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# NORTHUMBRIAN WATER RESPONSE TO OFWAT CONSULTATION UNDER SECTIONS 13 AND 12A OF THE WATER INDUSTRY ACT 1991 ON PROPOSED MODIFICATIONS TO STRENGTHEN THE RING-FENCING LICENCE CONDITIONS

SEPTEMBER 2022

## NWL response to s13/12A consultation on strengthening the ring-fence

This document sets out the response of Northumbrian Water Ltd (NWLs) to Ofwat's recent consultation under sections 13 and 12A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions.

### EXECUTIVE SUMMARY

**NWL does not support the proposals set out in that consultation**. We maintain our position as set out in our previous response[1] (Jan 2022) and we have added additional comments based on the Ofwat s13/12a consultation (July 22)

**Ofwat has failed to produce reasonable evidence to support the existence of its financial resilience concerns and has also failed to provide any reasonable assessment of the impact of its proposed remedies. This procedural error in turn leads Ofwat to a series of proposals that are inconsistent with its duty to protect the interests of customers and based on assumptions that contain factual errors.**

We do not support the proposed dividend lock-up arrangements at a higher credit rating threshold and the proposed licence modification for a revised dividend policy:

- **We do not consider that a reasonable case has been made that there is a financial resilience problem in the sector to be addressed in the first instance**. Whilst levels of financial resilience do vary across the sector companies have successfully endured many financial challenges over the past 30+ years since privatization including the global financial crisis and more recently the Covid pandemic. Importantly this has happened without any instances of service levels to customers deteriorating because of companies' financial resilience and Ofwat has failed to show a direct link between these two issues. This is unsurprising in a monopoly sector where there are already many existing protections to ensure that businesses remain financially resilient and can continue to deliver the essential services that customers require. These same points were noted by the CMA in the PR19 redeterminations where it did not consider there was any reasonable case for such a mechanism beyond Ofwat's existing powers. Indeed, as we highlight in the more detailed response the level of the equity buffer has actually increased recently, levels of gearing across the sector on average are falling and many companies' ratings have improved. Ofwat has failed to demonstrate a reasonable case for intervention in the first instance.

- **The proposals are ambiguous, poorly defined and will increase risk and cost**. The proposed licence modification is unclear, for example it is ambiguous what is meant by 'performance for customers' the lack of clarity creates a situation where Ofwat could open an enforcement case against a company where it considered that the companies' distributions did not reflect this. This lack of clarity will likely have a chilling effect on the payment of dividends in the sector making it less attractive to external investment, particularly for the listed sector. This point is also expanded in a paper by First Economics which challenges the notion in the proposals that the trigger should be the lower of the two credit ratings[2]. We support their conclusion which is that Ofwat's proposal is inconsistent with how competitive markets would operate.

- **The proposals suggested in the consultation will fail to achieve their stated aims and will actually harm customers, in direct contradiction to Ofwat's statutory duties**. Unfortunately, Ofwat has conducted insufficient analysis of the problem or the impact of the remedy it

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[1] NWL Response to Financial resilience in the water sector, Jan 2022

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

proposes to implement. We have sought to correct this procedural gap by commissioning an independent impact assessment with other companies across the sector which we have provided alongside our response. That analysis clearly shows that the remedies proposed will only reduce the likelihood of a company defaulting by a tiny fraction thereby representing a very weak remedy to financial resilience concerns. Moreover, as has been highlighted in a separate paper by First Economics[3], financial resilience cannot reasonably be assumed based on a credit rating metric. In fact, the proposals will result in a risk transfer to equity investors that will increase the cost of capital, reduce certainty and damage investor sentiment precisely at a time when the sector is seeking substantial amounts of new capital for environmental improvement, to address water scarcity challenges and meet net zero ambitions. The impact assessment provides several examples from preference shares, debt pricing and other analysis to illustrate the potential scale of this impact which are consistent with economic and corporate finance theory. It also provides a clear illustration from the banking sector of the impact comparable changes have had there on the cost of capital. Finally, the impact assessment highlights that the proposals will restrict companies from adopting the most efficient capital structure for customers and could damage incentives for efficient outcomes. It is clear that the remedies proposed will do more harm for customers than good and they are therefore inconsistent with Ofwat's statutory duties, the table below summarises the overall costs and benefits of the proposals from the impact assessment for customers.

**Figure 1: Summary of costs and benefits of Ofwat's financial resilience proposals**

| Area | Cost of capital estimate |
|---|---|
| **Benefits of Ofwat's proposals** | |
| Probability of default analysis (i.e., reduction in likelihood of water company default arising from increased rating threshold) | 0-2bps |
| Cost of debt allowance (i.e., reduction in cost of debt from increased rating) | Immaterial |
| **Total estimated range of benefits associated with Ofwat's proposals** | **0-2 bps** |
| **Costs of Ofwat's proposals** | |
| Dividend signalling / costs arising from changes to dividends | 18-22bps |
| Pricing changes in equity claims – e.g., from Preference share analysis | 45- 98bps |
| Pricing changes in equity payback period/Duration of cash flows | 14-28bps |
| **Total estimated range of costs associated with Ofwat's proposals** | **14-98bps** |
| **Net benefits of Ofwat's proposals (benefits minus costs)** | **Between 12 and 96 bps increase in cost of capital** |

Source: KPMG, 2022, Financial resilience impact assessment

These proposals follow on from Ofwat's poorly designed Gearing Outperformance Sharing Mechanism (GOSM) which was removed by the Competition and Markets Authority (CMA) for all the PR19 appellant companies. During our discussions with Ofwat staff they have consistently highlighted that this financial resilience risk is 'not a concern for Northumbrian Water' and the consultation similarly makes clear that this is not a concern for most of the sector. Whilst we agree that we are a financially resilient business and don't need these remedies to be imposed, as we have highlighted in previous correspondence with you on this matter and to the CMA in relation to the GOSM, we believe that Ofwat already has sufficient tools in place to address any risk that might exist. Moreover, if Ofwat's concerns are limited to a small number of companies then a better approach would be to target

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

interventions on those companies where Ofwat has concerns rather than imposing a blanket change across the sector which will result in a detriment to customers.

