to improve the credit rating. One debt investor said they would also engage directly with the credit rating agencies.

Eight investors said there were thresholds beneath which they could not invest; and as such they could not invest in high yield debt investments (at BB+/Ba1 or lower). Even the three debt investors that could invest in high yield were cautious about investing in water companies at the lower end of the investment grade spectrum due to the higher probability of default, the higher risk of the company falling below investment grade (as this, in many cases, is outside of investment mandates) and the potential for cash lock-ups where holding company debt is held.[35]

While many debt investors said they can and do invest in holding company debt, even among these, the majority said they could only invest in holdco debt that is investment grade. Two of the 11 investors had no holding company debt in water at all; and a few of those that had holding company debt held it only for water companies with an A-/ strong BBB+ credit rating.

On the other end of the spectrum, one investor expressed they would have to sell-down any debt that crossed over into the high yield rating category, even at a loss, as their clients were all conservative UK pension funds.

Maintaining two investment grade credit ratings

Eight out of 11 debt investors were supportive of asking companies to maintain two credit ratings, to varying degrees. Reasons cited included that:

- it would lead to greater scrutiny;
- it was sensible given it is aligned with best practice and increases the chances of arriving at the 'right'/correct answer on where the credit sits;
- it would help with increased disclosures and greater transparency;

[35] As interest on holding company debt is usually funded with dividends from the regulated company.

- it would make companies focus on maintaining all financial metrics within good ranges not just the metrics used by one credit rating agency.

One debt investor expressed that we need to allow for the fact that different methodologies lead to different results, so, they could see why equity investors could be nervous about the proposal.

Three debt investors were not strongly supportive;

- one debt investor did not view the proposal as necessary;
- one expressed that no rating, on its own, tells the whole story. They suggested that in some cases a BBB- rating may not matter, it can depend on the performance and trajectory of the company.
- one expressed that the reliance on credit ratings exposes the system to factors outside the control of regulation such as changes in methodology. They considered that maybe Ofwat could create its own credit ratings system.

Change in the cash lock-up to BBB/Baa2 with negative designation

9 out of 11 debt investors supported an adjustment in the cash lock-up trigger to BBB/Baa2 with negative designation (from the current BBB-/Baa3 with negative designation) seeing it as reasonable and credit positive including eight that are also invested in the debt of holding companies. This was driven by the view that given the long-term nature of water, operating at BBB-/Baa3 into the long-term did not provide appropriate/ sufficient headroom to absorb shocks. So, companies should be taking action to avoid a downgrade to that level in advance of the event.

Out of the 9 in support, four expressed some concern for equity investment. They expressed the need to ensure that the sector remains attractive to equity and so, said our final decision on the trigger for cash lock-up ought to be balanced between the views of both debt and equity investors. Two of the 9 in support also expressed that companies should be provided with sufficient time to transition. One said they would consider the need to transition to occur over a period of several AMPs. One suggested that companies could be given 'x months' (predefined) before the lock-up trigger becomes effective. This debt investor expressed that if a glidepath is provided, companies would work to deleverage the regulated business by adopting a dividend policy that allowed leverage to fall over available time scales.

Of the two that were not supportive, one was indifferent (i.e. not really persuaded either way) to the proposal and said they were more focused on companies making the best use of capital. They considered this to be the case where they see investments made that lead to improved operational performance over time. The investor was also concerned that rating agencies could easily change methodology making it harder to maintain a given rating.

The other debt investor that did not support a change to the cash lock-up trigger expressed that they see cash lock-up as a safety net and that the current cash lock-up licence condition is well understood. While the debt investor agreed that companies should be operating above the minimum of investment grade, they didn't see the need for increasing the position of the lock-up, as it would be a change that investors would need to understand. The investor said they can only invest if at least one part of the formula is fixed; and that investing is difficult if there is too much movement (as there is more for investors to understand). They said we should consider if there is more that could be done to require companies to demonstrate they are making responsible decisions.

