

March 2023

**Decision under sections 13 and
12A of the Water Industry Act
1991 to modify the ring-fencing
licence conditions of the
largest undertakers**

Ofwat

About this document

This document contains our decisions to modify certain ring-fencing¹ provisions in each water company's² Instrument of Appointment (**licence**). It states the effect of the modifications and our reasons for introducing them, having considered the representations made to us. It follows our July 2022 '[Consultation on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers](#)³ (**the Consultation**) which gave notice of our proposed modifications. It describes the responses we have received since the Consultation and how we have taken these into account. It also reflects the significant engagement we have had with water companies and stakeholders since the publication of a [discussion paper](#) on this topic in 2021.

Our decision relates to Condition P of water company licences.

In two cases – namely, the introduction of a grace period and a drafting correction to capture a rating of the lowest investment grade (i.e. BBB- or Baa3) as a trigger for cash lock-up, as we intended – our modifications differ from those set out in the Consultation – and the document explains the reasons for these changes.

The licence modifications that are common to all companies' licences are set out in appendix A4.

For one water company, Wessex Water, this document sets out our decision to modify Conditions A, I, K and P to bring its ring-fence licence conditions in to line with the Conditions of the other large, regulated water companies. Again, it explains the effect of the modifications and our reasons for introducing them and sets out our responses to the representations we received. The licence modifications for Wessex Water are shown in appendix A5.

The licence modifications are made in accordance with section 12A and section 13 of the Water Industry Act 1991.

¹ The terms 'regulatory ring-fencing framework', the 'regulatory ring-fence' or simply the 'ring-fence' refer to the ring-fencing licence conditions in Condition P of companies' licences (or currently 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.

² 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, WIA91. The decision set out in this document does not apply to new appointments and variations (NAVs).

³ Responses to the July 2022 consultation are [available on the Ofwat website](#).

The modification to amend the cash lock-up⁴ trigger level will take effect from 1 April 2025 and the remaining modifications will take effect on 17 May 2023.

Alongside our decision, we publish in appendices A2 and A3:

- A draft Information Notice setting out the factors we will consider in assessing whether dividends declared or paid comply with the modified dividend policy licence condition⁵.
- Draft Guidance setting out how we would expect companies to submit a request for us to make a determination that the cash lock-up licence condition (as modified in this decision) should not apply, in the event the condition is triggered.

We welcome comments on the draft Information Notice and draft Guidance by 2 May 2023, and we will take account of the views we receive before publishing final versions of these documents.

⁴ Each company's licence contains a 'cash lock-up' condition that, when triggered, prohibits the company from transferring, leasing, licencing or lending any sum, asset, right or benefit to any Associated Company, without the prior approval of Ofwat, other than where certain exceptions apply.

⁵ Each company's licence contains a 'dividend policy licence condition' requiring companies to declare or pay dividends only in accordance with a policy that complies with certain principles.

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1. Executive summary

Financial resilience is the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption. 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. Water companies are responsible for ensuring that they remain financially resilient; 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.

Debt and equity investors have an essential role to play in providing the finance necessary for companies to deliver their investment programmes, to encourage companies to be efficient and to meet the levels of service expected by customers and wider stakeholders. Adequate levels of equity in a company's financing structure, together with dividend payments and equity returns that reflect company performance, are important to the successful operation of an effective incentive-based regulatory regime and to maintaining stakeholder trust and confidence.

We have been, and continue to be, clear that we support the payment of dividends that reflect the performance delivered to customers and the environment. Enhanced rewards are available for equity investors where companies deliver great levels of performance. However, it is critically important that the regulatory system adequately protects customers from the consequences of a company's decisions where financial resilience is weak. Weakened financial resilience can present a risk to customers by potentially compromising a company's ability to turn around poor levels of performance as well as limiting a company's ability to invest to maintain, or enhance, its assets.

The decision in this document builds on significant work we have carried out in recent years. Our decision follows our Consultation⁶ published in July 2022 and a discussion paper published in December 2021.⁷ And follows our consideration of the Consultation responses, as well as extensive engagement with respondents and sector stakeholders, including a range of debt investors. The modifications also take into account the wider, ongoing risks to financial resilience we see from our experience of regulating the sector and support the engagement we have with companies where we have identified financial risks.

Our decisions to strengthen the regulatory ring-fence licence conditions across the sector are:

⁶ Ofwat, [Consultation on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers](#), Jul-2022, gave the requisite statutory notice of the proposals.

⁷ Ofwat, [Financial resilience in the water sector, December 2021](#).

Modify the cash lock-up licence conditions⁸ to raise the cash lock-up trigger to BBB/Baa2 with negative outlook from BBB-/Baa3 with negative outlook, effective from 1 April 2025.

We have always expected companies to maintain headroom within the investment grade. 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 lower). Despite this we have become concerned about the decline in credit quality of some companies in the sector over time, with instances where companies are operating at, or at risk of falling to, the lowest category of the investment grade (i.e. BBB-/Baa3). A weak financial position means there is less headroom available for a company to withstand financial shocks and maintain performance for customers.

We consider the cash lock-up trigger of BBB-/Baa3 with negative outlook does not provide an effective regulatory protection for customers where financial resilience is at risk. By raising the trigger level, dividends or transactions outside of the regulatory ring-fence would be restricted at an earlier stage where financial resilience of a company is at risk. This would mean that companies would be incentivised to enter into meaningful discussions with us at an earlier stage where risks to financial resilience are identified. This is important as we have had examples of companies being unwilling to engage openly with us about the risks to their financial resilience despite us raising concerns. This licence modification will also incentivise companies to maintain long-term financial resilience and to maintain headroom well within the investment grade, or to take corrective action where it is required.

Based on the responses to our Consultation, we have made an amendment to the Consultation proposal to provide for a 3-month grace period between the point that a credit rating falls to the trigger level of BBB/Baa2 with negative outlook and the cash lock-up being applied. This allows companies to ask us to determine that the cash lock-up should not apply on the basis that the company's financial resilience isn't at risk, should they wish to do so. This addresses concerns raised by some respondents to our Consultation that there might be circumstances where a credit rating agency's decision to assign a rating of BBB/Baa2 with negative outlook may not fully reflect a company's financial resilience and related risks.⁹ If a credit rating were to fall to BBB-/Baa3 or lower, then the cash lock-up would automatically apply.¹⁰

We intend to provide guidance to help companies understand how we expect the grace period to operate. We therefore provide draft guidance along with our decision, setting out how we propose to apply the grace period licence condition in appendix A3. We welcome

⁸ The cash lock-up conditions place 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 its 'Issuer Credit Rating' (as defined in the licence) falls to a pre-specified threshold.

⁹ As seen in our annual reports on '[Monitoring financial resilience](#)' we use a wide range of quantitative and qualitative information to assess each company's financial position.

¹⁰ Our decision includes a correction of a drafting error, highlighted by a respondent, to the licence condition consultation text that gives effect to the intention set out in our consultation.

views on the draft guidance by 2 May 2023, and will take these into account before we publish the final Guidance as a supplement to our existing consents guidance¹¹.

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 monopoly service providers it is important that water companies ensure that decisions on dividends declared or paid take account of company performance for customers and the environment, investment needs and the need to maintain long term financial resilience. We have set out these expectations at PR19, in the final methodology for PR24, in the regulatory accounting guidelines (RAGs) and in our Board Leadership, Transparency and Governance (BLTG) principles.

Despite this we have raised repeated concerns (detailed in our 2020–21 and 2021–22 [monitoring financial resilience \(MFR\) reports](#)) that across the sector, several companies are not meeting our expectations and are not clearly and transparently linking dividend decisions to performance. Therefore, we are modifying the existing dividend policy licence condition to directly align it with these expectations.

To help companies understand our expectations and how we will assess company compliance with the modified dividend policy licence condition alongside other related obligations, we set out a draft Information Notice in appendix A2 with guidance on the factors that we will consider in our assessment. We welcome views on the draft Information Notice by 2 May 2023 ahead of publication of our final Information Notice.

Modify the licence requirements to require water companies to maintain investment grade issuer credit ratings with at least two credit rating agencies and to notify us of changes to credit ratings. These modifications align with best practice for companies which is to maintain two credit ratings. It also ensures changes to credit ratings are notified to us and that the reasons for the change are clearly set out, where applicable. We acknowledge that the costs of maintaining two credit ratings may be disproportionate for some smaller companies and we will consider alternative arrangements for those companies, where appropriate.

Modify the ring-fencing licence requirements of Wessex Water to bring them in to line with those of other water companies. This modification brings the other ring-fencing provisions in Wessex Water's licence up to the current industry standard and to achieve a broadly consistent ring-fencing framework for water companies in England and Wales. We set out the details underpinning our decision in section 6 and appendix A6 and as explained in our 2020 consultation on regulatory ring-fencing licence modifications¹². Wessex

¹¹ Ofwat, [Guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework](#), Feb-2020

¹² [Conclusions on section 13 of the WIA91 on proposed modification to ring-fencing provisions](#), Jul-2020

Water's licence modifications are in appendix A5.

The licence modifications

Overall, we remain clear that it is a fundamental requirement of companies that they take proactive steps to manage their financial resilience and, linked to this, engage early with us if they are experiencing challenges that could jeopardise their ability to deliver for customers and the environment. The licence modifications set out in this document are intended to strengthen the regulatory protections for all companies and to encourage that early engagement. It should not be inferred from the modification to the cash lock-up trigger that a company should only engage with us when it hits the modified trigger credit rating level.

The licence changes set out in this document reflect the strengthening of the regulatory ring-fence over time. We will continue to keep the protections of the regulatory ring-fence under review, taking steps where necessary to ensure it sufficiently protects the interests of its customers, where necessary.

The licence modifications set out in this document (and summarised in Box 1) modify certain ring-fencing provisions of water company licences. Our decision with respect to English water companies¹³ licences is made under section 12A of the Water Industry Act 1991 (WIA91) and our decision with respect to Welsh water companies¹⁴ licences is made under section 13 of the WIA91. The modification to the cash lock-up licence conditions will take effect from 1 April 2025. All other licence changes set out in this document will apply from 17 May 2023.

Box 1: Licence modifications

Our decisions are to:

1. modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook (from BBB-/Baa3 with negative outlook), with effect from 1 April 2025.
 - The modification includes a 3-month grace period between the point that a rating falls to the trigger level of BBB/Baa2 with negative outlook and the cash

¹³ 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 have decided to modify pursuant to s.12A WIA91 are Anglian Water Services Limited, Affinity Water Limited, 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.

¹⁴ 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 have decided to modify pursuant to s.13 WIA91 are Hafren Dyfrdwy and Dŵr Cymru.

lock-up being applied.

- During this period, companies can submit a request to us to determine (or Ofwat may determine on its own initiative) that cash lock-up should not apply.
- If a credit rating were to fall to BBB-/Baa3 or lower, then the cash lock-up would automatically apply.

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.
3. modify the licence to require companies to hold two issuer credit ratings, or to seek our agreement to an alternative arrangement, if appropriate.
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.
5. Bring the other ring-fencing provisions in Wessex Water's licence up to the current industry standard.

In addition, we invite comments on the draft Information Notice and the draft cash lock-up condition guidance set out in appendices A2 and A3:

- The draft Information Notice in appendix A2 sets out the factors we will consider in assessing whether dividends declared or paid align with the modified dividend policy licence condition and our other published expectations.
- The draft guidance in appendix A3 sets out how we would expect companies to submit a request for us to make a determination on the application of the cash lock-up licence conditions once the conditions are triggered.

We welcome comments on these draft documents by 2 May 2023.

The rest of this document is structured as follows:

- Section 2 sets out the case for making the licence modifications and their alignment with our duties and the UK and Welsh governments' strategic policy statements.
- Section 3 sets out our decision to amend the trigger for the cash lock-up licence conditions.
- Section 4 sets out our decision to update the dividend policy licence condition.
- Section 5 sets out our decision to require companies to hold two issuer credit ratings and to notify us of any changes to issuer credit ratings.
- Section 6 sets out our decision to align other ring-fencing provisions of Wessex Water's licence with the current standard.

2. The case for change

This section sets out our views on the case for change. It explains how the licence modifications align with our duties and the UK and Welsh governments' strategic policy statements.

2.1 Purpose of the licence modifications

The purpose of these licence modifications is to strengthen the protections of the regulatory ring-fence to incentivise companies to maintain adequate levels of financial resilience, engage with us earlier when they are experiencing difficulties, improve the availability and timeliness of information relevant to carrying out an assessment of financial resilience, and to allow us to intervene and seek mitigating actions sooner where companies do not take such steps themselves.

The licence modifications also seek to ensure dividend policies and dividends declared or paid take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term.

They also seek to ensure that Wessex Water's licence conditions are brought into line with the licence conditions of other water companies.

2.2 Respondents' views on the case for change

We received 27 responses (representing views from 38 named entities) to our Consultation. The responses represented views from 16 water companies, a business water retailer, a water project company, eight investors or investor representative bodies, a member of parliament, CCW¹⁵ and 10 environmental representative groups. Water company responses were supported by a report and impact assessment from KPMG¹⁶ (commissioned by seven water companies) and a report from John Earwaker¹⁷ (referenced in responses by six water companies), and both have been published as have the [responses to the Consultation](#).

Our Consultation requested views on the proposed licence modifications. While a number of respondents expressed general support for our proposals (including the responses from environmental representative groups, CCW, Hafren Dyfrdwy, Severn Trent and Welsh Water), several respondents raised a number of points about the case for change relevant to our

¹⁵ CCW (previously the Consumer Council for Water or CC Water) is the independent voice for water consumers in England and Wales. Its primary function is to provide advice and represent consumers on water matters and to investigate and handle complaints made against licensed water suppliers or companies.

¹⁶ KPMG LLP, [Financial Resilience: Impact Assessment](#), 29-Sep-2022

¹⁷ John Earwaker, [Ofwat's Proposed Financial Resilience Licence Modifications: An Assessment](#), Sep-2022

proposals as a whole. We address those points in this section. Sections 3, 4, 5 and 6 address issues raised by respondents in relation to specific proposals.

Views expressed by water companies and equity investors that objected to our proposals fell into the following main categories:

The modifications are not necessary: several respondents considered that the licence amendments were not necessary. Reasons stated included views that:

- there was no sector-wide issue to be addressed;
- we already have sufficient powers or mechanisms to ensure companies maintain financial resilience;
- we had not met the evidential threshold required to strengthen ring-fencing protections in the licence, as, for example, we had not provided adequate proof that there is a 'market failure';
- it was not necessary to adopt a 'one-size-fits-all' approach by seeking to amend every company licence; and
- a few respondents said that covenants introduced in their whole business securitisation arrangements¹⁸ already provide additional relevant protections.

Reference was made to the fact that the water sector had continued to operate through the shocks of the 2008 financial crisis, the Covid-19 pandemic and several severe climate events. One respondent referred to the fact that two water companies had each survived the failure of their corporate owner: specifically, Wessex Water survived the failure of Enron and Welsh Water that of Hyder. Some respondents also referred either to low default rates in the global utilities sector in general, or to the absence of a UK water company failure since the water sector was privatised over 30 years ago as evidence that the proposed licence modifications were not necessary.

Link between operational performance and financial resilience: A number of respondents suggested that our proposals made a direct link between operational performance and financial resilience which we had not proved to exist. The main view expressed by several respondents was that we should focus on instead on honing performance incentives (by reviewing the calibration of the methodology for the price review, including totex allowances and the ODI framework) rather than amending incentives related to financial resilience.¹⁹

¹⁸ Some companies in the water sector have adopted highly covenanted financing arrangements within a whole business securitisation (WBS) arrangement. The covenants introduce a range of financial and other restrictive arrangements that protect the interests of debt investors.

¹⁹ Our regulatory framework seeks to align management's performance incentives with the outcomes that are important for customers. As such, as part of our price control determinations each company is set performance commitments and depending on performance on each target, the company either receives an outperformance payment or pays an underperformance adjustment that is ultimately reflected in customer bills, these are 'Outcome Delivery Incentives' or ODIs.

Negative impact on equity investment: several respondents expressed views that our proposals would have a negative impact on equity investment in the water sector for a range of reasons including that:

- the proposed licence modifications introduced higher risk, uncertainty or higher volatility of returns;
- dividend restrictions would result in longer expected payback periods;
- a perception that there is higher regulatory risk or reduced equity control rights for shareholders in the water sector; and,
- there was no compensatory higher return to reduce the impacts stated above (i.e. some respondents suggested our proposals resulted in a requirement to increase the allowed return which companies can achieve to balance the risks to them of the modifications).

Links to our duties and strategic policy statements: several respondents raised concerns that the proposals had not considered our duties or strategic priorities as set by the UK and Welsh Governments.

We respond to the issues set out above in the following sections.

2.3 Our view on the case for change and respondent's concerns

The view that modifications are not necessary

It is important that, as monopoly providers of an essential public service, water companies are able to maintain access to finance at all times and to be resilient to shocks, whether driven internally or externally, to the regulated company. It is a minimum expectation that water companies should be able to provide services to customers through all stages of the economic cycle, including at times where there are shocks to the wider economy, whether they are driven by climate events, economic variables or other factors.

We also expect water companies to be isolated from failures that arise in a group structure outside of the regulatory ring-fence.²⁰ We consider the fact that companies have continued to operate throughout the period since privatisation without a case of special administration or where failures above the level of the regulatory ring-fence have occurred,²¹ does not

²⁰ In support of this, company licences include a requirement for the company to obtain undertakings from its Ultimate Controller(s). These undertakings require equity investors that we determine to be Ultimate Controllers to refrain from any action which may cause the Appointee to breach any of its obligations under the Water Industry Act 1991 or under its licence conditions.

