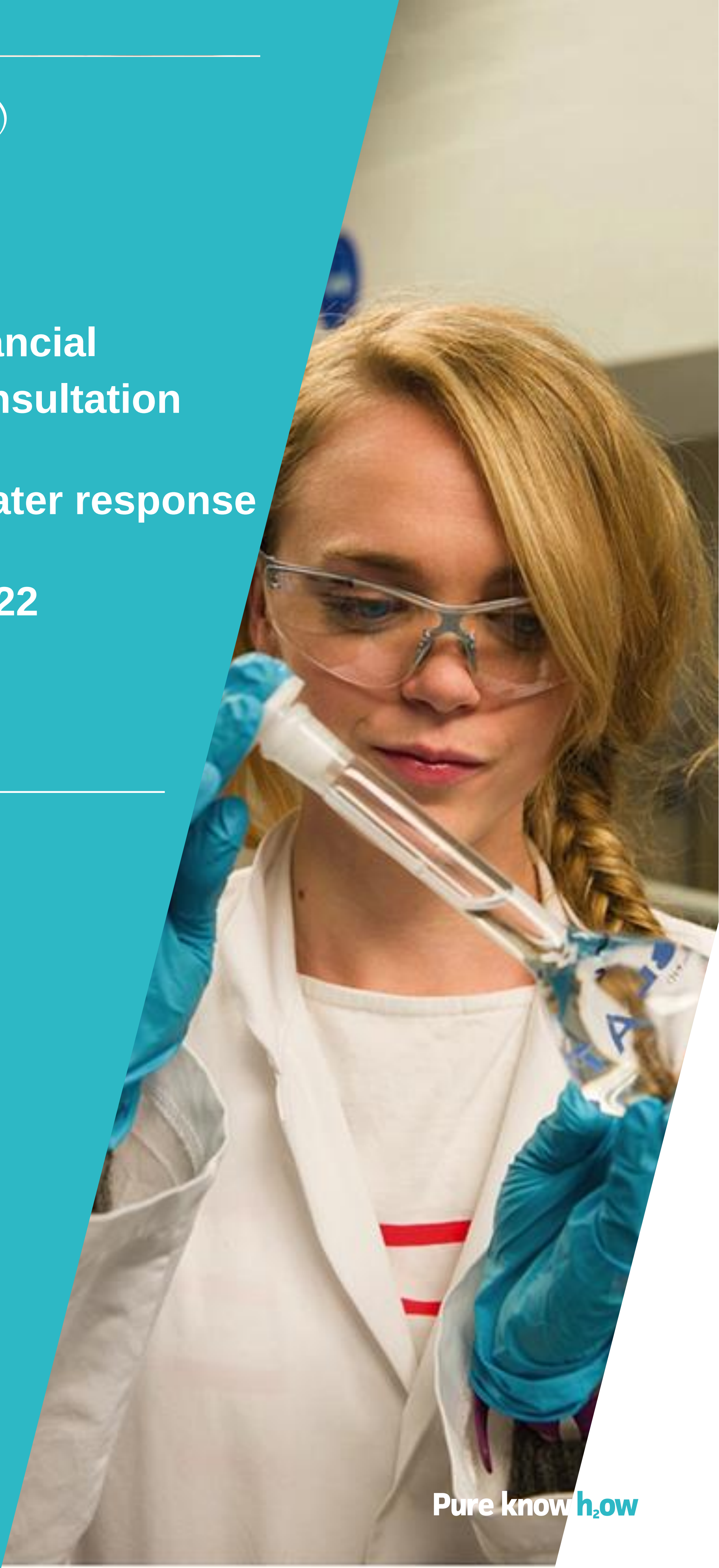
OFWAT's Financial Resilience consultation

South East Water response

September 2022

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH



Executive summary

South East Water Limited (**SEW**) has carefully considered Ofwat's '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' dated 28 July 2022 (the **Consultation**) and welcomes this opportunity to respond.

SEW understands that Ofwat is under considerable political pressure to act on, among other things, the subject of financial resilience.[1] Ofwat's desire to take, and be seen to take, strong and demonstrable action is more easily explicable when viewed against this backdrop. However, in SEW's view, Ofwat's proposed licence modifications in respect of the cash lock-up licence condition, dividend policy and holding two issuer credit ratings are **practically and legally erroneous** and **harmful to consumers** and, as such, **should not be taken further**.

More specifically, SEW considers that:

1. **Ofwat's licence modification proposals are unjustified** because:
    a. Ofwat has not clearly defined the financial resilience problem it is seeking to address. As set out in SEW's response to Ofwat's earlier discussion paper on this topic[2], Ofwat's proposals come across as "*solutions in search of a problem*."
    b. Ofwat has applied too narrow a definition of financial resilience, including placing too much weight on the views of credit rating agencies (which do not equate directly to financial resilience) and failing to acknowledge its own role in securing financial resilience in the sector.
    c. Ofwat has not explained how and to what extent its extensive range of existing regulatory mechanisms is inadequate to address financial resilience. This is essential in ensuring that regulatory activity is targeted only at cases in which action is needed.
    d. Ofwat's proposals are contrary to its clear and oft-stated policy that companies are best placed to make, and must bear responsibility for, decisions over their financing and capital structure arrangements.
    e. Ofwat has failed to provide robust evidence in support of its licence modification proposals, including a clear explanation of how they discharge its statutory duties.
2. **Ofwat's licence modification proposals are harmful** because:

[1] There has been strong criticism levelled at economic regulators in recent months – including difficult oral evidence sessions on 24 May 2022 (available at Committees - UK Parliament) and a highly critical House of Commons Business, Energy and Industrial Strategy Committee (**BEIS Committee**) Report on financial resilience in the energy sector entitled 'Energy pricing and the future of the Energy Market (parliament.uk)' dated 19 July 2022.

