Our Ref: PK/LAT/Ofwat

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SES Water
London Road
Redhill, Surrey,
RH1 1LJ
Telephone: 01737 772000
Facsimile: 01737 766807
Website: www.seswater.co.uk
Email: contactus@seswater.co.uk

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Dear Sirs

Consultation on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers

Thank you for the opportunity to respond to the above consultation issued in July 2022 (the "Consultation").

While we continue to welcome Ofwat's continued focus on financial resilience across the sector for the benefit of customers, we remain highly concerned with the proposed modification in the Consultation on lifting the cash lock-up trigger to Baa2 (at Moody's) or equivalent where such a rating is on review for possible downgrade or is on Credit Watch with a negative designation. Such a modification to our licence is not required to maintain financial resilience and places an unnecessary burden on our company and its shareholders – and in our view will detract from the water sector in terms of future investment, at a time when – through the PR24 consultation – Ofwat are calling for further equity in the sector. We also believe that Ofwat's proposed requirement for companies to hold two issuer credit ratings will only exacerbate the above matter.

We note in the consultation response that we are not alone in this position and highly question the entire discussion and consultation process in this regard when Ofwat still proposes to lift the cash lock-up trigger when "no water company or equity investors that responded to the discussion paper expressed support for raising the trigger to BBB/Baa2 with negative outlook."

In the Appendix to this paper, we have responded to the five proposals listed in the Consultation – however, our responses remain consistent with the views we presented in our response issued on 31 January 2022 to Ofwat's discussion paper on financial resilience.

Our Board and shareholders have reviewed and approved this consultation response, noting in addition that such proposed licence changes would represent a significant increased "country risk" for investment in the UK Water sector. In addition, such proposed changes to the licence appear to contradict the focus on increased equity investment and ambition detailed in Ofwat's PR24 draft methodology.

We appreciated the opportunity to discuss the above matters early with Ofwat's Financial Resilience team (most recently on 16 September 2022) and welcome further dialogue with Ofwat ahead of any proposed licence changes.

We continue to work with our colleagues across the sector on this matter, and the Board will consider further external legal and regulatory advice depending on Ofwat’s consideration of the Consultation responses from all stakeholders.

Yours faithfully

[redacted]

Paul Kerr
Group Chief Financial Officer

Appendix I - Responses to Ofwat's 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

1.1 Modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, as set out in section 2, box 3, proposed to take effect from 1 April 2025.

Response:

We strongly object to amending the existing trigger level for the cash lock-up conditions to a higher credit rating – and so support the current requirement that a cash lock would occur – with the use of Ofwat's consent – where a credit rate is sub-investment grade or is at the lowest investment grade with a negative designation. Changing this trigger to a higher credit grade places too much emphasis on a single measure of financial resilience.

A clear understanding by Ofwat of individual companies' relationships with their shareholders should also be considered where options exist that may impact potential distributions, such as the above cash lock-up triggers. Within SES Water, our shareholders continue to work very closely with the Board and management and continue to prove to be an investor focused on the long term. From a financial resilience perspective, this level of support has been demonstrated in the past, through our de-gearing exercise (where preference shares were also converted into ordinary shares) in 2018 and adherence to a dividend policy aligned to Ofwat's recent guidance. Altering of licence conditions has not been required in the past for us to ensure our shareholders' continued support, and we would not support any future amendments.

1.2 Modify the dividend policy licence condition to require that dividend policies and dividends declared or paid should take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term, as set out in section 3, box 4.

Response:

We agree that the alignment of the licence text to clarify that "dividends declared or paid will not impair the ability of the Appointee to finance the Appointed business, taking account of current and future investment needs and financial resilience over the longer term". This makes explicit what we do as a Company and is a key component of our dividend discussions with the Board and our long-term viability statement.

With respect to the proposed licence text amendment to clarify that "dividends declared or paid take account of service delivery for customers and the environment, including performance levels of and other obligations" we do not support a short-term linkage in the licence of dividends to in-year service performance. The latter could lead to a volatile dividend profile, would fail to take into account the long-term performance of the company (which should be the basis of stable dividend payments) and would likely not be in the interests of investors. Ultimately it should be for boards to decide on the level and timing of dividend payments.

1.3 Modify the licence to require companies to hold two issuer credit ratings, or to seek our agreement to an alternative arrangement, if proportionate, as set out in section 4, box 5.

Response:

As a smaller company in the sector, we remain concerned with the additional cost such additional requirements to hold two issuer credit ratings may incur versus the benefits potentially provided. In addition, the requirement to hold two issuer credit ratings we believe will exacerbate the issues noted above arising from Ofwat's proposal to raise the cash lock-up trigger, leading to further concerns on future investment in the sector. We therefore do not support this proposed modification.

1.4 Modify the licence to require companies to notify us about any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals), with reasons for the change, where applicable, as set out in section 4, box 6.

Response:

We support the requirement for companies to formally notify Ofwat of changes to credit ratings, including changes in rating and outlook. As part of this notification, we would expect companies to be allowed the ability to state whether they believe this change materially effects their ability to deliver its regulated activities. We agreed that notification to Ofwat within 5 business days after a credit rating agency announcement is a reasonable notification period.

1.5 Bring other ring-fencing provisions in Wessex Water's licence up to the current industry standard as set out in appendix A4 and as explained in our 2020 consultation on regulatory ring-fencing licence modifications7.

Response:

We have no comments with respect to Wessex Water's licence.