²¹ A respondent to our consultation referenced the failure of Hyder and Enron in 2001 and 2002, where the regulatory ring-fence operated to protect the respective interests of Welsh Water and Wessex Water. However, these examples were the result of circumstances arising in group companies beyond the level of the regulatory ringfence and do not mean we should not continue to consider the adequacy of existing regulatory protections or the possible risks that can still arise as a result of circumstances that arise in the regulatory ring fence.

provide sufficient reason for claiming that there is no case for change. Special administration is a provision of last resort and can introduce costs that are not fully borne by water companies or their investors.²² Furthermore, customers of a monopoly service provider can suffer poor levels of service for prolonged periods, and the environment can suffer from the consequences of weak levels of resilience, well before special administration might be triggered.

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 levels of financial resilience (through equity injections or restricting dividends). However, in some instances, we remain concerned about risks to company resilience as explained in our recent annual MFR reports.

A number of companies we regulate have credit ratings, monitored for licence compliance purposes, that are below the notional company target set in the last price review (PR19) of at least BBB+/Baa1. This notional company target was considered to provide a level of headroom that was considered reasonable for companies to access debt finance, at all times, and at efficient cost, while providing headroom against financial shocks (that is, any unexpected fall in revenue or increase in costs). While we do not seek to dictate a single capital structure for the sector, the regulatory ring-fence includes a number of protections that are designed to limit the risk to customers associated with a company's financing choices. The decisions we set out reflect our view that there is a need to tighten these existing protections.

Many of the less resilient financial structures in the water industry were put in place before the 2007-08 global financial crisis. In putting these structures in place, a number of companies adopted financial structures with restrictive covenants to support their aim of financing the business with a greater proportion of debt, with refinancing arrangements delivered through the payment of high dividends or loans to shareholders.

Since then, there have been changes in wider economic conditions and consequent reductions in the level of returns that companies can earn, reflecting changes in financial markets. Changes in the regulatory regime over time, for example, an increased use of outcome delivery incentives have also meant a greater proportion of allowed revenue is now at risk (i.e. more revenue is reduced by underperformance payments now compared to in earlier years of privatisation when such a mechanism did not exist). Companies also face

²² Evidence from other sectors suggests that the costs and impacts on customers can be large. For example, in 2004 former Rail Regulator Tom Winsor put the overall cost of the government's decision to put Railtrack into administration at £11-14 billion; and in 2009 the National Audit Office estimated that the failure and entry into administration of Metronet in 2007 led to a direct loss to the taxpayer of £170-£410m. The Office for Budget Responsibility (OBR), said the total cost of Bulb Energy's bailout reached £6.5 billion in late 2022, ahead of its sale to Octopus Energy ([The OBR](#), 17-Nov-2022).

higher court-imposed fines for failure to comply with environmental law²³ and as a consequence of other enforcement action. It is vital that such costs fall on shareholders, without impacting on companies' ability to deliver their obligations for customers. In all such circumstances, companies need to ensure they maintain adequate levels of financial resilience to withstand such adjustments.

Some of the companies with highly covenanted (whole business securitisation) structures have cited the covenants as placing certain disciplines on management that enhance the protections to customers. However, such covenants are specifically aimed at protecting the interests of lenders, allowing water companies to operate with higher levels of debt than might otherwise be the case. As set out in our 2021 discussion paper²⁴, there have been instances of company management making decisions in the short term that are not in the long-term interests of customers. These include paying dividends that do not align with the financing needs or operational performance of the company. They also include the risky use of swaps to boost short-term cash balances and short-term financial ratios which have had the effect of diluting the claimed protections of the covenants and masking underlying financial weakness.

Looking forward, we see a significantly increased requirement for investment in future years including to reduce pollution from company networks and ensure resilient water supplies to cope with climate change/net zero and population growth impacts. Consequently, there is a greater need for companies to ensure that they have adequate financial headroom. At the time that some companies adopted more risky financing structures around 15 years ago, we were clear that companies and their investors took the risk of such arrangements noting that highly geared structures had not been tested over the long term.

Over the last several years we have intervened and taken steps to encourage companies to improve their levels of financial resilience, where appropriate. In 2007 we started to introduce the cash lock-up licence conditions to the licences of water companies. These licence conditions were intended to provide protection to customers in the event that a water company's investment grade credit rating was at risk of downgrade to a sub-investment grade level.

Reflecting our ongoing concerns about the financial resilience of some companies in the sector: in 2016 we introduced a more rigorous and transparent financial monitoring framework, following consultation. We have taken significant steps aimed at requiring companies to improve the levels of reporting transparency, and we introduced an assessment of financial resilience as part of our assessment of PR19 business plans.²⁵ We have continued

²³ For instance, Southern Water was subject to the highest ever [court-imposed fine of £90 million in 2021](#).

²⁴ Ofwat, [Financial resilience in the water sector: a discussion paper](#), Dec-2021, pp15-19

²⁵ See for example our '[Putting the sector in balance: position statement on PR19 business plans](#)', Jul-2018, section 8; and Ofwat, [PR19 Final Determination – Aligning risk and return technical appendix](#), Dec-2019, section 7.

with our ongoing engagement and challenge to companies that we have identified as carrying weak levels of financial resilience.

Despite these changes our 2022 MFR report, identified eight out of 17 companies as having a financial resilience status of 'elevated concern' or where there is 'action required'. In addition, our recent engagement on the matter of financial resilience has revealed some instances where companies have:

- not been willing to engage openly with us about the risks to their financial resilience;
- not clearly or transparently explained the link between dividend decisions and performance for customers and the environment;
- stepped back from public commitments made to strengthen financial resilience;
- sought to defer capital investment into future regulatory periods when faced with pressures on finances, as referenced in our Consultation;
- made risky use of swaps to bolster short-term cash flows and financial ratios defined in covenants, pushing a financial resilience problem into the future while masking an underlying poor financial position, as explained in detail in our December 2021 discussion paper;²⁶ and,
- stated that ODI penalties have reduced funds available to improve service, which suggests a level of resilience that is not sufficient to deliver necessary investment to provide service for customers and the environment as well as bearing the consequences in terms of financial penalties of a failure to do so.

Our engagement has also revealed instances where weak levels of financial resilience have been combined with poor levels of operational performance:

- The case study of Southern Water (presented in our December 2021 discussion paper²⁷) set out the evidence of a company whose operational performance and financial resilience declined over many years under its previous management and ownership. We engaged extensively with the company and its investors over several years before the investors committed to strengthen the company's financial resilience. The previous equity investors sought new equity capital and in doing so accepted a material dilution and reduction in their ownership of the company. Nonetheless, customers continue to be subject to the ongoing poor performance of the company while it continues to execute its multi-year turnaround plan.
- The case of Yorkshire Water²⁸, where we had sought engagement with the company on matters related to its financing arrangements over several years, culminating in the closure of an enforcement case in 2022. This was accompanied by a plan for the company to strengthen its financial resources in the interest of customers and a contribution of £100 million from shareholders to reduce spills from storm overflows. The company is also

²⁶ Ofwat, [Financial resilience in the water sector: a discussion paper](#), Dec-2021, p12

²⁷ Southern Water case study: Ofwat, [Financial resilience in the water sector: a discussion paper](#), Dec-2021, p12

²⁸ Ofwat, [PN34/22 Yorkshire Water improve financial arrangements because of Ofwat intervention](#), Oct-2022

identified as a company that is lagging behind in our Service Delivery report, with a requirement to develop an action plan to address poor performance.

- The case of Thames Water, where we have engaged with the company to consider issues related to its operational performance and financial resilience over many years. The company has announced that shareholders have committed to an initial £500 million of new equity and that the company is working with shareholders on plans to provide a further £1 billion of equity funding within the 2020-25 period (subject to certain conditions) to deliver a significant multi-year turnaround in performance. It also expects it is likely to require the provision of further additional equity support to increase financial resilience.²⁹

The outcome of the processes set out above has been achieved only after significant engagement between us, the companies in question and both incoming and outgoing investors. Our experience suggests that where poor levels of financial resilience are combined with poor levels of service performance it takes significant time for finance to be brought forward to deliver a necessary improvement plan for customers. And it can take many years for a subsequent turnaround in performance to be delivered to customers, with customers suffering the consequences of poor performance for extended periods and potentially bearing increased costs over the long term, for example, if short-term operational cost savings result in higher life cycle costs.

We have taken significant steps in recent years to encourage companies to improve the levels of transparency around the reporting of financial resilience risks using our existing licence conditions and wider regulatory tools.³⁰ The issues set out above suggest there is a need to ensure the protections of the regulatory ring-fence are sufficient. A stronger ring-fence should strengthen the ability of companies to engage with their investors on issues related to financial resilience, potentially reducing the need for regulatory intervention, but also provide us with formal powers of intervention at an earlier stage where companies are experiencing financial resilience challenges so that we can seek timely improvements and/or mitigating actions.

Applicability of the licence modifications

Some respondents to our Consultation also suggested there was no sector-wide financial resilience issue to be addressed or that it was not necessary to adopt a one-size-fits-all approach by seeking modifications to licence conditions, rather than targeting issues or circumstances faced by a specific company.

Reflecting on our experience of regulating the sector, we have concluded that the licence modifications should apply to all regulated companies as all customers deserve the same

²⁹ Thames Water, [Investor Report 31 March 2022](#), pp7-8.

³⁰ Ofwat, [Financial resilience in the water sector: a discussion paper](#), Box 2: Recent steps we have taken to strengthen financial resilience, Dec-2021.

level of regulatory protections in their water company's licence. This is for the following reasons:

- The modifications provide a clear signal to companies and their management about our expectations regarding financial resilience and the design and application of a reasonable dividend policy.
- While some companies may currently be financially resilient there is potential for a company's circumstances to change. It is important for the regulatory protections and reporting requirements to be applied consistently across the sector as consistency will enable us to identify any such decline more quickly, and to intervene promptly if necessary. Our experience outlined above and in recent MFR reports³¹ indicates that challenges have arisen to the financial resilience of several of the companies we regulate, and our existing mechanisms have not proved sufficient. Given the increasing challenges facing the sector, we do not consider it appropriate to wait for a material risk or problem to materialise before making modifications to any given company's licence.
- For the same reasons, we consider it important and appropriate to align the ring-fencing conditions in Wessex Water's licence with those of all other companies (as referenced in section 6), so that its customers have an equivalent level of protection to all other water customers in England and Wales. This was supported by a number of respondents to the Consultation.

2.3.1 Link between operational performance and financial resilience

A number of respondents to our Consultation suggested that we were drawing a direct link between operational performance and financial resilience and that if we were concerned about operational resilience or customer service levels, we should focus on honing performance incentives or target specific companies, rather than amending incentives related to financial resilience.

As we stated in the Consultation document, we are not suggesting that poor financial resilience automatically leads to poor operational performance, however a weak financial position means there is less headroom available for a company to withstand financial shocks. Furthermore, where poor levels of financial resilience are combined with poor levels of service performance such that a company does not have the financial flexibility to deliver a necessary improvement plan, customers may suffer the consequences of poor performance for extended periods.

There are reasons to consider that financial resilience problems can exacerbate other challenges, for example, a company seeking cost savings might focus on the short term, satisfying near-term financial obligations such as interest payments or deferring

³¹ In particular, see the 2021 and 2022 [monitoring financial resilience \(MFR\) reports](#).

expenditure, rather than focussing on necessary investment. Indeed, recently we have experienced an instance of a company seeking to defer key expenditure, which customers have funded, driven by financing pressures. We have been clear that such expenditure deferrals are not acceptable.

The findings set out above are consistent with the findings of academic literature. We note that a review³² carried out by Economic Insight for the Civil Aviation Authority (CAA) shows that high leverage has a significant negative effect on investment. The review posits that highly levered companies may be forced to service commitments such as cash interest and principal repayments on debt, and this can have a constraining effect on investment (or can at least leave less room for manoeuvre in times of crisis). This suggests that capital structure plays an important role in a firm's investment policies and that excessive leverage (one of several indicators of a lack of financial resilience) can have a detrimental effect on a firm's investment levels. Furthermore, corporate finance theory suggests that where the finances of a company are stretched, this may impact on a company's or investor's decisions,³³ which may not be in the longer-term interest of customers who are served by a monopoly water company (and who cannot seek out alternative suppliers).

Some companies have stated that the impact of ODI underperformance payments is to reduce funds available to improve service. This is despite our objective of setting determinations with revenue allowances that should allow efficient companies to deliver levels of performance and hence equity returns that are aligned with our determination. This raises concerns about the ability of companies to make the necessary investment to provide a high quality service for customers and the environment and to bear the consequences of financial underperformance adjustments associated with a failure to do so. It also suggests some companies do consider there to be a link between financial resilience and operational performance.

2.4 Impacts on equity investment in the sector

2.4.1 Respondents' views

Several respondents were concerned that the modified cash lock-up conditions may deter equity investors as a higher trigger was perceived as being likely to increase regulatory risk, or introduce uncertainty or volatility to dividend payments. In each of these instances company and investor respondents tended to cite the need for an increased allowed return to

³² Economic Insight, [Need for gearing recovery – A report for Heathrow Airport Limited](#), Mar-2021, section 3.1

³³ See for example, Brealey, Myers and Allen – Principles of Corporate Finance (10th Edition) 2011 pp.452-455.

compensate for the perceived increase in risk. In support of their views, seven companies³⁴ provided an impact assessment prepared by KPMG.³⁵

2.4.2 Our views on the impacts on equity investment

The regulatory regime aims to align the interests of customers and investors through the implementation of incentive mechanisms that align efficiency and service performance with the equity return. We are clear that dividends are an important part of the equity return to investors and we support the payment of dividends that reflect performance delivered to customers and the environment.

Outperformance provides capacity for companies to pay higher dividends than would otherwise be the case but we would expect dividend payments to be lower where companies underperform or where this is needed to align with the long-term financing needs of the company. It is important that the regulatory system adequately protects customers from the consequences of a company's decisions in such cases, particularly where financial resilience is already weak.

Our licence modifications have no material impact on companies who maintain resilient financial structures, and whose dividend decisions reasonably reflect the performance of the company in delivering services to customers and the environment. The modifications are expected to have an impact on companies who do not maintain financially resilient structures or whose dividend decisions do not reasonably reflect the performance of the company. But they should not reduce the long-term value of the company such as to have a material impact on investors with long-term investment horizons.

Indeed, the licence modifications may increase the attractiveness of the sector to investors with long-term investment horizons, to the extent that they contribute to encouraging companies to maintain adequate levels of financial resilience. This is because, as explained above, weak levels of financial resilience carry reduced levels of headroom and a reduced ability for companies to withstand financial shocks. This increases the risk that resources are diverted to meet a company's short-term financial resilience objectives and away from the requirement to deliver expected levels of service or investment for customers and the environment.

We expect the sector to continue to be attractive to investors with long-term investment horizons given relatively predictable, low-risk, index-linked revenue allowances and the opportunity for RCV growth. The modifications should help to improve stakeholder confidence

³⁴ Anglian Water Services Limited, Northumbrian Water Limited, South East Water Limited, Southern Water Services Limited, Thames Water Utilities Limited, Wessex Water Services Limited and Yorkshire Water Services Limited

³⁵ KPMG LLP, [Financial Resilience: Impact Assessment](#), 29-Sep-2022

in the regime, which will also support long-term value of the sector. We note also that the decisions set out in this decision document have been signalled since publication of our discussion paper in December 2021. Since then, the market values of listed companies have aligned with, or been greater than, the long term average market-to-asset premia of 1.1x, suggesting the sector remains attractive to investors.

KPMG considered our consultation proposals would lead to an increase in the return required by investors because: water company stocks could become less attractive to certain groups of investors who prefer stable dividends; there would be increased restrictions on achieving the optimal capital structure; it may result in company managers making inefficient decisions to invest; and further distortions would be introduced due to the perceived impacts on the allocation of value between debt and equity. We comment on these points below. They fail to recognise that the cash lock-up only applies where financial resilience is weak.

KMPG also fails to recognise that the successful operation of an effective incentive-based regulatory regime requires that the interests of investors are aligned with customers, such that equity returns, and the dividends paid from those equity returns, reflect reasonable return expectations and performance over time. In these circumstances there may well be reasons for dividends to be reduced (or indeed increased to reflect outperformance), such that they no longer align with past dividend payments. This challenges the notion that underpins KPMG's quantification exercises based on dividend signalling, preference shares³⁶ and duration of cash flows that dividends should not be adjusted over time to reflect performance or financial needs.

We address wider concerns about the application of the modified cash lock-up and dividend policy licence condition through the publication of a draft information note and application of the consents guidance in appendices A2 and A3.³⁷

Investor preferences – KPMG state that utilities are considered to be income/dividend stocks that provide stable dividends and that if dividends are restricted, utilities become less attractive.

We agree that relatively stable dividend profiles are attractive to water sector investors with long-term investment horizons. For customer confidence in the regime to be maintained returns to investors, including dividend payments, should reflect performance delivered, as referenced above. If dividends are artificially smoothed such that they are not reflective of

³⁶ Preference shares form only a small part of the financing of the sector for a small number of companies and largely reflect historical financing arrangements.

³⁷ We consider that sufficient detail is provided in our decision document for companies to properly understand the modifications and their effect without reference to the guidance; the draft dividend guidance is intended to help stakeholders understand the factors we will consider in assessing compliance with the dividend licence condition and the draft guidance on cash lock-up requests is intended as a supplement to our existing consents guidance, to assist companies understand how we will approach such requests including the procedure and information we require in order to make our decision. We expect to follow usual regulatory practices if there were any future update to the either guidance.

actual company performance or financing needs, then the company may not have the ability to continue such dividends in the future.