Resilience plans

There was strong support among debt investors for resilience plans with many stating that companies should be encouraged to share as much of their resilience plans with wider stakeholders as possible given that the information is helpful for credit assessments. A few mentioned that they saw resilience plans as complementary to cash lock-up triggers as 'credit basics' would usually require additional disclosures to trigger in advance of a lock-up.

A few debt investors pointed out that companies would already be producing such information for their own Boards, and one suggested we should ask companies what factors trigger development of their own resilience plans for internal purposes.

A couple of debt investors expressed that better use could be made of LTVSs. However, one investor said LTVSs can be 'woolly', for instance, because the assumptions are not clear and that often companies looked to remedy issues through refinancing without properly considering if this option would be available at the time it is needed. Another said LTVSs do not give enough detail around the assumptions used and how the company has reached its view on mitigation strategies. Debt investors were supportive of improvements in transparency around the parameters used in LTVS assessments. Specifically, one investor expressed that they would like to see more stress tests from companies, e.g. on the impact of high inflation and deflation on RCV growth and other financial metrics.

One investor suggested that in order to have teeth, resilience plans would need to be as prescriptive as possible. In their view the objective should be for equity to be injected into the company or for retained earnings, and so, they questioned whether resilience plans were sufficient to deliver this.

Several ideas were proposed:

- One debt investor expressed that the level of headroom a company has under reasonable (i.e. not extreme) stress test scenarios would be the focus of attention in resilience plans. They suggested that under a reasonable stress test, a company should look to maintain at least a BBB/Baa2 rating

- It was suggested resilience could be improved if companies were asked to address issues around energy and climate change using the framework from the Task Force on Climate-related Financial Disclosures; the framework was seen as useful for considering risks and opportunities.
- Finally, one debt investor suggested we could take a more nuanced approach with resilience plans. They expressed that the onus to produce plans could be placed with companies to tease out better behaved companies. They proposed that, for instance, we could request that if a credit rating falls to a pre-specified level (to be defined) the company may wish to show commitment to resilience by producing a resilience plan, i.e. resilience plans should be voluntary.

Views on the other options presented in our discussion paper

There was general consensus among debt investors that higher levels of transparency are beneficial and support greater levels of resilience. Investors were especially supportive of increased transparency around swaps. Where specifics were raised investors expressed that they would like to see more detail on: accretions, paydown dates, break clauses (including the cost of managing breaks) and explanations on what the long-term strategy is around swaps. One investor expressed that where swap restructures are used a transparent rationale should be shared by the company with stakeholders.

Where it was discussed, there was also general support for Board assurance statements when companies pay dividends at lower credit ratings. One debt investor highlighted this is more useful if cash lock-up stays at the current level (BBB-/Baa3 negative) but less useful if lock-up is at BBB/Baa2 with negative designation.

Other views from debt investors

Several debt investors expressed that ESG is gaining increasing importance in mandates and hence in their investment process. Related to ESG the following views were shared:

- One debt investor considers it is currently too easy for water companies to issue 'green' bonds. As water companies provide little evidence to support why the bond is green. Going forward the investor expects and wants to see more evidence and industry standards for assigning green credentials. The same debt investor expressed that work needs to be done on changing broader attitudes to water; and that there's a need for public education on capex needs going forward, e.g. to support ESG so that increasing bills become more palatable.
- Two debt investors expressed that ESG scores for some companies were weak. One suggested this could be due to a lack of data being shared with ESG rating platforms. The other debt investor expressed that going forward, water companies need to more proactively ask questions / get corrections to ensure that their position in ESG league tables is appropriate and makes sense.

Another debt investor expressed that ideally, we would place limits on gearing – to help protect against rating changes. The investor cited Germany (energy networks) as an example where if a company is geared above a set limit, there is no additional allowance on cost of equity and this acts to disincentivise gearing above a certain level.

One debt investor expressed that, as a creditor, it's better if there are more protections in water, however, they also considered it could also be bad for credit if a) less equity is attracted into the sector or b) a change in the shareholder make-up leads to a lower overall quality of equity holders. So, there could also be a reasonable credit view that the regulator shouldn’t tighten protections beyond a certain point.

