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

Response of Castle Water Limited

Introduction

1. This is the response of Castle Water Limited ("**Castle**", "**we**") to the above consultation document (the "**Document**") issued by Ofwat on 28 July 2022. Our remarks focus on the proposal to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, which we support with some important caveats set out below.

2. We also support the proposal to require companies to hold two issuer credit ratings.

3. Whilst we have no objection to the remaining proposals, we consider them to be essentially cosmetic and / or otiose.

Summary

- We welcome this proposal, with caveats, given the progressive weakening of the financial resilience of certain water undertakers, in their capacity both as suppliers to end customers and as Wholesalers, over a number of years.

- Ofwat clearly acknowledges that these provisions have neither had the incentive effect that had been intended, nor enabled Ofwat to take corrective action despite the warning signals and consequent engagement with undertakers that Ofwat cites.

- There is therefore a case for going further than Ofwat proposes in order to protect all customers' interests and promote confidence in the Non-Household ("**NHH**") retail water market in line with its statutory duties,

- In particular, given that Ofwat identifies customers as at risk from the consequences of undertakers' financial weakness, it is a material omission that no mention is made of NHH retail water customers' exposure to Retailer failure that could potentially be triggered by Wholesaler financial weakness.

- In parallel with the implementation of its proposals, Ofwat should therefore now promote (or give support to) an amendment to the Wholesale-Retail Code (the "**WRC**"):

    - to make Wholesalers as well as Retailers subject to a minimum credit rating requirement; and

    - to pitch that requirement *at least* equal to the level that Ofwat now proposes,

  or explain fully and coherently why it should not do so.

- This should include a proper analysis of the legal and investment environment that would obtain in the event of continuing Wholesaler financial weakness.

- If Ofwat does not do this, and the financial stress of an undertaker were to give rise to its failure and / or that of its counterpart Retailer(s), Ofwat would be open to justified criticism given its:

    - long-held concerns, including that certain undertakers have dragged their feet or ignored the issue over a number of years; and

    - giving undertakers a clear two years' further leeway (and even longer warning) to implement the necessary changes.

The case for a WRC Code Change

4. The current requirements relating to Credit Security and Minimum Credit Rating apply only to Retailers, on the implicit assumption that only Retailers give rise to financial resilience risk. That is clearly not now the case.

5. In December 2021, in response to Ofwat's predecessor document ("Financial resilience in the water sector: a discussion paper", December 2021)[1], Castle accordingly proposed a Code change[2] that based on the thesis, in brief, that where a Wholesaler is financially stressed and cannot extend its credit lines on a timely or affordable basis:

    - There is no legal impediment to such an undertaker incorrectly calling on a Letter of Credit ("**LoC**"), nor an immediate remedy for that situation. The Mason and Wright study[3] observed that "it may be possible to delay administration for many years but in that time, a range of sub-optimal behaviours may occur".

    - If a LoC were called in that way, there is no legal protection for the Retailer having to post further Credit Amounts in order to avoid possible Default.

    - This would transfer financial stress to one of more Retailers, increasing the risk of systemic Retailer failure and the instability of the NHH market as a whole.

    - Even if an undertaker close to financial default were ultimately to be placed into Special Administration that would not prevent the LoC being called or protect Retailer Credit Security.

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[1] https://www.ofwat.gov.uk/wp-content/uploads/2021/12/Financial-resilience-in-the-water-sector_a-discussion-paper_Updated_9_Dec_2021.pdf
[2] (https://mosl.co.uk/document/changes/4958-cpw132-credit-support-and-wholesaler-credit-ratings-change-proposal-form/file
[3] https://www.ofwat.gov.uk/wp-content/uploads/2021/12/Mason-and-Wright-A-report-on-financial-resilience-gearing-and-price-controls.pdf

6. The proposal was, in essence, that Retailers should not be required to post Credit Security in favour of an undertaker that fails the Minimum Credit Rating test; and that the required rating should be raised *at least* to that now proposed by Ofwat.

7. In January 2021 at Ofwat's request the then MOSL Panel put that proposal on hold pending Ofwat's conclusions on undertakers' financial resilience.

8. Ofwat's conclusions now negate the views expressed in previous Panel proceedings[4] that Retailer Credit Security is adequately protected by Ofwat's duty to ensure companies can finance their activities; the intrinsic unlikelihood of insolvency and special administration; the capacity of cash lock-up to forestall these; and the prospective continuation of services if administration occurred.