Resilient companies are likely to have less volatility in their equity returns and be better able to provide stable dividend yields as they can accommodate the impacts of regulatory performance adjustments that reflect company performance. Therefore our licence amendments should improve the stability of dividends over the future by improving the financial resilience of a company.

Finally, if a company's weak level of financial resilience or operational underperformance is the result of the payment of excess equity returns in the past that were not reflective of the performance or ongoing financing needs of the company, there may be a need to rebalance equity returns to ensure they are reasonable, reflecting the objective of maintaining long-term financial resilience.

Adopting the optimal capital structure and increased cost of capital – KPMG, and some other water companies, state that the licence modifications mean companies will not be able to choose their optimal leverage levels, with the result that the required cost of capital will increase.

Water companies and their investors are responsible for the regulated company's financing and capital structure within the constraints of our price determinations, company licences and company law. As a result the companies that we regulate have adopted a variety of capital structures, in some cases with debt levels well in excess of the levels used in the notional structure used to set our price control determinations.

Our licence modifications do not define the capital structures that companies should adopt, and water company boards continue to have autonomy over their financing choices within the constraints stated above. Where companies with weak levels of financial resilience need to strengthen their financial position and avoid cash lock-up, we consider that to be a matter for the company and its investors where we would expect companies to be considering carefully their financial resilience position in any case. Any increase in the required cost of capital that is perceived to result from the licence modifications is therefore in line with the financing cost we allow, which is sufficient for an efficient company with the notional capital structure to maintain adequate levels of financial resilience.

Efficiency of management actions and agency costs – KPMG set out that agency theory suggests leverage and required distributions act as a financial discipline on management, preventing them from making inefficient NPV negative investments. It suggests that restricting dividends could increase agency costs³⁸ and hence the required return.

³⁸ Agency costs are an increase in the costs of a business arising from management (the agent) making decisions not aligned with objectives important to shareholders (the principal), e.g. exercising less financial discipline.

If there is a perceived increase in agency costs, this applies only to the company that has triggered its cash lock-up licence conditions or has considered that it needs to restrict dividends to reflect poor levels of performance or its financing needs. In these circumstances it is reasonable to expect the company to retain cash to fund ongoing investment programmes, necessary performance improvements or to strengthen financial resilience. Moreover, in the water sector, which is characterised by significant investment needs and hence RCV growth, the risk that a company with weak levels of financial resilience may use withheld dividends to invest in NPV-negative projects is very limited. It also implies that management decision making is inherently irrational and would not take a wide range of issues into consideration in making investment decisions.

Allocation of value across debt and equity – KPMG argue that the licence modifications result in a reallocation of risk and cash flow rights between debt and equity providers.

We agree that, for companies whose financial resilience is at risk as a result of their past financing choices (including choices made about their capital structures) or ongoing poor performance, the licence modifications, once implemented, would reduce the likelihood that financial resources are transferred to equity investors. However, this is in the context of circumstances where the financial resilience of a company is at risk, not in circumstances where a company maintains a resilient structure, and is, in our view, appropriate.

2.5 Impact on customers

The licence modifications benefit customers by reducing the chance that a company might seek to defer necessary, or required, investment as a result of a weak financial resilience position, which may then have consequences in terms of the cost and service provided to customers over time (or which delays the benefits from investment that might otherwise accrue).

KMPG omit to consider these benefits. Instead, in their impact assessment, KPMG assume that the key motivation is a reduction in the probability of bankruptcy. It notes the potential externality associated with bankruptcy, is that some costs are borne by customers or taxpayers. It suggests that without other externalities, investors' and companies' risk appetites should align with customers, and if they do not, we should adjust performance incentives. This misunderstands the aims of the licence modifications, which is not solely about avoiding bankruptcy. As explained above, weak financial resilience creates risks of service issues or life-cycle cost increases well ahead of bankruptcy. Given our incentive-based regime this may reduce returns in the long-term. But we are concerned that there are nevertheless some instances of short-term behaviour, which may not be aligned with customers' interests.

KPMG also set out that an increase in the cash lock-up trigger could benefit customers if it incentivises companies to hold higher credit ratings, thereby reducing the cost of debt. Our decision to amend the cash lock-up trigger is not aimed at reducing the cost of debt, and does not require resilient companies or companies with credit ratings that are aligned with the target for the notional capital structure in a price determination to hold higher credit ratings; it is targeted at strengthening the regulatory protections where financial resilience is weak or at risk.

We note that our proposals were considered by a credit rating agency to be credit positive for regulated companies.³⁹ Further, if companies target higher credit ratings, this could lead to lower borrowing costs over time which could be passed to customers *if* this impacts on the benchmark used to set the cost of debt. However such impacts are uncertain and any impact on borrowing costs is not a core reason or objective of the licence modifications.

Overall, we do not expect there to be any material impact on the allowed cost of capital. Our approach to allowed returns focuses on an efficient company maintaining adequate levels of financial resilience. To the extent there are any increases through an increase in the cost of equity, these may be offset by reductions in the cost of debt and will be outweighed by the benefits to customers outlined above.

2.6 Link to our duties and the strategic policy statements

Some respondents to our Consultation challenged that our proposals were not consistent with our duties, and South East Water challenged that our Consultation made no reference to our strategic priorities⁴⁰. Our consideration of these issues is set out below.

We consider that our decision is consistent with our duties taken in the round. We summarise this below by reference to our primary duties arising from section 2(2A) of the WIA91 and it is also apparent from our assessments of the representations made by respondents to our Consultation, and reasoning, set out throughout this document which have been made with those duties in mind.

Consumer duty (section 2(2A)(a)) – the regulatory ring-fence comprises a set of licence conditions that aim to protect the company and ultimately the interests of current and future customers from the actions of the group and to minimise the impacts on customers of a company's financial arrangements. Strengthening the regulatory ring-fence protections will further protect water customers from the risks and consequences of financial distress and weak financial resilience. Encouraging companies to align dividend policies with service

³⁹ Moody's – Sector in depth – Ofwat focuses on financial resilience as regulatory regime evolves, 14-Feb-2022; Moody's, Regulated Water Utilities – United Kingdom: Ofwat's strengthening of ring-fence positive for OpCos, but negative for HoldCos, 29-Jul-2022

⁴⁰ As set out in the UK and Welsh Governments' strategic policy statements, SPS.

delivered to customers and the environment is consistent with the expectation that companies' incentives should align with the interests of customers and the environment.

Duty to secure that companies properly carry out their functions (section 2(2A)(b)) – companies must maintain access to debt and equity finance to deliver significant investment programmes and in doing so, deliver their functions. It is a minimum expectation that companies should be able to properly carry out their functions; as noted elsewhere, encouraging companies to maintain good levels of financial resilience mitigates the risks that companies are not able to deliver their functions both now and into the long term.

Financing functions duty (section 2(2A)(c)) – we interpret our financing duty as a duty to secure that an efficient company with the notional capital structure can finance its functions, in particular by securing reasonable returns on its capital. Our licence modifications aim to encourage companies to maintain financial resilience and take steps where necessary to strengthen financial resilience where this is at risk. We consider the licence modifications will support efficient companies to be able to access both debt and equity capital necessary to properly carry out their functions. We do not accept that equity investors will be deterred from investing in water companies.

Resilience duty (section 2(2A)(e)) – the licence modifications are aligned with the resilience duty. Financially resilient companies are better placed to take appropriate steps for the purpose of long-term planning and investment to enable them to meet, in the long term, the needs of their customers and the environment. This also links closely to our duties to protect customers' interests and to secure that companies can properly carry out their functions.

Strategic policy statements – the licence modifications are aligned with the UK government's strategic priorities for Ofwat⁴¹ which were published and updated in early 2022. Among other things, the UK government's strategic priority statement (SPS) for Ofwat guides us to promote efficient investment, protect and enhance the environment, deliver a resilient water sector, serve and protect customers – all of which our modifications will encourage.

Similarly, the Welsh Government's strategic policy statement⁴² sets an expectation for Ofwat to promote an appropriate focus on addressing long-term risks including environmental challenges, safeguarding long-term resilience and performance, and seeking to ensure that the timing of investment results in intergenerational equity. Again, our modifications are geared towards meeting these aims.

⁴¹ UK Government, [Policy Paper – The government's strategic priorities for Ofwat](#), last updated Mar-2022

⁴² Welsh Government, [Strategic Priorities and Objectives Statement for Ofwat \(SPS\)](#), last updated Jul-2022

3. Cash lock-up licence conditions

This section sets out our decision to amend the trigger for the cash lock-up licence condition.

3.1 Our Consultation proposal

Our Consultation proposed modifying the 'cash lock-up' licence condition⁴³ to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, from a trigger level of BBB-/Baa3 with negative outlook⁴⁴, with effect from 1 April 2025.

All companies have an existing cash lock-up licence condition except Wessex Water because the company did not consent to the otherwise sector-wide licence modifications made in July 2020⁴⁵.

3.2 Respondents' views

Responses representing 15 named organisations (including CCW, environmental bodies, Severn Trent, Welsh Water and Hafren Dyfrdwy) supported the proposal. 22 respondents (all representing companies or their equity investors) did not support it and one respondent did not comment on it.

A range of views were expressed in support of the cash lock-up proposal. These included views that:

- the current regulatory protections are not sufficient to protect the interests of customers and that the proposal will protect against the progressive weakening of the financial resilience of certain water undertakers;
- the proposals could reduce the risk of a deterioration in environmental performance in response to financial shocks;

⁴³ The cash lock-up conditions (conditions P27-28 in most licences) place 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.

⁴⁴ The trigger levels in licences prior to this decision were where the company holds either (i) one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is not an Investment Grade Rating; or (ii) an Issuer Credit Rating which is the Lowest Investment Grade Rating and the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or otherwise where the rating outlook of the Lowest Investment Grade Rating has been changed from stable or positive to negative.

⁴⁵ As explained in '[Conclusions on section 13 of the WIA91 on proposed modification to ring-fencing provisions](#)', July 2020, Wessex Water did not consent to modifications made to all other companies' licences at that time.

- the proposals will ensure companies can comfortably finance any underperformance payments and are resilient in the face of any fines that may be payable in relation to permit breaches;
- maintaining sufficient headroom will help companies to focus on improving operations and on investment priorities.
- CCW said it was difficult to understand why any company would decide not to accept the licence modifications given all companies targeted a rating stronger than 'BBB/Baa2 with negative outlook' for their actual structure at PR19; and
- Castle Water said that we should consider a trigger at an even higher level to reflect that price determinations are based on a target credit rating of BBB+/Baa1.

While we did not receive formal responses from debt investors, our engagement with representatives of debt investors found general support for all our proposals. The cash lock-up modifications are consistent with the views of the debt investors that we engaged with, all of whom suggested that a credit rating of BBB-/Baa3 was not appropriate for a UK water company over the long term.⁴⁶

Many company and equity investor respondents disagreed with our proposals. In addition to the general views about our proposals set out in section 2, views expressed on the specific mechanics of the proposed cash lock-up licence condition modifications fell into the following main categories:

Views that it is not appropriate for the trigger to operate at BBB/Baa2 with negative outlook. Reasons expressed included views that:

- there is little material distinction with regard to credit ratings within the BBB band, such that companies can continue to raise funds efficiently with a credit rating of BBB-;
- the current trigger of BBB-/Baa3 with negative outlook is clear and justified as the boundary between investment grade and sub-investment grade, at which point companies accept that they would have reduced access to capital markets.
- One respondent said that even if companies such as Southern Water had failed (i.e. entered special administration), customers would have been properly protected through existing licence protections. And our proposals did not show how the proposed provisions would have prevented the circumstances that Southern Water found itself in.

Reliance on credit rating agencies: several respondents suggested the proposals placed too much reliance on the views of the credit rating agencies. Many of these respondents quoted a [paper submitted by John Earwaker](#). Views expressed included that:

- credit ratings are too narrow a basis for triggering the cash lock-up conditions given that credit ratings do not map perfectly to financial resilience;

⁴⁶ An [anonymised report summarising the views expressed by debt investors](#) on the proposed licence changes can be found in appendix A2 of the July 2022 consultation.

- our proposal placed too much reliance on single credit ratings and hence the decision of individual credit rating agencies;
- we were considered to be 'outsourcing' or 'delegating' our functions to credit rating agencies despite instances showing agencies' opinions to sometimes be inaccurate – and not presenting the complete picture of financial resilience;
- credit ratings only look out 3 to 5 years (rather than the long term focus required of a financial resilience assessment);
- a focus on credit ratings would distract company boards;
- there is no single standard for credit ratings being monitored, i.e. we monitor a combination of corporate-level 'issuer' ratings and debt-specific 'issue' ratings;
- it is not appropriate to base the cash lock-up trigger on the lowest credit rating; and,
- raising the cash lock-up trigger would discourage companies from holding three credit ratings as a company would rather withdraw an outlier rating than enter cash lock-up.

3.3 Our view on the cash lock-up proposal and respondents' concerns

The purpose of our decision to amend the trigger for the cash lock-up licence condition is to strengthen the regulatory protections where companies have weak levels of financial resilience and to encourage companies to engage openly with us at an early stage, where financial resilience is at risk.

Our position remains as set out in our Consultation that the present cash lock-up trigger of BBB-/Baa3 with negative outlook in company licences allows water companies' financial resilience to decline too far before the existing licence protections are triggered. Distributions and other transactions can continue before companies have to engage in meaningful corrective actions or engage in discussions with us on the mitigations being planned or executed, as evidenced by the circumstances set out in section 2.3 above.

Our view that water companies should not operate at the lowest investment grade was supported by the large majority of respondents to our discussion paper and also supported in the views expressed by representatives of debt investors.⁴⁷ CCW, several environmental groups, and three water companies have expressed support for our Consultation proposal to amend the trigger for the cash lock-up licence conditions and in some instances it was suggested that the trigger should be amended to a higher level.

Many of the arguments set out in responses to our Consultation paper repeated arguments previously made by some of the water companies. In making our decision, we have considered carefully the views expressed in responses to our Consultation. We have taken into account our experience of regulating the sector and in representations made to us

⁴⁷ Ofwat, [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](#), Jul-2022, appendix A2.

during follow-up engagement. Overall, we consider our decision to amend the trigger for the cash lock-up licence condition is a proportionate response reflecting the evidence set out in the case for change section above (section 2). As explained in further detail below, we have amended our original proposal to include a grace period in order to respond to some of the concerns raised about the proposal. Again, we consider that this strikes a proportionate balance between the need to strengthen regulation and some of the points made by respondents concerning the weight placed on credit ratings. Our decision also includes a correction of a drafting error contained in the licence condition Consultation text, highlighted by a respondent, to clarify that cash lock-up will be triggered if a company has a rating which is at the lowest investment grade (i.e. BBB- or Baa3). It was clear in our Consultation that this was the intended effect of our proposal.

3.3.1 The distinction between investment grades

We recognise views that there is a stronger distinction between a credit rating that is within the BBB/Baa band and one that is sub-investment grade. However, we have not been convinced that this justifies not increasing the trigger for the cash lock-up licence conditions within the BBB/Baa band. This takes account of views expressed by the large majority of respondents to our December 2021 discussion paper that we should not expect water companies to operate at the lowest investment grade without greater regulatory intervention and evidence we cited in our discussion paper and Consultation, which included the following:

- default rates approximately double for a starting credit rating of Baa3 compared to Baa2, suggesting a material increase in credit risk between the BBB/Baa2 and BBB-/Baa3 credit rating categories;^{48 49}
- the ability of certain large debt investors to invest reduces at the lowest investment grade credit rating;⁵⁰
- debt spreads associated with a movement from BBB/Baa2 to BBB-/Baa3 are 2 to 4 times as great as those associated with a movement in credit rating from BBB+/Baa1 to BBB/Baa2; and
- the increase in spreads is materially greater for issuers with lower credit ratings at times of market disruption.

⁴⁸ Moody's Annual default study, 8-Feb-2022, Exhibit 36 and Exhibit 43; [S&P Global Ratings – 2020 Annual Global Corporate Default and Rating Transition Study](#), 7-Apr-2021, Table 26.

⁴⁹ And, as illustrated on Table 1, page 14 of [the July 2022 consultation](#), companies with a credit rating at BBB-/Baa3 have a higher probability of being downgraded to a sub-investment grade level.

⁵⁰ An [anonymised report summarising the views expressed by debt investors](#) on the proposed licence changes can be found in appendix A2 of the July 2022 consultation.

3.3.2 Incentivising early engagement

Some respondents expressed that it is not clear how our proposals would have prevented the circumstances set out in the Southern Water case study and that in any event the special administration regime provides sufficient protection to customers in cases of company failure.

While we cannot be certain whether the modified licence changes would, on their own, prevent similar circumstances arising in the future, we consider they would allow for and require more substantive engagement to occur earlier where financial resilience is identified as a risk. The revisions would also provide companies and their shareholders with stronger incentives to strengthen levels of financial resilience at an earlier stage when it starts to erode. In the case of Southern Water, under the current regime, it took many years of engagement before investors took steps to strengthen the company's financial position to the detriment of the company and its customers. Reliance on the special administration regime is not sufficient to protect customers' as it would allow for a prolonged and harmful period of declining resilience before the conditions for triggering it were met.

Circumstances have arisen, including in the case of Southern Water, where distributions were made while the company held a credit rating of BBB/Baa2 with negative outlook. The cash lock-up conditions as set out in our licence modifications would have triggered a requirement for the company to seek our consent to any distribution. It would have enabled us to prevent such a distribution if we considered that it may affect the company's ability to finance its regulated activities. This would have resulted in the company to having to engage substantively with us and with its investors on its plans to improve financial resilience and provided better protection to customers.

