Ofwat Centre
City Tower
7 Hill Street
Birmingham
B5 4UA

Dear consultation director,

We welcome the opportunity to respond to your consultation on the *Proposed modification to strengthen the ring-fencing licence conditions for the largest undertakers.*

We recognize and welcome the fact that Ofwat has modified some of its earlier proposals in relation to the question of financial resilience and welcome Ofwat's engagement with the sector, which will be critical in building a foundation from which to secure the investment needed to meet the sector's challenges.

Nevertheless, we have received further comments of concern from investors in relation to aspects of the proposed modifications to licence conditions and we would like to reiterate investors' concerns on a number of fronts and ask Ofwat to consider these carefully ahead of your final determination.

GIIA would argue that Ofwat's approach towards utilising credit ratings to gauge the probability of default should not be the sole measure drawn upon in as it is less relevant than other factors in defaults such as stable cashflows, operational performance and access to debt and equity finance. We argue that a company default would not have a material impact on consumers and is only relevant if the company enterprise value falls below zero and cannot support any financing without subsidy from the consumer. In addition, the current regulatory model makes this occurrence very unlikely. In examples where this has happened, such as the Channel Tunnel and Welsh Water, there was no cost to consumers when the companies defaulted.

More broadly, during the time that Welsh Water defaulted, service to consumers continued as normal and even in insolvency, the assets that Welsh Water held were worth more than the debt and the company was restructured at no additional cost to the consumers. This is similar to the Channel Tunnels default period, where train services and cost of fares continued as normal, incurring no additional cost to consumers. In both cases the financial markets resolved the matter.

Ofwat proposes that all water companies should not operate at or be at risk of falling to the lowest investment grade rating.[1] Investment grade ratings are an indicator of strong credit quality, with 5-year historical default rates under 3%; the difference between default rates of Baa2 and Baa3 is minimal (1%)[2]. Ofwat highlights the transitional risk between BBB- and investment grade but does not consider how much more resilient the infrastructure and utilities sector are, with infrastructure assets more likely to be upgraded than downgraded. There have been multiple examples of infrastructure assets operating sustainably at Baa3/BBB- across utilities, telecoms and transport. The decision around capital structure should ultimately be a matter for companies' boards and their shareholders to decide their optimal position.

[1] Ofwat (2022) Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers, p.20
[2] According to Moody's (Annual Default Study: Corporate Default and Recovery Rates, 1920 – 2017, Exhibit 35); LINK

Ofwat claims that the benefits of these proposals would be in the reduction on the cost of debt. However, if the same asset has a reduction in the cost of debt, then there must be a reactive increase in the cost of equity- whatever the impact in cost to debt, it must be balanced by the corresponding increase in equity. Such proposals restrict companies' structures and at the very least would increase the cost of capital, therefore the benefit on the cost of debt would be minimal but would impact the cost of equity in a greater way.

Ofwat references performance levels, environment, and service delivery in their consultation, however, does not provide further detail and clarity on how these factors would feed into dividend decisions, leaving it open to regulatory discretion. Having dividends linked to operational performance reduces the control that shareholders have on dividends and reduces the incentive to invest in the long term. These proposals and limits on dividend frequency would also limit the ability of holding companies to service their external debt. If a lock up of a healthy operating company is triggered, this additional stress would move through the ownership chain which could then have a negative impact on the operating companies' business plan delivery.

We urge Ofwat to focus on enabling investment by working with water companies, their management teams, and boards to move away from a focus on capital structures, which have featured prominently within previous price controls, and towards incentivising the transformational levels of investment needed in the sector to meet the current and future challenges. GIIA would welcome the opportunity for continued engagement with Ofwat on these challenges beyond this consultation period.

Yours sincerely,

[redacted]

Lawrence Slade
Chief Executive
Global Infrastructure Investor Association
Email address – [redacted]
Telephone number – [redacted]
Mobile number - [redacted]