Anglian Water response to:

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

Anglian Water

September 2022

Response to Ofwat Consultation on Financial Resilience

Introduction

(1) We welcome the opportunity to respond to Ofwat's consultation on the proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers.

(2) We agree that it is important that companies have adequate levels of financial resilience to deliver obligations and commitments to customers and the environment now and in the long-term. This is necessary for supporting the investment required to meet the challenges of asset resilience and climate change.

We support a focus on financial resilience and transparency in dividend policies

(3) Financial resilience is important to Anglian Water – as a securitised company we already have many protections in place to ensure financial resilience, maintain credit ratings and protect debt investors. We actively took steps in 2022 to strengthen our financial resilience and reduce our gearing, a principal aim of which was to stabilise the credit ratings, a total of £1,165.0 million was injected as equity by its immediate shareholders into Anglian Water.

(4) Our revised Articles of Association require Anglian Water to conduct its business and operations for the benefit of shareholders while delivering long-term value for the company's customers, the region and the communities it serves, and seeking positive outcomes for the environment and society. Put simply, this means that our Board must take account of the wider impact Anglian Water has on our customers, communities and the environment, as well as delivering a fair return for our shareholders. This is a legal duty that is binding on all of our Directors.

(5) Our existing dividend policy also explicitly references our purpose as enshrined in our Articles of Association:

"In making decisions (including decisions in relation to dividend payments), directors are required to act in the way that is considered most likely to promote the purpose of the company. In doing so, directors must have regard (among other things) to the likely consequences of any decision in the long term, the interests of the company's employees, relationships with suppliers, customers and others and the impact of the Company's operations on the community and the environment. "[1]

We have some concerns on the evidence base used to support the proposals

(6) This is the first time that licence changes have been proposed under the new licence change process. Statements in the Environmental Bill Impact Assessment included that the rationale for the change in Ofwat's powers in this regard was to prevent a company from blocking a change for "*trivial reasons*"[2]. The consultation also stated that any licence modifications should be "*in the public interest and where appropriate, provide an assessment of the economic impact of the proposed change*" and be supported by "*a robust business case*"[3].

(7) We do not believe that the licence modifications proposed meet this standard. Moreover, given the scale of proposed intervention in relation to company financing and dividend policies (which are matters for individual company Boards) we would expect that an appropriate impact assessment should have been completed, in line with best regulatory practice. In absence of this, we have engaged KPMG (report attached with our consultation response) to undertake an impact assessment of Ofwat's proposals: the conclusion of their assessment is that any marginal benefits of the proposals are considerably outweighed by the costs.

[1] https://www.anglianwater.co.uk/siteassets/household/about-us/aws-dividend-policy.pdf

[2] Environmental Bill Impact Assessment (3 December 2019), Improving our management of water in the environment, Summary of responses and government response (July 2019).

[3] Improving our management of water in the environment Consultation (January 2019),

(8) This is the first licence modification to go through this new process. Given that the responses to Ofwat's December 2021 discussion document showed universal lack of support for the proposed changes from companies and equity investors alike, it does not seem to fit with the rationale Ofwat gave for the need for the new licence change process.

(9) The consultation paper lacks a clear exposition of a market failure that would require regulatory intervention. We note that Ofwat is concerned that a company with weak financial resilience may take years to recover and that this may be associated with poor operational performance. We agree that it would not be fair for customers and the environment to bear the real consequences of poor service delivery for extended periods of time. However, the evidence for a link between operational performance and financial resilience is weak and we would suggest that concerns about the former are best addressed directly.

(10) We welcomed the chance for early engagement and the opportunity to respond to Ofwat's December 2021 discussion document on financial resilience. However, early engagement and discussion papers only assist the process if respondents can see that their involvement helps to shape the direction of travel. While we understand that not all views can be accommodated, we are disappointed that our response and indeed those of all companies and equity investors in relation to the proposed licence modifications appear to have been rejected completely.

(11) Indeed, when no debt investors responded to the discussion paper (which likely indicates the lack of concern of debt investors on this issue), Ofwat then actively solicited views from debt investors who unsurprisingly supported greater protections for debt investors. Ofwat appears to have given more weight in its decision to these views. Good, open consultation on material licence changes is crucial to maintain the legitimacy of the process, if companies do not feel they can influence then the whole process suffers.

