OFWAT'S PROPOSED FINANCIAL RESILIENCE LICENCE MODIFICATIONS: AN ASSESSMENT

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1. Introduction

On 22 July 2022, Ofwat proposed a series of modifications to water companies' conditions of appointment.[1] The stated purpose of these changes is "to strengthen regulatory protections to incentivise companies to be financially resilient". The proposed modifications include:

- a requirement that each appointee must maintain at all times two issuer credit ratings from two different rating agencies that are investment-grade (up from a minimum of one such rating at present);
- a requirement that the appointee must inform Ofwat if there is a change in a credit rating or outlook, if a new credit rating is obtained, or if a credit rating is withdrawn; and
- a one notch change to cash lock-up provisions, through which an appointee is to be prohibited from paying dividends or other monies to an associated company if its weakest rating is no better than Baa2/BBB and the rating is on review for downgrade or the assigned outlook for the rating is negative (up from Baa3/BBB- at present).[2]

This report offers an assessment of these proposals. The paper is structured as follows:

- section 2 provides some relevant factual background information;
- section 3 charts the path that Ofwat took prior to arriving at its proposed modifications;
- section 4 sets out my thoughts; and
- section 5 concludes.

[1] In this paper I use the shorthand "licence" in place of conditions of appointment.

[2] I note that the text of paragraph P.28.2 in the proposed modification does not, in practice, have this effect. I assume that this is an unintentional slip and that Ofwat will issue corrected wording in due course.

2. Preliminaries

I start my assessment of Ofwat's proposed modifications by providing some basic background information.

2.1 Financial resilience

The first thing to be clear about is the meaning of the term "financial resilience". Ofwat defines financial resilience as:[3]

> … the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption.

This definition identifies that water companies are exposed to a range of uncertainties, some of which a company can control but many of which a company cannot. In the event that a business is hit by a downside shock, it is important that the company has the wherewithal to ride through that shock without customers suffering from avoidable damage to services. This entails that the company keeps in hand sufficient management, technical, operational and, importantly for the discussion that follows, financial resources to deal with most types of downside scenarios.

Ofwat has previously given a helpful list of some of the key factors that can affect a company's financial resilience.[4] The list is reproduced in Box 1 below.

Box 1

Debt/liabilities

Level of overall debt (gearing), cost and maturity profile of debt

Nature of debt (senior versus subordinated)

Financial covenants

Proportion of fixed and index-linked debt

Credit rating and potential for future downgrades

Contingent and other liabilities (for example pension liabilities)

Equity

Nature of investors (active versus passive and short versus long term) and willingness of existing equity investors to increase investment if required

Availability of new equity investors

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[3] See, for example: Ofwat (2018), Putting the sector back in balance: consultation on proposals for PR19 business plans, p.33; Ofwat (2021), Financial resilience in the water sector: a discussion paper, p.8; Ofwat (2022), Consultation under sections 13 and 12A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers, p.2.

[4] Ofwat (2018), Putting the sector back in balance: consultation on proposals for PR19 business plans.

Group

Risks arising in the wider group

Recoverability of intergroup loans

Management and operations

Quality of company management, including how they engage with Ofwat

Quality of risk management and risk mitigation measures

Revenue recovery

Cost variability

Exceptional events

This looks to me to be a fairly good survey of the different dimensions that there are to financial resilience. The list of factors recognises, in particular, that resilience will be built on multiple foundations, each reinforcing or buttressing one another in a systemised manner.

2.2 Credit ratings

A credit rating is a measure of a firm's creditworthiness. There are three organisations ("credit rating agencies") that assign credit ratings to water companies in this country: Moody's Investors Services; S&P Global Ratings; and Fitch Ratings. The rating scales that these agencies use are shown in figure 1, below.

Figure 1

Moody's	S&P	Fitch	Interpretation[5]
Aaa	AAA	AAA	Highest credit quality
Aa	AA	AA	High / very high quality
A	A	A	High / upper medium-grade quality
Baa	BBB	BBB	Good / medium-grade quality
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Ba	BB	BB	Speculative
B	B	B	Speculative and of poor standing
Caa	CCC	CCC	Vulnerable to default
		CC	Default is probable
Ca	CC	C	Near default
C	D	D	In default

[5] This is my interpretation of the rating agencies' scales. Readers are advised to refer to the rating agency publications detailed in footnote references 6 to 8 overleaf for more information.

The ratings from Aa/AA to Caa/CCC are further graduated to indicate where an issuer ranks in its rating category by the addition of the modifiers 1, 2 or 3, in the case of Moody's, or the symbols "+" and "–", in the case of S&P and Fitch (e.g. Moody's Baa ratings may be Baa1, Baa2 or Baa3 and S&P's and Fitch's BBB ratings may be BBB+, BBB or BBB-). Ratings from Aaa/AAA down to Baa/BBB are commonly known as investment-grade ratings. Ratings from Ba/BB downwards are speculative ratings or junk ratings.

Each of the three rating agencies uses slightly different language to describe precisely what their ratings represent. Moody's states that its ratings are:[6]

> …forward-looking opinions of the relative credit risks of financial obligations issued by non-financial corporates, financial institutions, structured finance vehicles, project finance vehicles, and public sector entities.
>
> …ratings reflect both the likelihood of default and the expected loss suffered in the event of a default.

S&P does not use the same likelihood of default combined with loss given default formulation, and instead produces ratings that focus more narrowly on likelihood of default only:[7]

> Credit ratings are opinions about credit risk. Our ratings express the agency's opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time ... Typically, ratings are expressed as letter grades that range, for example, from 'AAA' to 'D' to communicate the agency's opinion of relative level of credit risk.

Fitch, similarly, gives the following description of its issuer ratings:[8]

> Fitch Ratings publishes credit ratings that are forward-looking opinions on the relative ability of an entity or obligation to meet financial commitments ... Credit ratings are indications of the likelihood of repayment in accordance with the terms of the issuance.

The three organisation's ratings therefore have slightly different character, but they also have a good number of things in common:

- they constitute opinions;
- the opinions are deliberately forward-looking in nature;
- the opinions consider the likelihood that an issuer might default on the promises it has made to creditors; and
- an issuer will be placed in the scale shown in figure 1 above according to its relative credit strength.