3.3.3 Usefulness of ratings in assessing financial resilience

Some Consultation responses suggested credit ratings may not map perfectly to financial resilience as we have defined it. We acknowledge that the primary users of credit ratings are debt investors and that credit rating agencies do not have a duty to customers. However, credit ratings provide an assessment of credit risk that is independent of the regulated company and hence relevant and valuable in an assessment of longer term financial resilience.

Some respondents were concerned that ratings only look out 3 to 5 years and that assessments of financial resilience should be looking at a longer time frame. We agree that financial resilience should look into the long-term, however, we also consider that if a rating agency is concerned that a risk may crystallise within 3 to 5 years, that is an indicator that there are issues that may need to be considered and addressed in the short to medium term, so that they do not continue to play out over a longer period.

We do not agree with views expressed in responses to our Consultation that the licence amendments should be regarded as outsourcing our regulatory powers. Existing cash lock-up provisions already rely on a credit rating assessment and we regard these as meaningful tools to help us assess financial resilience. As stated below, we will also take into account representations made to us by companies as to whether cash lock-up should be disapplied. We also note that each company⁵¹ 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, an Issuer Credit Rating which is an Investment Grade Rating so there is already an acceptance of the relevance of credit ratings as part of an assessment of financial resilience. The licence modifications also align fully with the view expressed to us by most respondents to our discussion paper that we should not expect companies to operate at the lowest investment grade.

Furthermore, we would, in any case, expect companies to engage with us to discuss matters related to their financial position as part of our regular engagement and review of company circumstances under our monitoring financial resilience framework, and our more intensive engagement where financial resilience is at risk. In these circumstances we would expect that companies explain the risks and the possible reasons why the cash lock-up conditions might trigger well before the condition is triggered.

Some concerns were raised that we should not base the cash lock-up trigger on the lowest credit rating held by a company, with suggestions the trigger should be set by reference to the average or highest credit rating. However, the existing licence condition is based on a rating which is either not an investment grade rating or at the lowest investment grade (and on review for possible downgrade or has a negative outlook), which was accepted by companies when introduced into company licences. We do not consider it appropriate to weaken the existing regulatory protections by triggering action too late, as might be the case if we were to rely on the highest or average rating.

Furthermore, the requirement to maintain a second credit rating (as set out in section 5) mitigates the risk of over-reliance on the views of a single credit rating agency.

3.3.4 Introduction of a grace period

Our final decision introduces a three-month grace period between a company receiving a rating of BBB/Baa2 with negative outlook and the application of the cash lock-up conditions. This reflects respondents' views that raising the trigger for cash lock-up may exacerbate potential concerns about the weight attached to the decisions of individual credit rating

⁵¹ Wessex Water has had a slightly different requirement but will have the same investment grade credit rating requirement as all other companies following the modifications that we are now making to its licence.

agencies. For example the concern that such decisions may not be fully reflective of a company's financial resilience and related risks.

Though we are clear that credit ratings are a relevant and useful tool in assessing financial resilience, the grace period allows a company to make a submission as to why it believes it should not be in a cash lock-up before that cash lock-up takes effect and to submit a case supporting its position. If we are satisfied that the evidence provided is such that acceptable levels of financial resilience will be maintained, we may determine a cash lock-up should not apply. This determination might be subject to conditions.

Ultimately, the outcome of our assessment following a request made during a grace period would be:

1. cash lock-up applies; or
2. disapplication of the cash lock-up provisions (for a defined time period and/or with other conditions attached); or
3. an extension of the grace period, for a limited time, to allow for further evidence to be presented by the company and assessed by us.

While the default expectation is that the grace period would apply for the full three-month period set out in the modifications, there may be circumstances where we make a determination to shorten the grace period once triggered. We may make such a change on our own initiative. We consider that the ability to reduce the period, in appropriate circumstances, is necessary in order to protect consumers, for example, if a distribution during that period would be highly detrimental to the financial state of the company. In such circumstances, the company would enter cash lock-up at the end of the shorter or longer period. In all instances the dividend policy licence condition set out in section 4 would continue to apply.

A grace period would not apply to any downgrade to a lower credit rating than this, i.e. BBB-/Baa3⁵² or lower, where the cash lock-up would automatically apply.

To help companies understand our expectations about the operation of the grace period and the process for seeking a determination to disapply the cash lock-up provision, we set out draft guidance in appendix A3. The guidance also provides expectations about the circumstances where a company wishes to put forward a consent request while in cash lock-up to make a transaction that would otherwise be prohibited. The guidance is intended to help companies and stakeholders to understand how we intend to apply the licence provisions and should be read in conjunction with our [consents guidance](#)⁵³.

⁵² Regardless of outlook, designation, "Credit Watch" or "Rating Watch" status.

⁵³ [Guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework](#), Feb-2020

Overall, we remain clear that it is a fundamental requirement of companies that they take proactive steps to manage their financial resilience and, linked to this, engage early with us if they are experiencing challenges that could jeopardise their ability to deliver for customers and the environment. Including a grace period at the modified cash lock-up trigger level reinforces our intended aim of encouraging early engagement and enables our wider assessment of financial resilience to be taken into account prior to implementing cash lock-up at BBB/Baa2 with negative outlook, including enabling us to consider the reasons for the credit rating agencies' decisions.

The licence amendments set out here are intended to strengthen the regulatory protections in addition to encouraging that early engagement. In the circumstances of the modified cash lock-up conditions, it should **not** be inferred that a company should only engage with us when it hits the trigger credit rating level.

We also consider that the inclusion of a grace period would allow an effective regulatory response where exogenous factors trigger the cash lock-up of several companies in the sector at the same time. In this example, the grace period provides time for us to consider whether or not the cash lock-up conditions should apply, reflecting the specific circumstances that are common across the companies in question.

The grace period allows for a review procedure to be followed rather than automatically placing a company in cash lock-up. Nevertheless, we expect the underlying purpose and intent of the modified cash lock-up conditions to be respected and for companies to engage with us and in particular to signal any intent to make a transaction that might otherwise be prohibited (were the cash lock-up to be in force), in advance of entering into that transaction.

3.3.5 Maintaining financial headroom

We understand that company boards may be concerned about the need to maintain financial headroom against the licence trigger. We consider our proposals would have no material impact on companies that maintain credit ratings that are aligned with, or stronger than the credit ratings used as the target for the notional structure in our regulatory determinations. Our view remains that we do not consider that resilient companies would need to increase levels of financial headroom.

3.3.6 Timing of application of cash lock-up licence condition, company focus, issuer rating and holding multiple ratings.

We recognise that there are circumstances where companies either have, or have had, credit ratings that would trigger either the grace period or immediate cash lock-up and we

acknowledge that companies with lower credit ratings may need to consider steps to improve their levels of headroom over time. To allow companies to make adjustments to their financing arrangements, if they consider this is necessary, the modified cash lock-up licence condition will be effective from 1 April 2025, a period of over three years from when we first mooted proposals to strengthen the regulatory ring-fence in a discussion paper published in December 2021.

We note references in Consultation responses that a focus on credit ratings could distract company boards. However, we do not expect resilient companies to be impacted by our proposals. Consistent with the prudent operation of a company, company boards should rightly be focussed on addressing financial resilience when it is weak and should already take seriously any diminution in credit rating or negative watch designation. The licence amendments provide clear signals to company boards about our expectations on long-term financial resilience and in so doing improve the predictability of the regulatory framework. Investors and potential investors will have greater clarity about our expectations.

A few respondents suggested that it is problematic to use a combination of issuer and issue ratings as the trigger for cash lock-up as it means different companies are held to different standards.⁵⁴ The licence already defines 'Issuer Credit Rating' and companies are responsible for procuring their own ratings to align with this. We have also provided clarity to companies about the credit ratings we monitor for licence compliance purposes.⁵⁵ Our aim is to monitor credit ratings that reflect the creditworthiness of the company as a whole and, as part of our process of determining the credit ratings we monitor, companies may engage with us and make representations or provide evidence in respect of the relevance of particular credit ratings that we monitor for licence compliance purposes.

One respondent said that raising the trigger for cash lock-up discourages companies from holding three credit ratings as a company would rather withdraw an outlier rating than enter cash lock-up. This risk is present under the current system, which requires companies only to maintain one credit rating.

Finally, we note that the modification to the cash lock-up trigger only formalises what more financially responsible companies have already been doing when faced with financial resilience issues, as a matter of principle – i.e. engaging with us, early in the process, to explain the specific challenges they are facing and their mitigating actions.

⁵⁴ Issuer credit ratings are ratings assigned to a corporate entity and issue ratings are credit ratings assigned to a particular debt instrument issued by an entity.

⁵⁵ These letters are published on our website at: ofwat.gov.uk/regulated-companies/resilience-in-the-round/monitoring-financial-resilience/credit-ratings/

3.4 Our decision on cash lock-up

Our decision to modify the cash lock-up licence conditions has followed a period of extensive engagement with the sector and the consideration of alternative arrangements, as set out in the Impact Assessment in appendix A7. The licence modifications include minor changes to simplify the existing drafting (as shown in P28 below) and will raise the trigger for cash lock-up to BBB/Baa2 with negative outlook (from BBB-/Baa3 with negative outlook), subject to the application of a grace period which will apply when a rating is at one notch above the Lowest Investment Grade Rating (i.e. BBB at Fitch or Standard & Poor's or Baa2 at Moody's) and on negative outlook or designation as set out in Box 2. The licence modifications will take effect from 1 April 2025 to provide companies time to adapt, where necessary.

Box 2: Updated cash lock-up conditions in licences:

P28⁵⁶ The “Cash Lock-Up” provisions set out in paragraph P30 apply in any circumstances:

P28.1 where neither the Appointee **nor** 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 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is:

P28.2.1 not an Investment Grade Rating; or

P28.2.2 **at** holds an Issuer Credit Rating which is the Lowest Investment Grade Rating ~~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; or~~

P28.3 where (subject to any determination made pursuant to paragraph P29)⁵⁷ the Appointee or any Associated Company which issues corporate debt on its behalf holds one or more Issuer Credit Ratings and one or more

⁵⁶ Note precise paragraph numbering may be different depending on the existing numbering in Condition P of each company's licence.

⁵⁷ Note, adjustments have been made to the original July 2022 consultation text to accommodate the grace period at BBB/Baa2 with negative outlook. It was also identified that the licence wording was not capturing issuer credit ratings of BBB-/Baa3 and BBB-/Baa3 with negative outlook as intended, so this has been corrected.

such Issuer Credit Ratings is, and has been for a period of three months, at one notch above the Lowest Investment Grade Rating (one notch above being an Issuer Credit Rating of BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent) and:

P28.3.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P28.3.2 the rating outlook is negative.

P29 Ofwat may determine, either following the Appointee's written request or on its own initiative that:

P29.1 sub-paragraph P28.3 should have effect as if the reference to "a period of three months" was a reference to a shorter or longer period of time and, if so, what that period should be;

P29.2 the "Cash Lock-Up" provisions set out in paragraph P30 should not apply in the circumstances specified in sub-paragraph P28.3;

in either case subject to any conditions set by Ofwat, a breach of which will mean the "Cash Lock-Up" provisions set out in paragraph P30 apply.

4. The dividend policy licence condition

This section sets out our decision on the amendments to the dividend policy licence condition.

4.1 Our Consultation proposal

All companies have an existing licence condition that 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.

Our Consultation proposed modifying the dividend policy licence condition to require that dividend policies should embody the principles that dividends declared or paid should also take account of: service delivery for customers and the environment over time; current and future investment needs; and financial resilience over the long term.

4.2 Respondents' views

18 out of 38 named entities supported the proposal, 19 respondents did not support it and one respondent said they needed more information before they could support the proposal. Since the Consultation closed several MPs have voiced support for linking dividends to company performance.⁵⁸

In addition to all environmental representatives, Anglian Water, Hafren Dyfrdwy, Severn Trent, United Utilities, Welsh Water, Castle Water, CCW and Anthony Brown (MP) supported this proposal. Most respondents that expressed support either agreed or acknowledged that investors should receive returns that reflect the performance that their company delivers. Many supporters of the proposal especially agreed that dividends should align with environmental performance.

Key reasons for not supporting the proposals were that:

- some respondents considered we had provided insufficient evidence to justify the need for a licence change;
- investors could view the proposal as conferring the ability for Ofwat to control or oversee company dividend decisions, which could materially reduce the attractiveness of the

⁵⁸ Members of Parliament that have supported linking dividends to company performance – particularly on the environment, include: [Peter Aldous](#), [Dr Thérèse Coffey](#), Mark Menzies in addition to Anthony Brown who responded to the Consultation.

sector to equity investors, potentially constraining the availability of equity or leading to an increase in the cost of equity and higher bills for customers and so be inconsistent with our financing functions duty;

- our proposals were not necessary as they replicate factors that are already covered in other parts of the legal or regulatory framework including the UK Corporate Governance Code;
- our proposals may unduly distract boards who will focus on how to interpret the provision to avoid legal challenge; and,
- one respondent said that distributions to preference shareholders should not be included in the meaning of dividends for the purpose of the proposed condition.

4.3 Our view on the dividend policy licence condition and respondents' concerns

Equity investors earn their returns through dividends and through growth of the RCV. It is important that the water sector remains an attractive investment proposition to investors, and so overall equity returns, and dividend payments, that reflect company performance are important to the successful operation of an effective incentive-based regulatory regime.

Where dividend payments take appropriate account of performance for customers, the environment and investment needs including over the longer term, this improves the trust and confidence in, and legitimacy of, the water sector. It is appropriate that the monopoly providers of an essential utility whose revenue is paid for by customers should explain how their dividends take account of their performance.

This modification formalises expectations that we set at PR19 and which we continue to reflect in the final methodology for PR24, and that are reflected in the regulatory accounting guidelines (RAGs) and in our Board Leadership, Transparency and Governance (BLTG) principles.

Several companies have told us that, overall, they already take the factors we are adding to the licence condition into account as section 172 of the Companies Act 2006, 'Duty to promote the success of the company', places similar requirements on directors.⁵⁹ For most companies, therefore, a substantive change to their approach will not be required; the updated dividend policy licence condition will simply mean that dividend policies will have to set out how the company will link company performance and dividends, and how decisions taken in accordance with that policy have properly considered that link (as well as other

⁵⁹ Companies act 2006, [section 172 – Duty to promote the success of the company](#). This duty requires that a director, acting in good faith to promote the success of the company, will have regard to a range of considerations including 'the likely consequences of any decision in the long term', 'the need to foster the company's business relationships with suppliers, customers and others' and 'the impact of the company's operations on the community and the environment'.

matters set out in it). We consider this is consistent with directors' existing statutory duty under section 172 of the Companies Act 2006.

While companies did step up to better align their forward looking dividend policies with our expectations through the PR19 price control process, our 2022 MFR report identified that more than half of companies (nine of the 17 that are subject to price controls) still fell short of our expectations on dividend policy and its application.⁶⁰ The MFR report sets out why we considered that disclosures did not provide sufficient transparency for stakeholders and in addition to this, for 2020–21 and 2021–22 we provided each company with feedback on how it met our expectations on dividends declared or paid.⁶¹

Companies still have work to do to demonstrate how their decisions take account of delivery for customers and the environment in their dividend policies and decisions. The amendment to the dividend policy licence condition will introduce further focus for companies to explain how their dividend policies and decisions align with the interests of customers, reflecting the privileged status of water companies in providing monopoly essential services – by increasing the focus in this area, and providing us with additional powers, the licence amendment is consistent with, and supports our financing functions duty. In section 2 we set out further detail to explain why the licence modifications are necessary and consistent with our duties.

Our licence modifications do not have the effect of the regulator stepping into the role of company boards. Company boards remain responsible for their dividend decisions taking account of the obligations and expectations placed on them. The licence modifications together with our expectations and the reporting requirements placed on companies will, however, allow all company boards to be more strongly held to account for their actions.

We do not agree that distributions to preference shareholders should be excluded in the meaning of dividends for the purpose of the condition. Their inclusion is critical as the provision would not be effective if companies could circumvent the requirements by choosing to structure more of their share capital as preference shares and making distributions to preference rather than ordinary shareholders, thus avoiding the licence requirement.

4.4 Application of the dividend policy licence condition

To support companies and their boards to understand our expectations about how they should consider, interpret and explain reported dividends, we set out a draft Information

⁶⁰ Ofwat, [2021–22 Monitoring Financial Report](#), pp29–33

⁶¹ Feedback letters sent to companies for 2021–22 'Monitoring Financial Resilience' have been published on our website alongside the [2021–22 MFR report: Anglian Water](#), [Affinity Water](#), [Bristol Water](#), [Dŵr Cymru](#), [Hafren Dyfrdwy](#), [Northumbrian Water](#), [Portsmouth Water](#), [Severn Trent Water](#), [South East Water](#), [Thames Water](#), [South Staffordshire Water](#), [Southern Water](#), [South West Water](#), [Sutton and East Surrey Water](#), [United Utilities](#), [Wessex Water](#) and [Yorkshire Water](#).

Notice containing guidance in appendix A2. This is intended to help companies comply with the updated dividend policy licence condition.

We intend the guidance to also demonstrate to shareholders including prospective investors that we have no intention of preventing well run companies that are delivering for customers from paying a reasonable level of dividends. We do not expect every regulatory target to be met before a dividend can be paid – a concern raised in discussions with some affected companies. Rather, we expect dividends to reflect performance in the round and over time.

