

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham  
B5 4UA

Via email: [REDACTED]

29 September 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 (“Consultation”)**

Thank you for the opportunity to comment on the proposed modifications to strengthen the ring-fencing licence conditions for Affinity Water. We are grateful that Ofwat have engaged constructively on this matter both during the December discussion paper and this licence modification consultation.

We are also pleased that some of the more extreme options contained in the discussion paper have been left out and that the current proposals represent more proportionate and targeted regulation.

However, we do have concerns with certain elements of the modifications as currently proposed. These concerns are addressed in this letter and the accompanying Annex which includes responses to the specific questions raised.

Overall, we do not think that either the Consultation or the December 2021 discussion paper: Financial resilience in the water sector, present compelling evidence that the existing framework for ensuring financial resilience is inadequate or poses material risk to customers or taxpayers. We outlined the reasons for this in our response to the original discussion paper ([link](#)).

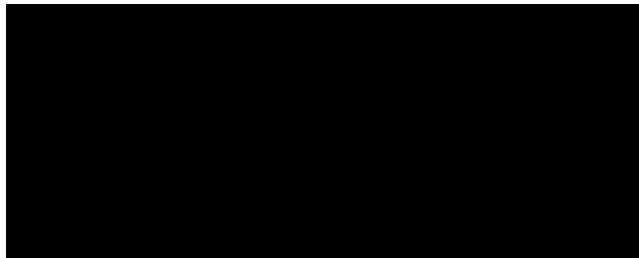
We believe that many of the options in the discussion paper would not produce a clear customer benefit but may inadvertently create customer disbenefit by making the sector less investable or imposing additional costs on companies/customers without improving service levels.

Finally, we are concerned that the interconnection between the two highly related areas of Risk and Return for PR24 and Financial Resilience has not been properly considered. On one hand Ofwat raises concerns with financial resilience, on the other it is proposing methodological changes to the cost of equity which, all else being equal, will weaken financial resilience. The balance of risk and return has a large impact on financial resilience and the topics should not be viewed in isolation.

We recognise the importance of this issue to the future of the sector, and we hope that these thoughts, and those contained in the Annex, are useful contributions to Ofwat's thinking in this area.

As always, we would be very happy to meet to discuss our comments further and look forward to future engagement with Ofwat on this topic.

Yours sincerely,



**Liv Walton**

Regulation and Strategy Director

## Annex

In this annex we set out our answers to the specific questions raised in the Consultation ([link](#)).

**Q1. 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.**

We do not consider that any amendments to the cash lock-up conditions are warranted. As an overarching point, we do not see robust evidence and justification that additional regulatory intervention is required in the first place, given the existing mechanisms and arrangements to maintain financial resilience and protect customers.

This being said, we are pleased to see Ofwat avoid the more severe options which were included in the December 2021 discussion paper: Financial resilience in the water sector.

The challenge with a credit rating trigger is that credit ratings are not solely a function of a companies' capital structures. They are decided by independent third-party rating agencies with their own views and are impacted by various external factors such as macro-economics, politics and critically regulators' own decisions. This being the case, miscalibration of the trigger level represents significant risk to companies and equity investors.

Equally, we do not think it appropriate that credit ratings are used as the sole indicator of financial resilience, when in reality a myriad of factors contribute to ..."the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption"<sup>1</sup>. As Ofwat has previously recognised factors including (but not limited to) the scale and structure of a company's debt liabilities, the liquidity that is available to a company in the event that it requires access to cash, and the strength and flexibility in the company's equity backing are all important factors in assessing financial resilience, and are more nuanced and complex than a credit rating agency opinion on a company's credit worthiness.

We believe an amendment to the current licence to change the trigger from BBB-/Baa3 with negative outlook to simply BBB-/Baa3 represents more proportionate regulatory intervention and request this is considered by Ofwat.

---

<sup>1</sup> Ofwat (2019) Putting the Sector back in balance: consultation on proposals for the PR19 Business Plans

Q2. 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.

Much progress has already been made with regard to ensuring dividend policies take account of service delivery and financial resilience. Our own Dividend Policy ([link](#)) is an example of this. We think that the hurdle for making licence changes has not been met. Licence changes have a wider impact and real-world consequences which could reduce the company flexibility that would best support customer interests.

Regulatory intervention in the form of licence changes which limit or restrict dividend payments could undermine the attractiveness of the sector as an equity investment proposition at a critical time, especially given the increased investment required to meet the Government's ambitions as set out in the draft SPS.

Q3. 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.

While this requirement would not impact Affinity Water currently – given that we already hold two credit ratings in line with the rating requirements in our WBS – we are not convinced that this additional regulatory requirement is effective or proportionate.

We are also concerned with the proposal that only the lowest grade rating will count in determining if a company does/does not go into cash lock up. It is a worryingly mechanistic approach and places heavy reliance on a single external credit rating opinion. We note the evidence provided by Ofwat in the CMA19 hearings in which the Chief Executive and Director of Risk and Return both expressed concerns that rating agencies have differing approaches and that a single rating agency approach should not be determinative.<sup>2</sup>

Q4. 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.

A requirement to notify of published changes would not be of concern to us as rating assessments would be available publicly and formalising reporting to Ofwat could support more robust and timely regulatory monitoring. However, notification of

---

<sup>2</sup> CMA (2020), Notes of a video conference with Ofwat held at Competition and Market Authority , Cabot Square, London, Monday 20<sup>th</sup> November 2020

planned or potential changes in advance of publication by the agencies themselves is inappropriate given the sensitive nature of the information.

Best practice is to minimise the distribution of market sensitive information even if technically allowable to share with regulator. So, if this is changed, we have a strong preference for it to be a post event notification rather than in advance.

**Q5. 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.**

We support the objective to align all licences with the current industry standard, and we consider this principle should also hold if the proposed licence modifications to raise the cash lock up trigger are rejected in any subsequent referral to the CMA.