There are some of the proposals in the consultation which we could accept including:

- the proposed requirement for two credit ratings, which we already hold;
- the proposal to inform Ofwat if we have a change in our credit rating, which is a purely procedural change albeit we would already inform Ofwat of a change in our credit rating in any event; and
- the proposal for additional reporting and transparency around swaps and pensions, where we already voluntarily provide some of the transparency Ofwat is seeking on pensions and have very few swaps and derivatives as a business.

Attached to this response is the new dividend policy for NWL which was agreed at the board in September. This policy, which both aligns distributions more directly to service performance for customers and places a constraint on the business from paying distributions that might reduce levels of financial resilience in the business. We consider that this policy is a far better remedy and has been developed voluntarily by us in response to the external appetite for greater transparency around these issues. We began work on this last year long before Ofwat's first consultation on financial resilience. This policy goes far further than Ofwat's proposed licence modification and negates the need for any specific licence condition around this for NWL.

However, we also recognise Ofwat's concerns in this area and want to make constructive suggestions. We note, as the First Economics paper highlights, that similar changes have been introduced in the banking sector following the Global Financial Crisis. In that sector banks are now subject to more rigorous 'stress testing' arrangements to ensure that they are resilient to various shocks and stresses that could occur. In the water sector we already produce Long Term Viability Statements (LTVSs) which include some stress testing and provided further detail on those tests in our Annual Performance Reporting this year at Ofwat's request. We would be happy to work with Ofwat to develop those arrangements further which, as the First Economics report highlights, represent a much better and more rigorous assessment of financial resilience.

## NWL response to s13/12A consultation on strengthening the ring-fence

**Summary of the NWL position on the proposals**

| Ofwat proposal | NWL's view | Comments |
|---|---|---|
| Modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, effective from 1 April 2025. | Disagree | • We cannot find any clear evidence of a financial resilience issue in the sector to be resolved in the first place, the sector is resilient and has withstood many financial shocks since privatisation.<br>• Even if such an issue did exist a mechanism like this which equates financial resilience purely to a rating agency assessment is insufficient – 'financial resilience' requires a much broader assessment.<br>• The impact of the proposal is very marginal anyway in terms of the change to default probability- the proposals will largely fail to achieve their stated aim.<br>• Ofwat has not conducted an impact assessment of these proposals. Independent analysis of the costs and benefits suggests that the costs to customers will likely outweigh any marginal benefit.<br>• NWL still considers that a company specific remedy is most appropriate, as we previously highlighted to the CMA in relation to the GOSM. However, we could also support amendments to the Long-Term Viability Statements (LTVS) or financial stress testing that is already undertaken in the sector. This is the approach taken in the banking sector, for example.<br>• The current licence condition links the assessment to the lowest rating, i.e., if the company fails to achieve an investment grade rating for any agency, then it moves into dividend lock-up. In a competitive market, which regulation should seek to mimic, if a lender saw that a company had two split ratings, they would likely seek to understand what was driving the lower rating and form their own view for pricing that lending based on a collective assessment of both ratings. The approach proposed should move to the average of the two ratings, better reflecting the market. |
| 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 in the long term. | Disagree | • We have recently shared with Ofwat our revised dividend policy which already goes further than Ofwat is proposing, negating the need for the licence amendment.<br>• The current drafting is ambiguous increasing risk and uncertainty. If a licence modification was to be proposed, then it would need to be much clearer and more specific. For example, it is not clear what is meant by '*will not impair* the ability of the Appointee to finance the Appointed Business' or '*take account of* service delivery for customers and the environment over time'. Where the licence is ambiguous then this will likely drive uncertainty and cost damaging investor confidence precisely at a time when the sector is seeking to attract substantial private capital. |
| Additional licence modifications and other mechanisms. | Agree | • NWL already holds two ratings and would already inform Ofwat if those ratings changed.<br>• NWL already provides much of the additional transparency Ofwat is seeking on pensions and has very few swaps or derivatives. |

## 1 MAIN RESPONSE

This section sets out our more detailed response to the Ofwat consultation on proposed licence changes to support financial resilience. The response is structured around the key errors in Ofwat's consultation and the supporting proposals.

- Section 2 sets out the procedural failures of Ofwat's approach and how this has led them to a set of proposals that are based on errors of fact and inconsistent with its statutory duties.
- Section 3 sets out how and why we do not consider that Ofwat has provided sufficient evidence that a problem exists to address in the first instance.
- Section 4 examines the remedies proposed by Ofwat and how they fail to achieve their intended effect with negligible benefit to the financial resilience of the sector.
- Section 5 examines the impact of the proposed remedies based on the external impact assessment and sets out how the proposals will increase the cost of capital for customers and damage investor sentiment in the sector putting that future investment at risk.
- Section 6 discusses the specifics of the remedies proposed, focussing on the dividend policy licence amendment and the proposals for cash lock-up at a higher rating threshold and how the proposals will create uncertainty, ambiguity, and risk.
- Finally, section 7 summarises our conclusions on the proposals and suggests those areas that we could support, those where we will reject the Ofwat proposals and suggests some alternative options that Ofwat should explore.