4.5 Our decision on the dividend provision

We have decided to modify the dividend policy licence condition in all company licences as set out in box 3.

Box 3: Dividend policy licence condition

P32⁶² 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:

P32.1 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;

P32.2 that dividends declared or paid take account of service delivery for customers and the environment over time, including performance levels, and other obligations; and

P32.3 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.

⁶² Note precise numbering may differ depending on existing paragraph numbering in Condition P of companies' licences.

5. Credit rating licence requirements

This section sets out our decision to amend company licences to require companies to maintain two credit ratings and to notify us of changes to their credit ratings.

5.1 Requirement to maintain two credit ratings

5.1.1 Our Consultation proposal

All regulated companies except Wessex Water have the following credit rating requirement.⁶³

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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.

Our Consultation proposed modifying the licence to require companies to hold two Issuer Credit Ratings, instead of one, or to seek our agreement to an alternative arrangement.

5.1.2 Respondents' views on the rating requirement

Overall, there were high levels of support for the proposal to maintain two credit ratings. 18 out of 31 named respondents that commented on the proposal expressed their support. Nine entities did not support it and only South West Water was strongly against the proposal. Seven respondents did not comment on the proposal.

Companies in support of the proposal noted that holding two credit ratings is generally considered best practice, or that it is sensible (or ought to be an obligation). One respondent said having more than one credit rating should provide a more balanced view of credit quality, as the methodology between credit rating agencies differs.

The two main reasons provided for not supporting the proposal were that it is unnecessary, or it is not effective or proportionate and that the additional cost of the measure, particularly for

⁶³ Precise paragraph numbering may vary between companies' licences. Wessex Water's licence requires it to use 'all reasonable endeavours' to maintain an investment grade rating. Section 6 sets out our proposal to update Wessex Water's licence to align the ring-fencing provisions (including the credit rating provision) with other companies'.

⁶⁴ 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. The investment grade credit rating condition comes into force in South West Water's licence no later than 31 March 2025.

smaller companies, was disproportionate or burdensome. Two respondents said that their support was contingent on Ofwat adequately remunerating the regulated company to hold two credit ratings.

Two respondents suggested that the licence should include the criteria for allowing only one credit rating to be maintained. One of these said such criteria would remove the need for formal written permission and would reduce the requirement for additional representations.

5.1.3 Our view and decision on the credit rating requirement and respondents' concerns

We agree that it is generally best practice for a company to maintain two credit ratings. Having a range of views on financial resilience is especially helpful where rating agencies hold diverging views or come to different conclusions based on differing methodologies. 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 December 2021 [discussion paper](#) – and our [2021 MFR report](#) – expressed 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 the motivations for such withdrawal, particularly in circumstances where financial resilience is weak. A requirement to maintain two investment grade issuer credit ratings (from two different rating agencies) rather than one, would help to address such concerns in addition to providing useful extra information to us and other stakeholders.

13 of 16 water companies that we regulate already hold at least two issuer credit ratings. We consider therefore that updating the licence requirement so that companies must maintain at least two investment grade issuer credit ratings should not represent a significant increase in regulatory burden or cost impact, but would act to mitigate the risk that companies remove credit ratings that are at risk of triggering the cash lock-up conditions.

Our Consultation acknowledged that the costs of maintaining two credit ratings may be disproportionate for smaller companies. We will consider alternative arrangements where companies provide convincing evidence that it would be disproportionate for them to obtain two credit ratings. We consider it beneficial to retain the flexibility to consider requests on a case by case basis rather than by setting qualifying criteria in the licence that allow a company to retain only one credit rating. Such a flexible approach will allow us to accommodate changing circumstances.

To request an alternative arrangement companies should submit a request using our published consents guidance⁶⁵ providing reasons why only one credit rating is in the best interests of their customers. It is worth noting, however, that should a company only hold a single credit rating, if it is downgraded to a cash lock-up trigger level then it may lose the benefit of there being another rating agency opinion to support a request to disapply the cash lock-up conditions.

5.1.4 Our decision on maintaining two credit ratings

We have decided to modify the credit rating condition in all company licences as set out in box 4.

Box 4: Updated credit rating provision

P26⁶⁶ 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.

5.2 Requirement to notify Ofwat of credit rating changes

5.2.1 Our Consultation proposal

All regulated companies except Wessex Water have a requirement to notify us about 'material issues' (as determined by the board) but they have no specific requirement to notify us about changes to their credit rating. For example, where there is a change in credit rating or, for example, the withdrawal of a credit rating, it is helpful to understand the reasons for the change where relevant to an assessment of financial resilience.

As a result, given the importance of credit ratings as an indicator of a company's financial resilience, our Consultation proposed setting an explicit 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) with reasons for the change, where applicable.

⁶⁵ [Guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework](#), Feb-2020

⁶⁶ Note precise numbering may differ depending on existing paragraph numbering in Condition P of companies' licences.

5.2.2 Respondents' views on credit rating notifications

There was, overall, a high level of support for this proposal. 25 out of 38 named respondents supported the proposal, two entities saw limited benefit in it and eleven did not comment on the proposal.

Key reasons for supporting the proposal were that the company would notify Ofwat anyway, so the proposal does not pose an extra burden and that the proposal is proportionate given credit ratings are an important factor in determining financial resilience.

The main reason provided for not being fully supportive of the proposal was that there is limited value in it given the information is already public.

5.2.3 Our view and decision on credit rating notifications and respondents' concerns

As stated in the Consultation, we consider that notification of any changes to credit ratings supports timely engagement between companies and Ofwat on issues of financial resilience and the effective operation of the cash lock-up licence condition, where necessary. We do not 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 provision (e.g. if the rating impacts the cash lock-up trigger).

In addition, while we acknowledge that credit rating data is publicly available, we do not always get notification directly from the credit rating agencies when a rating changes so a notification from the company, alongside an explanation from the company of the reasons for any change and, where appropriate, the action it is taking as a result, is useful and relevant to an assessment of financial resilience.

5.2.4 Our decision on notification of changes to credit ratings

We have decided to make it an explicit licence requirement for companies to inform us of all credit rating changes as set out in box 5, and where appropriate, to provide us with reasons for a change or the withdrawal of a rating.

If there is a change in a credit rating that we are not monitoring for licence compliance purposes, we would still expect to engage the company to understand the drivers for any changes.

Box 5: New credit rating notification provision

P27⁶⁷ 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 5 working days of:

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

P27.2 a new Issuer Credit Rating being obtained;

P27.3 the withdrawal of an Issuer Credit Rating.

⁶⁷ Note precise numbering may differ depending on existing paragraph numbering in Condition P of companies' licences.

6. Wessex Water licence conditions

This section sets out our decision to align the ring-fence licence conditions of Wessex Water with those of other companies in the sector.

6.1 Our Consultation proposal

In July 2020 we made modifications to all company licences, with the exception of Wessex Water, to bring their regulatory ring-fencing licence conditions up to the industry-leading standard⁶⁸.

Our Consultation proposed to update and align Wessex Water's licence with that of all other companies in the sector. We explained that although we do not currently have any concerns about the financial resilience of Wessex Water, the financial position of any company can change over time, and we 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 the customers of all other companies.

6.2 Respondents' views on Wessex Water's licence amendments

Only Wessex Water did not support this proposal, eight entities explicitly supported it (including CCW, four water companies, and 3 investor responses) and 29 did not comment on the proposal.

Supporters of the proposal said they did so because they agree with the principle that licences and the application of regulatory policy should be consistent across the sector and that the same standards should apply to all the water companies.

Wessex Water said that it continued to disagree with the proposal to align their licence with that of all others in the sector, as it did in 2020, because the Consultation did not raise any new evidence or justification for the proposal. Specifically, Wessex Water set out that its owner, YTL, has held its equity interest in the company for the longest period of any single owner of a water company in the UK and has been a responsible steward of Wessex Water and its financial resilience since 2002. The company added that, on acquisition, YTL committed to maintain a simple financial structure with gearing below 70% and that the commitment remains unchanged. Wessex Water expressed that it has resisted any temptation to increase

⁶⁸ 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 ring-fencing provisions](#))

gearing levels and to use swaps and derivatives, and so explained that it could not understand why we proposed the licence modifications. It suggested also that we had not provided evidence to explain why the current conditions are not fit for purpose and challenged on grounds that we did not pursue our proposal in 2020 by taking the matter to the CMA.

Wessex Water went on to agree with us that financing is the duty of the board and state that under YTL's ownership the only credit rating downgrade incurred has been one related to changes made to the regulatory framework at PR19. Wessex Water added that their dividend policy already explicitly includes all the factors that we wish to add to the dividend policy licence condition.

Overall, Wessex Water considered the proposed modifications were unnecessary and did not reflect the full scope of the board's statutory duties.

6.3 Our view and decision on Wessex Water's licence and its concerns

We welcome the commitments set out by Wessex Water and YTL to maintain a simple and transparent financial structure and the statements made about financial resilience. However, we continue to consider it appropriate to modify its licence for the reasons set out in our July 2022 Consultation and 2020 licence modification consultation and decision documents. In particular, while we do not currently have concerns about the financial resilience of Wessex Water, we recognise that the financial position, guiding financial policies and the ownership of any company can change over time. We also continue to consider it appropriate that all customers in England and Wales should have consistent regulatory ring-fencing protections included in their company's licence both now and in the future. This is an important safeguard for customers. We have therefore decided to update Wessex Water's licence.

A summary of the licence modifications is set out below and Wessex Water's updated licence wording is in appendix A5. Our reasoning for making these licence amendments remains as set out in '[Consultation under section 13 of the Water Industry Act 1991 on proposed modification to the largest licences for ring-fencing](#)' (May 2020), with our concluding views in the July 2020 conclusions document '[Conclusions on section 13 of the WIA91 on proposed modification to ring-fencing provisions](#)', a summary of our detailed reasoning is in appendix A6.

The licence modifications that we will now bring into Wessex Water's licence are to:

- insert a new requirement to inform us when the regulated company becomes aware of arrangements which may lead to a change of control;

- insert a new provision that enables us to issue a direction to the company requiring it to enforce its Ultimate Controller’s undertaking;
- modify the requirement to use “reasonable endeavours” to maintain an investment grade credit rating, to a requirement that companies “must ensure” that an investment grade credit rating is “maintained at all times”;
- adjust the definition of Issuer Credit Rating to clarify which ratings will be used as regulatory markers for the purposes of triggering cash lock-up;
- insert the cash lock-up licence provisions into the licence;
- update the requirement and definition for Ring-fencing Certificate, so that the requirement is consistent across companies;
- insert a requirement to report any circumstance that might materially affect the company’s ability to carry out its Regulated Activities to Ofwat as soon as possible; and
- simplify some of the wording to be consistent with earlier simplification changes made to licences.⁶⁹

These modifications will have effect from 17 May 2023, with the updated cash lock-up licence provisions described in section 3 having effect from 1 April 2025, in line with the implementation date for all other companies.

In summary, overall, the modifications to 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. Some modifications have the effect of simplifying Wessex Water's licence and ensuring the wording is consistent with that of other water company licences.

The modifications to its licence bring it up to the industry leading standard. In order to achieve a broadly consistent regulatory ring-fencing framework across England and Wales, we will 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 we will add or update certain relevant definitions in Condition A.

Our July 2020 decision document expressed our disappointment that Wessex Water had not consented to the licence changes made at that time, we further stated that we would consider how to proceed. As Wessex Water did not consent to the July 2020 ring-fencing modifications, in the circumstances, and given the further cross-sector work we anticipated in this area, we decided not to proceed with the Competition and Markets Authority (CMA) process that would have been required, if we were to pursue this licence modification. Taking account of our broader priorities and our work on financial resilience, together with the Consultation process and stakeholder engagement with companies which we are concluding

⁶⁹ Our modifications to Wessex Water's licence also align with the conventions we developed during our 2018 licence simplification process to make the licence easier to follow and understand for all stakeholders. 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.](#)

with this decision document has been part of that process of helping companies, including Wessex Water, to understand our concerns and our plans to strengthen financial resilience in the water sector.

CCW, the independent statutory body representing water customers in England and Wales, has also expressed disappointment that Wessex Water did not accept the 2020 licence modifications, expressing its expectation that Wessex Water customers should have an equivalent level of protection to all other customers in England and Wales.

We consider that the reasoning for making each specific licence modification as set out in our July 2020 consultation and conclusions documents and July 2022 Consultation (and summarised above) 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 in this paper for the benefit and protection of its customers.

A1 Responses to our July 2022 Consultation

We received 27 responses supported by 38 named entities. The [responses are published on our website](#). Respondents comprised:

- Sixteen regulated water companies:
 - Anglian Water;
 - Dŵr Cymru;
 - Hafren Dyfrdwy;
 - Northumbrian Water;
 - Severn Trent Water;
 - South West / Bristol Water;
 - Southern Water;
 - Thames Water;
 - United Utilities;
 - Wessex Water;
 - Yorkshire Water;
 - Affinity Water;
 - Portsmouth Water;
 - SES Water;
 - South East Water;
 - South Staffs Water;
- Thames Tideway;
- Castle Water;
- CCW;
- Anthony Browne (MP).
- Seven private equity investors or investor representation groups:
 - British Columbia Investment Management;
 - Global Infrastructure Investor Association (GIIA);
 - A joint response from Morrison & Co and Vantage;
 - Macquarie; and
 - A joint response from Infrared Capital Partners, DIF Capital Partners and Allianz.
- The Welsh Rivers Trust;
- Wildlife and Countryside Link, supported by eight Link members:
 - The Wildlife Trusts;
 - RSPB;
 - The Rivers Trust;
 - Angling Trust;
 - Surfers Against Sewage;
 - Institute for Fisheries Management;
 - British Canoeing; and
 - Amphibian & Reptile Conservation.

A2 Information notice – guidance on factors Ofwat considers in assessing dividends declared or paid

DRAFT – for comment by 2 May 2023

20 March 2023

Introduction

Equity investors have an essential role to play in providing the finance necessary for companies to deliver their investment programmes, to encourage companies to be efficient and to meet the levels of service expected by customers and wider stakeholders. Adequate levels of equity in a company's financing structure, together with equity returns that reflect company performance, are important to the successful operation of an effective incentive-based regulatory regime and to maintaining stakeholder trust and confidence. This in turn is important to attracting equity to the water sector.

Decisions about the declaration and payment of dividends are the responsibility of the board of each company, taking account of relevant legal obligations.^{70,71} Company boards are also responsible for ensuring that dividend policies meet the licence requirements and that any dividends that are declared or paid are made in accordance with both the licence conditions and the company's dividend policy.

As monopoly providers of essential public services with inflation-linked revenues paid for by customers, it is critical that companies can demonstrate that decisions on dividends reflect delivery of the company's wider obligations. To this end, we expect dividends to take account of a range of matters including service delivery for customers and the environment, current and future investment needs and financial resilience over the longer term. As of 17 May 2023, Condition P of companies' licences requires that any dividends declared or paid by companies are made in accordance with dividend policies that comply with the principles set out in the box below.

Dividend policy licence condition

The Appointee shall declare or pay dividends only in accordance with a dividend policy

⁷⁰ The payment and disclosure of dividends is governed by company law, accounting standards, and guidance from the Financial Reporting Council, FRC.

⁷¹ Our [Board leadership, transparency and governance principles](#) include a guiding provision that companies should publish an explanation of dividend policies and dividends paid and how these take account of delivery for customers and other obligations (including to employees). We look at whether companies have considered how their dividend decision demonstrates that they are meeting the licence objectives that underpin these principles. Disclosure requirements relating to dividends are also set out in our Regulatory Accounting Guidelines.

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.

Expectations

In order to maintain public trust in the water sector, it is imperative that each company is transparent to customers and other stakeholders about its dividend policy and how decisions leading to the declaration or payment of any dividend align with that policy, including how delivery for customers and the environment has been taken into account.

We set out expectations in relation to reasonable dividend policies and these expectations may be updated from time to time. We last set out our expectations for a reasonable base dividend and dividend policy for the 2020–25 period in the PR19 final determinations and the expectations that will apply for the 2025–30 period in the PR24 final methodology⁷². This guidance and our expectations are not intended to conflict with one another, although we may update our guidance or expectations drawing on findings from our ongoing monitoring of the sector.

Reporting and compliance

Our dividend disclosure requirements are reflected in the regulatory accounting guidelines (RAG 3 – Guidelines for the format and disclosures for the annual performance report), which are updated from time to time.⁷³ RAG3 requires companies to provide sufficient explanation within the annual performance report such that a reader will understand the process

⁷² Ofwat, '[Creating tomorrow, together: Our final methodology for PR24](#)', December 2022, Chapter 9, pp. 129–130, and Ofwat, '[Creating tomorrow, together: Our final methodology for PR24, Appendix 10 – Aligning risk and return](#)', Dec-2022, Section 9, pp. 62–65

⁷³ The current reporting accounting guidelines are published on the [Ofwat website](#). The latest dividend disclosure requirements are set out in '[RAG 3.12 Guidelines for the format and disclosures for the annual performance report](#)', Feb-2021. These guidelines will soon be updated following '[RAG 3.14 – Guideline for the format and disclosures for the annual performance report Draft for consultation](#)', Feb-2023.

undertaken by the board in determining the appropriate level of dividend and the basis of their decisions.⁷⁴

Our intended approach is to report on each company's compliance with the dividend policy licence condition as part of our review of companies' annual performance reports in our annual [MFR report](#). We may write to companies individually where we have concerns with a company's dividend policy, the application of that policy, or disclosure in its annual performance report. We will take action if we consider a company has not complied with the dividend licence condition.