This final point about credit ratings being a relative assessment is worth emphasising. Moody's states that:

[6] Moody's Investors Service (2022), Rating symbols and definitions.
[7] S&P Global Ratings (2019), Guide to credit rating essentials.
[8] Fitch Ratings (2022), Rating definitions.

> Moody's credit ratings are opinions of ordinal, horizon-free credit risk and, as such, do not target specific default rates or expected loss rates. Moody's believes the needs of market participants are best served by ratings that are assessments of relative credit risk rather than cardinal risk measures.

S&P uses similar language:

> … S&P Global Ratings opinions are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default. Instead, ratings express relative opinions about the creditworthiness of an issuer … from strongest to weakest, within a universe of credit risk.

Fitch states that:

> Credit ratings express risk in relative rank order, which is to say they are ordinal measures of credit risk and are not predictive of a specific frequency of default or loss.

This is important because there is not a hard definition of what, say, a Baa2 or BBB rating equates to in terms of absolute credit risk. The answer to the question "why does Company X have a Baa2/BBB rating?" will therefore be of the form "because the company is less creditworthy than companies with a Baa1/BBB+ rating and more creditworthy than companies with a Baa3/BBB- rating" rather than because the likelihood that a company will default on its obligations sits above a particular percentage threshold but below another percentage level.

2.3 The rating process

All of the ratings currently held by appointees in England & Wales are solicited ratings. This means that a company selects a rating agency, initiates the rating process and pays fees to the rating agency for its work. It is conceivable that a rating agency could in future give a rating to a water company without specifically being asked (an "unsolicited rating"). However, my previous contacts with the rating agencies indicate that this is unlikely to happen if a rating agency cannot count on the cooperation of the company and is unable to obtain access to privately held information.

A rating agency may give two types of rating:

- an issuer rating,[9] which pertains to the overall creditworthiness of a company; and
- an issue rating, which pertains to the credit risks associated with an individual debt issue (e.g. a particular corporate bond).

This distinction matters for the purposes of the discussion that follows because the three rating agencies do not always assign issuer ratings to water companies. This is particularly the case when a water company structures its debt into more than one tranche (e.g. A class debt, and B class debt) with different seniority, and a rating agency chooses to rate the individual debt issues rather than the issuer.

Table 1 indicates which companies use which rating agencies and whether the agency has to date given issuer ratings or only issue ratings.

[9] Moody's uses the label "corporate family rating". I interpret this rating to have the same character as an issuer rating.

Table 1

Key: ✓ = issuer rating; * = issue rating(s) only

	Moody's	S&P	Fitch
Anglian Water	✓	*	*
Dwr Cymru	✓	*	*
Hafren Dyfrdwy		✓	
Northumbrian Water	✓	✓	
Severn Trent	✓	✓	
Southern Water	*	*	*
South West Water			
Thames Water	✓	*	
Wessex Water	✓		✓
United Utilities	✓	✓	✓
Yorkshire Water	*	*	*
Affinity Water	✓	*	*
Bristol Water	*		
Portsmouth Water	✓		
SES Water	*		
South East Water	*	*	
South Staffs Water	*	✓	

2.4 Origins of rating requirements in appointees' licences

Conditions that refer to a company's credit rating first started to appear in water companies' licences in the late 1990s and early 2000s following a wave of takeovers and ensuing financial restructurings that washed through the sector after privatisation. Ofwat's concern at this time, in common with other regulators facing similar trends in other sectors, was to ensure that appointees with much higher gearing ratios than had been seen previously did not over-borrow and, in particular, did not lose ongoing access to new debt finance.

The references to ratings were initially very straight-forward. A company would typically be required by its licence to use all reasonable endeavours to obtain and maintain a credit rating that is investment-grade. A 1997 Competition Commission report into an acquisition by Pacificorp of one of the electricity distribution networks, Eastern Electricity, articulated the rationale for this approach:[10]

> Evidence provided to us by PacifiCorp and a ratings agency suggested that if the credit rating of a debt were to fall below 'investment grade' (for example, a Standard & Poor's BBB-rating), the cost of borrowing could increase significantly ...

[10] Competition Commission (1997), Pacificorp and the Energy Group plc.

> In order that the DGES [Ofgem's predecessor] can enforce any provision of the licence or the Electricity Act, it would be essential for Eastern Electricity to have access to requisite finance on acceptable terms. This can be ensured by the maintenance of an investment grade credit rating for the debt of the company. Such a rating would also provide an objective and quantifiable measure of the financial health of Eastern Electricity. Failure to maintain an investment grade credit rating would represent an indication that, on an independent assessment by the credit rating agencies, there was a significantly increased risk of financial difficulties within Eastern Electricity …

Starting in 2006, Ofwat added further wording to companies' licences which restricted companies from making certain types of payment, including dividend payments, out of the appointee if its investment-grade rating was under threat. These so-called cash lock-up rules were designed to kick in if a rating agency put a company on notice that a Baa3/BBB- rating could be downgraded, either by way of beginning a formal review for possible downgrade or by assigning a negative outlook to a rating. I have not been able to locate the exact reasons that Ofwat gave for introducing these provisions, but my recollection is that Ofwat was influenced by the actions of Ofgem, which had introduced such rules one year previously as part of its regulation of electricity companies. Ofgem explained that the purpose of its licence modifications was:[11]

> … to clarify how the existing financial ring-fence conditions of companies' licenses would be enforced in the event of a marked deterioration in the credit position of a licensed network operator.

The view, therefore, appears to have been that a company would not be using best endeavours to maintain an investment-grade credit rating if it moved money out of the regulated business while on warning from a credit rating agency that its credit rating was in danger of being downgraded below investment-grade, thereby worsening whatever financial issues it was facing. The cash lock-up provisions codified this interpretation on the face of the licence.[12]

Following an administrative clean-up exercise that Ofwat carried out in 2020, all appointees with the exception of Wessex Water now have exactly the same rules in relation to credit ratings using the exact same wording in Conditions P25 to P28 of their licences. The text is reproduced in annex 1.