## 2 OFWAT'S PROCEDURAL FAILURES HAVE LED THEM TO A SET OF PROPOSALS THAT ARE BASED ON ERRORS OF FACT AND INCONSISTENT WITH THEIR STATUTORY DUTIES

**Ofwat has failed to produce reasonable evidence to support the existence of its financial resilience concerns and has also failed to provide any reasonable assessment of the impact of its proposed remedies.**

Ofwat is subject to various statutory duties set out in s.2 of the Water Industry Act. One of these duties requires Ofwat to have regard to the principles of better regulation, the 'better regulation' duty. As part of that duty Ofwat, like other public bodies, is required to produce an impact assessment[4] of its policy proposals examining the costs and benefits of those proposals. The intention of this duty is to support the best policy decisions by ensuring that policy proposals are well evidenced.[5]

Whilst Ofwat has been discussing its financial resilience concerns for some time, including:

- Its 'putting the sector back in balance' proposals;
- In PR19;
- At the CMA through the redeterminations process; and
- In its more recent consultations.

We are surprised that at no point throughout this period has it provided reasonable evidence to justify either the existence of the financial resilience problem it is concerned about or indeed to examine different options and the costs and benefits of those options.

As an example, in the Ofwat publication - *Financial resilience in the water sector: a discussion paper – Dec 2021*, there was no quantification of the costs of a credit rating falling to BBB/Baa2 neg, or even below this. The case study presented on Southern Water did not show how the proposed provisions would have prevented the circumstances that Southern found itself in. Southern fell to Baa3 in Sept

[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/916918/better-regulation-guidance.pdf

[5] Section 2(4): ..the Authority shall have regard to the principles of best regulatory practice (including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed

2019 and announced a dividend lock up under the existing licence provision. We note that Southern did not pay a dividend in 18/19 and 19/20 and had a dividend yield of 0.5% in 17/18 when it was rated Baa2. It fell to Baa2 neg in 18/19 with no dividends declared that year or the next. So, it seems a dividend lock up at BBB/Baaa2 neg would have made little difference to what appear to be primarily operational issues (e.g., misreporting) that in turn caused financial distress.

Indeed, as KPMG note in their assessment of these costs and benefits:

"Overall, it is not clear in relation to each that there is a financial resilience "problem" which justifies the introduction of new regulation based on potential market or regulatory failures"

They note that:

- Whilst under-investment in the sector could lead to deteriorating customer service levels and financial resilience issues could arise in the sector due to asymmetric information across Ofwat and companies. The existing regulatory protections and reporting requirements should be sufficient to address these issues or could be easily amended.

- Whist there could be externalities relating to bankruptcy costs. The regulatory framework includes a special administration regime, with the primary focus of maintenance of uninterrupted operations whilst the financial position of the company is stabilised. The special administration regime has not been used in the UK water sector. It is uncertain whether there will be externalities relating to bankruptcy or special administration.

**This procedural error in turn leads Ofwat to a series of proposals that are inconsistent with its duty to protect the interests of customers and based on assumptions that contain factual errors.**

As we set out elsewhere in this response and the accompanying evidence, we believe that the absence of any reasonable assessment or evidence of the financial resilience problem has led Ofwat to base its proposals on errors of fact and to suggest remedies that will not achieve their intended aims and would in fact result in a detriment to customers. In particular:

- The failure to examine the scale and nature of any potential financial resilience problem and to engage with the evidence NWL and others put forward in relation to its previous responses has led Ofwat to conclude in error that there is a clear financial resilience challenge for the sector to address;
- The failure to conduct a proper impact assessment on its proposals has led Ofwat to conclude in error that the proposals will not increase the cost of capital and damage investor confidence in the sector creating costs for customers; and
- The failure of Ofwat to consider the benefits of its proposals via an impact assessment has led it to conclude in error that the proposed remedies will improve the financial resilience of the sector when, in fact, they will not.

**Ofwat have not recognised the listed corporate governance legal issues that may be raised through the subjective interpretation of the licence modifications**

We are concerned that Ofwat do not appear to have considered the legal interpretation of the licence modifications. In particular, that Company Boards may require legal advice to interpret the licence condition to ensure they are compliant when paying a dividend. In doing so, they face two possible challenges – a post dividend challenge from Ofwat if a dividend is paid, and a class action challenge from listed shareholders should an anticipated dividend not be paid which could generate substantial market losses for investors through any sizeable stock price impact. Either form of legal/regulatory challenge would distract management from the central aim of providing a good service for customers.

**Ofwat has used the new licence modification powers in a way not envisaged at the time and, in the light of the concerns expressed, should carry out a regulatory impact assessment.**

This is Ofwat's first substantive use of the new s12a licence modification powers. When originally proposed, these were presented as a way of streamlining decision making, with removal of the right of veto for individual companies:

*The current process for making changes to all companies' licences is burdensome for companies and for Ofwat. In other sectors – energy, for example – in the absence of unanimous agreement, **if enough companies agree with the changes that the regulator is proposing, these changes can be made for all companies**. We consider that there are merits in a framework such as this and will work with the UK Government to see if this is an appropriate and achievable solution for the water and sewerage sectors.*
*And we are seeking some flexibility to change the way we set prices in the future without the need for further time-consuming and burdensome changes to licences, while still retaining the importance of the licence as a key foundation document and protection for companies, investors and others on the basis of our regulation.* [6]

In contrast to this democratic approach, the proposed modifications **are opposed by the whole industry rather than individual companies**: *All 32 respondents commented on this issue. All except CCW disagreed with amending cash lock-up to trigger at a higher credit rating or linking it to measures of service performance (p39)*

The consultation sets out 13 different concerns expressed by stakeholders (p40). We do not believe that Ofwat has sufficiently addressed these concerns, apart from making a confusing statement that: *As we are not proceeding with a link to **service performance**, some of these concerns fall away.* We do not understand how that statement aligns with the retention of a **service delivery requirement** in the licence modification.