This guidance sets out the factors we expect to consider in assessing companies' compliance with the dividend policy licence condition. We also set out the factors we may expect a company to take into account in justifying decisions about the level of dividends paid, and the disclosure we expect companies to provide in annual performance reports. The guidance is intended to support company decision-making on dividend policies and payments and the quality of explanations provided to justify dividends.

Any and all dividends must be justified on the basis of the criteria set out in the licence. This guidance therefore applies to the payment of any dividend, regardless of the purpose of that dividend or the position of the company, including preference dividends and dividends to service interest on intercompany loans and group debt, or in circumstances where a company in cash lock-up requests to pay a dividend in accordance with our consents guidance⁷⁵.

Factors to consider and taking account of performance

Each company's licence condition requires that dividends declared or paid are in accordance with a dividend policy that aligns with the principle that such dividends take account of service delivery for customers and the environment over time, including performance levels, and other obligations. The factors a company may need to take into account are set out in our expectations for the 2020–25 period in the PR19 final determinations and the expectations that will apply for the 2025–30 period in the PR24 final methodology. Each company should be able to justify its dividends by reference to an 'in the round' assessment of its performance.

Our incentive regime means high-performing companies continue to have opportunities to earn higher returns, commensurate with the levels of performance delivered to customers. 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

⁷⁴ Companies may choose to include the relevant disclosure in relation to dividends in their annual report and accounts in addition to, or instead of in the annual performance report. In the latter instance, companies should include a clear reference to where the disclosure may be found within the annual report and accounts.

⁷⁵ Ofwat. [Guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework](#).

performance or poor historical financing choices or where equity is needed to contribute to significant investment growth.

If a company is significantly underperforming when compared with its determinations, has a serious performance issue in one or more areas or is encountering issues with financial resilience, the board may consider that funds would be better directed towards investing in improving services for customers or bolstering financial resilience. The board should also consider the external environment and if this poses additional risks that need to be taken into account.

The base dividend that we set out at a price determination reflects our view of an appropriate level of dividend for a company performing in line with its determination across all relevant indicators⁷⁶. It does not mean that investors are entitled to that level of dividend if it is not supported by company performance. There are a number of reasons why a dividend yield below this level may be appropriate for an individual company, such as where companies must fund significant investment programmes, address pension funding concerns or operational or performance issues, or improve financial resilience.

Many companies are facing significant investment needs over the long term and we have said that equity has a role to play in funding investment where there is material real growth in RCV. For a company that is growing its RCV, investors may expect more of their return as growth in value of their investment rather than as cash dividends, particularly where there is a need to maintain gearing at reasonable levels.

Each company should consider its performance in the round and over time, encompassing all aspects of delivery against its licence including delivery against its performance commitments, investment plans, cost efficiency and other areas of its operations. The board should consider all areas of underperformance alongside outperformance in determining the level of dividend and should pay particular attention to matters of public scrutiny. Failure to deliver on a single performance commitment does not necessarily mean that a dividend declared or paid does not take account of performance. However, we would expect the company to be able to demonstrate that overall it has delivered against the majority of other commitments. If a company that has underperformed seeks to pay a dividend, an additional explanation as to why this is appropriate is likely to be required.

The company may also consider performance across a number of periods in determining its level of dividends. For example, a company may wish to consider the sustainability of its outperformance before committing to pay an enhanced dividend reflecting performance in any given year. Alternatively, if a company with performance in line with its determinations withholds dividends for a specific year due to potential future liabilities or market disruption, it may choose to reflect that performance in a future period where circumstances allow. If a

⁷⁶ In the PR24 final methodology we set out that we consider that four percent is a reasonable base dividend yield for the period 2025-30 based on our early view of the allowed return.

dividend is being paid in respect of performance in previous years, the company should explain the level of dividend by reference to performance in those years, along with any dividends that have already been paid in respect of the earlier years. Companies should provide sufficient explanation of how the board has ensured that performance in previous periods has not been reflected in previous dividends such that investors are not rewarded more than once for each year's performance.

We would not expect a company to consider future outperformance in the level of dividend for a particular period. However, if a company anticipates underperformance across a range of areas in future periods, the board should consider whether the funds would be better utilised in addressing that underperformance.

In our consideration of how a company's dividends reflect overall performance for customers and the environment, we will also look at material issues or circumstances disclosed under the ring-fencing certificate or in other parts of the annual performance report and consider how these same issues were considered in determining dividends.

We recognise that some companies are in different positions to others in the sector, and that some need to attract new equity to improve financial resilience. While equity investors in such companies may expect to receive their return over a longer period, there may be an expectation of cash returns in the shorter term to help secure new investors who are prepared to invest to support a turnaround. Therefore, in some circumstances it may be appropriate to pay a level of dividend to recognise where significant improvement or progress along a recovery plan has been made. We expect such dividends to be considered within the context of our published expectations and that the boards of such companies will go through the same robust decision-making process, ensuring that any distribution is transparent, clearly justified and does not impact on the financial resilience of the company or its ability to deliver the further improvements necessary. We expect a clear explanation of how such progress has influenced dividends.

It is not sufficient for companies to justify or scale their dividend payments on the basis that a holding company in the group needs to meet specified interest costs or other holding company obligations. Dividend decisions are the responsibility of the board of the regulated business. These decisions should be made independently of the group, and justified on the performance or financing needs of the regulated company. We do not consider it appropriate for dividends to be justified on the basis of group obligations. Companies whose holding companies have intercompany loan or group loan obligations to fulfil should reasonably expect that the group structure builds in sufficient resilience and flexibility to manage holding company liabilities in periods when the regulated company is unable to justify dividend payments or if dividend payments are insufficient to meet those obligations.

Generally, we would not expect a company to pay a dividend while it is in cash lock-up. However, we accept that there may be exceptional circumstances where such companies

may put forward a case to pay a dividend. Companies should refer to our 'Guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework ' provides information as to the requirements for our assessment of a request to pay dividends (or enter into an arrangement that is otherwise prohibited by the licence without our approval), while the company is in cash lock-up.

In linking dividends to performance we would expect companies to demonstrate dividends paid are in respect of performance delivery. We have set out that in an environment of high inflation, companies will benefit to a varying extent depending on the proportion of index-linked liabilities. Companies with a high proportion of fixed rate debt, may see revenues increase faster than interest charges and RCV grow faster than net debt. We would not expect such benefits that accrue as a result of high inflation to be distributed if this is not linked to operational performance; instead the benefits could be retained to strengthen financial resilience or reinvested. Where a company has a high proportion of index-linked liabilities, we expect some disclosure on how this increasing liability has impacted dividends.

Impact of paying the dividend on the company

We expect companies to take account of the impact of paying out the dividend on the ability of the company to continue to finance its functions. The licence condition requires 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.

We therefore expect the board to consider if paying the dividend will materially impact on the resilience of the business over the short or longer term, impair the ability of the company to finance its future investment needs, or will materially affect the timing of any turnaround plan, where needed. Where a potential financial resilience issue has previously been identified, for example, in a company's stress testing of long term viability, it should consider undertaking or repeating that stress testing as part of its decision making process.

Companies should consider withholding or restricting dividends where there are significant service failures to be addressed or there is a risk of regulatory fines, penalties or a need to take remedial actions. For example, if the board is aware of potential future liabilities or risks, a more prudent dividend may be appropriate. The company should explain this in its annual performance report. If material investigations are underway which may lead to enforcement action, we would expect an explanation of how this has been taken into account in deciding the level of dividends, if any, and a more cautious dividend would be expected in such circumstances.

Similarly, we expect to see an explanation where a company restricted dividends in earlier years due to underperformance, or an ongoing enforcement case or an investigation into a potential material breach in a specific area, as this may, for example, help to explain why a

dividend is higher in the current period.

Overall consideration of the level of dividend

Before final approval of the dividend, the board should consider if the level of dividend reasonably reflects the overall performance of the company across all of its commitments to its various stakeholders including customers and the environment, taking account also of ongoing investment, financial resilience and other needs. The board should also consider if it can provide a sufficiently clear explanation in its annual performance report to fully justify the level of dividend in a way that demonstrates accountability and maintains trust and confidence.

A3 Draft Guidance on requests in respect of the cash lock-up licence conditions

DRAFT – for comment by 2 May 2023

Introduction

The modification to the licence conditions made in March 2023 takes effect from 1 April 2025. This amends the trigger for the cash lock-up⁷⁷ licence conditions and introduces a grace period prior to entry into cash lock-up. Where a company has entered the grace period, or the cash lock-up has been triggered, the company may put forward a request under our consents guidance⁷⁸ that would allow transactions (otherwise prohibited following the trigger of the cash lock-up conditions) to be made.

This guidance builds on the derogations guidance already in place and aims to provide additional guidance in the following two circumstances:

- where a company's lowest credit rating, that is monitored for licence compliance purposes, is BBB/Baa2 with negative outlook or designation, and the company wishes to make a request that the cash lock-up licence provisions should not apply; or
- where a company is in cash lock-up, and wishes to make a request for our consent to make a distribution or to undertake another transaction that would otherwise be prohibited while in cash lock-up.

The aim of this guidance is to provide clarity to companies about how we will assess any such requests. The guidance also aims to ensure that companies are aware of the processes that we have in place to ensure a robust, consistent and transparent assessment for requests, including the need for submission of the appropriate evidence to enable us to carry out a careful assessment of the relevant circumstances.

Our request assessment framework

The expectations set out in the assessment framework in the consents guidance apply in circumstances where a company puts forward a request that would otherwise be prohibited under the cash lock-up provisions.

⁷⁷ Each company's licence contains cash lock-up conditions that, when triggered, prohibit the company from carrying out certain transactions without the consent of Ofwat. Condition P28 of the company licence sets out that where 'cash lock-up' 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 certain exceptions apply.

⁷⁸ Ofwat. [Guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework.](#)

When carrying out our assessment and making our decision, our aim is to ensure that customers' interests are protected and that companies remain financially resilient and able to carry out their functions.

It is the responsibility of the Appointee to demonstrate that its proposed request is demonstrably in the interests of customers and the Appointee, in line with our statutory duties. Consistent with the consents guidance, it is intended that a high bar applies and there should be no expectation that we will necessarily provide consent to certain arrangements even if they are similar to arrangements which we have consented to in the past. We will examine each request on its own merits.

Undertaking transactions during the grace period

The cash lock-up provisions do not apply during the grace period. The default expectation is that the grace period would apply for the full three-month period, although there may be circumstances where we make a determination to shorten the grace period once triggered. These circumstances might arise, where it is necessary to protect customers, for example, if a distribution during that period would be highly detrimental to the financial state of the company.

During the grace period, a company is not required to request approval to undertake a transaction that would be prohibited under cash lock-up, such as the payment of dividends or other distribution. However, we would expect a company to provide us with reasonable notification of any plans to undertake such a transaction prior to it taking place, along with the reasons why it considers such a transaction is appropriate.

Companies must, in any case, ensure any dividend payments made in the grace period are made in accordance with the dividend policy licence condition and their other obligations under company law. We would take payments of any dividends during the grace period into account when considering any request to disapply cash lock-up.

A grace period would not apply to any downgrade to a lower credit rating than BBB/Baa2 with negative outlook, i.e. BBB-/Baa3 (regardless of outlook) or lower, where the cash lock-up would automatically apply.

Overall, we remain clear that it is a fundamental requirement of companies that they take proactive steps to manage their financial resilience and, linked to this, engage early with us where financial resilience is at risk.

The grace period allows for a review process to be undertaken rather than automatically placing a company in cash lock-up. Nevertheless, we expect the underlying purpose and intent of the modified cash lock-up conditions to be respected and for companies to engage with us and in particular to signal any intent to make a transaction that might otherwise be

prohibited (were the cash lock-up to be in force), in advance of entering into that transaction.

Consideration of requests made during the grace period to disapply cash lock-up

Based on the information received within a company's submission, we will conduct an 'in the round' assessment, taking account of all the relevant evidence provided by the company.

The outcome of our assessment following a request made during the grace period to disapply cash lock-up could be:

- a decision not to accept the request, such that the cash lock-up provisions apply at the end of the three-month grace period (or a shorter or longer period should we so determine); or
- a determination to disapply cash lock-up (for a limited time period and/or with conditions attached); or
- an extension of the grace period, for a limited time, to allow for further evidence to be presented by the company and assessed by us.

In the event that we decide it is appropriate to determine that the cash lock-up provisions do not apply, we will publish our determination and reasons. Our decision will confirm any conditions that apply to the determination, for example the period for which the determination will apply or any conditions relevant to the payment of dividends or distributions or entry into any other transaction. If the company breaches the conditions of our determination, the cash lock-up provisions will immediately apply from that point.

Consideration of requests made during cash lock-up

Generally, we would not expect a company that is in cash lock-up to consider it appropriate to declare or pay a dividend or to undertake another prohibited transaction.

However, there may be certain circumstances where a company considers that it can demonstrate that it is in the best interests of customers and in line with Ofwat's statutory duties to be permitted to make a transaction that would otherwise be prohibited, for example where the prospect of a distribution being permitted may assist with attracting new equity during a turnaround period.

Where a company wishes to pay a dividend or other prohibited transaction while subject to the cash lock-up licence conditions, it can only do so with Ofwat's written approval.

Information required to support any request

We expect Appointees who have triggered the cash lock-up conditions and are applying for approval either for cash lock-up to be disapplied or to undertake a transaction that is prohibited when they enter cash lock-up, to outline their understanding of the factors that led to a trigger of cash lock-up conditions and, where appropriate, set out a clear plan of action to correct the identified issues. Our starting assumption, in any case, is that the company ought to be in cash lock-up given that its position has deteriorated sufficiently that a credit rating agency assigns a rating of BBB/Baa2 with negative outlook.

Ideally, we expect companies to actively engage with us before the cash lock-up conditions are triggered. Any decision we ultimately make in relation to any requests associated with the cash lock-up conditions will consider how constructively a company has engaged with us including in the lead up to triggering the cash lock-up conditions.

In any subsequent request, we expect companies to present an assessment of the risks to the company and to customers if consent were granted, including evidence on how the risks considered could be mitigated or avoided. If we are not persuaded that a particular transaction would be in the interests of customers and consistent with our statutory duties, we will refuse the request for consent.

Companies should follow our consents guidance when engaging with us throughout the process. Table A3.1 sets out the information we would expect companies to submit in order for us to carry out our assessment of a request for us to either disapply cash lock-up or permit a company to undertake a transaction that would otherwise be prohibited, such as a dividend payment, while in cash lock-up.

Information required from companies when submitting a request

Table A3.1 – Information requirements for a request to disapply cash lock-up or to undertake a prohibited transaction while in cash lock-up

Information category	Disapplication of cash lock-up	Payment of a dividend or other transaction prohibited under cash lock-up
Description ⁷⁹	Set out the licence condition that is applicable to the proposed request.	Set out the licence condition that is applicable to the proposed request. The request should set out the details of the proposed transaction. For example, where this is a dividend payment, this would include the proposed size and timing of dividends, and where the request is for a single transaction or the ability to make ongoing payments under

⁷⁹ Note precise paragraph numbering may be different depending on the existing numbering in Condition P of each company's licence.

Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers

Information category	Disapplication of cash lock-up	Payment of a dividend or other transaction prohibited under cash lock-up
		specific conditions, full details of the payment or payments should be provided.
Purpose	Provide a detailed explanation of the purpose of the request including why it is appropriate that the cash lock-up conditions should not apply, that is, reasons why the company considers it remains financially resilient despite holding a credit rating at a cash lock-up trigger level.	Provide a detailed explanation of the purpose of the proposed transaction and why it is appropriate to enter into the specified transaction while in cash lock-up. Explain the period over which the consent should remain in place including why it is necessary and in the best interests of customers for the Appointee to pay dividends or carry out the relevant transaction. An explanation may include details of the corporate structure showing the recipients of the dividend and how the revenue will be used.
Alternative options	Set out the impact on the company and the delivery of its obligations and commitments to customers and the environment of the cash lock-up provisions associated with the request and the alternative arrangements that could be put in place to mitigate any detrimental impact.	The company should set out, if relevant, whether there are any alternative approaches (which may or may not require consent), for example other potential financing options that could be taken by the Appointee; to what extent they have been explored; and why the proposed arrangement that requires the consent is the most appropriate and will better allow the Appointee to deliver the stated purpose. This may include the consequences of group liabilities being unpaid or alternative sources of revenue that may be available to fund group obligations such as holding company interest. Companies may also provide details of discussions with lenders/suppliers to defer or reschedule payments.
Impact	Provide any qualitative assessment which is appropriate to demonstrate the impact on the interests of customers, the environment and the Appointee, in the short and long term. Provide quantitative analysis with key inputs, assumptions, calculations and models where applicable to support your assessment. This may include cash flow forecasts and projected financial metrics along with stress testing against the company's principal risks demonstrating that the company remains financially resilient. Where the company is already in cash lock-up, it should also provide evidence that the payment of dividends or other prohibited transaction will not adversely impact its financial resilience or any plans that the company has in place where there is a need to improve financial resilience.	
Risk assessment	Provide a risk assessment setting out any risks that the Appointee considers may arise, in the short and longer term. Provide key inputs, assumptions, calculations or models where applicable to support the assessment. Provide any risk mitigation or avoidance actions that could be taken by the Appointee to minimise or eliminate risks to customers or the Appointee.	
Supporting evidence	Provide further supporting evidence to justify why the company considers that cash lock-up should not apply. Depending on the nature of the request, this might include (but is not limited to):	Provide further supporting evidence to justify why the company considers that consent for the transaction should be granted to the Appointee. Depending on the nature of the request, this might include (but is not limited to): <ul style="list-style-type: none"> the Appointee's understanding of the factors and circumstances that led to cash lock-up

Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers

Information category	Disapplication of cash lock-up	Payment of a dividend or other transaction prohibited under cash lock-up
	<ul style="list-style-type: none"> • the Appointee's understanding of the factors and circumstances that triggered the licence condition; • details of discussions with credit rating agencies; • detailed plans associated with the aim of maintaining financial resilience; • financial analysis/models including financial forecasts, cash flow projections and key financial metrics; • stress testing of severe but plausible scenarios based on an assessment of the risk profile of the company; • third-party reports obtained by the company; • relevant legal documentation such as debt covenants; • market reports, etc. <p>We would expect to see evidence of firm commitments from the company's board and from investors to improve the position of the company during the requested disapplication period. This should include an understanding of the factors that led to the trigger being reached and how these will be addressed over a reasonable time period.</p>	<p>and how these will be addressed over a reasonable time period;</p> <ul style="list-style-type: none"> • proposed profile of dividend payments or timing of entry into the relevant transaction with an associated company. • financial analysis/models including financial forecasts, cash flow projections and key financial metrics including the proposed transactions; • stress testing of severe but plausible scenarios based on an assessment of the risk profile of the company following the payment of proposed dividends or other prohibited transactions; • third-party reports obtained by the company; • relevant legal documentation such as debt covenants; • details of discussions with credit rating agencies and market reports, etc.
Timing	<p>We will aim to make a decision whether to grant the request, or not, within a reasonable time period provided that the company provides sufficient evidence to support its request. It is helpful to let us know as soon as possible any timings which are relevant to our decision.</p>	

A4 Licence modifications

We set out below the modifications we have decided to make 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 modifications are set out in Appendix A5. Our reasoning and intended effects are set out in the body of this decision document. Text added is marked in bold blue, and text deleted is marked in blue strikethrough. Our decision does not include any modifications to those provisions of Condition P that are not listed in this Appendix.

