Affinity Water draft methodology response

Chapter 9

Q9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

We consider the proposed standard set of scenarios and reverse stress testing to be a useful starting point for testing financial resilience and welcome Ofwat's expectation that companies will model individual and combined scenarios that reflect their specific risk factors. We maintain that risk analysis for PR24 must be capable of reflecting the characteristics of each company and of capturing a notional company like Affinity Water. Company-derived stress test scenarios can be an important input to facilitate this.

This exercise of stress testing business plans is complementary to the work we do in our annual Long Term Viability Statement. We have not yet undertaken risk analysis of the PR24 business plan so have not assessed what scenarios could be considered severe, reasonable and plausible.

Given the potential changes to licences in respect of lifting the rating trigger for cash lock up, we feel strongly that financeability and financial resilience should allow companies to aim for the mid-point in the credit rating range, rather than leaving them on a cliff edge.

Q9.2. Do you agree with our approach to how the Board of the company should approach its Board assurance statement?

We consider that financial resilience should be at the heart of the calibration of the PR24 price control. We do not disagree with the requirement to produce Board assurance statements *per se*, rather we disagree with Ofwat's assumption – implied in the proposed approach – that companies have full control over financeability and financial resilience.

Ofwat's expectations that (1) Boards are able to provide unqualified assurance of each company's financial resilience over the PR24 period and beyond and (2) companies and their investors will put plans in place to mitigate any issues, combined with the proposals to reduce allowed returns without reducing risk exposure based on the draft methodology are indicative of a complete dismissal of the link between Ofwat's approach and financial resilience. This is likely to make it very challenging for Boards to provide assurance based on the draft methodology.

In practice financial resilience is dependent on a combination of the asset side (regulatory revenues, assets and risk allocation) and the liability side (company structures and financing, corporate governance arrangements). On the asset side, financial resilience is critically linked to the decision around allowed cost of equity and the extent to which this is commensurate with the risk exposure implied in the regulatory framework. As a result, securing resilience is as a result a function of both Ofwat and company decisions.

We illustrate the impact of regulation and the degree of control a company would have on debt metrics using an example from the ICR ratio. The inputs to ICR are:

revenue, operating expenditure, working capital, RCV depreciation and cash interest.

The most material drivers of the ICR ratio are cost of equity and cost of debt – as evidenced by the use of the economic form of ratio, including by Ofgem – both of which are driven by regulator decisions, with limited constraints from the financing duty during the latest price controls.

Other revenue building blocks, including RCV depreciation, are to a large extent driven by the regulator's decisions although there is some constraint arising from, for example, the size of the firm, pension deficit funding, nature of spend, etc.

Operating expenditure and cash interest are the only levers left for the company to pull and the relationship between cost and service performance means any reduction in operating expenditure is likely to lead to a fall in service performance and potential ODI penalties which would offset any reduction in operating expenditure achieved.

This leaves cash interest paid as the only factor over which a company has complete control.

Q9.3. Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

Dividend policy

Affinity Water's policy is to pay a dividend commensurate with the long-term returns and performance of the business and allowing shareholders to earn an appropriate return from an investment in the company, whilst not impairing the company's longer term financeability and taking into account commitments to its stakeholders and customers.

Our dividend policy, which is published on our website[1], clearly and transparently sets out the factors considered by the Board in the assessment of the appropriate level of dividend, namely whether:

- The dividend reflects the long-term social, financial and operational commitments made to stakeholders. This is assessed with reference to (1) customer service (C-MEX, D-MEX, complaints), (2) operational commitments (e.g. leakage, water quality, supply interruptions, etc), (3) community commitments (e.g. vulnerable customers, sustainable abstraction etc), and (4) employees and pensions (safety and health of the pension scheme).

- From a financeability perspective, whether: (1) sufficient liquidity would be maintained (at least 15 months), (2) distributable reserves are sufficient, (3) the company is viable over the long-term and (4) the company maintains ratios that are in line with a credit rating equal to or above investment grade and to maintain the headroom target set for gearing and interest cover.

- The proposed dividend payments conform with legal and regulatory requirements and restrictions, including the management of economic risk and compliance with financial covenants.

[1] Dividend-Policy-2022-CLEAN.pdf (affinitywater.co.uk)

The base dividend yield for the regulated business is consistent with the 4% outlined by Ofwat.

Performance related executive pay

Affinity Water's performance related pay for executives is aligned with Ofwat's expectations. Affinity Water's approach is governed by the Remuneration Committee, this is outlined each year in the Remuneration report which is contained in the Governance section of our Annual Report and Financial Statements.

Voluntary sharing

We have not thus far identified a clear area where voluntary sharing might be appropriate but will keep this under review. It is key that any voluntary sharing takes into account financeability, risk allocation and incentive properties.

Separately, we agree with the CMA's findings that the GOSM mechanism is not supported by finance theory, correct diagnosis and evidence of the underlying problem and so cannot, by design, be targeted, proportionate and effective. In this context and further to the decision made by the CMA, we consider that any GOSM penalty relating to AMP7 should not apply in AMP8.