[2] Ofwat, Financial resilience in the water sector: a discussion paper, 7 December 2021 and Mason & Wright, A Report on Gearing, Price Controls and Financial Resilience, 3 December 2021. Also, SEW's response dated 31 January 2022.

a. Contrary to Ofwat's statutory duties and strategic priorities, the proposals will lead to increased costs for consumers, reduce regulatory certainty, and have other adverse consequences.

b. Ofwat has failed to consider or quantify these effects in any proper impact assessment.

SEW does not have any objection to Ofwat's proposal to modify the licence to require companies to notify it about any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals), save to note that such information is already publicly available and could also be required in accordance with the existing provisions of Condition M (Provision of Information to Ofwat) of the licence. The proposed licence modification in relation to notification is therefore duplicative and unnecessary, contrary to the principles of best regulatory practice, but SEW will not resist it to the extent that Ofwat considers it might support more robust and timely regulatory monitoring.

SEW deals with each of the above issues more fully in the remainder of this response, drawing on the expert evidence set out in John Earwaker's report entitled 'Ofwat's Proposed Financial Resilience Licence Modifications: An Assessment' dated September 2022 (**Annex 1**) and the report prepared by KPMG LLP for a group of companies including SEW entitled 'Financial Resilience: Impact Assessment' dated 29 September 2022 (**Annex 2**).

With regard to Ofwat's statement in the PR24 Draft Methodology[3] that, in relation to financial resilience, it "*may apply an incentive-based mechanism within the price review if [it] is not satisfied with progress achieved through other means*", SEW considers that any such mechanism would still require a clear rationale and evidence base, which has not currently been articulated.

[3] Ofwat "Creating tomorrow, together: consulting on our methodology for PR24", 7 July 2022 (at para 9.1, page 109).

SEW's Detailed Response to the Consultation

SEW sets out below its detailed comments on Proposals 1-4 of the Consultation.[4]

In SEW's view, there is **no evidenced need** for these proposed licence modifications and they will **do more harm than good**.

Financial resilience proposals

1. Proposal to modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, proposed to take effect from 1 April 2025.
2. Proposal to 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.
3. Proposal to modify the licence to require companies to hold two issuer credit ratings, or to seek Ofwat's agreement to an alternative arrangement, if proportionate.
4. Proposal to modify the licence to require companies to notify Ofwat 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.

[4] SEW also refers Ofwat to the letter dated 7 September 2022 submitted by our shareholders setting out their views on the Consultation.

1) SEW considers that there is no evidenced need for Ofwat's licence modification proposals.

a. Ofwat has not clearly defined the financial resilience problem it is seeking to address.

In SEW's view, Ofwat has failed to clearly articulate the financial resilience problem it is trying to solve. In the Consultation, Ofwat states that whilst "*many companies in the sector show good levels of resilience, … some do not*" (suggesting that there is no industry-wide issue) and it "*has concerns … that the current regulatory protections … are not sufficient to protect the interests of customers*". It goes on to state (without evidence or analysis) that *"[w]eakened financial resilience can lead to reduced levels of operational performance and erode a company's capacity to cope with financial pressures or shocks without compromising service to customers*". However, **it identifies no specific problem – or gap in the existing regulatory framework** (as to which, see further below) – **which its licence modification proposals are intended to address**. Where there is not a clear gap the introduction of new regulation risks *creating* distortions and unintended consequences.

Ofwat's proposals therefore seem to be "*solutions in search of a problem*" – a fundamental issue which SEW highlighted in its response to Ofwat's earlier discussion paper on this topic.[5] This is contrary to the principles of best regulatory practice – to which Ofwat is required to have regard under section 2(4) of the Water Industry Act 1991 (**WIA91**) – as, by definition, proposals cannot be transparent, accountable, proportionate, consistent or targeted only at cases in which action is needed if, as a starting point, the underlying problem they are seeking to address is not clearly identified and articulated.

And whilst Ofwat states that its "*targeted proposals to strengthen regulatory protections to incentivise companies to be financially resilient …are part of a proportionate regulatory approach, which should not have a material impact on financially resilient companies*", this is not the case. By failing to clearly identify a financial resilience problem and conduct any impact assessment of its proposals, Ofwat has put forward licence modifications which will, if taken forward, do more harm than good (see further **Section 2** below).

Put another way, by targeting service delivery with an erroneous focus on credit ratings and dividend payments, Ofwat's proposals will increase costs for consumers without any clear or substantive benefit.

b. Ofwat has applied too narrow a definition of financial resilience, including placing too much weight on the views of credit rating agencies (which do not equate directly to financial resilience) and failing to acknowledge its own role in securing financial resilience in the sector.

Ofwat's licence modification proposals place undue weight on the views of credit rating agencies

SEW considers that Ofwat's licence modification proposals place undue weight on credit rating agencies' assessment and fail to take into consideration a broader suite of measures which would be required to assess robustly whether a company is financially resilient.

[5] Ofwat, Financial resilience in the water sector: a discussion paper, 7 December 2021 and Mason & Wright, A Report on Gearing, Price Controls and Financial Resilience, 3 December 2021. Also, SEW's response dated 31 January 2022.