A3 Draft modifications

This appendix forms part of the statutory notice to companies under sections 12A and 13 of the Water Industry Act 1991.

We set out below proposed changes to certain paragraphs within the Credit Ratings and "Cash Lock-Up" and Dividend Policy provisions of Condition P of all companies' licences, apart from Wessex Water whose proposed modifications are set out in Appendix A4. Our reasoning and intended effects are set out in the body of this consultation. Text proposed to be added is marked in blue, and text proposed to be deleted is marked in blue strikethrough. Our proposals do not include any modifications to those provisions of Condition P that are not listed in this Appendix.

We note that the existing text on Dividend Policy is broadly similar, however varies slightly, across company licences. Our intention is that the below proposed changes will apply to all companies' Dividend Policy text, resulting in consistency of drafting across all licences. We also note that the numbering of each paragraph may differ slightly across company licences. Our intention is for the numbering to align in the appropriate chronological order for each company's existing Condition P.

"**Condition P: Regulatory ring-fence**

…

Credit Ratings and "Cash Lock-Up"

P25 The Appointee must demonstrate its ability to service its debt obligations by complying with paragraph P26.

P26 The Appointee must ensure that it or any Associated Company which issues corporate debt on its behalf maintains, at all times, ~~an~~ **two** Issuer Credit Rating**s** which ~~is an~~ **are** Investment Grade Rating**s from two different Credit Rating Agencies, other than where Ofwat provides its written agreement for the Appointee to maintain only one Issuer Credit Rating which is an Investment Grade Rating**.

P27 The Appointee must inform Ofwat as soon as reasonably practicable when the Appointee changes or becomes aware of a change in any of its Issuer Credit Ratings including reasons for the change in rating. A notification must be provided within a maximum of five working days of:

P27.1 a change in Issuer Credit Rating grade or outlook;

P27.2 a new Issuer Credit Rating being obtained; or

P27.3 the withdrawal of an Issuer Credit Rating.

P28 The "Cash Lock-Up" provisions set out in paragraph P29 apply in any circumstances:

P28.1 where neither the Appointee or any Associated Company which issues corporate debt on its behalf holds an Issuer Credit Rating which is an Investment Grade Rating; or

P28.2 where the Appointee or any Associated Company which issues corporate debt on its behalf:

P28.2.1 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is not an Investment Grade Rating; or

P28.2.2 holds an Issuer Credit Rating which is **one notch above** the Lowest Investment Grade Rating **(i.e. BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent)** and:

P28.2.2.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P28.2.2.2 ~~otherwise where~~ the rating outlook ~~of the Lowest Investment Grade Rating has been changed from stable or positive to negative to~~ has been changed from stable or positive to negative.

P29 Where paragraph P28 applies, the Appointee must not, without the prior approval of Ofwat, transfer, lease, licence or lend any sum, asset, right or benefit to any Associated Company, other than where:

P29.1 the Appointee makes a payment to an Associated Company which is:

P29.1.1 pursuant to an agreement entered into prior to the circumstances referred to in paragraph P28 arising, which provides for goods, services or assets to be provided on an arm's length basis and on normal commercial terms; and

P29.1.2 properly due in respect of the relevant goods, services or assets;

P29.2 the Appointee transfers, leases, licenses or lends any sum, asset, right or benefit to any Associated Company (excluding a dividend payment, a distribution out of distributable reserves or a repayment of capital), where:

P29.2.1 the transaction is on an arm's length basis on normal commercial terms; and

P29.2.2 the value due in respect of the transaction is payable wholly in cash and is paid in full when the transaction is entered into;

P29.3 the Appointee makes a repayment of, a payment of interest on or payments in respect of fees, costs or other amounts incurred in respect of:

P29.3.1 a loan made from a Financing Subsidiary to the Appointee, provided that the Financing Subsidiary continues to be an Associated Company of the Appointee; or

P29.3.2 a loan made prior to the circumstances referred to in paragraph P28 arising which is otherwise in accordance with these Conditions, provided that payment in respect of such a loan is not made earlier than provided for in accordance with its terms;

or

P29.4 the Appointee makes a payment for group corporation tax relief or for the surrender of Advance Corporation Tax, calculated on a basis not exceeding the value of the benefit received, provided that the payment is not made before the date on which the amounts of tax subject to the relief would have become due.