The opposition to the changes is such that Ofwat should carry out a **regulatory impact assessment** to consider

- What is the problem under consideration? Why is government action or intervention necessary?
- What are the policy objectives of the action or intervention and the intended effects?
- What policy options have been considered, including any alternatives to regulation?
- An economic assessment of costs and benefits
- What unintended risks may arise because of the proposed changes

**Without evidence-based justification, Ofwat is proposing a change to the regulatory contract, a reversal of the position it has held since privatisation**

Ofwat have not yet carried out a **regulatory impact assessment** of the proposals. We refer in our response to an impact assessment carried out by KPMG on behalf of a group of water companies. We recommend that Ofwat consider this evidence and carry out their own impact assessment. See section 5 for more details.

## 3 OFWAT HAS NOT PROVIDED SUFFICIENT EVIDENCE THAT A PROBLEM EXISTS IN THE FIRST INSTANCE

[6] lic_pro20121026s13all.pdf (ofwat.gov.uk)

**The consultation fails to demonstrate that customers are put at risk through any perceived weak financial resilience**

The 2021 discussion paper[7] refers to three *'companies with weaker levels of financial resilience'*, yet no company has defaulted and only Southern is actually at the lowest investment grade.

Even the case study of Southern as set out in the paper showed that the regulatory regime worked as intended – when there was financial distress, Southern stopped paying dividends, there was an equity injection and new ownership.

The consultation refers to this:
*..we welcome the significant injection of equity to stabilise the balance sheet of Southern Water and to help fund its improvement plan. However, we do not think it's acceptable that monopoly companies providing an essential service should get to such a weakened financial position in the first place. In the case of Southern Water and in other instances where companies maintain weak levels of financial resilience, we consider the amendment to the position of the cash lock-up licence condition should encourage companies with weaker levels of financial resilience* ***to engage with us at an earlier point in the process****, thereby encouraging companies and investors, where necessary, to take steps to improve financial resilience sooner and particularly before risks crystalise and service performance becomes affected.*

As noted later, we agree that earlier engagement is valuable, which is why we suggest a requirement for a resilience plan at BBB/Baa2 negative outlook would be of value (see 1.7). A crude dividend lock up requirement is not engagement and may even be a disincentive for companies to share concerns before ratings change crystallise.

We agree with the CMA observation that, even had Southern failed, customers would have been properly protected through existing licence protections:

*The existing regulatory licence protections also mean that customers are less likely to bear these costs. As noted in paragraph 9.1167, the licence conditions requiring the ring-fencing of the regulated operations mean that the impact of Group problems are not likely to fall on customers or taxpayers. Special administration should allow water services to continue to be supplied to customers.*

*Also, in terms of continuing operations, we note that the operation of water businesses in a regulated environment carries many attractions for investors; demand is stable, revenues are set in a regulated process, and a return is assured on the substantial regulated capital base. This indicates that it is likely that new equity investors could be readily found for a failed business.* ***These factors do not indicate that customers are likely to bear disproportionately the costs of financial failure.***[8]

Since privatisation, the water industry financial model has successfully endured the financial difficulties at Welsh Water (Hyder), the Enron/Wessex corporate failure, the 2008 credit crunch, the Covid 19 pandemic and multiple severe operational events relating to weather events (e.g., Beast from the East 2018, Storm Arwen).

In all these cases, the financial regulation of the industry worked as intended, shareholders absorbed the impacts either on a temporary basis until true up adjustments were made or more permanently. In some cases, there was a change of ownership. Customers did not bear any financial risks and services and bills were unaffected.

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[7] Ofwat, Financial resilience in the water sector: a discussion paper, Dec 2021
[8] 2021 CMA Final Determination para 9.1210

In their PR19 Final Determination, the CMA agree: *We recognise that the quantification of risks is difficult, but we have not seen evidence suggesting that material harm to customers is likely should further default events occur in the water sector.*[9]

**Ofwat has not shown a link between financial resilience and service to customers**

Section 2.2 of the consultation sets out evidence on why a BBB-/Baa3 credit rating is not an optimal credit rating for a water company, in particular with reference to the cost of debt (p15). It does not suggest there are any issues for a company at BBB/Baa2. As we note later, to impose a cash lock up while a company is still BBB/Baa2 rated is a disproportionate response that could be replaced with a more staged approach such as requirement for a resilience report if the rating fell to BBB/Baa2 negative outlook.

***Operational resilience and financial resilience***

*In addition, there are reasons to consider that financial resilience problems can exacerbate other challenges, for example, where a focus on the short term might result in a company seeking cost savings or satisfying near-term financial obligations such as interest payments or deferring spend rather than a focus on necessary investment. Indeed, in recent months we have seen companies consider deferring key expenditure, which customers have funded, when faced with pressures on their finances. We have been clear that this approach is not acceptable. (p11)*

We would welcome Ofwat referencing evidence of companies considering deferring capital expenditure due to financial resilience constraints[10]. Through the cost sharing mechanism, Ofwat have created incentives to maximise totex efficiencies, which can translate into internal pressures to meet totex targets, but the counterbalance of service performance incentives ensures that customers are protected overall.