Ofwat's annual Monitoring Financial Resilience Report[6] (**MFRR**) sets out a range of measures which should be considered when assessing financial resilience including credit ratings, interest rate, dividend yield and RoRE. In addition, John Earwaker, in his report at **Annex 1,** states that resilience is "*built on multiple foundations, each reinforcing or buttressing one another in a systemised manner*" and refers to a further helpful list of some of the key factors that can affect a company's financial resilience, which has previously been published by Ofwat.[7]

Examples of factors that may affect a company's financial resilience

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.

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.

Whilst the Consultation appears to acknowledge the relevance and importance of these different measures (e.g. when it states that Ofwat's "*assessment of financial resilience takes account of a range of information and the specific circumstances of each company*" and notes that Ofwat does "*not rely on any single source of information and, in turn, assess all information that is available to us to inform our own view of financial resilience which we share through our annual [MFRR]*"), Ofwat's licence modification proposals do not reflect this. On the contrary, they do not consider a range of

[6] Ofwat (2021), Monitoring Financial Resilience Report Year ended 31 March 2021, page 5.

[7] **Annex 1**, Box 1, page 3 (referencing Ofwat, Putting the sector back in balance: Consultation on proposals for PR19 business plans - Ofwat, dated 26 April 2018, at page 33).

factors and measures of financial resilience and they do rely solely on credit ratings – which is too narrow a measure to assess financial resilience.

Specifically:

- Companies are to be required to obtain and maintain issuer ratings with at least two rating agencies (or to seek Ofwat's agreement to an alternative arrangement, if proportionate).
- 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 cash lock-up.
- Cash lock-up is 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.

SEW considers that these proposals are wrong for a number of reasons.

First, it is appropriate to highlight a number of key points about the nature of credit ratings and the rating agencies' methodology, which are clearly set out by Earwaker in his report at **Annex 1**.

- The credit ratings applied by each agency are *calculated differently* and have different meaning – so, for example, a Moody's corporate family rating is very different to an issue or instrument specific rating provided by S&P.
- Credit ratings represent a relative assessment so, as Earwaker makes clear, "*there is not a hard definition of what, say, a Baa2 or BBB rating equates to in terms of absolute credit risk*".
- A credit rating focuses very narrowly on the question of whether creditors can expect to receive payments that are owed to them when promised and in full (meaning that the methodology that the agencies' apply in arriving at their assessment is focused on debt rather than equity).
- There is therefore, in Earwaker's words, no "*perfect mapping from financial resilience to credit rating, or from credit rating to financial resilience*". And as a "*specific credit rating does not equate directly to financial resilience*" there is 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*".
- The three rating agencies do not always assign issuer ratings to water companies. SEW, for example, holds only issue ratings with Moody's and S&P, which pertain to the credit risks associated with an individual debt issue, rather than the overall creditworthiness of the company.

Second, the proposed modifications effectively outsource the assessment of financial resilience in the sector to third parties. As Earwaker states: *"…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"* and "*… 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 … raises quite serious issues about the integrity of regulation*."

Third, Ofwat's proposed approach ignores the role of equity in financial resilience. Whilst SEW's licensed regulated activities are funded by a mix of equity and debt capital, Ofwat's proposal to raise the cash lock-up trigger is based solely on an assessment of debt financeability. However, companies cannot be resilient if they cannot attract equity investment and, paradoxically, the proposed new cash lock-up trigger could result in reduced equity investment in the sector required for ongoing investment in the network to maintain customer service levels.

Fourth, whilst the current cash lock-up threshold is set at a clear level – the trigger from investment grade to sub investment grade, which has implications for companies' ability to access capital markets – Ofwat's new threshold is arbitrary. It is not a simple one notch tweak to established licence architecture, as the proposed requirement for companies to hold a minimum of two issuer credit ratings is an integral part of the package. As set out by Earwaker, 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-.

Fifth, and with regard to the proposal that 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 cash lock-up, SEW agrees with Earwaker that "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 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*".

Sixth, Ofwat's proposed licence modifications place too much store on the possibility that a rating *may* change as opposed to the actual rating that a company *is* able to maintain at any given point in time, i.e. it is proposed that lock-up 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. However, neither of these things can in and of themselves be interpreted to mean that a company is no longer exhibiting Baa2/BBB credit quality. As Earwaker states: *"In the first case, formally, the rating agency is going no further [than] 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."* Earwaker's report also highlights that 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). In several of these examples, companies would, under Ofwat's proposed licence modifications, have gone into and out of lock-up despite maintaining credit quality commensurate with at least a Baa2/BBB rating.

Seventh, the different rating agency methodologies are not consistent (the S&P rating is Class A, Moody's is a Corporate Family rating and Fitch is an Issuer Default rating) which could result in inconsistent lock-up levels across the sector.[8] This inconsistency could result in different levels for cash lock up across the sector and may result in different treatment of junior and senior debt. For example, SEW has a BBB credit rating with S&P whereas many of its peers have a BBB+ credit rating. This is because SEW only has one class of debt in its OpCo and S&P choose to apply the credit rating in line with the class B debt of its peers. Ofwat applies the credit rating to the majority of OpCo debt when assessing the credit rating. As a result, SEW could be disadvantaged due to its

[8] Moody's, Fitch and S&P all include a range of qualitative and quantitative analysis to arrive at their rating assessments. However, there are differences in the details of the methodologies which may result in different ratings provided across the three agencies. For example, in its assessment Moody's excludes PAYG financeability adjustments which Ofwat included in the PR19 Final Determination. In contrast, S&P considers that the PAYG adjustment can increase cash flows in the short term and therefore boost credit metrics.

debt structure, not its underlying credit quality. The subjectivity applied by the rating agencies when evaluating credit worthiness should not be the deciding factor of whether a company enters cash lock-up and is potentially unable to pay dividends to its shareholders.