Dividend policy

P30 The Appointee shall declare or pay dividends only in accordance with a dividend policy which has been approved by the Board of the Appointee and which complies with the following principles:

P30.1 ~~the~~ **that** dividends declared or paid will not impair the ability of the Appointee to finance the Appointed Business, **taking account of current and future investment needs and financial resilience over the longer term**; ~~and~~

P30.2 that dividends declared or paid take account of service delivery for customers and the environment over time, including performance levels, and other obligations; and

P30.~~2~~**3 that dividends declared or paid** ~~under a system of incentive regulation dividends would be expected to~~ reward efficiency and the management of ~~economic~~ risk**s to the Appointed Business**.

For the purpose of this licence condition, dividends refers to any distributions declared or paid in respect of any ordinary shares or preference shares."

A4 Draft modifications for Wessex Water

This appendix forms part of the statutory notice to Wessex Water under section 12A of the Water Industry Act 1991.

We set out below proposed changes to Conditions A, I, K and P of Wessex Water's licence. Our reasoning and intended effects are set out in section 4.3 of this consultation and our previous regulatory ring-fencing consultation from 2020[36].

Paragraph 2 of **Condition A** is amended by:

deleting ‘and’ from the end of subsection (1);

replacing ‘.’ with ‘;’ at the end of subsection (2); and

inserting the following new subsections:

"(3) references to a liability shall be taken to include the creation of any mortgage, charge, pledge, lien or other form of security or encumbrance, the making of a loan and the taking on of a debt;

(4) references to a loan shall be taken to include the transfer or lending, by any means, of any sum of money or rights in respect of such sum; and

(5) references to a transfer of any asset or liability includes a part transfer of an asset or liability and, without limitation, there is a part transfer of an asset where an interest or right in or over the asset is created".

Paragraph 3 of **Condition A** is amended by inserting the following definitions in the appropriate place determined alphabetically:

"**“Corporate Family Rating”** means a credit rating assigned by a Credit Rating Agency to reflect its opinion of the ability of a corporate group to honour all of its financial obligations, as if there was a single class of debt and the corporate group was a single legal entity, where the corporate group is as determined by the relevant Credit Rating Agency;

“Credit Rating Agency” means:

[36] See our May 2020 consultation document (Consultation under section 13 of the Water Industry Act 1991 on proposed modification to the largest licences for ring-fencing) and subsequent July 2020 conclusions document (Conclusions on section 13 of the WIA91 on proposed modification to ringfencing provisions).

(a) S&P Global Ratings (or any of its affiliates or its successors);

(b) Moody's Investors Services, Inc (or any of its affiliates or its successors);

(c) Fitch Ratings, Inc (or any of its affiliates or its successors); or

(d) any credit rating agency which has been agreed by Ofwat as having comparable standing to S&P Global Ratings, Moody's Investors Services, Inc or Fitch Ratings, Inc;

"Cross-Default Obligation" means a term of any agreement or arrangement whereby the Appointee's liability to pay or repay any debt or other sum arises or is increased or accelerated by reason of a default of any person other than the Appointee;

"Financing Subsidiary" means a subsidiary company of the Appointee:

(1) (a) which is wholly owned by the Appointee; and

(b) the sole purpose of which, as reflected in the company's articles of association, is to raise finance on behalf of the Appointee for the purposes of the Regulated Activities; or

(2) which Ofwat has agreed in writing will be considered a Financing Subsidiary;

"Holding Company" has the meaning set out in section 1159 of the Companies Act 2006;