[11] Ofgem (2003), Electricity distribution price control: second consultation.
[12] Interestingly, the Competition Commission had considered the merits of such codification in the aforementioned Pacificorp inquiry. Its reasons for not introducing formal cash lock-up rules were as follows: "We considered whether it would be appropriate to provide a more explicit power for the DGES to take action such as limiting dividends if such a rating was not maintained, but concluded that this was unnecessary. If the debt rating fell below the required level, it would provide an important indication to the DGES of actual or potential financial difficulty, enabling him to consider what action should be taken. Any failure by the company to use all reasonable endeavours to restore an investment grade rating could itself be regarded as a breach of the condition which the DGES can require to be remedied."

3. Ofwat's July 2022 proposals

Ofwat's rationale for changing the credit rating and associated cash lock-up requirements in companies' licences has been set out across a series of speeches and documents dating back almost ten years.

The starting point in this story is probably in 2013 when Ofwat's then newly appointed Chair, Jonson Cox, made a particular point of challenging companies to prove, and where necessary reinforce, their long-term financial resilience. After the conclusion of PR14, Ofwat devised and implemented a new framework for monitoring financial resilience. It also introduced a requirement for boards to issue annual long-term viability statements.

Further action came in 2018 when Ofwat issued two documents with the title 'Putting the Sector Back in Balance'. The main proposal in these documents was a new mechanism for the 2020-25 regulatory period that would, in Ofwat's words, require companies with higher levels of gearing to "share their higher returns with their customers" (the so-called gearing out-performance sharing mechanism).

Two of the companies that were most affected by the gearing out-performance sharing mechanism rejected Ofwat's PR19 determinations. This meant that the CMA was required to opine on the mechanism as part of a statutory redetermination process. In its March 2021 decision, the CMA concluded that the sharing mechanism was not justified and should be deleted from the appellant companies' price control frameworks:

> We do not include Ofwat's proposed Gearing Outperformance Sharing Mechanism (GOSM) in our determinations for the Disputing Companies. We found the mechanism was not well-designed to increase the financial resilience of the Disputing Companies and might even reduce it, in the absence of any evidence of any relevant benefits that could be shared with customers. Also, we considered there was insufficient evidence that an intervention of this nature was required for the Disputing Companies within this price control.

The CMA also said that:

> There are different options open to Ofwat to address any concerns it may have about the consequences of high gearing and other factors affecting financial resilience ... In general, financial resilience is addressed by regulators through licence conditions.

albeit warning Ofwat that:

> … neither Ofwat nor any other party has presented us with sufficient evidence that an intervention on gearing is required … We have not been convinced that the risks of high gearing for the Disputing Companies in current circumstances merit any additional mechanisms over and above those that are already available to Ofwat.

The CMA's findings appear to have prompted Ofwat to undertake further work in this area, and in December 2021 Ofwat came forward with a consultation titled 'Financial resilience in the water sector: a discussion paper' which identified a number of ways in which the regulator could "strengthen customer protections and encourage companies to maintain resilient financial structures". The 'long list' of ideas that Ofwat consulted on included:

- a regulator-defined and regulator-enforced cap on gearing;
- limits on certain financing arrangements, such as the use of swaps;

- either a one or two notch increase in the cash lock-up trigger;
- the insertion into the licence of an additional lock-up trigger set with reference to levels of service;
- a requirement for companies to prepare and publish resilience plans when a rating falls below a prescribed threshold;
- a requirement that each company should hold two investment-grade credit ratings;
- tying of the payment of dividends to service performance levels;
- changes to reporting requirements.

In a July 2022 follow-up document, Ofwat announced that it had decided to take forward two of the options identified in its consultation:

- the requirement that all companies should have at least two credit ratings; and
- a one notch change to cash lock-up rules.

Ofwat also tabled a modified version of its prior proposal on dividends, under which companies would only be permitted to pay dividends in accordance with a written dividend policy which, among other things, provides that the sizing of a company's dividends must take account of service delivery for customers and the environment over time.

The July 2022 document was a formal notice under the Water Industry Act 1991 stating that Ofwat intends to modify companies' licences. The text of Ofwat's proposed modifications is reproduced in annex 1. The deadline for interested persons to make representations to Ofwat in relation to the proposed modifications is 29 September 2022.

4. Assessment

As noted in the introduction in section 1, I focus in the remainder of this paper only on paragraphs P25 to P29 of Ofwat's proposed licence modifications and specifically the provisions that would:

- require appointees to hold two issuer credit ratings;
- prohibit the payment of dividends and other monies to associated companies in the event that a company's lowest rating is no higher than Baa2/BBB and either (a) that rating is on review for possible downgrade or (b) the relevant rating agency has assigned a negative outlook.

I offer the following observations.

4.1 Financial resilience vs credit quality

The first thing that stands out to me when I look at Ofwat's proposals is that there is not a perfect mapping from financial resilience to a credit rating, or from credit rating to financial resilience. This follows from the definitions that I ran through in section 2:

- financial resilience is the underpinning that a company's financial arrangements provide to the company to enable it to avoid, cope with and recover from disruption; and
- a credit rating is the opinion that a rating agency has about the likelihood that a company's creditors will be paid when promised and in full.

Just writing these two definitions side by side makes it clear that the two concepts are not synonymous. Among other things:

- financial resilience is a product of many different factors, including but not limited to the scale and structure of a company's debt liabilities, the liquidity that is available to the firm in the event that it requires access to cash, and the strength and flexibility in the company's equity backing. The company's credit rating is one of the factors that can improve or detract from financial resilience. But it would be wrong to think that the credit rating is the only relevant consideration, or to downplay the importance of the multiple other contributing factors identified in Box 1;
- a credit rating focuses very narrowly on the question of whether creditors can expect to receive payments that are owed to them. A rating does not in and of itself tell us anything about the difficulties that a company might experience as it strives to meet those obligations. As such, the perspective of customers and the perspective of the regulator as regards resilience could conceivably be very different from the perspective that a rating agency has when it is assessing raw credit quality; and
- a credit rating is an opinion. It is also an opinion which is bound into specific rules and conventions – for example, the way in which rating agencies opine on relative rather than absolute credit quality, and the different weights that the three rating agencies attach to probability of default vs the probable quantum of loss in the event of a default. This means that one has to be extremely careful to understand exactly what a rating is saying, and why, before one reaches any sort of conclusions about financial resilience or lack thereof.