If Ofwat is concerned about companies not making necessary investment, then a reconsideration of the cost sharing rates would be a far more effective way of incentivising this than the theoretical approach proposed.

**The consultation does not recognise that the financial resilience of the industry has increased recently**

Since 2008, the regulatory equity buffer has increased by more than either turnover or totex, thus reducing the risk of financial distress from revenue or cost shocks.

Ofwat suggest that the changes are required due to increased risk of financial distress:
*Since then [2008], there have been changes in wider economic conditions and consequent reductions in the level of returns that companies can earn. This reflects changes in financial markets, as well as changes in the regulatory regime over time, for example, an increased use of outcome delivery incentives and so, a greater proportion of allowed revenue is now at risk. (p10)*

Since 2008, the equity buffer has increased by 67% to absorb totex and revenue risks. Totex and revenue as a percentage of RCV (and thus regulatory equity) have both fallen over time.

[9] 2021 CMA Final Determination para 9.1209 and footnote 3110

[10] We note, for example, that Southern Water spent its 2015-20 Totex FD in full, despite the financial pressures set out in the original case study

**Table 2: Equity buffer in the water sector 2008 versus 2022**

| Industry Appointed | | |
|---|---|---|
| **£m outturn** | **2007-08** | **2021-22** |
| **Debt (actual gearing)** | 30,828 | 57,545 |
| **Regulatory Equity** | 15,862 | 26,439 |
| **RCV** | **46,691** | **83,984** |
| **Totex** | 8,387 | 10,869 |
| **Totex/RCV** | **18%** | **13%** |
| **Revenue** | 9,239 | 12,269 |
| **Revenue/RCV** | **20%** | **15%** |

Source: NWL analysis of company reported data

Finally, we note that half of the water companies improved their credit rating position from 2021 to 2022, with the remainder staying flat, with no company rating worsening. Whilst it would be reasonable for Ofwat to be concerned over a general industry downward trend towards BBB-/Baa3, we can see that companies in the BBB/Baa2 negative outlook range have taken steps to remedy this, without the need for regulatory intervention.

## 4 THE REMEDIES PROPOSED FAIL TO ACHIEVE THEIR STATED EFFECTS

**Financial resilience and credit rating are not necessarily the same**

Financial resilience is where a company's financial arrangements provide to the company to enable it to avoid, cope with and recover from disruption. 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.

Financial resilience is a product of many different factors, including the scale and structure of a company's debt, the liquidity that is available to the company if 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 credit rating is the not the only relevant consideration, there are multiple other contributing factors.

From the First Economics report:
*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 still 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.*

## 5 THE PROPOSALS WILL HAVE NEGATIVE IMPACTS ON CUSTOMERS

The proposals have been made at a time of falling equity returns, industry underperformance of costs and service targets and zero dividends for six companies[11]. They also arrive at a time when the industry is facing significant investment requirements to deliver environmental improvements, maintain security of water supply and achieve net zero carbon emissions[12]. It is thus counterintuitive to discourage equity investment at a time when additional equity investment will be required for the much-increased investment requirements in AMP8 and beyond. The water industry faces material challenges for PR24, and a successful review should be based on agreement of a fair balance of risk and reward, rather than starting with an unnecessary dispute over a licence change that adds no customer benefit.

It risks reducing the power of equity incentives to meet and beat challenges and could result in companies choosing sub-optimal capital structures by restricting equity cash returns.

Ofwat have not yet carried out a **regulatory impact assessment** of the proposals. We recommend that Ofwat consider this evidence and carry out their own impact assessment. We have set out below a summary of the impact assessment carried out by KPMG on behalf of a group of water companies.

**The benefits of the proposals**

The quantifiable benefits to be considered are around the lower probability of default, although we note Ofwat recognise that this risk is mitigated by the current licence conditions:

*We consider that the risk of default is not the primary metric to be concerned about, given the protections of the licence; we consider the propensity of BBB-/Baa3 rated entities to fall to a sub-investment grade rating .. to be the more relevant data to look at because if a company does not hold an investment grade credit rating it is in breach of its licence.(p22)*

The financial risks of falling to a sub-investment grade rating can only be quantified in terms of a default risk. Assessing default risk is the fundamental purpose of a credit rating[13].

The KPMG report suggests that the customer or taxpayer benefit of the proposed change can be presented as avoided default (insolvency) cost. The benefit from Ofwat's proposal is assessed at around 0-2 basis points per annum (return on RCV). We note that the KPMG report uses infrastructure corporates for their analysis and the default risk reduces further when the current dividend lock up provision is included.

This confirms our view that the current provisions (regulated infrastructure companies with a dividend lock for Baa3/BBB- rating) reduce default risk significantly and Ofwat's further modification add little to that reduction.

**The costs of the proposals**

The costs of Ofwat's proposals are centred around the various impacts on a higher cost of equity. The loss of predictability and control over dividend policies increase risk for equity investors. They relegate equity holders' control in the same way that preference shareholders powers are relegated below other debt holders.

[11] See Ofwat's 2020-21 Service and Performance report: https://www.ofwat.gov.uk/publication/service-and-delivery-2020-21/
[12] The combined cost of these elements are likely to be around £80bn which is similar to the scale of the industry RCV in 2021
[13] *Moody's long-term ratings are opinions of the relative credit risk of financial obligations with an original maturity of one year or more. They address the possibility that a financial obligation will not be honoured as promised.*
https://ratings.moodys.io/ratings#:~:text=Moody's%20long%2Dterm%20ratings%20are,not%20be%20honored%20as%20promised.