We note that the text on Dividend policy in company licences that was in place prior to 17 May 2023 was broadly similar, however varied slightly⁸⁰. The below changes apply to all companies' Dividend policy text, resulting in consistency of drafting across all licences.

For 13 companies' licences⁸¹, the paragraphs at point 1 below are inserted in the same sequence and with the same numbering as shown, and the paragraph numbering that follows in Condition P is adjusted accordingly if necessary.

For the licences of the other two companies, South West Water Limited and Hafren Dyfrdwy Cyfyngedig, the paragraphs at point 1 below are inserted to accommodate the existing provisions that enable each company's board to provide an annual certificate in place of the credit rating requirement if Ofwat agrees. For South West Water Limited's licence, paragraph P26 below replaces existing paragraph P25 and is numbered accordingly, existing paragraphs P27, P28, P29 and P29A remain unchanged, paragraph P27 below is inserted as new paragraph P30, paragraph P30 below replaces existing paragraphs P30 and P31 and is numbered P31, and the paragraph numbering that follows in Condition P is adjusted accordingly. For Hafren Dyfrdwy Cyfyngedig's licence, paragraphs P25 and P26 below replace existing paragraphs P25 and P26, paragraph P27 below is inserted as a new paragraph P27, existing paragraphs P27 to P30 become paragraphs P28 to P31 in order to accommodate new

⁸⁰ The comparison between previous and updated Dividend policy drafting applicable to the licences of Anglian Water Services Limited, Affinity Water Limited, Northumbrian Water Limited, South East Water Limited, Southern Water Services Limited, South Staffordshire Water plc, Sutton and East Surrey Water Plc, United Utilities Water Limited and Yorkshire Water Limited, is set out in the below marked up version of paragraph P30. Previous Dividend policy drafting in the licences of Portsmouth Limited, Severn Trent Water Limited, South West Water Limited and Thames Water Utilities Limited set out broadly similar requirements however in two paragraphs at P29 and P30, which have now been replaced with one paragraph P30 per the below drafting. Previous Dividend policy drafting in Hafren Dyfrdwy's licence was at paragraphs P31 and P32, which have now been replaced with one P31 per the below drafting. Previous Dividend policy drafting in paragraph P29 of the licence of Dwr Cymru Cyfyngedig contained a requirement for dividends to be declared or paid only in accordance with a policy which, in the written opinion of Ofwat, will not impair the ability of the Appointee to finance the Appointed Business, and this has now been replaced with the drafting shown at paragraph P30 as set out below.

⁸¹ Anglian Water Services Limited, Affinity Water Limited, Dwr Cymru Cyfyngedig, Northumbrian Water Limited, Portsmouth Water Limited, Severn Trent Water Limited, South East Water Limited, Southern Water Services Limited, South Staffordshire Water plc, Sutton and East Surrey Water Plc, Thames Water Utilities Limited, United Utilities Water Limited, and Yorkshire Water Services Limited.

paragraph P27, and paragraph 30 below replaces existing paragraphs P31 and P32 as new paragraph P32.

The modifications set out at point 1 below will take effect from **17 May 2023**:

1. Condition P is amended as follows:

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 Ratings which ~~is an~~ **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.**

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 the Lowest Investment Grade Rating 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.

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 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

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

~~P30.23 that dividends declared or paid under a system of incentive regulation dividends would be expected to~~ reward efficiency and the management of ~~economic~~ 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.

The modifications set out at point 2 below will take effect from **1 April 2025**:

2. Condition P is amended by:

Modifying paragraph P28⁸² as follows:

"P28 The "Cash Lock-Up" provisions set out in paragraph **P30** apply in any circumstances:

⁸² For the licence of South West Water Limited, the paragraph modified is P27, with a reference to paragraph P29 in the first line.

P28.1 where neither the Appointee nor 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 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is:

P28.2.1 not an Investment Grade Rating; or

P28.2.2 ~~at holds an Issuer Credit Rating which is the Lowest Investment Grade Rating 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; or~~

P28.3 where (subject to any determination made pursuant to paragraph P29) the Appointee or any Associated Company which issues corporate debt on its behalf holds one or more Issuer Credit Ratings and one or more such Issuer Credit Rating is, and has been for a period of three months, at one notch above the Lowest Investment Grade Rating (one notch above being an Issuer Credit Rating of BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent) and:

P28.3.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P28.3.2 the rating outlook is negative."

Inserting the following paragraph P29⁸³ after paragraph P28:

"P29 Ofwat may determine, either following the Appointee's written request or on its own initiative that:

P29.1 sub-paragraph P28.3 should have effect as if the reference to "a period of three months" was a reference to a different period of time and, if so, what that period should be;

P29.2 the "Cash Lock-Up" provisions set out in paragraph P31 should not apply in the circumstances specified in sub-paragraph P28.3;

⁸³ For the licence of South West Water Limited, the paragraph inserted is numbered P28

in either case subject to any conditions set by Ofwat, a breach of which will mean the "Cash Lock-Up" provisions set out in paragraph P30 apply."

Adjusting subsequent paragraph numbering sequentially in order to accommodate new paragraph P29⁸⁴.

⁸⁴ For the licence of South West Water Limited, the paragraph inserted is numbered P28.

A5 Licence modifications for Wessex Water

This appendix sets out the modifications we have decided to make to Conditions A, I, K and P of Wessex Water's licence. Our decision and reasoning is set out in the body of this document and is supported further by the reasoning in our previous regulatory ring-fencing consultation from 2020⁸⁵.

The modifications set out at points 1 to 4 below will take effect from **17 May 2023**:

1. 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:

⁸⁵ 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;"

2. **Condition I** is deleted in its entirety.
3. **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.

4. **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.

Listing of financial instruments

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.

Transfer pricing and Cross-default Obligations

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.

Credit Ratings and "Cash Lock-Up"

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 the Lowest Investment Grade Rating 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 otherwise where the rating outlook of the Lowest Investment Grade Rating 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 P29 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."

Modifications set out at point 5 below will take effect from **1 April 2025**:

5. Condition P is amended by:

Deleting paragraph 29 and replacing it with the following:

P29 The "Cash Lock-Up" provisions set out in paragraph P31 apply in any circumstances:

P29.1 where neither the Appointee nor 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 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is:

P.29.2.1 not an Investment Grade Rating; or

P29.2.2 at the Lowest Investment Grade Rating; or

P29.3 where (subject to any determination made pursuant to paragraph P30) the Appointee or any Associated Company which issues corporate debt on its behalf holds one or more Issuer Credit Ratings and one or more such Issuer Credit Rating is, and has been for a period of three months, at one notch above the Lowest Investment Grade Rating (one notch above being an Issuer Credit Rating of BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent) and:

P29.3.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P29.3.2 the rating outlook is negative.

Inserting the following new paragraph P30 after paragraph 29:

P30 Ofwat may determine, either following the Appointee's written request or on its own initiative, the questions whether:

P30.1 sub-paragraph P29.3 should have effect as if the reference to "a period of three months" was a reference to a different period of time and, if so, what that period should be;

P30.2 the "Cash Lock-Up" provisions set out in paragraph P32 should not apply in the circumstances specified in sub-paragraph P29.3;

in either case subject to any conditions set by Ofwat, a breach of which will mean the "Cash Lock-Up" provisions set out in paragraph P31 apply.

Adjusting subsequent paragraph numbering sequentially in in order to accommodate new paragraph P30.

A6 Reasons for the July 2020 licence modifications

Below is a summary of the reasons for each licence modification made to company licences in 2020 which we consider remain valid and support our decision to modify Wessex Water's licence as set out in the body of this document.

A6.1 Notification of change of control.

We have a duty to act in a way which we consider is best to secure that the functions of companies are properly carried out. We need to ensure that we can identify and address any regulatory issues arising from a change of control in a company. The two primary outputs of our change of control process are to identify from whom Ultimate Controller undertakings⁸⁶ need to be procured, and to identify the need for any modifications to licence conditions in light of our analysis.

Our July 2020 licence modifications introduced a new condition in all licences that requires the company to inform us when it becomes aware of a change, or an upcoming likely change, that might be considered to have led to or may lead to a change to the Ultimate Controller of the company. As we clarified [at the time](#), we do not intend the company to exercise definitive judgement on whether or not there has been or might be such a change. For this reason we couched the licence text in the terms “may lead to...” and “might be considered to have led to...”.

Once we have been notified and have gathered any necessary information, we will consider if there has been or might be a change to the Ultimate Controller(s) and consequently whether any action needs to be taken. We recognise that the identification of this change may not be straight-forward, for instance where control is widely distributed or control is exerted through many holding tiers. We would, therefore, encourage Appointees to take a precautionary approach in deciding when to notify us. We would expect to be notified at the point where there is reasonable certainty that a change to the Ultimate Controller(s) may take place. An example would be when a “Heads of Terms” agreement is about to be signed, but it is possible that there are other points in any investment process where an Appointee might consider that a change to the Ultimate Controller(s) might occur and notify us accordingly.

⁸⁶ The Appointee must ensure that at all times there is an undertaking in place which is given by the Ultimate Controller of the Appointee and where the United Kingdom Holding Company of the Appointee is not the Ultimate Controller of the Appointee, the Appointee must ensure that there is an undertaking in place which is given by the United Kingdom holding company. The undertaking should provide that the Ultimate Controller will provide the Appointee with information as is necessary to allow it to comply with its legal and licence obligations and will not act in a way which would make the company breach those obligations.

A6.2 Enforcing the Ultimate Controller's undertaking

Wessex Water's licence requires the company to procure legally enforceable undertakings from its Ultimate Controller(s). The Ultimate Controller undertaking is intended to prevent behaviour by Ultimate Controllers which leads to the company breaching its licence. It shields the company from influence exerted by an Ultimate Controller to act in breach of its licence and provides a route for the company to ensure that the actions of its Ultimate Controller(s) do not themselves lead to a breach (for example by the Ultimate Controller failing to provide information or by amending group finance arrangements in a way that breaches the regulatory ring-fence). This in turn protects customers' interests by preserving the integrity of the licence obligations. Wessex Water's licence does not, however, currently provide for an obligation on the company to enforce an undertaking, nor does Ofwat have the power to force an Ultimate Controller to comply with an undertaking it has given. We have decided, therefore, to insert an ability for us to issue a direction to the company requiring it to enforce its Ultimate Controller's undertaking.

The undertaking is only as good as the company's willingness to enforce it. We appreciate that company Boards will wish not to breach their licences and will take a robust line with their Ultimate Controllers. There may be some circumstances, however, where they are influenced by the Ultimate Controller or are under pressure not to enforce the undertaking. These are the circumstances where we see the direction from Ofwat coming into play, because the possibility of Ofwat using this enforcement power may strengthen the company's position. Therefore, just as the undertaking strengthens the ability of the company to comply with its licence, this regulatory direction strengthens the "shield" from Ultimate Controller influence which may prejudice licence compliance.

A6.3 Credit rating requirement

Credit ratings are helpful for monitoring companies because they provide a widely recognised and independent, forward-looking view of a company's financial strength and resilience.

Wessex Water's current licence provision requires it to use "reasonable endeavours" to maintain an investment grade credit rating, whereas all other licences require that the company "must ensure" that an investment grade credit rating is "maintained at all times".

We intend to implement the "must ensure" requirement for Wessex Water because the clarity gained from the amended condition would mean that no time is lost in judging whether or not a company has used reasonable endeavours before determining if breach has occurred, allowing solutions to be considered and implemented faster. Our [Enforcement guidance](#)⁸⁷ provides details of the things we would take into account in the event of a breach. This would

⁸⁷ Ofwat, [Ofwat's approach to enforcement](#) 2017

include whether circumstances genuinely outside of a company's control contributed to a breach.

Requiring both the company and any Associated Company which issues corporate debt on its behalf to be rated increases the burden on some companies for little practical benefit. In light of this, our July 2020 licence modifications included wording which recognises an issuer credit rating assigned to the company or an issuer credit rating given to its dedicated financing company. We consider this to be helpful, for instance, where the company is not rated because it does not issue publicly listed financial instruments.

A6.4 Definition of Issuer Credit Rating

Our July 2020 modifications also sought to ensure companies have a flexible range of rating options available to them such that where we have determined that a given rating offers equivalent protection to customers as other accepted ratings, the option to use it should be reflected in the licence. The licence text was, therefore, updated to reflect our regulatory practice and to confirm that we accept as regulatory markers those credit ratings which, in our view, are representative of the creditworthiness of the company as a whole.

The definition of Issuer Credit Rating was modified as follows:

“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.

A6.5 Cash lock-up

We are inserting a cash lock-up provision into the licence of Wessex Water for the first time.

When a company is in cash lock-up, it is prohibited from making certain payments, such as dividends. Our May 2020 consultation set out that having the cash lock-up provision places the regulated business in a better position because it prevents resources flowing out from the business by way of dividends or non-contractual payments to connected parties when the company's finances are under pressure. Cash lock-up should also encourage dialogue

between the company and Ofwat, focussing attention on the causal factors and improvement of the company's financial position.

A6.6 Ring-fencing certificate

The annual ring-fencing certificate provides assurance to Ofwat and other stakeholders that the company has adequate facilities, systems, financial resources and management resources to enable it to carry out its Regulated Activities for at least another 12 months from the date the certificate is submitted to Ofwat. This enhances the protection for customers provided by the regulatory ring-fencing framework.

Our July 2020 licence modifications removed minor variations between companies' licence requirements on ring-fencing certificates so that wording was consistent across different licences and removing any confusion about the requirement.

A6.7 Reporting of material issues

Our July 2020 licence modifications inserted a provision into licences requiring the Board of the company to inform Ofwat as soon as possible when they become aware of any circumstance that might materially affect the company's ability to carry out its Regulated Activities. At the time, the provision had already been added to some licences at the point of a change in control.

The provision to report material issues to Ofwat is designed to make us aware of significant issues to help us better discharge our regulatory responsibilities. The obligation is a notification requirement and not a regulatory approval process. The provision is designed to capture all relevant material issues even those that are not specifically connected to licence compliance.

A7 Summary impact assessment: strengthened ring-fencing licence conditions

This appendix provides a table setting out the expected impacts of our modifications to strengthen the ring-fence licence conditions. These impacts are core to our policy decisions and have been considered in the main body of this document. We do not repeat the arguments and evidence in this appendix but summarise the impact of the licence modifications across four groups – customers, equity investors, debt investors and company management. Each option has been assessed relative to the status quo.

For the cash lock-up licence condition, we have assessed the likely impacts of the modification as set out in the decision document which raises the cash lock-up trigger to BBB/Baa2 with negative outlook (from BBB-/Baa3 with negative outlook), with effect from 1 April 2025. We have included the impact of the grace period which was not part of the original Consultation proposal. We have not assessed the consultation proposal separately, but instead have made clear what additional impact the grace period has.

We have also considered the impacts of alternative proposals to the cash lock-up that were put forward by respondents. These include:

- Raise the cash lock-up trigger by a lesser extent to BBB-/Baa3 stable;
- Raise the cash lock-up trigger by a greater extent than BBB/Baa2 with negative outlook;
- Cash lock-up trigger based on the average ratings, or disapplying cash lock-up where a company holds two other credit ratings above BBB/Baa2 with negative outlook;
- Trigger cash lock-up when companies breach financing covenants;
- Trigger resilience plans at a credit rating of BBB/Baa2 with negative outlook;
- Notification requirements;
- Placing limits on gearing;
- Stress testing similar to that used in banking.

We also summarise the expected impacts of the modifications to the dividend licence condition, the credit rating licence requirements and updating Wessex Water's licence to align it with those of all other companies in the sector.