Given the number of different factors that determine whether a company is financially resilient, and given the particular character and purpose that ratings have, it came as a surprise to me when I read Ofwat's July 2022 consultation document and saw Ofwat emphasise ratings sill further as its be-all and end-all indicator – for licence purposes – of financial resilience. If it were the case that the type of rating being targeted here were an explicit 'financial resilience rating', the design of Ofwat's licence condition would be easier to understand. But since a specific credit rating does not equate directly to financial resilience, I see a clear danger of taking false comfort when a company has a strong rating and, potentially, of over-reacting if a company's rating weakens.

I would suggest that one of the comments that the CMA made when rejecting Ofwat's earlier gearing out-performance sharing mechanism may be instructive here. The CMA found that:

> … the GOSM addresses only the level of gearing, whereas in practice there are other factors … that can influence the financial resilience of a water company and would not therefore be addressed by the GOSM. It is therefore possible that gearing, certainly in isolation, may not be the key unmet resilience issue.

This statement might now be reworded as follows: a licence design that focuses only on the maintenance of a specified rating addresses only a company's position vis-à-vis its lenders, whereas in practice there are other factors that can influence the financial resilience of a water company. It is therefore possible that credit rating, certainly in isolation, may not be the key unmet resilience issue.

4.2 Reliance on the three rating agencies

The next standout feature of Ofwat's approach is the fact that the persons determining appointees' credit ratings are not the Ofwat board or the Ofwat staff team but the employees of three outside organisations.

This has advantages and disadvantages.

The main advantage is that the individuals that sit on the rating agencies' committees are experts in risk assessment. It is understandable, therefore, that Ofwat, like other parties, should pay heed to the rating agencies' expert opinions and consider any rating issued by the rating agencies to be a useful piece of information for regulatory purposes.

The main disadvantage is that Ofwat as regulator is not directly responsible for the judgments that are being made about appointees' credit quality. This matters because the opinions that rating agencies issue have real consequences under the terms of Ofwat's licence design and yet Ofwat cannot exert any form of control over the timeliness, thoroughness or accuracy of a rating agency's analysis.

This is not a new observation. When references to ratings were first brought into regulated companies' licences more than 20 years ago, regulators, companies and outside commentators all worried about the wisdom of linking regulatory rules and regulatory mechanisms directly to the opinions of external organisations. The charge that was put to regulators at this time was that it is not good regulatory practice for a regulator to out-source the assessment of a company's financial health or to allow a third party's opinion to determine, in effect, whether a particular licence requirement should or should not be activated.

The licence modifications that Ofwat is proposing bring such concerns back into focus. Where previously one could rationalise that the licence's rating requirements are only a back-stop measure, and something that does no more than recognise that real-world consequences follow from the real-world delineation between having an investment-grade rating and having a non-investment grade rating, the one notch change to Baa2/BBB gives the rating agencies' opinions a very different status. Specifically, Ofwat is no longer just codifying the practical steps that it expects a company to take as it uses all reasonable endeavours to stay at investment-grade. It is going further and saying that it will harness the rating agencies' published output both to "incentivise" companies and to define what is ultimately a much less tangible boundary between deemed financial resilience and non-resilience.

In this context, I think it is important to ask whether it is right from a public policy perspective that a regulator should be delegating responsibility in this way. An unjustified rating is now many times more likely to have punitive consequences for a company and yet Ofwat, as regulator and decision-maker, sits completely outside of the rating process. This, for me, raises quite serious issues about the integrity of regulation.

4.3 The rating agencies are fallible actors

Concerns about the division of responsibilities also have to be looked at in the light of the rating agencies' historical track records.

Rightly or wrongly, it is quite natural to remember that the rating agencies have sometimes come in for criticism for failing to recognise the true nature of particular credit risks. The textbook reference here is the global financial crisis and the rating agencies' collective blindness to the risks presented by mortgage-back securities and collateralised debt obligations.[13] However, this is not the only example. The rating agencies have also been challenged in other settings, as set out in Box 2

Box 2

Case study: Sovereign debt	Case study: Developing countries
The rating agencies have been criticised by European Commission for exacerbating sovereign debt crises through erratic and subjective rating decisions.[14]	The United Nations,[15] in common with other commentators, has suggested that the rating agencies methodologies are biased against developing nations.
Case study: Financial services	**Case study: COVID**
Over the last decade, there has been a drive by financial regulators to reduce the reliance that banks and institutional investors place on ratings by reducing the hard-wiring of ratings in standards, laws and regulation.[16]	A recent University of Cambridge study[17] found that the rating agencies "kept coasting in business-as-usual mode" during the recent COVID pandemic.

[13] Financial Crisis Inquiry Commission (2011), The financial crisis inquiry report.
[14] See statements made prior to the finalisation of European Commission Directive 2013/14/EU.
[15] UN (2022), Credit rating agencies and sovereign debt: challenges and solutions.
[16] Financial Stability Board (2010), Principles for reducing reliance on CRA ratings.

In the regulated industries, I recall that when rating requirements were first brought into licences more than 20 years ago there were complaints that the rating agencies were becoming more "trigger happy" in their approach to rating water companies.[18] Since this time, regulators have often come into opposition with rating agencies over what the regulators have seen as the rating agencies' failure to recognise regulated companies' true credit strengths. A good example of this divergence of views came in Ofwat's PR19, when Ofwat went as far as to disregard two of the rating agencies' established methodologies in its final determination assessment of appointees' financeability (I return to this episode in section 5.4 of this paper).

My own view, for what it is worth, is that there is a tendency for the rating agencies to overstate the risk of non-payment of regulated utilities' debt obligations. To the best of my knowledge, no lender to a licensed monopoly company in this country has ever been forced to take a loss on the principal or interest owed to them over a period of more than 30 years, notwithstanding that companies for most of this period have typically had ratings in the A or Baa/BBB categories (indicating that the rating agencies have assessed that obligations are subject to moderate credit risk). I personally struggle to see the risk that rating agencies say that they are seeing in companies that have equity buffers[19] worth a healthy multiple of annual expenditure, and I find it hard to construct scenarios in which such companies could get into such serious difficulties that lenders would have to accept a loss on their investments.

