Portsmouth Water

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Ofwat
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29 September 2022

Dear Sir or Madam,

Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers

Financial resilience is a critical consideration for the water sector as we look to secure the required investment to address the future challenges around climate change and water resources resilience.

This is a very real issue for Portsmouth Water as we look to deliver the first major new reservoir since privatisation. At a time where we need to secure financing, including significant levels of new equity, we need to maintain investor confidence and at the same time protect our customers. We also need flexibility within the regulatory framework to secure the appropriate capital structure to deliver the investment efficiently; as well as being able to accommodate risks that could emerge without any detriment to our customers.

Whilst we strongly support the principles of what Ofwat is trying to achieve around the financial resilience of the sector we share the industry's concern around aspects of the licence change consultation. However, we welcome the opportunity to respond and put forward some alternative approaches which believe could support Ofwat's objectives in other ways.

The two key areas we would like to address in our response are the proposals on the requirement for companies to hold two credit ratings and the proposal around changes to the lock up provisions.

We are very pleased that Ofwat has reflected some of the considerations we put forward in our earlier response to the discussion paper. While we accept that holding two investment grade ratings reflects common practice for companies regularly accessing debt markets, the cost of maintaining two credit ratings is disproportionate for smaller companies and does not reflect value for money for customers.

As well as the direct costs we would argue that it would also place an additional pressure on management time and regulatory burden for small, high performing water companies. In addition, from a Portsmouth Water perspective a change in the rating agency requirement in a period when we are raising finance to support development of Havant Thicket could be extremely disruptive given the differences in rating agency methodologies; this could undermine our financing plans.

We welcome the provision within the proposals for Ofwat to provide written agreement for the Appointee to maintain only one issuer credit rating. We think this could be further simplified by Ofwat outlining the criteria to be met to hold a single rating to remove the need for written permission. This would reduce requirement for additional representations for companies and Ofwat and could be dealt with through the normal compliance processes.

Our proposal would be that the following criteria could be applied to evaluate whether a company requires two credit ratings:

- Company is a Water Only Company
- Company holds either a Moody's or S&P company level rating
- Company has less 1 million customers
- Regulatory Capital Value is less than £1 billion

We would also recommend that companies should engage with Ofwat and seek consent before changing credit rating provider to address concerns of 'shopping for ratings'. Satisfying the above criteria should not prevent companies from choosing to hold two credit ratings if supportive of financing activities.

We have more serious concerns about the proposals to change the dividend lock up provision where a company's rating is BBB/Baa2 and the rating is on review for a downgrade or is on "Credit Watch" or "Rating Watch" with a negative outlook.

Whilst we fully support the licence condition that companies should hold an investment grade credit rating we do not believe that credit ratings should be the primary assessment for financial resilience. We are concerned that the revision to the lock up provision puts an over reliance on a third party and as such leaves companies exposed to rating agencies' assessment of external risk including uncertainty around regulatory policy and reviews. Portsmouth Water experienced this with two other companies through the PR19 process where our ratings where given a 'negative outlook'. Whilst we accept that the proposal makes provision for Ofwat to grant permission for dividend payment in this circumstance we think that the lack of certainty around the outcome will significantly impact investor confidence.

We believe there is a more pragmatic risk-based solution to address concerns and risks in this area. We advocate that companies that maintain a rating below Baa1 i.e. Baa2 are required to provide a Board Assured assessment on financial resilience containing a comprehensive suite of financial stress tests to demonstrate it can sustain its dividend payments (similar to developments in the banking industry). The financial stress test can then consider the specific company circumstances (including greater transparency on holding company commitments) and covenant requirements and provide further support to current dividend and financial viability tests.

We believe this approach reflects good corporate governance for company boards and creates better transparency for stakeholders including Ofwat; at the same time, it retains investor confidence at a time when more equity investment is needed across the industry. By placing a requirement for additional assurance on company boards Ofwat could use its existing powers under the licence of appointment to intervene if they have cause for concern.

An area of concern discussed at industry level is that this is the first consultation of its kind since the changes that came into force through the Environment Act and licence changes can now be made without company consent. We would seek to achieve greater collaboration and trust built between Ofwat and the industry and would advocate Ofwat consider the risk to this process that results from these proposed changes.

Our final point is that we believe that any changes in this area need to be supported by a full third-party economic impact assessment to demonstrate the changes represent good value for customers.

Your sincerely,

[redacted]

Chris Milner
Chief Financial Officer