(12) The stated purpose of these changes is "to strengthen regulatory protections to incentivise companies to be financially resilient". There are already a number of existing regulatory protections in the water sector which are designed to support financial resilience. There should be a high hurdle for the introduction of new regulation which typically needs to address specific market or regulatory failures to avoid introducing distortions and unintended consequences, and an impact assessment should be part of any process to demonstrate that this hurdle has been cleared.

A proposed amendment to the cash-lock up licence modification

(13) As currently drafted, the licence modification gives significant weight to the opinion of a single credit rating agency's view which we disagree with. Whilst we do not agree with the justification for the licence modification as set out above, a change to the proposal where the cash lock-up should be triggered where a company fails to have ***two*** ratings above BBB (negative outlook) would act to mitigate the undue influence of a single CRA.

(14) Our responses to the individual questions are set out below:

Question 1 – 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 section 2, box 3, proposed to take effect from 1 April 2025.

(15) We agree it is important that companies have adequate levels of financial resilience to deliver on obligations and commitments to customers and the environment now and in the long-term. We also recognise the benefits of cash lock-ups that protect investment grade credit ratings. However, protecting credit ratings does not guarantee financial resilience. Ofwat already has sufficient tools to ensure financial resilience and the existing licence conditions adequately protect investment grade credit ratings. A full critique of the limitations of using ratings as a proxy for financial resilience is included in the First Economics' paper "Ofwat's Proposed Financial Resilience Licence Modification - An Assessment" [4]. This paper concludes that "a regulator should have a very high bar before it takes action to block such payments [dividends]" and "Ofwat is wrong to have come to the conclusion that a single rating action from a single rating agency automatically meets this threshold".

(16) Relying on Rating Agency assessment of creditworthiness, is a blunt and overly simplistic mechanism on which to try and "solve" Ofwat's concerns over financial resilience. In particular we are concerned that the proposal could result in cash lock-up being triggered by the opinion of a ***single*** rating agency, despite a company potentially having stronger ratings with other CRAs. In the example below, company A has significantly stronger ratings where a like for like comparison is possible but would be adversely impacted under the proposals by having a third rating where that CRA has taken a negative view, which could be informed by a broader view of the of the industry rather than any company specific concerns.

	Company A	**Company B**	**Company C**
Rating agency 1	BBB+	BBB	BBB
Rating agency 2	BBB+	BBB	No rating
Rating agency 3	BBB (negative outlook)	No rating	BBB (negative outlook)
Result	Cash lock-up	No lock-up	Cash lock-up

(17) This would provide a disincentive to companies to seek more than the minimum number of credit ratings. As a remedy to the undue influence of a single CRA, we propose the cash lock-up should be triggered where a company fails to have ***two*** ratings above BBB (negative outlook). In this instance Company A above would not be in cash lock-up but Company C would continue to be impacted.

(18) Strengthening protection for debt investors does not come without cost to equity investors. We are concerned that Ofwat seeks to impose this cost on equity holders without considering and quantifying the impact of its proposals.

Question 2 – 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 section 3, box 4.

(19) While we agree with the principle that dividends *"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"*, our dividend policy already includes very similar statements which serve the same purpose as the proposed licence changes. Our Articles of Association also contain commitments to ensuring that we are acting in ways that deliver social and environmental benefits for the region we serve. Our dividend policy is therefore already fit for purpose and addresses the issues Ofwat is most concerned about which we principally understand is driven by bringing the licence in line with Ofwat's previous PR19 expectations. Indeed, in Ofwat's most recent

[4] http://www.first-economics.com/financialresilience.pdf

Monitoring Financial Resilience Report (2020/21) [5] all companies' dividend policies were assessed as sufficient in referencing "key factors as set out in our [Ofwat's] expectations". Given the industry's alignment with Ofwat's requirements on dividend policies, we question the need to enforce the position via licence changes.

Question 3 – 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 section 4, box 5.

(20) Notwithstanding our responses to question 1, we already hold issuer credit ratings from 3 agencies and therefore we are content with this proposal.

Question 4 – 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 section 4, box 6.

(21) We are supportive of transparent reporting of changes in ratings to Ofwat.

Question 5 – 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 licence modifications7.

(22) We have no specific comments to make on this proposal, but generally we are supportive of licences being consistent across the industry.

[5] https://www.ofwat.gov.uk/publication/monitoring-financial-resilience-report-2020-21/