In the table, one or two ticks (✓) or crosses (X) have been used to indicate a small or large positive or negative outcome for that group. If the evidence suggests that the outcome for the group as whole is neutral, this will be reflected by a dash. However, it is possible that the outcome for the group as a whole is neutral, but subsections of the group are positively or adversely affected. This will be captured in the text in the table.

For clarity, the table reflects the impacts on equity and debt investors in the regulated companies and not the holding company, as it is the regulated company that holds the licence.

We note that some of the impacts of our modifications, and the alternative proposals, are hard to quantify precisely, particularly where they are probabilistic in nature. However, we consider the analysis proportionate. In particular, the table shows that, on the basis of current evidence, our modification to raise the cash lock-up trigger to BBB/Baa2 with negative outlook from BBB-/Baa3 with negative outlook, effective from 1 April 2025 better protects the interests of customers compared to the alternatives proposed.

The modifications to the dividend licence condition, the credit rating licence requirements and the Wessex Water licence conditions are all seen as preferable to the status quo, and therefore are regarded as the preferred options.

We will continue to keep the protections of the regulatory ring-fence under review, taking further steps where necessary to ensure it sufficiently protects the interests of customers.

	Customers	Equity Investors	Debt Investors	Company Management
Cash lock-up conditions				
<p>Modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook with effect from 1 April 2025.</p> <ul style="list-style-type: none"> • The modification includes a 3-month grace period between the point that a rating falls to the trigger level of BBB/Baa2 with negative outlook and the cash lock-up being applied. • During this period, companies can submit a request to us to determine (or Ofwat may determine on its own initiative) that cash lock-up should not apply. • If a credit rating were to fall to BBB-/Baa3 or lower, then the cash lock-up would automatically apply. 	<p>✓✓</p> <p>The modification will, compared to the status quo, better incentivise companies to maintain adequate levels of financial resilience, engage with us earlier when they are experiencing difficulties, improve the availability and timeliness of information relevant to carrying out an assessment of financial resilience, and allow us to intervene and seek mitigating actions sooner where companies do not take such steps themselves. This reduces the risk to customers of significant impacts on service and higher long-run costs, arising from limitations in companies' ability to invest to maintain or enhance their assets. This includes financing a turnaround plan, to ensure faster turnaround of performance.</p> <p>We recognise that credit ratings are not perfect</p>	<p>-</p> <p>Little to no negative impact on equity investors with long-term investment horizons. Indeed, increased regulatory protections may enhance the value of equity to the extent that there is a perceived reduction in regulatory risk associated with dealing with the challenges of companies with risky financial structures.</p> <p>Investors in companies with weak levels of financial resilience would bear the consequences of the cash lock-up condition triggering at an earlier stage, however, this is consistent with the expectation that companies should be taking steps to address financial resilience where they are at risk of</p>	<p>✓</p> <p>Modifications will be credit positive to the extent that it encourages companies to take earlier corrective action where financial resilience is at risk.</p>	<p>-</p> <p>The modification provides clarity to management regarding regulatory expectations in the area of financial resilience, and as such is beneficial to company management.</p> <p>There will be no material impact on the management of financially resilient companies.</p> <p>Decision making on transactions prohibited while in cash lock-up will be more constrained for less resilient companies but aligns with the expectations that are already in place that companies with weak levels of financial resilience should already be considering corrective action.</p> <p>Any increase in the required cost of capital that is perceived to result from the licence modifications, for example because companies with weak levels of financial</p>

	Customers	Equity Investors	Debt Investors	Company Management
	<p>indicators of resilience. We do not expect a water utility to operate at a credit rating of BBB-/Baa3 (and many stakeholders agree with this view) but companies may still have resilience problems above this level, for example, because rating agencies do not downgrade them promptly. Cash lock-up would not be triggered in these cases, but we would expect these companies to be considering carefully their levels of financial resilience in any case.</p> <p>Will improve stakeholder trust and confidence in the water sector.</p> <p>We do not expect there to be any material impact on customer bills through the allowed return.</p>	<p>downgrade to BBB-/Baa3.</p> <p>The provision of the grace period recognises there may be some cases where a cash lock-up may not be appropriate at BBB/Baa2 with negative outlook. The grace period provides the ability for companies to put forward a case for disapplication of the cash lock-up conditions (in addition to their right if cash lock-up applies to seek consent for payment of restricted transactions).</p>		<p>resilience need to strengthen their financial position and avoid cash lock-up, is in line with the financing cost we allow, which is sufficient for an efficient company with the notional capital structure to maintain adequate levels of financial resilience.</p>
Raise the cash lock-up trigger by lesser extent to BBB-/Baa3 stable	<p>✓</p> <p>This option provides customers with better protection than the status quo.</p>	<p>-</p> <p>Increasing the cash lock-up licence condition to BBB-/Baa3 stable should have little to no negative impact on equity investors with</p>	<p>-</p> <p>Modifications will be credit positive to the extent that it encourages companies to take earlier corrective action where financial resilience is at risk,</p>	<p>-</p> <p>Decision making on transactions prohibited while in cash lock-up will be slightly more constrained for less resilient companies but agrees with the expectations</p>

	Customers	Equity Investors	Debt Investors	Company Management
	<p>However, most respondents to the December 2021 discussion paper agreed that they would not expect a regulated utility to hold a credit rating of BBB-/Baa3 (or lower).</p> <p>Therefore, this option could result in customers being exposed to greater risk compared to the preferred option.</p>	<p>long-term investment horizons.</p> <p>Investors in companies with weak levels of financial resilience would bear the consequences of the cash lock-up condition triggering at an earlier stage, however, this is in line with the expectation that companies should be taking steps to address financial resilience at BBB-/Baa3.</p>	<p>although to a lesser extent than our proposed modification.</p>	<p>that are already in place that companies with weak levels of financial resilience should already be considering corrective action.</p> <p>However, it would still allow for the company's resilience to be eroded to a harmful extent to the detriment of customers before distributions would be restricted, compared to the proposed modification.</p>
<p>Raise the cash lock-up trigger for cash lock-up by a greater extent than to BBB/Baa2 with negative outlook</p>	<p>✓</p> <p>A greater increase in the cash lock-up trigger would likely result in some further benefits for customers as companies may retain greater levels of reserves in the business (recognising that there may be companies with financial resilience issues which do not trigger the modified cash lock-up of BBB/Baa2 with negative outlook).</p>	<p>X</p> <p>May deter even investors with long term investment horizons if the licence constraint is set at a level above that which might be a reasonable lower bound for monopoly water businesses.</p>	<p>✓</p> <p>Modifications will be credit positive to the extent that it encourages companies to take earlier corrective action where financial resilience is at risk.</p>	<p>X</p> <p>Decision making on transactions prohibited while in cash lock-up will be more constrained even for companies with adequate levels of financial resilience.</p> <p>This may require companies to consider whether it is necessary to maintain higher levels of financial resilience and raise their financing costs potentially beyond the levels currently allowed for in our price control.</p>

	Customers	Equity Investors	Debt Investors	Company Management
	<p>The financing costs allowed for in our price control is based on a notional company with sufficient financial resilience to maintain investment grade credit ratings of at least BBB+/Baa1.</p> <p>However, such a greater increase in the cash lock-up licence condition may require companies to maintain greater levels of headroom, even for a financially resilient company, which may come at a cost that is borne by customers.</p>			
<p>Cash lock-up trigger based on the average ratings, or disapplying cash lock-up where a company holds two other credit ratings above the threshold of BBB/Baa2 with negative outlook</p>	<p>X</p> <p>Amending the threshold to be by reference to the average credit rating could weaken existing regulatory protections in some cases. This is because a company may have a credit rating below the existing trigger of BBB-/Baa3 with negative outlook from one credit rating agency, but above that level from others, such</p>	<p>-</p> <p>Such a proposal would have limited impacts on equity investors, as it does not significantly differ from the status quo.</p>	<p>-</p> <p>Such a proposal would have limited impacts on debt investors, as it does not significantly differ from the status quo.</p>	<p>-</p> <p>Unclear – could be more or less restrictive on decision making on transactions prohibited while in cash lock-up compared with the status quo, depending on circumstances.</p>

	Customers	Equity Investors	Debt Investors	Company Management
	<p>that the average is higher than the existing trigger.</p> <p>In situations where even one credit rating agency has a rating at or below BBB/Baa2 with negative outlook, there is still a potential impact on customers, and we want the licence condition to encourage engagement with us and corrective action on the matter of financial resilience at this point. We have also introduced a grace period in the cash lock-up conditions to allow companies to make the case that a rating of BBB/Baa2 with negative outlook by an agency is not representative of its underlying financial resilience and that the condition should not apply.</p> <p>For similar reasons, disapplying a cash lock-up where a company holds ratings from two other credit rating agencies above the threshold of BBB/Baa2 with negative outlook, despite holding one rating at a cash</p>			

	Customers	Equity Investors	Debt Investors	Company Management
	lock-up level, may not strengthen protections.			
Trigger cash lock-up when companies breach financing covenants	<p>X</p> <p>Covenants in borrowing documents vary between companies, depending on the financial structure in place, and may not all be in the public domain, meaning we cannot be sure about the protection this may provide. Moreover, they are put in place by companies and their investors to protect the interests of debt investors rather than customers. Companies may negotiate with lenders to accommodate temporary changes (or a temporary breach) to financing covenants, even where there's an ongoing risk to financial resilience.</p> <p>It would also potentially legitimise the steps some companies have taken to 'borrow through swaps' to circumvent the existing covenants, and so mask the financial resilience constraint and reduce the</p>	<p>-</p> <p>The impacts on equity investors would vary depending on the nature of the covenants which may vary between companies. The ability of lenders to accommodate changes (or allow temporary breach) means it is unclear whether this approach would have a negative or positive impact.</p>	<p>-</p> <p>This would ensure that transactions prohibited by cash lock-up are restricted whenever financing covenants are breached.</p> <p>However, it would also potentially legitimise the steps some companies have taken to 'borrow through swaps' to avoid triggering the existing covenants, and so mask the financial resilience constraint and reduce the focus on financial resilience in the future.</p>	<p>✓</p> <p>Unclear – may be marginal benefit in terms of more flexible company decision making if this is less restrictive than the status quo.</p>

	Customers	Equity Investors	Debt Investors	Company Management
	<p>focus on financial resilience in the future.</p> <p>We therefore consider this would leave customers exposed to significant risk.</p>			
Trigger resilience plans at a credit rating of BBB/Baa2 with negative outlook	<p>X</p> <p>Would take time for companies to finalise a resilience plan and upon submission the onus would be on Ofwat to determine whether or not the plan adequately supports the company's resilience. Meanwhile, there would be a risk that funds that are better retained in the business to strengthen financial resilience are transferred outside the company.</p> <p>This complexity and potential delays in triggering cash lock-up, erodes its effectiveness as a regulatory protection and lowers level of benefits for customers compared to a cash lock-up licence condition based on other triggers such as credit ratings.</p>	<p>-</p> <p>It is possible the outcome of an assessment of resilience plans results in some restrictions of transactions otherwise prohibited in cash lock-up, relative to the status quo, although these would be delayed relative to our preferred modification.</p> <p>May be longer term benefits, as with our preferred modification, although these are reduced by the delays in the cash lock-up.</p>	<p>-</p> <p>May have marginal positive impacts on debt investors.</p>	<p>-</p> <p>There would be no impact on financially resilient companies with higher credit ratings.</p> <p>Decision making on transactions prohibited while in cash lock-up will be more constrained for less resilient companies but aligns with the expectations that are already in place that companies with weak levels of financial resilience should already be considering corrective action. However, the cash lock-up for less resilient companies could be delayed relative to our proposed option as time would be spent producing and assessing a plan before a cash lock-up could be triggered.</p>

	Customers	Equity Investors	Debt Investors	Company Management
				There could be an increased regulatory burden on companies with weaker levels of financial resilience as the requirement would automatically require them to prepare resilience plans.
Notification requirements	<p>XX</p> <p>One company proposed that we consider a formalised information notification process as a way of ensuring companies discuss financial resilience issues with us at an earlier stage, e.g., notification of events impacting significantly on key financial metrics such as interest coverage ratios.</p> <p>We consider that the 'reporting of material issues' provision which was added to Condition P of companies' licences in 2020 (except the licence of Wessex Water) already performs a similar notification function, albeit it does not act as a trigger for cash lock-up.</p> <p>The material issues provision (and any notification</p>	-	-	X
		Such a proposal has no significant impact compared to the current cash lock-up licence condition.	Such a proposal would have marginal impacts on debt investors compared to the current cash lock-up licence condition.	Greater regulatory burden on companies and potential ambiguity regarding the nature of the information that triggered a notification requirement.

	Customers	Equity Investors	Debt Investors	Company Management
	requirements) relies on self-reporting and is not sufficient as a trigger for cash lock-up, because it relies on companies' own judgements about their levels of resilience, and so would not offer the same degree of protection as a defined licence trigger.			
Placing limits on gearing	X Defining limits on gearing (or constraints based on other defined financial ratios) is unlikely to capture the full range of risks to financial resilience (for example, our annual Monitoring Financial Resilience report looks at a broad range of factors). Fixed gearing caps may also lack flexibility to address changing circumstances and investment programmes.	X Potential cost to equity investors as there is a risk that the gearing cap is set at the wrong level.	✓ Potential benefit to debt investors as a gearing cap may reduce downside risk.	- Will restrict management decisions but will provide clarity about gearing expectations.
Stress testing (similar to that used in banking)	- Could take significant time to develop, during which time there would be no difference to the status quo. May or may not increase	✓ Could take significant time to develop, during which time there would be no difference to the status quo. Compared to	- Could take significant time to develop, during which time there would be no difference to the status quo.	X The requirement for companies to provide additional stress tests to the regulator would introduce an additional and potentially

	Customers	Equity Investors	Debt Investors	Company Management
	<p>protections, depending on stress tests adopted and the requirements placed on companies as an outcome of the stress testing process.</p>	<p>the current cash lock-up licence condition, this could reduce restrictions on dividend payments. However, it is also possible that the outcome of stress test could be to restrict dividend payments.</p> <p>Could deter investors if there is a lack of clarity about the expectations on the basis of the outcome of the stress testing or predictability as to how regulatory decisions would be made in the context of the stress test results.</p>	<p>Impact would then depend on stress test developed.</p>	<p>significant administrative burden. This is because it would require additional, and potentially complex, decisions to be made about what factors ought to be stress tested, when and by whom. In contrast, credit rating agencies already set credit ratings in accordance with their determined methodologies and setting the cash lock-up trigger by reference to existing process does not introduce any additional administrative burden, and ensures the regulatory protections remain proportionate.</p>
Dividend Licence Condition				
<p>Modifying the dividend policy licence condition to take account of service delivery for customers and the environment over time, current and future investment needs, and financial resilience over the long term</p>	<p>✓✓</p> <p>Will improve financial resilience and reduce the risk of service issues by ensuring dividend policies and payments declared or made under those policies take account of delivery for customers and the environment and current and future investment needs and financial resilience over</p>	<p>✓✓</p> <p>Where dividend payments take appropriate account of performance for customers, the environment and current and future investment needs, this improves trust and confidence in, and legitimacy of, the water sector, which</p>	<p>✓</p> <p>There would be marginal positive impacts for debt investors through aligning the licence condition with expectations that we set at PR19 (and will take forward for PR24) on ensuring dividend payments and policies take account of delivery for customers and the environment.</p>	<p>-</p> <p>The modified dividend policy licence condition formalises the existing expectations of water companies as set out in PR19 and as will continue with PR24, thereby providing consistency and predictability for company management in the regulatory regime.</p>

	Customers	Equity Investors	Debt Investors	Company Management
	the long term. Will also improve stakeholder trust and confidence in the water sector.	aligns with the interests of investors with long term investment horizons.		
Credit Rating Licence Requirements				
Modifying the credit rating licence requirements: requirement to maintain two credit ratings	✓✓ It is typically considered best practice for a company to maintain two credit ratings and, in the case of diverging views between credit rating agencies, the breadth of views can be captured to better inform decisions on how to improve financial resilience.	✓ Using two credit ratings will provide further information to equity investors.	✓✓ Using two credit ratings will provide further information to debt investors and is aligned with best practice	- Most large water companies already hold at least two issuer credit ratings – and these costs fall into base cost allowances that are modelled as part of our approach to setting our determinations – and so for these companies there will be no impact. For smaller companies, we will consider alternative arrangements when companies are able to provide evidence that the cost of maintaining two ratings would be disproportionate.
Modifying the credit rating licence requirements: credit rating change notifications	✓✓ Timely notification by companies to us of any changes to credit ratings enables engagement and understanding to be clarified	- Minimal impact on equity investors.	- Minimal impact on debt investors.	X Timely notification by companies to us of any changes to credit ratings enables timely engagement, thereby reducing any

	Customers	Equity Investors	Debt Investors	Company Management
	in terms of the reasons for the change, thereby reducing potential future negative impacts on customers.			potential future negative regulatory impact on the company. However, this does add an additional management and regulatory burden on the company.
Wessex Water Licence Conditions				
Updating Wessex Water's licence to align with those of all other companies in the sector	✓✓ Our regulatory ring-fence arrangements are an important safeguard for customers and this change will ensure water customers benefit from the same level of licence protections whomever their supplier.	- Assuming Wessex Water is already operating in a manner that is consistent with the licence modifications, such a proposal would have marginal impacts on equity investors.	- Assuming Wessex Water is already operating in a manner that is consistent with the licence modifications, such a proposal would have marginal impacts on debt investors.	- Assuming Wessex Water is already operating in a manner that is consistent with the licence modifications, such a proposal would have marginal impacts on the company.

**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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