"Investment Grade Rating" means an Issuer Credit Rating recognised as investment grade by a Credit Rating Agency;

"Issuer Credit Rating" means:

(a) an issuer credit rating assigned to the Appointee or any Associated Company which issues corporate debt on its behalf by a Credit Rating Agency;

(b) a Corporate Family Rating assigned by a Credit Rating Agency to a corporate group of which the Appointee is a member and which has been approved for this purpose by Ofwat; or

(c) a rating assigned by a Credit Rating Agency to the Appointee or any Associated Company, for so long as Ofwat has determined in writing that this rating sufficiently reflects the creditworthiness of the Appointee;

"Lowest Investment Grade Rating" means:

(a) an Issuer Credit Rating of BBB- by S&P Global Ratings or Fitch Ratings, Inc or an Issuer Credit Rating of Baa3 by Moody's Investors Services, Inc or such Issuer Credit Rating as may be specified from time to time by any of these credit rating agencies as the lowest Investment Grade Rating; or

(b) an equivalent rating from any other Credit Rating Agency;

"Ring-fencing Certificate" means a certificate, submitted to Ofwat by the Appointee, which states that, in the opinion of the Board of the Appointee:

(a) the Appointee will have available to it sufficient financial resources and facilities to enable it to carry out the Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted;

(b) the Appointee will have available to it sufficient management resources and systems of planning and internal control to enable it to carry out the Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted;

(c) the Appointee has available to it sufficient rights and resources other than financial resources, as required by paragraph P14; and

(d) all contracts entered into between the Appointee and any Associated Company include the necessary provisions and requirements in respect of the standard of service to be supplied to the Appointee, to ensure that it is able to carry out the Regulated Activities;

"subsidiary" has the meaning set out in section 1159 of the Companies Act 2006;

"Ultimate Controller" means any person which, whether alone or jointly and whether directly or indirectly, is, in the reasonable determination of Ofwat, in a position to control or in a position to materially influence the policy or affairs of the Appointee or any Holding Company of the Appointee;

"United Kingdom Holding Company" means a Holding Company which is registered in the United Kingdom and which is not a subsidiary of any company registered in the United Kingdom;"

Condition I is deleted in its entirety.

Condition K is amended by:

deleting the words "Ring-fencing and" from the title**.**

deleting paragraph 1 and replacing it with:

“1 Introduction

The purpose of this Condition is to ensure that the best price is received from disposals of land to which this Condition applies so as to secure benefits to customers through the application of the proceeds of such disposals to reduce charges as provided in, and subject to the provisions of, Condition B.”

Deleting paragraph 3.

Condition P is deleted in its entirety and replaced with the following new condition:

“**Condition P: Regulatory ring-fence**

Introduction

This condition requires the Appointee to ensure that it maintains sufficient financial and management resources to enable it to carry out its functions in a sustainable manner, and protects the Appointee from the activities of other group entities. It also requires the Appointee to meet the Board Leadership, Transparency and Governance objectives and procure undertakings from its Ultimate Controller(s).

Conduct of the Appointed Business

P1 The Appointee must, at all times, conduct the Appointed Business as if the Appointed Business were:

P1.1 substantially the Appointee’s sole business; and

P1.2 a public limited company separate from any other business carried out by the Appointee.

P2 The Appointee must:

P2.1 meet the objectives on board leadership, transparency and governance set out in paragraph P3, and

P2.2 explain in a manner that is effective, accessible and clear how it is meeting the objectives set out in paragraph P3.

P3 The objectives are:

P3.1 The Board of the Appointee establishes the company's purpose, strategy and values, and is satisfied that these and its culture reflect the needs of all those it serves.

P3.2 The Appointee has an effective Board with full responsibility for all aspects of the Appointee's business for the long term.

P3.3 The Board of the Appointee's leadership and approach to transparency and governance engenders trust in the Appointee and ensures accountability for their actions.

P3.4 The Board of the Appointee and its committees are competent, well run, and have sufficient independent membership, ensuring they can make high quality decisions that address diverse customer and stakeholder needs.