Eighth, these problems arise as a direct consequence of the fact that – as set out in a. above – Ofwat has failed adequately to define the financial resilience problem it is seeking to address or conduct any impact assessment and, as a result, is using a blunt and poorly targeted approach. This results in an unacceptable risk of perverse outcomes – which are more fully explored in Earwaker's report and with which SEW agrees – without any obvious available solutions.

In SEW's view, it is no answer to these problems to state, as Ofwat does in the Consultation, that *"it is [Ofwat], rather than the credit rating agencies, that is in the position to agree distributions once the cash lock-up condition has been triggered*." As Earwaker makes clear, this residual power does not cure the harm that the flawed licence modification proposals create:

> "*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 [be] 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 … 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 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 kind of wrongs that I have identified. 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."*

Ofwat has failed to acknowledge its own role in securing financial resilience in the sector

It is also noteworthy that, in the Consultation, Ofwat fails to acknowledge its own role in securing financial resilience in the sector. For example, it states: "*The credit ratings we monitor for licence compliance purposes across the sector have fallen over time, indicating reduction in financial headroom. Several companies have ratings below the notional company target of at least BBB+/Baa1.*" However, the reduction in credit ratings in the sector over time has primarily been driven by regulatory determinations. This is because, as noted in our response to Ofwat's earlier discussion paper, financial resilience is contingent on appropriate calibration of the regulatory framework, including the price control.

Rating agencies react to any changes in regulation introduced by Ofwat, meaning that any stricter requirements in terms of gearing or rating or weakening of financeability testing are likely to have a negative impact on the sector outlook as a whole. For example Moody's downgraded the sector following Ofwat's PR19 methodology, noting credit rating "*…downward pressure could result from a significant increase in business risk for the sector as a result of legal and/or regulatory changes* *leading to a reduction in the stability and predictability of regulatory earnings, or the company facing unforeseen funding difficulties."*[9]

Ofwat has failed to consider or explore this important inter-dependency. As noted in our response to Ofwat's earlier discussion paper, the balance of risk and return underpins financial resilience, but the implications of Ofwat's PR24 proposals for the financial resilience of the sector do not appear to have been explored, even though they are key to protecting customers' long term interests.

c. Ofwat has not explained how and to what extent its extensive range of existing regulatory mechanisms are inadequate in addressing financial resilience. This is essential in ensuring that regulatory activity is targeted only at cases in which action is needed.

SEW notes that the existing regulatory framework includes a number of protections to minimise the impact on customers if a company falls into financial distress. Specifically, it includes a series of protections including the existing cash lock-up, regulatory ringfence provisions, Interim Determination of K (**IDoK**) [10], shipwreck clause and special administration regime, all of which limit the risk exposure which is borne by customers. In addition, SEW has corporate governance arrangements, a dividend policy, and Whole Business Securitisation (**WBS**) which includes additional covenants and protections which are in several instances stronger than the ones imposed by ringfencing mechanisms, e.g. requirements to avoid debt maturity concentrations, which ensure SEW has strong mechanisms in place to protect customers and support financial resilience of the regulated business.

In addition, there are of course **ex ante mechanisms** (such as totex sharing, revenues linked to outturn inflation and cost of new debt indexation, which are included within the price control and are applied automatically to reduce the risk exposure companies face on individual elements of the regulatory building blocks) and **intra price control reporting** (where water companies are required to report financial and operational information to Ofwat each year in addition to the publication of the annual report, providing Ofwat with visibility of company performance throughout the price control).

With regard to dividends, SEW revised our dividend policy following the PR19 Final Determination to reflect Ofwat's expectations.[11] It provides that: "*Dividends should be set and paid at a level that enables the Company to maintain its long term financial resilience in the interest of shareholders, customers, employees and other stakeholders*"[12] We set dividends taking into consideration all of these factors in the round. It should also be noted that our Appointed business dividend yield in PR19 to date (2.1% in 2020/21 and 1.6% in 2021/22) is significantly below the 4% nominal yield set out by Ofwat in the PR19 Final Determination. Our OpCo Board, whose single largest group is independent directors, approves each dividend payment having regard to all stakeholders' interests, including customers. No dividends would be paid from SEW Ltd should the operating company be under financial distress.

It is neither clear how Ofwat has taken these protections into account in the Consultation, nor how and to what extent this extensive range of existing regulatory mechanisms is inadequate to address

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[9] Moody's Investor Service (2020), South East Water (Finance) Limited Credit Opinion, page 2.

[10] Excluding in period ODIs.

[11] SEW (2020), Dividend policy, page 2.

[12] SEW (2020), Dividend policy of South East Water Limited, para 6.

financial resilience. As with the Gearing Outperformance Sharing Mechanism in PR19, there is "*weak evidence of a regulatory gap after considering the range of relevant regulatory tools*"[13].

Ofwat's proposed licence modifications are additional regulation which, in some cases, duplicate existing – more efficient and tailored – commercial measures that limit financial risk. As a result, they are likely to introduce distortions and result in detrimental outcomes for consumers.

It is also relevant to note, as highlighted in our response to Ofwat's earlier discussion paper, that there have been no observed water company failures over the last fifteen years (despite a global financial crisis and a worldwide pandemic, as recognised by the CMA[14]).

d. Ofwat's proposals are contrary to its clear and oft-stated policy that companies are best placed to make, and must bear responsibility for, decisions over their financing and capital structure arrangements.

There is strong regulatory precedent in UK utilities that decisions relating to capital structures are for companies and shareholders to manage, along with the associated risks. This is reflected in the water sector, where the choice, and risk associated, with capital structures has always been the responsibility of companies and shareholders.