**We make the following observations on the costs of the proposals from the KPMG report:**

**The impact on the divergence between dividend expectations and actual dividends increases the investors cost of capital (dividend signalling)**
The analysis of dividend signalling considers how a lower-than-expected dividend payment might impact equity value. Ofwat's proposals may result in divergence between market expectation of dividends and actual dividends paid, therefore dividend signalling analysis, which considers the impact of lower-than-expected dividend payments, may be a good proxy for the impact of Ofwat's proposals on value.

**The loss of control rights increases investors cost of capital (preference shares)**
Ofwat's proposals imply a loss in company decision making power on dividends (control rights). KPMG have analysed the impact of variations in of voting rights and control premia from transactions to assess the impact of Ofwat's proposals on the cost of capital.

**Delaying dividend cash flows increases the investor cost of capital (Xia-Brennan model)**
Ofwat's proposals could restrict dividend payments if the lock-up threshold is met, or operational performance deteriorates. Under these scenarios, companies would be forced to shift capital distributions to future periods, which implies a longer payback period on investments for equity holders.
A longer duration of cash flows would result in a higher cost of capital and therefore lower equity valuation as investors require additional return to be compensated on:

- Time value of money value lost, resulting from shifting cash flow to future periods.
- Term premium effect, resulting from the increased risk exposure to systematic factors such as interest rate fluctuations.

In summary, the KPMG impact assessment summarises the following projected costs and benefits of the proposals (Table 1 of the KPMG report).

| Table 3: Summary costs and benefits of Ofwat's proposals from KPMG's impact assessment | Cost of capital estimate |
|---|---|
| **Benefits of Ofwat's proposals** | |
| **Probability of default analysis** | 0-2bps |
| **Cost of debt allowance** | nil |
| **Total estimated range of benefits associated with Ofwat's proposals** | **0-2bps** |
| **Costs of Ofwat's proposals** | |
| **Costs arising from changes to dividends** | |
| Dividend signalling | 18-22bps |
| **Pricing changes in equity claims** | |
| Cash flow rights – i.e. Preference shares | 45-98bps |
| **Pricing increases in equity payback period** | |
| Duration of cash flows (Xia-Brennan) | 14-28bps |
| **Total estimated range of costs associated with Ofwat's proposals** | **14-98bps** |

For NWL, a net increase of 12-96bps (per the costs and benefits of the above) on the cost of capital would increase customer bills by up to 5% pa.

In summary, when the costs and benefits are properly assessed it is clear that the proposed remedy will increase costs to customers, provide very marginal benefit (if any) and is also in direct conflict with Ofwat's statutory duties.

## 6 THE PROPOSALS ARE POORLY DESIGNED AND WILL INTRODUCE AMBIGUITY AND COST

**Ofwat's proposal to use the lower of the two ratings is badly designed**

Under Ofwat's proposals, companies are to be required to obtain and maintain issuer ratings with at least two rating agencies and it is the lowest of a company's ratings that will count when determining whether a company goes into lock-up.

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

In practice, faced with this scenario, 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 further issue over a 'rogue rating', where a single ratings agency takes a different interpretation from convention or other ratings agencies. Markets may well ignore such a rating, but as the licence condition has no flexibility, it would become the de facto regulatory measure. See Annex B for Ofwat's views on the risks of relying on a single Ratings Agency.

There is a contrast, therefore, between the nuanced way in which the markets will deal with a variety of rating opinions and the mechanistic way that Ofwat is adjusting the licence to process the same information.

**From the First Economics paper (p15):**
*'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.'*

**The licence proposals introduce ambiguity through the interpretation of 'taking account of' service delivery. They do not deliver greater transparency, which is better delivered through the Regulatory Accounting Guidelines**

Listed companies have a particular legal duty to communicate with their investors in a transparent and predictable way, so the introduction of an ambiguous licence clause relating to dividends will be of particular concern for them.

We agree with Severn Trent when they state:

***Extract from Severn Trent Financial Resilience response Dec 2021***

***Linking cash lock-up conditions to measures of service performance***
*We fundamentally disagree with the proposal to link the cash lock-up condition to service performance because it could lead to more volatile dividend payments as follows:*

- *First, operational performance can vary from year to year, e.g. due to a cold winter, a drought or a storm, such as Storm Arwen in November 2021 which was the worst in two generations. It would create uncertainty for investors if distributions were effectively linked to weather conditions rather than underlying performance.*

- *Second, it will be difficult to define the operational performance levels that would trigger the cash lock up conditions, creating uncertainty for investors. Large water companies have more than thirty performance commitments and no company has achieved more than 88% in a single year, reflecting their stretching nature. As a result, Ofwat will need to define what proportion of commitments a company needs to achieve, whether near misses count the same as large misses and whether a materiality threshold should be applied to overall performance. This would involve a complex system. The alternative is a more flexible system involving judgment, but this would create Ofwat discretion over payments to investors, undermining the stability of returns for investors.*

***More volatile dividend payments are likely to lead to investors requiring higher equity returns from water companies.***[14]

We recommend that the making the link to service performance is better approached through transparent reporting of dividends, including how they relate to service delivery. The Northumbrian Water dividend policy (see Annex A) recently approved by our Board takes such an approach.