The role of the company's Ultimate Controller and United Kingdom Holding Company

P4 The Appointee must ensure that, at all times:

P4.1 there is an undertaking in place which is given by the Ultimate Controller of the Appointee in favour of the Appointee; and

P4.2 where the United Kingdom Holding Company of the Appointee is not the Ultimate Controller of the Appointee, there is an undertaking in place which is given by the United Kingdom Holding Company of the Appointee in favour of the Appointee.

P5 The Appointee must ensure that any undertaking given pursuant to paragraph P4 provides that the person giving the undertaking must, and must procure that each of its subsidiaries other than the Appointee and its subsidiaries:

P5.1. provides to the Appointee such information as is necessary to enable the Appointee to comply with its obligations under the Water Industry Act 1991 or under these Conditions; and

P5.2 does not take any action which may cause the Appointee to breach any of its obligations under the Water Industry Act 1991 or under these Conditions.

P6 In the circumstances set out in P7, the Appointee may only enter into any new contract or arrangement with a person who is required to give an undertaking under paragraph P4 or the subsidiaries of such a person other than subsidiaries of the Appointee, with the prior written approval of Ofwat.

P7 The circumstances referred to in P6 are:

P7.1 where an undertaking required to be given by a person in accordance with paragraph P4 is not in place; or

P7.2 where there has been a breach of the terms of such an undertaking by the person that gave it and that breach has not been remedied.

P8 The Appointee must provide to Ofwat such certified copies of any undertaking given pursuant to paragraph P4 as are requested by Ofwat.

P9 The Appointee must immediately inform Ofwat in writing if the Appointee becomes aware that:

P9.1 an undertaking given by a person pursuant to paragraph P4 has ceased to be legally enforceable; or

P9.2 there has been a breach of the terms of such an undertaking by the person that gave it.

P10 The Appointee must inform Ofwat as soon as reasonably practicable if the Appointee becomes aware that:

P10.1 arrangements are in progress or in contemplation which, if carried into effect, may lead to a change to the Ultimate Controller(s) of the Appointee; or

P10.2 arrangements have been put into effect which might be considered to have led to a change to the Ultimate Controller(s) of the Appointee; or

P10.3 any person intends to submit a merger control filing to the Competition and Markets Authority or the European Commission with respect to an actual or potential change of control of the Appointee.

P11 The Appointee must comply with any direction given by Ofwat to the Appointee to enforce the terms of an undertaking given to it pursuant to paragraph P4.

Assets, rights and resources

P12 To enable it to carry out the Regulated Activities the Appointee must, at all times, act in a manner which is best calculated to ensure that it has in place adequate:

P12.1 financial resources and facilities;

P12.2 management resources; and

P12.3 systems of planning and internal control.

P13 The requirements set out in paragraph P12 must not be dependent upon the discharge by any other person of any obligation under, or arising from, any agreement or arrangement under which that other person has agreed to provide any services to the Appointee in its capacity as a Relevant Undertaker.

P14 The Appointee must ensure that, as far as reasonably practicable, it has available to it sufficient rights and resources other than financial resources so that if, at any time, a special administration order were to be made in relation to it, the special administrator would be able to manage the affairs, business and property of the Appointee in accordance with the purposes of the special administration order.

P15 For the purposes of paragraph P14, the Appointee is not required to amend the terms of any legal obligation which has been transferred to it in accordance with a scheme made under Schedule 2 to the Water Industry Act 1991.

P16 Where rights and resources which are required to be made available pursuant to paragraph P14 are made available by a Group Company, the Appointee must ensure that if, at any time, a special administration order were to be made in relation to it, the rights and resources would be available to the special administrator for the purpose set out in paragraph P14.

<u>Listing of financial instruments</u>

P17 Subject to paragraph P18 below, the Appointee shall, not later than 31 December 2000, issue a Bond yielding a variable rate of interest and shall use all reasonable endeavours to procure its listing on the London Stock Exchange.