Ofwat's proposed licence modifications blur the line as to which party is responsible for the actual financial structure and are at odds with Ofwat's clear and long-standing policy.

Whilst Ofwat acknowledges its long standing approach in the Consultation, it attempts to reposition it as follows: "*Our long standing approach is that companies are best placed to make decisions over their financing and capital structure arrangements, including a target credit rating which provides them with a robust level of headroom to allow for financial flexibility, within the boundaries set by our regulatory controls, their licence and company law. Therefore, investors should bear the risks and consequences of decisions made for and by the company and an equity buffer is a necessary part of this.* ***Within this framework*** *it is still important that as a regulator of an essential service we have a clear ongoing assessment of the financial resilience of companies and have the right regulatory tools to protect customers*" (emphasis added). Ofwat uses this 'remoulded' position as a platform for its more intrusive approach but does not address its inherent contradictions.

In SEW's view, Ofwat's proposed licence modifications will mean that, in some circumstances, companies will not be able to choose their optimal capital structure. In this regard, we note the evidence given by Lawrence Slade, CEO of the Global Infrastructure Investor Association, to the House of Lords Industry and Regulators Committee on 19 July 2022, as part of that Committee's inquiry into '*The work of Ofwat*'[15]. In particular, Mr Slade noted: "*There are concerns around the level of regulatory intervention compared to some of the other UK markets. … one of the areas of disagreement between the investor community and the regulator is the sense that the regulator has become too involved and too engaged in trying to look at and regulate funding models that are*

[13] Ibid., at paragraph 9.1223.

[14] CMA, Final Report dated 17 March 2021, at paragraph 9.1203 (available at [Final report (publishing.service.gov.uk)]).

[15] Available at [Committees - UK Parliament].

engaged by the sector. Ultimately, that should be one for company boards and not necessarily for the regulator."

Further, SEW considers that the proposals could result in significant regulation of capital structures, effective constraints on possible financial structures – which risk distorting and blurring incentives for companies and increasing costs. For example, the increase in the cash lock-up level could require changes in capital structure to maintain headroom against the new threshold. This, in turn, would require compensation for the change in capital structure, in particular for water only companies like SEW that cannot easily change their capital structure over a short timeframe given the long-dated debt they hold.

More generally, there are key characteristics – including investment profiles, capital structures, governance arrangements and financing strategies – that differ for each company across the sector and mean that a 'one-size-fits-all approach' is not appropriate (and is certainly not targeted). For example, SEW is a small water only company located in one of the most water-stressed areas in the UK with a network close to capacity. It also has additional financing costs due to less frequent debt issuance, access to fewer sources of finance, and higher cost of carry. It is imperative that the risks associated with the efficient running of our business are properly priced to ensure financial resilience in the short and long term.

In its 'Financial Resilience: Impact Assessment' dated 29 September 2022 at **Annex 2**, KPMG sets out a case study of the impact of increased regulation of capital structures on the cost of capital. KPMG draws on the regulation introduced in the banking sector following the financial crisis which required companies to recapitalise. This recapitalisation increased the cost of capital by up to 0.15% with each percentage point increase in capital ratios. The introduction of additional regulation, and the corresponding increase in the cost of capital, was justified in the banking sector due to the risk of bankruptcy and costs to customers which crystallised during the financial crisis. However, the position in the water sector is different and the costs associated with recapitalisation are not well justified.

e. Ofwat has also failed to provide robust evidence in support of its licence modification proposals, including a clear explanation of how they discharge its statutory duties.

The Consultation is sparse and high level when it comes to providing evidence in support of Ofwat's proposed licence modifications, and an explanation of how they discharge Ofwat's statutory duties. There is simply a series of high level justificatory assertions, with no supporting information.

In SEW's view, Ofwat has failed to provide robust evidence in support of its proposals. For example:

- The Consultation states: "*Weakened financial resilience can lead to reduced levels of operational performance and erode a company's capacity to cope with financial pressures or shocks without compromising service to customers*". It thus draws a link between financial resilience and customer service levels (i.e. improved operational performance and service delivery) without any evidence that this is the case in the water sector or analysis to show that existing regulatory mechanisms are insufficient to protect service delivery within the ringfence.

- The proposal to raise the cash lock-up trigger from BBB-/Baa3 (negative outlook) to BBB/Baa2 (negative outlook) is not based on any clear evidence and is arbitrary. The change from BBB to BBB- does not result in a restriction in access to capital markets nor does it materially impact the pricing of debt in this sector, but this is not addressed in the Consultation. Ofwat does not evidence how an increase in rating requirement to BBB improves financial resilience or customer service levels.

- There is no evidence or analysis of how the proposed modification to the dividend policy licence condition will improve financial resilience (noting that SEW's Board – and no doubt others – already take the relevant factors into account when approving the payment of any distributions) and no reason to conclude that it would positively impact on investment or customer service.

- Similarly, there is no evidence that the proposed requirement for companies to hold two issuer credit ratings will improve financial resilience. SEW is already incentivised to hold an investment grade credit rating, and headroom to the minimum investment grade, as maintaining a robust credit rating supports our efficient cost of debt and access to a wide pool of investors and capital markets. This incentive exists independently of Ofwat's requirement that we hold an investment grade credit rating. In addition, our WBS already requires us to hold two investment grade credit ratings – although we welcome Ofwat's recognition that holding two investment grade credit ratings could place a disproportionate burden on smaller companies such as us.[16]

- Ofwat's proposal to modify the licence to require companies to notify it about any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals) is neither evidenced nor necessary, as such information is already publicly available and could also be required in accordance with the existing provisions of Condition M (Provision of Information to Ofwat) of the licence.