Be that as it may, the broader point here is that a rating agency's opinion is exactly that: an opinion. The three rating agencies have strong commercial and reputational incentives to get their credit assessments as 'right' as possible, but there will always be a possibility that an agency will get big calls wrong and either inadvertently overstate or inadvertently understate a water company's true credit quality.

4.4 Only the lowest rating counts

The concerns that I have started to sketch out under the two preceding headings need to be read in the context of the particular way in which Ofwat has chosen to structure its rating requirements. Specifically, under Ofwat's proposed licence design:

- companies are to be required to obtain and maintain issuer ratings with at least two rating agencies; and
- it is the lower/lowest of a company's two/three ratings that will count when determining whether a company does or does not go into lock-up.

This 'lowest common denominator' approach says, in effect, that the rating agencies' opinions should be weighted either 100% or 0% with no middle ground in between. If, for example, a company has three ratings of, say, A-, A- and BBB,[20] the licence says to discard the two higher ratings and focus only on the lowest rating.

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[17] Tran, Vu, Klusak, Kramer, Hoang (2021), Sovereign credit ratings during the COVID pandemic.
[18] See Smith and Hannan (2003), Structure of the water industry in England: does it remain fit for purpose – a report for Defra and Ofwat.
[19] Calculated as the value of the regulatory asset base minus net debt.
[20] In this case, and in similar examples that follow, I deliberately use the S&P/Fitch rating scale so as to be agnostic about which rating agency gives which rating.

I question whether this is desirable. To my mind, a rule which says that you are only as good as your weakest rating is a poorly targeted rule in that it increases the risk that a rogue rating could activate the prohibition on payment of dividends for no good reason. If one of the rating agencies is clearly out of line with its peers, as in the above example, the rogue rating will not necessarily affect lenders' perceptions of credit risk. Nor will market appetite for the company's debt necessarily dry up. Instead, my expectation is that lenders would look at the specifics of the rating agencies' differing opinions, form their own views, and adjust their pricing and willingness to lend accordingly.

There is a contrast, therefore, between the intelligent way in which the markets will deal with an atypical rating opinion and the mechanistic way that Ofwat is programming the licence to process the same information. In my view, if a single rating does not in practice have direct financial consequences, it is disproportionate and wrong for Ofwat to write the licence in such a way as to automatically and unthinkingly put a company into lock-up on the basis of a single rating action.

4.5 Actions that stop short of a change in rating

A similar set of points can be made about the way in which lock-up will be triggered not just if a rating falls below Baa2/BBB but also if:

- a Baa2/BBB rating is placed on review for downgrade; or
- the rating agency assigns a negative outlook to a Baa2/BBB rating.

The key thing to note here is that neither of these things can in and of themselves be interpreted to mean that a company is no longer exhibiting Baa2/BBB credit quality. In the first case, formally the rating agency is going no further announcing that it is undertaking a review of a credit rating and that the results of that reassessment will likely be made known in 3-6 months time. In the second case, the rating agency is conveying an opinion that it sees a non-trivial probability that a rating could move lower at a future date, but without going as far as to say that the existing rating is unsuitable at the present time.[21]

There are many historical instances in which a rating agency has placed a water company's rating on review for downgrade or assigned a negative outlook but no actual change of rating has followed despite there being no material change in the company's obligations to lenders. I give some examples from the last five years in the box below. In several of these examples, companies would have gone into and then out of lock-up despite maintaining credit quality commensurate with at least a Baa2/BBB rating.

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[21] Moody's states that: "A stable outlook indicates a low likelihood of a rating change over the medium term. A negative, positive or developing outlook indicates a higher likelihood of a rating change over the medium term. A rating committee that assigns an outlook of stable, negative, positive, or developing to an issuer's rating is also indicating its belief that the issuer's credit profile is consistent with the relevant rating level at that point in time ... Historically, approximately one-third of issuers have been downgraded (upgraded) within 18 months of the assignment of a negative (positive) rating outlook." S&P states: "If S&P Global Ratings anticipates that a credit rating may change in the coming 6 to 24 months, it may issue an updated ratings outlook indicating whether the possible change is likely to be "positive," "negative," "stable," or "developing"". Fitch states: "Outlooks indicate the direction a rating is likely to move over a one- to two-year period. They reflect financial or other trends that have not yet reached or been sustained the level that would cause a rating action, but which may do so if such trends continue … Positive or Negative Rating Outlooks do not imply that a rating change is inevitable …"

Box 3

1) Affinity Water, Portsmouth Water, South Staffs Water Moody's put 12 companies' ratings on review for downgrade in December 2019, four days after the publication of Ofwat's PR19 determination. 5 of the 8 companies that did not appeal to the CMA were subsequently downgraded between January and March 2020. The ratings for 3 companies were affirmed with no change by March 2020.	2) Anglian Water and Yorkshire Water Moody's moved Yorkshire Water's and Anglian Water's then issuer ratings (both Baa2) to negative outlook in December 2017 and May 2018 respectively. The rating and the outlook did not change through Ofwat's PR19 determination and the companies' subsequent CMA appeals. Moody's moved Anglian Water's outlook to stable in March 2021 and withdrew Yorkshire Water's issuer rating in May 2021.
3) Portsmouth Water Fitch moved Portsmouth Water's BBB rating from stable to negative in March 2019. It affirmed the rating and negative outlook in February 2020. The rating was withdrawn at the company's request in November 2020.	4) SES Water After PR19, Moody's in March 2020 moved SES Water's rating from Baa1 to Baa2 and assigned a negative outlook. The outlook was changed from negative to stable in October 2021.

Given this experience, I am concerned that Ofwat's proposed licence design places too much store on the possibility a rating *may* change as opposed to the actual rating that a company *is* able to maintain at any given point in time.