P18 The Bond referred to in paragraph P17 shall bear a variable rate of interest, linked to the credits rating of the Appointee, as ascertained by reference to two independent rating agencies operating in London.

P19 The obligation in paragraph P17 applies unless the Appointee satisfies Ofwat that market conditions make it appropriate for the Appointee defer the issue of the bond.

<u>Transfer pricing and Cross-default Obligations</u>

P20 In accordance with Regulatory Accounting Guideline 5 (Transfer Pricing in the Water and Sewerage Industry) published by Ofwat and revised from time to time, the Appointee must ensure that:

P20.1 every transaction between the Appointed Business and any Associated Company is at arm's length, so that neither the Appointed Business nor the Associated Company gives a cross-subsidy to the other; and

P20.2 the Appointed Business neither gives nor receives any cross-subsidy from any other business or activity of the Appointee.

P21 The Appointee must provide Ofwat with any information about the costs of an Associated Company which provides services to the Appointee which Ofwat reasonably requires. For the purposes of this paragraph P21, reference to the provision of services includes references to anything (including the services of any employee) being made available.

P22 The Appointee must not, without the prior approval of Ofwat:

P22.1 give a guarantee in relation to any liability of an Associated Company;

P22.2 make a loan to an Associated Company; or

P22.3 enter into an agreement or other legal instrument incorporating a Cross-Default Obligation.

P23 The Appointee must not continue or permit to remain in effect an agreement or other legal instrument incorporating a Cross-Default Obligation unless:

P23.1 prior approval has been given by Ofwat; or

P23.2 the Cross-Default Obligation would only arise on a default by a subsidiary of the Appointee and the Appointee ensures that:

P23.2.1 the period for which the Cross-Default Obligation is in effect is not extended;

P23.2.2 liability under the Cross-Default Obligation is not increased; and

P23.2.3 no change is made to the circumstances in which liability under the Cross-Default Obligation may arise.

P24 The Appointee must not, without the consent of Ofwat, transfer to any Associated Company any right or asset to which paragraph P14 applies.

P25 In giving consent under paragraph P24, Ofwat may also give a direction to the Appointee on the valuation of the asset and the treatment of the consideration in respect of that asset in the Appointee's accounts.

<u>Credit Ratings and "Cash Lock-Up"</u>

P26 The Appointee must demonstrate its ability to service its debt obligations by complying with paragraph P27.

P27 The Appointee must ensure that it or any Associated Company which issues corporate debt on its behalf maintains, at all times, two Issuer Credit Ratings which are Investment Grade Ratings from two different Credit Rating Agencies, other than where Ofwat provides its written agreement for the Appointee to maintain only one Issuer Credit Rating which is an Investment Grade Rating.

P28 The Appointee must inform Ofwat as soon as reasonably practicable when the Appointee changes or becomes aware of a change in any of its Issuer Credit Ratings including reasons for the change in rating. A notification must be provided within a maximum of five working days of:

P28.1 a change in Issuer Credit Rating grade or outlook;

P28.2 a new Issuer Credit Rating being obtained; or

P28.3 the withdrawal of an Issuer Credit Rating.

P29 The "Cash Lock-Up" provisions set out in paragraph P30 apply in any circumstances:

P29.1 where neither the Appointee or any Associated Company which issues corporate debt on its behalf holds an Issuer Credit Rating which is an Investment Grade Rating; or

P29.2 where the Appointee or any Associated Company which issues corporate debt on its behalf:

P29.2.1 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is not an Investment Grade Rating; or

P29.2.2 holds an Issuer Credit Rating which is one notch above the Lowest Investment Grade Rating (i.e. BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent) and:

P29.2.2.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P29.2.2.2 the rating outlook has been changed from stable or positive to negative.