With regard to consistency with its statutory duties, Ofwat's description is high-level and unconvincing. For example, it states: "*modifying company licences to increase the cash lock-up … aligns with our duties to further both the consumer objective and the resilience objective as it reduces the likelihood that a company loses its investment grade rating thereby securing its ability to meet the need for water supplies and wastewater services into the long term for the benefit of its customers and the environment*".

The Consultation contains no reference to Ofwat's strategic priorities and objectives as set by the Government[17]. The Government states, among other things, that Ofwat is expected "*to provide the regulatory conditions to foster a culture which gives proper consideration to the long-term and balances the interests of current and future customers fairly*" and "*Ofwat should promote efficient investment, ensuring it is made in a way that secures long-term resilience and protects and enhances the environment, whilst delivering value for money for customers, society and the environment over the long-term*". In addition, Ofwat is expected to "*explain clearly how major decisions support delivery of [its] strategic priorities*".

Finally, Ofwat has failed to assess and provide evidence in relation to the impact of its licence modification proposals which is "*an important part of a transparent decision-making process*" and a

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[16] Ofwat states that the "*costs of maintaining two credit ratings may be disproportionate for smaller companies*".

[17] Strategic policy statement for Ofwat - GOV.UK (www.gov.uk) dated 28 March 2022.

way of ensuring that decisions "*are soundly based and well informed*".[18] We consider this further in **Section 2** below.

[18] Ofwat's policy on impact assessments dated April 2011, para 1.

2) SEW considers that Ofwat's licence modification proposals are harmful.

a. Contrary to Ofwat's statutory duties and strategic priorities, the proposals will lead to increased costs for consumers, reduce regulatory certainty and have other adverse consequences.

Under section 2 WIA91, Ofwat must carry out its functions in the way it considers will best further the consumer objective, secure that water companies can (in particular through securing reasonable returns on their capital) finance the proper carrying out of their statutory functions, further the resilience objective, promote economy and efficiency, and contribute to the achievement of sustainable development, among other things. Ofwat must also have regard to the principles of best regulatory practice, and act in accordance with the statutory strategic policy statement published by Defra.[19]

SEW considers that Ofwat's proposed licence modifications will, contrary to these duties and strategic priorities, lead to **increased costs for consumers, reduce regulatory certainty and have other adverse consequences**.

The sector is facing unprecedented investment requirements to meet environmental challenges, stretching performance targets and long term challenges on asset resilience. With regard to SEW, our requirement for investment is at historically high levels due to the challenges we face relating to population growth, climate change and environmental commitments. We are concerned that **Ofwat's proposed licence modifications will discourage investment in the sector and commitment of new equity capital at a time when sizeable investment is needed**.

SEW considers that the proposed modifications will reduce the attractiveness of the sector for equity investors by reducing equity investor's control rights and **introducing uncertainty** around dividend payments in the future (which will increase the duration of cashflows to equity). This will have a negative impact on equity cashflows and value and increase the required return for equity investors. This will either need to be (i) priced in the allowed cost of equity at future price controls, resulting in **increased costs to customers**; or (ii) will not be priced but deter commitment of new capital to the sector. This is in line with the CMA's conclusions at PR19 which noted that:

> "*If investors do not expect to be fully compensated for future investments over their life, then they may be unwilling to invest in the future to meet these requirements, with two possible scenarios with an adverse effect on consumers:*
>
> *(i)* *That **investors choose to exit the sector or are unwilling to put in further capital at the allowed WACC, resulting in a higher cost of capital from new investors** who are willing to put money into the sector, or a need to pay a premium in future price controls; or*
>
> (ii) *That the **wider social benefits of investment are lost,** either because companies do not identify investments or put resources into planning for them, or because the finance to deliver those investments is unavailable*."[20]

[19] Ibid.

[20] CMA, Final Report dated 17 March 2021, at paragraph 9.1269.

The proposed change to the cash lock-up level will increase protection and reduce risk for debt investors, but result in increased risk for equity investors – which, based on the PR24 Draft Methodology, will not be priced in the allowed return. It will therefore redistribute value and control from equity to debt investors without corresponding remuneration. This mismatch of increasing risk without a corresponding increase in return will deter equity investment. Alternatively, if it is priced in AMP8 (which Ofwat has not signalled in its PR24 Draft Methodology), it will result in a higher return requirement and bills in AMP8. This will represent a **significant additional cost to customers** with very limited observable benefit.

With regard to dividends, Ofwat's proposals will **reduce certainty** of future dividend payments to equity investors. Infrastructure investors take a long term view when making investment decisions. It is therefore **important for the regulatory framework to provide certainty and stability in the longer term**, not just for the upcoming five year period.

At **Annex 2** to this response, KPMG has performed analysis of dividend signalling, to evaluate how a lower than expected dividend payment might impact equity value. KPMG references academic studies which outline the impact of lower than expected dividend payments:

> *"The positive association between the dividend change and announcement returns suggests that investors update their valuation of the firm in response to the dividend change. Investors update their assessment of valuation in response to dividend changes, suggesting they infer new information from these corporate actions."*.[21]

This is supported by KPMG's analysis of United Utilities and Severn Trent's historical dividend announcements, which concludes: *"the analysis of UU and SVT's past dividend announcements and market data shows that a negative dividend announcement results in a reduction in stock price or equity value"*[22] and *"if Ofwat proposals were to be implemented, investors would require **a range between 45bps and 56bps uplift on CoE,** or between 18bps and 22bps on the cost of capital, to compensate for the implied equity value lost."*[23]

This greater restriction on dividend payments will deter new equity investors from committing capital within the regulatory ringfence and, for investors who rely on regular dividend payments, the heightened risk of non-payment of dividends could result in exit from the sector. This is especially the case if the increased risk to equity is not remunerated.