4.6 Practical implementation

One final point of concern that I have arises from what I said in section 2.3 about the limitations on the ability of some of the companies in the sector to obtain issuer ratings. I note that the licence as currently written allows Ofwat to determine that an issue rating shall be used in place of an issuer rating if, in Ofwat's assessment, "this rating sufficiently reflects the creditworthiness of the Appointee". Ofwat's proposed licence modifications also state that Ofwat may "provide its written agreement for the Appointee to maintain only one Issuer Credit Rating" In the event that an appointee cannot practically amass the requisite number of issuer ratings.

The intrinsic inability of some companies to obtain two issuer ratings, and Ofwat's response to this problem, make Ofwat's rules more difficult to apply than would ideally be the case. Rather than set a common, targeted standard that all companies are required to meet, Ofwat is forced in a number of cases either to squeeze a round peg into a square hole or to back away entirely from its publicly announced red line. This serves to further reinforce my concern that the rating process is unable to bear the load that Ofwat is seeking to place on it.

5. Conclusions

5.1 Overall summary

The comments that I have made under the preceding headings make me very uneasy about the line that Ofwat draws from financial resilience to ratings and, hence, about Ofwat's decision to make the payment of dividends conditional on the across-the-board attainment and maintenance of a particular level of issuer rating within the Baa/BBB rung. Equity investors, quite naturally, place great importance on the return of and on their investment, and I believe that a regulator should have a very high bar before it takes action to block such payments. I consider that Ofwat is wrong to have to have come to the conclusion that a single rating action from a single rating agency automatically meets this threshold.

5.2 The gaps in Ofwat's approach

To help illustrate the kinds of situations that I am worried about, I set out in Box 4 a series of possible scenarios that could emerge in the coming years. My view is that Ofwat's proposed licence design is not able to deal adequately with any of these scenarios, giving rise to an unacceptable risk of perverse outcomes without any obvious available solutions.

Box 4

Scenario 1: A company is not able to obtain two issuer ratings

Problem: I noted in section 4.6 that companies with structured financing arrangements will likely not receive issuer credit ratings from at least two of the three rating agencies. Ofwat has no choice but to give these companies special treatment – e.g. by using available issue ratings in place of issuer ratings or by releasing them from the obligation to obtain two issuer ratings. This inevitably means that different appointees are going to be held to different standards.

Scenario 2: A company has three ratings and one of the three ratings falls to Baa2/BBB with negative outlook. The company takes steps to get the rating agency to withdraw its rating.

Problem: I explained in section 2.3 that most ratings are solicited ratings and that it is unlikely that a rating agency would assign a rating without the cooperation of the relevant company. The ability that a company has to take itself out of lock-up by eliminating its least favourable rating begs the existential question: does the rating agency's opinion have worth or not?

Scenario 3: A company has a split rating – e.g. A-, A- and BBB. The outlook on the BBB rating is moved to negative outlook.

Problem: Ofwat proposed licence design places 0% weight on the two A- ratings and 100% weight on the BBB rating. The company would go into lock-up even if most debt investors choose to ignore the rogue BBB rating and show undiminished willingness to lend to the company at an unchanged price.

Scenario 4: Two companies have BBB+, BBB+ and BBB ratings and BBB and BBB ratings respectively. The outlook on only the first company's BBB rating is moved to negative outlook.

Problem: The first company would go into lock-up, but the second company would not, even though there are no real grounds for thinking that the first company exhibits weaker financial resilience.

Scenario 5: Fitch sees heightened risks facing the water industry and adjusts its ratings and/or outlooks accordingly.

Problem: I showed in table 1 that Fitch's opinions matter for licence purposes to only a minority of the 17 companies. This exposes these companies, and only these companies, to a Fitch-caused lock-up while the other companies in the sector are able, in effect, to ignore Fitch's assessment of risks.

Scenario 6: Ofwat behaves erratically during a future price review and a rating agency responds by moving one or more companies' ratings to Baa2/BBB with negative outlook. However, the CMA corrects Ofwat's errors through the statutory appeal process and after the publication of the CMA's determination the rating agency adjusts the ratings and/or the outlook upwards.

Problem: The affected companies could conceivably spend up to 3 years in lock-up without their ratings actually falling below Baa2/BBB and without there ever being an actual loss of financial resilience vis-à-vis a fair regulatory determination.

Scenario 7: A company's Baa2/BBB rating is placed on review for downgrade but the review ends with confirmation of the company's existing rating.

Problem: The company would spend 3-6 months in lock-up on the basis of what could be characterised as a false alarm.

Scenario 8: A rating agency assigns a negative outlook to a company's Baa2/BBB rating and retains that outlook for a period of [x] years without ever deeming it necessary to change the rating.

Problem: The company would spend [x] years in lock-up due to the rating agency's fear of eventualities that could have happened but did not happen, all the while exhibiting Baa2/BBB credit quality.

Scenario 9: Water company ratings are affected by changes in credit risks elsewhere in the economy.

Problem: Since credit ratings are relative ratings rather than absolute ratings, it is possible that a company will move closer to or further from lock-up due to factors that are entirely unrelated to water company credit risks and financial resilience.

Scenario 10: A rating agency downgrades (or upgrades) the sector due to circumstances that affect likelihood of default and/or loss given default but which have nothing to do with financial resilience - e.g. talk from an opposition party about renationalisation.

Problem: Companies might go into lock-up even though there is no material weakness in their ability to avoid, cope with and recover from service disruption.

5.3 Response to possible defences from Ofwat

I can envisage that Ofwat could have two main lines of response to the conclusions that I am making in this paper.

5.3.1 Ofwat's ability step in and approve dividends

The first line of defence might be to point out that the first sentence of Condition P29 of the proposed licence modification gives Ofwat the power to approve the payment of dividends or other monies to an associated company in circumstances where a rating has fallen below Ofwat's prescribed threshold.[22]

I do not think this residual power cures the harm that the flawed design of the proposed licence modifications causes. Ofwat has deliberately written the licence condition in such a way as to put a bar on dividend and other payments from the instant that a rating agency announces that a Baa2/BBB rating is on review for downgrade or a rating agency moves a Baa2/BBB rating to negative outlook. Equity investors looking at this set-up have no basis for assessing the likelihood that Ofwat would willing subsequently to lift that bar and would note that there are no set timescales within which Ofwat must make such a decision. In order for investors to place any reliance on Ofwat's step-in rights in the scenarios depicted in Box 4, Ofwat would need, as a minimum, to publish in advance a detailed set of criteria and timelines setting out how it would go about reviewing a rating action and the circumstances in which it would be willing to waive lock-up. I consider it is highly unlikely that Ofwat could write such guidance in a way that anticipates all possible states of the world or which would convey sufficient commitment to right the kinds of wrongs that I have identified.