**Transparency and certainty are better for all stakeholders than an ambiguous and undefined licence requirement**

In setting out the reasoning for the modification to include service delivery as a licence condition, Ofwat state:

*Despite this, in recent reporting to us, many companies did not meet our expectations in **explaining their dividend payments and/or policies**. This has raised concerns (detailed in our 2020-21 monitoring financial resilience (MFR) report) that the majority of companies were not **explaining things** clearly enough and **should do a lot more to show** how the levels of dividends paid or declared reflect the levels of service delivered. Therefore, we are proposing to modify the existing dividend policy licence condition to directly reflect our principles and to align them with expectations that we set and which companies agreed to meet at PR19 on ensuring dividends take account of delivery for customers and the environment. Our proposal will strengthen the regulatory ring-fence in the licence and improve protections for customers and the regulated company. It also ensures consistency, removes **the***

[14] https://www.ofwat.gov.uk/wp-content/uploads/2021/12/SVE-Financial-Resilience-response_Redacted.pdf

***potential for*** ***<u>ambiguity</u>*** *and* ***promotes the importance of explaining dividend decisions clearly*** *and as issues that matter for customers and the environment.*

The reasoning behind the change is thus for companies to **explain** their dividend payments more clearly. The most appropriate and simplest way for Ofwat to do this is through the Regulatory Accounting Guidelines, which can be easily changed and fully specified, both in narrative and tabular format. This would result in fully transparent Annual Performance Reports, in the standard format required by Ofwat. Northumbrian Water has recently revised our own dividend policy to more closely align the derivation of the dividend to the level of regulatory performance, we set this out in our covering letter.

Instead, Ofwat have proposed to impose a short, <u>ambiguous</u> licence amendment, requiring companies to **'take account of'** service delivery when paying dividends. This introduces uncertainty for all stakeholders in the interpretation of what is an imprecise term.

We note Ofwat have not proposed any additional guidance, leaving it to company boards to assess what 'taking account of' actually means. For example, if a typical company has met around half of its ODI targets, how does Ofwat expect company boards to take this into account when setting a dividend? If they interpret this differently from Ofwat, are they retrospectively in breach of this condition?

A board may consider that, to ensure legal compliance with the licence, it needs to have its interpretation of what dividend their service delivery warrants agreed with Ofwat before declaring dividends. Ofwat state*: However, we do recognise that there may be circumstances in which a dividend could be reasonably paid despite performance levels not being universally at target levels (p27).* This statement confirms the uncertainty that boards would struggle to interpret without direct conversations with Ofwat, resulting in Ofwat de facto regulating dividends.

The logical conclusion of the licence modification is that Ofwat will have to issue guidance on how 'taking account of' should be interpreted in a world of multiple service metrics and a variety of out and underperformance results across each for each company. The interaction with the ODI regime and whether services to customers should be interpreted wider than these will need to be set out in that ever-growing guidance. Before long, dividends become regulated and Ofwat and the industry create a new 'cottage industry' of making representations and counter-challenges every year on what dividends can be paid.

Finally, on page 12, Ofwat state: *We propose not to link the cash lock-up trigger directly to measures of* ***service performance****, at this time*[15]. This seems to contradict the licence condition proposals, which add a requirement that '*dividends declared or paid should take account of* ***service delivery*** *for customers* ***including performance levels'****.* If Ofwat is interpreting **service performance** and **service delivery** (with a reference to performance) differently, these definitions should be clarified as it currently appears to be a semantic difference.

**The licence proposals do not give sufficient consideration of using an escalation stage between no licence constraints and a cash lock up**

**Alternative Options – Stress Testing Resilience Plans (Section 2 of the Consultation)**
**Resilience report required for a BBB/Baa2 neg rating, including stress testing and remedies.**

[15] See also p22 - *As we are not proceeding with a link to service performance, some of these concerns fall away.*

We do not believe that Ofwat has sufficiently explored the option of requiring a financial resilience plan as a stage between the binary extremes of no licence constraints and cash lock up.

*We also considered a variation of this suggested by a respondent to the consultation (in follow-up discussions), in which, if we were not satisfied with the resilience plan, we could then place the company in cash lock-up (p23)*

Ofwat suggest that: *The onus should be on companies to demonstrate they are resilient rather than on us to determine that they are not.* We agree with the principle that there should be an opportunity for companies to submit a resilience report to Ofwat to explain why they have been rating downgraded and how they intend to ensure financial viability.

However, Ofwat's approach to a BBB/Baa2 neg rating seems to be to assume the company is 'guilty before the trial evidence is submitted'. The licence clause would automatically impose a cash lock up, with a company submitting a resilience plan for Ofwat to approve a dividend. We believe this is the wrong way around – the first requirement would be for a resilience plan and only if that is insufficient should a cash lock up be considered.

*The onus should be on companies to demonstrate they are resilient rather than on us to determine that they are not. If a company in cash lock-up wants to pay a dividend, it can seek approval to do so, and we can approve the request if considered appropriate. Our decision on whether to approve the dividend would necessarily involve assessing a company's plans to resolve its issues, among other things, as explained earlier in this document. However, if prior to a cash lock-up we consider it is appropriate to request a resilience plan, because of financial resilience issues that we observe a company is facing, we could make a request for a plan under condition M of the licence.(p23-24)*

We note that debt investors do seem to value resilience plans, including in advance of a cash lock-up.

***Resilience plans***
*There was strong support among debt investors for resilience plans with many stating that companies should be encouraged to share as much of their resilience plans with wider stakeholders as possible given that the information is helpful for credit assessments. A few mentioned that they saw resilience plans as complementary to cash lock-up triggers as 'credit basics' would usually require additional disclosures to trigger in advance of a lock-up. (p51)*

## 7 CONCLUSIONS

In conclusion, we do not believe that the proposals as set out are necessary or in customers interests. They would result in de facto dividend control by Ofwat, an approach that would restrict equity investment at a time when additional equity investment will be required for the much-increased investment requirements in AMP8 and beyond.