The proposals will also result in reduced ability to respond to clientele effects[24] as companies will have less control over the payment of dividends. The UK water sector, and other utilities, are considered income stocks with the expectation that they provide stable dividends. If dividends are restricted at certain times, investment in the water sector becomes less attractive as income stocks. Some investors which rely on dividends will no longer want to invest in the water sector, even if the increased risk to equity is priced.

[21] Ham, Kaplan and Leary, Do dividends convey information about future earnings? (2020), page 551.

[22] KPMG Impact Assessment, page 53

[23] Ibid, page 55

[24] The clientele effect is the principle that the requirements of investors attracted to a particular kind of investment will affect the price of the investment in reaction to changes in circumstances. The requirements come in reaction to policy changes, such as to tax or dividends, including corporate or regulatory changes which impact the company's ability to pay dividends.

The proposed licence modifications, and implied restriction on dividends, could be seen as equivalent to additional covenants but imposed by the regulator. These covenants would be similar to, but more stringent than, the covenants in place under SEW's WBS. As proposed, they might enhance credit rights, lower the cost of debt and marginally reduce probability of bankruptcy. But, again, the implications for equity investors have not been considered.

Ofwat states that the proposed licence modifications will strengthen the regulatory ringfence by increasing the threshold for cash leaving the operating company. However, as is clear from the above, Ofwat has failed to consider the implications for cash *entering* the ringfence, which will also be deterred.

In SEW's view, contrary to Ofwat's statements in the Consultation and accompanying press release[25], the licence modification proposals do "*cut across the key features of the regulatory regime that are valued by investors"* and will not "*improve the attractiveness of investing in water and wastewater companies".*

SEW also considers that the proposed modifications will have **a variety of unintended and adverse consequences, including the introduction of market distortions** (by duplicating existing – more efficient and tailored – commercial measures that limit financial risk) **and resulting harm to consumers**.

b. Ofwat has failed to consider or quantify these effects in any proper impact assessment.

It is critical that an impact assessment is performed to fully understand the costs and benefits of Ofwat's licence modification proposals and influence decision making (including comparing the likely impact of the proposed action against the impact of taking no action (the so-called 'do nothing' option)). However, Ofwat has failed to carry out any such assessment – even though its proposals comprise a major change and will have a significant impact[26] – with the result that it has not considered or quantified the associated costs to consumers.

The Consultation, rather simplistically, assumes that the introduction of the cash lock-up or linking dividends more closely to operational performance will result in additional investment which will in turn benefit consumers. However, it does not necessarily follow that increased cash available will result in additional investment or improved customer service levels. Classic corporate finance theory on agency costs indicates that to achieve the right incentives and efficient outcomes cash should not be held on balance sheet – which is one of the key drivers of dividend payments. KPMG note in its impact assessment that *"If a company chooses to pay out dividends, it is because it has exhausted all positive-NPV opportunities to invest, repay debt and hold precautionary cash. Paying out dividends is the best use of cash (having exhausted all those opportunities). Restricting dividends and forcing the company to allocate the cash to one of these three alternative uses is likely value-destroying (…) Ofwat's proposed dividend restrictions could increase the cash available to management and hence increase agency costs and the required cost of capital"*[27].

Together with a number of other companies, SEW has commissioned KPMG to perform an impact assessment of Ofwat's proposals in order to better understand their costs and benefits. This impact

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[25] PN 27/22 Ofwat raises bar on financial resilience - Ofwat dated 28 July 2022.

[26] Ofwat's policy on impact assessments dated April 2011, para 3.

[27] KPMG impact assessment, page 8

assessment can be found at **Annex 2** to this response, and a high-level summary of its methodology and conclusions are summarised below.

The costs of Ofwat's licence modification proposals outweigh the benefits

In its impact assessment, KPMG concludes that there is limited benefit to consumers of Ofwat's proposals and the associated costs are greater than the benefits.

<u>Benefits of Ofwat's proposals</u>

KPMG considers two potential benefits of Ofwat's proposals: (i) a reduction in the probability of default; and (ii) a reduction in the cost of debt allowance.

With regard to (i), KPMG's analysis considers the impact that Ofwat's proposed change to the cash lock-up trigger from BBB-/Baa3 (negative outlook) to BBB/Baa2 (negative outlook) credit rating has on the probability of default and ultimately on consumers. Overall, KPMG concludes that the reduction in the probability of default would result in a c.0-2bps reduction in the cost of capital per year on average.

Turning to (ii), KPMG assesses the impact of a credit rating downgrade on the cost of debt allowance. They start with Ofwat's assessment of the impact on the cost of debt, c. 14bps. The analysis then explores how the downgrade of a company would translate into the cost of debt allowance (based on the CMA's PR19 methodology) and arrives at an impact of 1bps on average over the next five price controls. KPMG notes that this potential reduction, however, would be offset by changes to cost of equity *"in theory, the potential reduction in the cost of debt would be offset by an increase to the cost of equity, with no impact on the overall cost of capital. The theory only holds true if there is a net neutral effect from the risk transfers between debt and equity, with the overall asset risk exposure unchanged".*[28]

In summary, KPMG finds that there are limited benefits to consumers of Ofwat's proposed licence modifications.