[22] Condition P29 states that: "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 …" (emphasis added).

If I were in a shareholder's shoes, therefore, I would feel that I would have no choice but to assume that the company I have invested in will not be in a position to pay me any sort of return for so long as its rating remains below the threshold stated on the face of the licence. As such, I think that a residual power to approve payments has little real worth.

5.3.2 What has actually changed?

A second possible argument Ofwat could make would be to question whether the harms that I have identified in this paper are strictly speaking caused by this particular set of proposed licence modifications. The view might be that most or all of the criticisms that I am making in this paper could just as easily be levelled at the requirements set out in the existing licence.

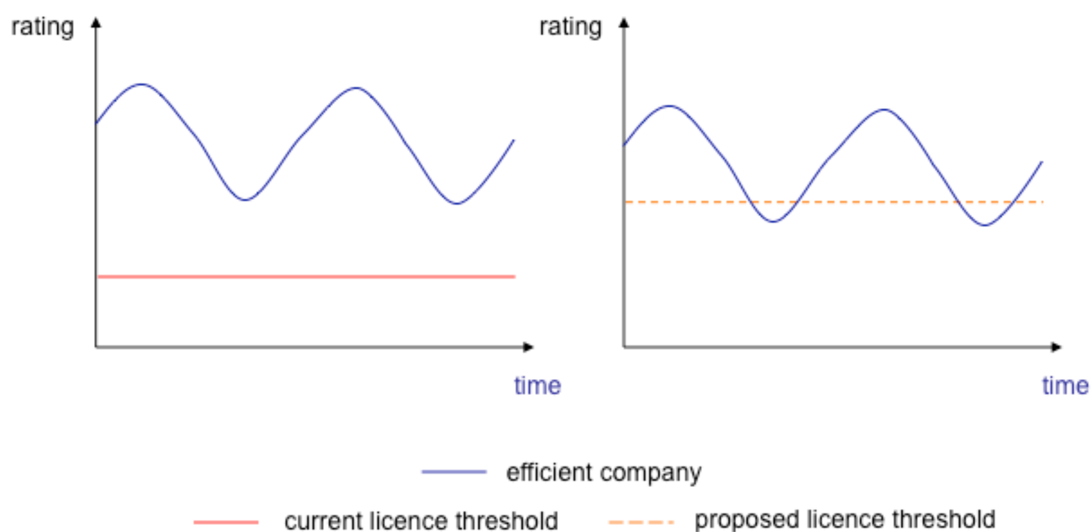
I have three responses to this observation.

First, it is fair to say that some of the issues that I have identified above would remain even if Ofwat were to withdraw its proposed modifications and stick with the existing licence design. I noted in section 4.2 that questions have been asked for a period of more than 20 years about the wisdom of attaching regulatory triggers to outsiders' rating opinions, and it is correct to point out these questions do not go away if the licence merely specifies a Baa3/BBB- rating threshold rather than a Baa2/BBB rating threshold.

It would be wrong, however, to characterise the proposed modifications as a simple one notch tweak to established licence architecture. The proposed change to Condition P26 to require an appointee to hold a minimum of two issuer credit ratings is an integral part of the package. This is important because the comments I made in section 4.4 about Ofwat giving 100% weight to the company's lowest rating lies at the heart of my concerns about the risk of a rogue rating putting a company into lock-up for no good reason.

Third, and perhaps most importantly, the risk that a well-managed company with sound finances will find itself in lock-up through no fault of its own increases markedly when the licence's minimum rating requirement is set at Baa2/BBB rather than at Baa3/BBB-. I can try to illustrate what I mean by this using the charts below.

Figure 1



The blue lines in the charts depict the rating that an efficient company with an efficient mix of debt and equity (i.e. what Ofwat calls a "notionally efficient company") would expect to obtain from a rating agency. The lines are drawn the way they are to reflect the natural 'noise' that I would expect to see in such a company's lowest rating.[23] The red line is the dividing line between investment-grade and non-investment grade. The dotted amber line is Ofwat's proposed new threshold of Baa2/BBB with negative outlook or pending a review for downgrade.

The charts illustrate that the kind of perverse lock-up outcome that I identified in the scenarios in Box 3 are now far more likely to occur and/or to affect a greater number of companies than under the existing licence design – i.e. the risk that an efficiently financed company could through no fault of its own end up with a rogue Baa2/BBB rating is many times greater than the risk that an efficient company could end up with a rogue Baa3/BBB- rating.

5.4 Ofwat's previous statements

Ofwat may say that it sees these matters in different terms. However, it has on several previous occasions expressed similar sentiments, and, indeed, sometimes passed more severe judgments than I have passed above, about the reliance one should place on ratings.

During the CMA's first PR19 hearing in July 2020, Ofwat's current Chief Executive, David Black, made the following overarching remarks:[24]

> Certainly I think it is fair to say that rating agencies are not, you know, they do not get the statutory duties of a regulator; their duty is not to customers; their duty, if anything, is to the bondholders, so they are not going to represent customers in these kind of transactions, nor should we expect them to do so.

He then added:

> We are very conscious that rating agencies have mixed incentives. So, they earn revenue from bonds being issued. And so, while we think investment-grade credit rating is a helpful protection to have and does utilise market disciplines in terms of companies, so we think they are valuable, they are not, in themselves, a substitute for a ring-fence or a substitution for a regulation; nor will they result in the right outcomes for customers.

Mr Black went on to say:

> I think while rating agencies are valuable, they are not infallible; the global financial crisis and the number of AAA bonds which magically turned into junk quite quickly is evidence that rating agencies do not always get things right. And indeed, there is an incentive problem that although rating agencies are paid by bondholders, there is a question about them benefitting from the gearing-up process.