We believe there are less intrusive approaches to address Ofwat's concerns. We summarise them below.

**Figure 2: Ofwat's proposals, their challenges, and potential alternative remedies**

| Ofwat Licence Modification Proposal | Key challenges | NWL Alternatives |
|---|---|---|
| **To increase the cash lock up threshold from BBB-/Baa3 to BBB/Baa2 neg.** | • Unnecessary given current powers.<br>• Increases costs for customers through higher equity costs and delivers very little if any actual protection or benefit to customers.<br>• Use of lower of two ratings is inconsistent with how markets would operate. | 1. Retention of current BBB-/Baa3 threshold in licence.<br>2. Resilience report required for a BBB/Baa2 neg rating, including stress testing and remedies.<br>3. Amend the proposal to reflect the average of the two ratings rather than the lower rating.<br>4. Further work to develop the LTVS and stress testing arrangements consistent with the banking sector. |
| **To add a requirement for dividends to take account of service delivery** | • Ambiguous statement that introduces risk and damages investor confidence for no obvious benefit. | 1. NWL's revised dividend policy (annexed to this paper) already goes further than Ofwat's proposals.<br>2. Additional transparency in reporting dividends could be added to the RAGS / APRs, showing the link to performance. |

We would be happy to further develop our proposed alternatives should Ofwat wish to continue this discussion.

**Northumbrian Water**
**September 2022**

**Annex A – the Northumbrian Water Dividend Policy (approved by the Board Sept 2022)**

## NWL DIVIDEND POLICY

A key overarching principle behind NWL's approach to dividends is that its owners should be able to receive a competitive and fair return on their investment which reflects the underlying risk profile of the business. This ensures that there will be access to the necessary capital required to make investments for customer needs now and in the future.

NWL is seeking to maintain a progressive dividend policy that takes into account long-run financial performance and ensures that an efficient balance sheet is maintained. In line with the businesses' vision of being an industry leader, the policy seeks a competitive return consistent with a high-performing water company and to maximise returns over the long-term.

NWL considers that its dividend policy should be transparent, recognising the company's commitments to various stakeholders including customers, employees[16] and investors, and with due attention to maintaining appropriate levels of financial resilience within the company. To deliver this the dividend policy will be based on four components:

a base dividend component largely derived from the price control determination.
• an outperformance component linked to business performance and outcomes delivered (Totex, ODIs and financing).
• a financial resilience adjustment designed to appropriately calibrate the company's overall gearing levels with the underlying risk profile of the business; and
• a smoothing adjustment to take into account smaller ad-hoc movements within any year that are expected to reverse out over the AMP.

These components are discussed in turn below.

**Base dividend component**
The approach to setting the base dividend is that it should broadly reflect the real cost of equity based on the capital structure as established in the latest regulatory determination, on the assumption that the regulatory cost of equity will always be set at a level that ensures the company remains financeable.

**Outperformance component**
The regulatory framework incentivises companies to outperform regulatory targets and shares these gains between shareholders and customers. The base dividend will be adjusted to reflect business performance in 3 areas:
• Totex outperformance: cost savings after the application of the regulatory approach to cost-sharing.
• ODI outperformance: net ODI rewards from improved outcomes for customers.
• Financing outperformance: where the company is able to secure debt financing at lower rates than assumed by the latest regulatory determination.

**Financial resilience adjustment**
Financial resilience adjustments are designed to ensure the company maintains a prudent investment grade credit rating and an appropriate buffer to absorb relevant financial risks. To achieve this an adjustment will be made to ensure that any real terms growth in the regulatory capital value is funded from both debt and equity over the investment cycle in line with an efficient capital structure.

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[16] Specifically, compliance with the pension deficit repair plan agreed with the Pension Trustee in respect of the NWPS, as submitted to the Pensions Regulator

**Smoothing adjustment**
To provide stability in dividends a further adjustment may be made to ensure that over a regulatory cycle there is a more even allocation of dividends. This is because expenditure within an AMP is not evenly spread and aligned with the phasing of the price control determination, and unexpected events (positive and negative) can impact financial performance in the short term.

In making these adjustments, the Board will aim to match dividends over a cumulative period of up to five years to the level required to deliver the policies set out under the first three components of the policy.

**Annex B: Ofwat's previous statements on Ratings Agencies at the PR19 CMA hearing**

**Notes of a remote hearing with Ofwat held via the Competition and Markets Authority, Cabot Square, London on Wednesday, 22 July 2020**

*P19-20*

*(Mr Black) 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*

Later…

*(Mr Black) But, 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 regulation**; nor will they result in the right outcomes for customers.*

Later…

*I mean firstly, we do acknowledge the rating agencies play a valuable role. As I say, we do put some weight on their views, as evidenced by the license provisions. But I think they are doing a different job from what Ofwat is trying to do. **It is our role to protect customers; rating agencies are not trying to do that.***

*Secondly, 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.***

We further note Ofwat's previous comments on the risks of using one Ratings Agency as 'the lowest common denominator' in regulatory policy:

**Notes of a video conference with Ofwat held at Competition and Markets Authority, Cabot Square, London on Monday, 30 November 2020**

*p86-87:*

*There are other options you could look at but I think what we are saying is the cost of capital should not be set by reference to a target financial ratio. It should be set by reference to market evidence and cross-checked to market evidence. **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.*

*A. (Mr Black) 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.*