P30 Where paragraph P29 applies, the Appointee must not, without the prior approval of Ofwat, transfer, lease, licence or lend any sum, asset, right or benefit to any Associated Company, other than where:

P30.1 the Appointee makes a payment to an Associated Company which is:

P30.1.1 pursuant to an agreement entered into prior to the circumstances referred to in paragraph P28 arising, which provides for goods, services or assets to be provided on an arm's length basis and on normal commercial terms; and

P30.1.2 properly due in respect of the relevant goods, services or assets;

P30.2 the Appointee transfers, leases, licenses or lends any sum, asset, right or benefit to any Associated Company (excluding a dividend payment, a distribution out of distributable reserves or a repayment of capital), where:

P30.2.1 the transaction is on an arm's length basis on normal commercial terms; and

P30.2.2 the value due in respect of the transaction is payable wholly in cash and is paid in full when the transaction is entered into;

P30.3 the Appointee makes a repayment of, a payment of interest on or payments in respect of fees, costs or other amounts incurred in respect of:

P30.3.1 a loan made from a Financing Subsidiary to the Appointee, provided that the Financing Subsidiary continues to be an Associated Company of the Appointee; or

P30.3.2 a loan made prior to the circumstances referred to in paragraph P29 arising which is otherwise in accordance with these Conditions, provided that payment in respect of such a loan is not made earlier than provided for in accordance with its terms;

or

P30.4 the Appointee makes a payment for group corporation tax relief or for the surrender of Advance Corporation Tax, calculated on a basis not exceeding the value of the benefit received, provided that the payment is not made before the date on which the amounts of tax subject to the relief would have become due.

Dividend policy

P31 The Appointee shall declare or pay dividends only in accordance with a dividend policy which has been approved by the Board of the Appointee and which complies with the following principles:

P31.1 that dividends declared or paid will not impair the ability of the Appointee to finance the Appointed Business, taking account of current and future investment needs and financial resilience over the longer term;

P31.2 that dividends declared or paid take account of service delivery for customers and the environment over time, including performance levels, and other obligations; and

P31.3 that dividends declared or paid reward efficiency and the management of risks to the Appointed Business.

For the purpose of this licence condition, dividends refers to any distributions declared or paid in respect of any ordinary shares or preference shares.

Ring-fencing Certificate and statement

P32 No later than the date on which the Appointee is required to deliver to Ofwat a copy of each set of regulatory accounting statements prepared under Condition F, the Appointee must submit a Ring-fencing Certificate to Ofwat.

P33 Where the Board of the Appointee becomes aware of any activity of the Appointee or any Group Company which does not form part of the Regulated Activities, and which may be material in relation to the Appointee’s ability to finance the Regulated Activities, the Appointee must:

P33.1 inform Ofwat; and

P33.2 within fourteen days of becoming aware of the activity, submit a new Ring-fencing Certificate to Ofwat.

P34 Where the Board of the Appointee becomes aware of any circumstances which would change its opinion such that it would not give the opinion contained in the Ring-fencing Certificate, the Appointee must inform Ofwat of this in writing.

P35 Whenever the Appointee submits a Ring-fencing Certificate to Ofwat, the Appointee must submit a statement of the main factors which the Board of the Appointee has taken into account in giving its opinion for the Ring-fencing Certificate.

P36 A Ring-fencing Certificate must be:

P36.1 signed by all directors of the Appointee on the date of submission; or

P36.2 approved at a meeting of the Board of the Appointee, convened in accordance with the Appointee's articles of association, in which case the Ring-fencing Certificate must:

P36.2.1 be signed by a director of the Appointee or the Appointee's company secretary; and

P36.2.2 have appended to it a certified copy of the minutes of the approval.

P37 Each Ring-fencing Certificate shall be accompanied by a report prepared by the Appointee's Auditors and addressed to Ofwat, stating whether they are aware of any inconsistencies between that Ring-fencing Certificate and either the statements referred to in condition F6.1 or any information which the Auditors obtained in the course of their work as the Appointee's Auditors and, if so, what they are.

Reporting of material issues

P38 Where the Board of the Appointee becomes aware of any circumstance that may materially affect the Appointee's ability to carry out the Regulated Activities the Appointee must inform Ofwat as soon as possible."

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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