[23] NB: the blue line is not meant to indicate that the rating would necessarily oscillate over time. Instead, I mean only to depict the inherent uncertainty in rating outcomes.

[24] CMA (2020), Note of a remote hearing with Ofwat held via the Competition and Markets Authority, Cabot Square, London on Wednesday, 22 July 2020.

I mentioned in section 4.3 that one of the issues that arose during PR19 was Ofwat and two of the rating agencies formed contrasting views about companies' credit quality given the revenues that Ofwat allowed in its price control determinations. There were, in fact, two disagreements relating first to the rating agencies' assessment of regulatory risk and then to the impact that advancement of revenues from future control periods would have on credit quality.[25] After reviewing Ofwat's evidence on these matters, the CMA asked Ofwat in its November 2020 hearing whether the CMA should "just use the methodologies of the agencies who actually do the ratings". Ofwat's Director, Risk and Return, answered as follows:[26]

> Now, credit rating agencies, of course, we appreciate the role that they do. They do not have a duty to customers; they have a duty to the companies that they rate and to bondholders. They do not have a duty to customers ...
>
> Rating agencies adopt different approaches to their methodologies and if you fall to the lowest denominator in amongst all of that, then you might be over-renumerating companies within the period of the price control if a financial ratio was set as a minimum threshold for modelling purposes.

Mr Black then followed up:

> Just to cut to the chase, Andy, but Standard & Poor's accept the use of cash flow adjustments such as PAYG rates, that is a run-off rate. Moody's look through them in the calculation of set financial ratios, although they do accept there are benefits to the company from a solvency and liquidity perspective. So, in terms of can you look at one rating agency and say this is the answer, the answer is no because they do take different approaches and so if you do not think a particular rating agency approach ought to be determinative even leaving aside Andy's points about what rating agencies' interests are and what they are there to do.

These comments matter because Ofwat appears to be acknowledging exactly the kind of risk of unforeseen and unjustified outcomes that I have tried to highlight in this paper. Assuming that Ofwat still has the misgivings that its Chief Executive and its staff have expressed openly in the past, it is surprising to me that Ofwat would want to bring forward licence modifications that put *more* weight on the rating agencies' opinions.

5.5 A better approach

Having set out a series of arguments against Ofwat's proposed licence modifications, the question that naturally arises is: what would be a better way of ensuring that water companies remain financially resilient?

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[25] In Ofwat (2020), Reference of the PR19 final determinations, Ofwat explains that: "In 2018, Moody's and Fitch increased their assessment of business risk, leading to a tightening of guidance for adjusted interest cover and gearing. These credit rating agencies set out they had changed their view of the stability and predictability of the regulatory regime alongside an expectation of more volatile cash flows resulting from more revenue at risk through incentive mechanisms." Ofwat then states bluntly: "We do not agree that regulatory risk has increased". In Ofwat (2020), Reference of the PR19 final determinations: risk and return – response to common issues in companies' statements of case, Ofwat then advised the CMA as follows: "Strict adherence to credit rating agency methodology would result in the cost to customer being influenced by credit rating agencies. The CMA may consider disregarding the increase in thresholds for adjusted interest cover and gearing."

[26] CMA (2020), Notes of a video conference with Ofwat held at Competition and Markets Authority, Cabot Square, London on Monday, 20 November 2020.

There are a number of possible approaches that Ofwat could consider, but as my final thought for this paper, I think it is instructive to go back to Box 1 and Ofwat's overview of the different factors that contribute to financial resilience. The big takeaway that I have from Ofwat's long list is the sense that a company's rating(s) does matter, however it matters as part of an interconnected web of multiple safeguards and buffers.

If I were a member of Ofwat's board looking at Box 1, I would worry that it was a mistake to have focused the July 2022 proposals so tightly on ratings. I would instead be encouraging the Ofwat staff team to look at companies' financial resilience in a more holistic way, taking account of all of the different factors that contribute to or detract from resilient service to customers.

I wonder if a helpful parallel can be drawn in this regard to the way in which financial regulators have been moving away from mechanistic reliance on ratings and developing their in-house risk assessment capabilities.[27] This is not my area of expertise, but my understanding is that the Bank of England exposes the organisations that it regulates to periodic 'stress tests' in order to ensure that they can cope with severe economic scenarios and are able to support the economy. If a financial institution fails these stress tests, the Bank of England has widely drawn powers, not dissimilar from Ofwat's licensing powers, to direct the business to build capital, including by restricting its dividends.

It seems to me that this might provide a better model for Ofwat to apply to the companies that it regulates.

[27] The first principle in the Financial Stability Board principles that I referred to earlier is: "Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness."

Annex 1

<u>Current licence condition</u>

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 Issuer Credit Rating which is an Investment Grade Rating.

P27 The "Cash Lock-Up" provisions set out in paragraph P28 apply in any circumstances:

P27.1 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

P27.2 where the Appointee or any Associated Company which issues corporate debt on its behalf:

P27.2.1 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is not an Investment Grade Rating; or

P27.2.2 holds an Issuer Credit Rating which is the Lowest Investment Grade Rating and:

P27.2.2.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P27.2.2.2 otherwise where the rating outlook of the Lowest Investment Grade Rating has been changed from stable or positive to negative to has been changed from stable or positive to negative.

P28 Where paragraph P27 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:

P28.1 the Appointee makes a payment to an Associated Company which is:

P28.1.1 pursuant to an agreement entered into prior to the circumstances referred to in paragraph P27 arising, which provides for goods, services or assets to be provided on an arm's length basis and on normal commercial terms; and

P28.1.2 properly due in respect of the relevant goods, services or assets;

P28.2 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:

P28.2.1 the transaction is on an arm's length basis on normal commercial terms; and

P28.2.2 the value due in respect of the transaction is payable wholly in cash and is paid in full when the transaction is entered into;

P28.3 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:

P28.3.1 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

P28.3.2 a loan made prior to the circumstances referred to in paragraph P27 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

P28.4 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.

Proposed licence condition

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, 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.

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 one notch above the Lowest Investment Grade Rating (i.e. BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent) 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 the rating outlook 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 P28 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.