<u>Costs of Ofwat's proposals</u>

KPMG assesses whether dividends are important in the water sector and finds that investors in utilities, including the UK water sector, have a preference for a cash yield and withholding dividend payments may deter investors from the sector.

KPMG draws on analysis of preference shares, dividend signalling in the water sector, impacts of a change in the pay-back period on the required return and the impact of regulation in the banking sector to evaluate the potential impact of Ofwat's proposals on the required return for equity investors. A summary of the analysis performed is set out below[29]:

- KPMG performs dividend signalling analysis on historic United Utilities and Severn Trent dividend announcements and dividends paid to evaluate the impact on equity value when lower than expected dividends are paid. KPMG finds *"The **reduction in the equity value is equivalent to an estimated 18-22bps on the cost of capital** based on UU and SVT. In*

[28] Ibid, page 41

[29] Ibid, section 1

practice this could under-state the potential impact of Ofwat's proposals as dividends for UU and SVT are relatively stable over time."

- KPMG analyses preference shares in the sector to proxy the impact of Ofwat's proposals on the required return for equity investors. *"The difference between interest payments on debt (which are regular and certain) and payments on preference shares (where shareholders do not have control over timing of payments) can be used as a proxy to evaluate the impact of Ofwat's increased regulation of dividend payments, and the impact on the cost of equity. The estimated difference between debt and preference share yields is equivalent to **45-98bps** on the cost of capital".*
- KPMG also considers duration of cash flow analysis, based on the Xia-Brennan model, to evaluate how shifting dividends to future periods *increases* the equity payback period, increases the duration of cashflows and estimates the impact on equity value. *"An analysis of different scenarios which could arise from Ofwat's proposals (for example, non-payment of dividends for three years) shows that **the impact of restricting dividend payments and increasing the duration of cash flows could have a 14-28bps** on the cost of capital."*

They include a range of 14-98bps impact on the cost of capital. This cost would need to be transferred to customers to ensure equity investors are not deterred.

Balance of costs and benefits

KPMG concludes that Ofwat's proposals on cash lock up and dividend policy will result in limited additional benefits for consumers, due to the extensive regulatory protections already in place. There are, however, material costs implied by Ofwat's proposals which would increase the return required by equity investors in the sector, could result in a reduced pool of investors available, and which would be passed to consumers. The table below summarises KPMG's analysis of the costs of Ofwat's proposals.

KPMG summary of quantification of costs of Ofwat's proposals

Potential cost of Ofwat's proposals	Cost of capital impact
Increased cost of capital due to potential disruptions to stability of dividend flow	
Dividend signalling	18-22bps
Pricing changes in equity claims (in addition to uncertainty of dividend flow)	
Preference shares	45-98bps
Pricing increases in equity payback period	
Duration of cash flows	14-28bps
Total estimated range of costs associated with Ofwat's proposals	**14-98bps**

On balance, Ofwat's proposals are likely to result in costs to consumers which materially outweigh the benefits.

3) Based on the above, SEW considers that Ofwat's proposed licence modifications in respect of the cash lock-up licence condition, dividend policy and holding two issuer credit ratings are unjustified and harmful and, as such, should not be taken further.

SEW does not have any objection to Ofwat's proposal to modify the licence to require companies to notify it about any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals), save to note that such information is already publicly available and could also be required in accordance with the existing provisions of Condition M (Provision of Information to Ofwat) of the licence. The proposed licence modification is therefore duplicative and unnecessary, contrary to the principles of best regulatory practice, but SEW will not resist it to the extent that Ofwat considers it might support more robust and timely regulatory monitoring.

To the extent Ofwat remains minded to proceed to make a licence modification decision in respect of some or all of its proposals, it should note that there are clear errors in the draft modifications in the Consultation which mean that they **fail to achieve the effect stated**.

Specifically, under the proposed drafting in P28.2:

- A <u>BBB-/ Baa3 rating does **not** result in a cash lock-up</u> because:

  (i) it <u>is</u> an investment grade rating, albeit the lowest investment grade rating – therefore it would not fall within P28.2.1 as currently drafted; and

  (ii) it is also <u>not</u> "*one notch above the Lowest Investment Grade Rating*" (therefore it would not fall within P28.2.2 as currently drafted, since that limb *technically* only catches a rating of BBB/Baa2, not the lowest investment grade rating (i.e. BBB-/ Baa3)).

- <u>A BBB/ Baa2 rating with negative outlook that has **not been changed from stable or positive to negative** also does **not** result in a cash lock-up</u>. This is because a rating of BBB/ Baa2 may be caught by P28.2.2. However, a BBB/Baa2 rating *with negative outlook* is currently <u>only</u> caught under Ofwat's proposed drafting where the Appointee/Associated Co has had its rating outlook *changed from stable/positive to negative*.

In addition, there is a **lack of clarity** in the proposed modifications to P30 (Dividend Policy), which will require additional guidance in terms of how they will be applied and operate to strengthen the regulatory ringfence. To the extent Ofwat intends to introduce an explicit link between performance on Outcome Delivery Incentives (**ODIs**) and dividend payments, SEW strongly disagrees.

Ofwat will need to consider the amendments required in order to correct these errors and the extent of any further consultation required.

If, instead, Ofwat is minded to "*apply an incentive-based mechanism within the price review*", SEW notes that such mechanism would still require a clear rationale and evidence base which, as yet, has not been articulated.

Annex 1: ‘**Ofwat’s Proposed Financial Resilience Licence Modifications: An Assessment’ by John Earwaker (September 2022)**

Annex 2: ‘**Financial Resilience: Impact Assessment’ by KPMG LLP (29 September 2022)**

south east water

Contact Us

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH

southeastwater.co.uk

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