9. Moreover, these assertions have not been underpinned by evidence that Retailers are *not* at risk of their Credit Security being misapplied or stranded in the event of Wholesaler financial stress or consequential events. Ofwat has confirmed that undertakers who have adopted risky financing structures have not been discouraged from adopting financing choices that are out of line with Ofwat's expectations, and thus deterred from exploiting opportunities for the kinds of poor behaviours that would not appeal to those with others with more prudent structures.

10. It is therefore important that Ofwat satisfies itself, supported by appropriate advice:

    - Whether and how Special Administration provides legal protection of Credit Security, or prevents LoCs from being called (including why Special Administrators would not be under an obligation to call the LoC, as their fiduciary duties are to secured creditors).

    - Whether the Board of an undertaker facing likely insolvency would not react to a change in its fiduciary duties by being required or advised to call the LoC (or other credit security), given that previous analogous situations suggest this is a likely scenario.

11. In that context, Ofwat should be cognisant of the relative position of trade creditors. We would expect, as is normally the case, that any retailer credit would be subordinate to intercompany loans from a holding company. The risk to Retailer credits held by undertakers in the event of a financial default by an undertaker can therefore be assessed only in the context of the overall capital structure of the undertaker.

12. Moody's have identified increased risk to undertaker holding company finances due to Ofwat's proposed financial resilience measures, which may increase risk for Retailers in the event of a default.[5] Moody's identify specific concerns regarding Thames: "Kemble appears most exposed following Ofwat's proposals". This reinforces the need for Ofwat fully and properly to assess the range of actions which could be taken by an undertaker close to a financial default, including incorrect use of retailer Credit Security, and the likelihood of recovery of Credit Security in the event of Special Administration.

[4] On CPW079, Part B.

[5] Moody's Sector Comment - Ofwat's strengthening of ring-fence positive for OpCos but negative for HoldCos_July 2022.pdf

13. There is also a case for Ofwat to consider whether, as it stated in its December 2021 document: “The trigger level [for cash lock-up] could be uplifted to […] an even higher level”, reflecting price determinations based on a target credit rating of BBB+/Baa1. Ofwat does not explain why it continues to rely on ‘target’ credit ratings that clearly have no effect (and which provide a perverse incentive for an undertaker to accept these targets whilst continuing to fall short of them).

14. Ofwat also notes that:

    “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.”

    “Companies with lower credit ratings carry a greater probability of default and greater risks associated with raising debt, or of being impacted by widening debt spreads at times of market disruption, as during the 2008 financial crisis. Furthermore, headroom is necessary as it enable companies to respond flexibly to a wide range of shocks”.

15. Against this background it is not clear whether the proposed uplift is designed to provide such headroom. If so, given Ofwat’s misgivings over some companies’ previous non-observance of headroom against the current requirements, and the possibility of a downgrade of more than one notch, it is notable that Ofwat has resiled from invoking a ‘higher level’ to ensure the necessary headroom.

16. It was for that reason that our WRC change proposal would not only have brought the Minimum Credit rating to the BBB/Baa2 level that Ofwat now proposes, but also required BBB+ / Baa1 where the BBB/Baa2 rating is on negative outlook.

17. Finally, Ofwat notes that “We consider it is reasonable to expect that regulatory requirements placed on companies progressively increase as the credit quality of a company declines” and discusses possible incentives to companies to adopt more resilient financing structures and instruments. A WRC change proposal to uplift the test in the definition of 'Minimum Investment Grade’ would clearly serve as such an incentive.

<u>The case for early action</u>

18. We recognise that the cash lock-up provision is not intended to be the only protection that customers have against the risk of undertaker financial weakness and its consequences, including entry into a spiral of decline whereby their debt costs increase with the perceived likelihood of failure; and that credit ratings are not the only indicator of such risk.

19. It is, however, palpably the case that Ofwat places considerable reliance on credit ratings as the principal practical regulatory forewarning of these risks potentially crystallising. As such, it forms the focus of Ofwat’s concerns:

    “We consider that modifying company licences to increase the cash lock-up trigger is in line with our statutory duties. 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."

20. Ofwat's duties to further the consumer objective and to ensure that companies can finance the proper carrying out of their functions apply equally to water and sewerage licensees. This includes taking early action to prevent and remedy financial weaknesses[6]. As Ofwat observes:

"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."

"We have become increasingly concerned about the impact of the financing decisions made by some companies on their long term financial position."

21. Action taken now by Ofwat is not, therefore, before time.

Castle Water Limited

29 August 2022

[6] These duties are broadly shared with Ofgem. See the report by the Select Committee on Energy. https://committees.parliament.uk/publications/23255/documents/169712/default/, In particular, see paragraph 33: "Ofgem's monitoring of firms was patchy, leaving systemic risks to go undetected. When risks were identified Ofgem was slow to act."