Southern Water Response to Ofwat Consultation on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers

Executive summary

In July 2022 Ofwat published a *"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] ("the Consultation"), with the stated aim of improving financial resilience in the water sector.

In the Consultation, Ofwat proposes to modify licence conditions to:

1. raise the cash lock-up trigger to BBB/Baa2 with negative outlook, effective from 1 April 2025;
2. 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. require companies to maintain investment grade issuer credit ratings with at least two credit rating agencies, or to seek Ofwat's agreement to an alternative arrangement; and
4. 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.

We have carefully considered the Consultation's proposals.

1. **We disagree with the proposed change to the cash lock-up trigger, and strongly recommend that Ofwat reconsiders maintaining the current approach.**
2. **We disagree with the proposed change to dividend policy, and strongly recommend that Ofwat reconsiders maintaining the current approach.**
3. If Ofwat delivers an appropriate risk-return and approach towards financeability, we could be supportive of the Consultation proposal that companies should maintain at least two investment grade credit ratings.
4. We are supportive of the proposed change that any rating changes are notified to Ofwat, subject to complying with law and regulation on disclosure of non-public information.

We continue to welcome transparency on derivatives and pensions. As you know, we disagree with Ofwat's historic and current position with regards to the treatment of derivatives within the allowed cost of capital and would welcome further engagement on this to ensure recovery of efficiently incurred costs.

In September 2021, a fund managed by Macquarie Asset Management ("MAM") acquired a majority stake in the holding company of Southern Water via a £1.1 billion injection of new equity, including £530 million invested as new equity into Southern Water Services Limited. This is evidence that the market is functioning effectively.

In an open letter from Ofwat to MAM upon signing of the above transaction in August 2021, Ofwat recognised that: Southern Water may make dividends where it was delivering on the turnaround plan

[1] Ofwat (2022), 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

discussed between Ofwat and MAM; capacity had been created for such distributions via the equity injection; and that the turnaround plan may continue into AMP8. The proposed change to the cash lock-up trigger would appear to contradict these statements, which we believe would damage trust.

Below, we articulate our views on the Ofwat proposals that we disagree with, namely the proposed change to the cash lock-up trigger and modifying the dividend policy licence condition:

- Ofwat has not clearly articulated and evidenced the alleged economic problem or consumer harm its proposals are designed to address.
- The proposed cash-lock up provisions place excessive emphasis on credit ratings, and do not give sufficient weight to evidence around other factors such as the strength of cash flows, operational performance, corporate governance, access to debt and equity finance, shareholder mix and strategy. In our view, a broad assessment of financial resilience provides a rounded perspective on this matter, something that Ofwat already has all the powers to undertake.
- We commissioned John Earwaker to develop an assessment of Ofwat's proposals, primarily focusing on the use of credit ratings to measure financial resilience. Earwaker notes that each of the credit rating agencies applies a different methodology to assess credit quality and these differences may lead to inconsistency in the lock-up threshold applied depending on which rating agency is applicable.
- Contrary to Ofwat's duties, the proposals will have unintended consequences and result in risk to equity investment, undermining licensees' financeability, and introduce distortions that will lead to increased costs for customers.

Ofwat should in the first instance address any financial resilience concerns it has through a robust calibration of notional company's risks and returns at each price control. Ofwat's PR24 Draft Methodology, published at the same time as the consultation, does the contrary by proposing methodological changes that will reduce allowed returns whilst increasing volatility of cashflows and asset risk, and the calibration of the notional company moving further away from sector norms which will mask potential financeability issues.

The consultation does not identify or evidence the specific market or regulatory failure that Ofwat is seeking to address, conduct an adequate impact assessment or make clear why the current regulatory framework cannot adequately address the alleged market failure.

- Ofwat sets out a series of proposed new regulatory mechanisms and changes to licence conditions but does not clearly articulate the problem it is trying to solve or provide robust evidence that these changes are necessary. We agree with Ofwat that maintaining, improving and designing incentives around customer service levels is an important issue as we approach PR24, however Ofwat does not provide evidence and analysis to support its assumption that declining financial resilience could lead to a deterioration in customer service levels and delivery.
- There is no causal link or linear relationship between a higher credit rating, or stronger financial resilience, and improved operational performance and services delivery. Robust evidence is required to support licence modifications. However, the consultation draws a link between financial resilience and customer service levels without (1) evidence that this is the case in the water sector or (2) analysis to show that existing regulatory mechanisms (such as the existing cash lock up, cost sharing rates, IDoK) or alternative tools are insufficient to protect service delivery within the ringfence.
- As a result, Ofwat's proposed solutions are disproportionate and poorly targeted given the singular focus on a company's lowest credit rating. It is important that regulation is proportionate and targeted to ensure that policy intervention is focused on a specific problem and to minimise any adverse side effects. By targeting service delivery with focus on credit ratings and dividend payments, Ofwat's proposals risk increasing costs for customers without a clear or substantive benefit. In fact, of the likely

increases to the actual cost of equity arising from the tightening of the cash lock up threshold if unrewarded through the price review, would risk discouraging investment at a critical time.

The proposals will have unintended consequences and will lead to increased costs for customers.

The proposals will reduce equity investor's control rights and introduce uncertainty around dividend payments in the future (which will increase the duration of cashflows to equity). All else equal 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 (1) priced in the allowed cost of equity at future price controls, resulting in increased costs to future customers; or (2) if not factored in price controls, will deter commitment of new capital to the sector, resulting in a flight of equity.

The proposal runs counter to the long-standing principle that financing decisions are for the company. The actual capital structure is a matter for company Boards and their investors to decide on, because an optimal position may vary depending on many factors, including investor risk appetite. Ofwat has previously recognised the need for companies to choose their own capital structures, a position which has been echoed by the CC / CMA has echoed in its decisional practice.[2] In *Bristol Water (2015)*, the CMA noted that it was for the shareholders and the management of the company to determine the most efficient financial structure and '*not for the regulator to second-guess*'.[3]

Further regulatory constraints on dividend policy are likely to discourage new equity injections to improve the sector's financial resilience and support the investment required over PR19 and beyond. The proposed changes increase risk to equity- both directly from the measure but also from the perception that Ofwat will fine companies on subjective grounds if they disagree with dividend assessments.

We have commissioned KPMG to prepare a "Financial Resilience – Impact Assessment" report (the "KPMG report") to evaluate the costs and benefits of Ofwat's proposals and consider whether the potential benefits of new regulation outweigh the costs to support the introduction of new regulation. The KPMG report explores whether there is a market or regulatory failure that needs to be addressed by new regulation on financial resilience. The potential failures identified are (1) externalities due to companies' under-investment in customer service, (2) externalities due to bankruptcies whose cost would be borne by taxpayers, and (3) asymmetry of information between companies and the regulator that could result in situations of financial distress not detected by Ofwat.

The KPMG impact assessment concludes that there is no clear market or regulatory failure that Ofwat is aiming to address, and the proposed regulation is not a proportionate and targeted solution:

- Issues of underinvestment in the sector and unsatisfactory customer service levels are better addressed via totex allowance setting and monitoring of expenditure performance, as well as via definition of Outcome Delivery Incentives targeted to the service areas of concern.
- If a water company enters financial distress there are a series of regulatory mechanisms in place (IDoK, the shipwreck clause and current regulatory ringfencing provisions) which provide protection to consumers, before a company enters Special Administration.

[2] *Bristol (2010),* paras. 10.10, 10.21; *SONI (2017)*, para. 7.306; *Firmus Energy (2017)*, para. 7.81.
[3] *Bristol (2015),* paras. 10.93, 10.27, 10.132.

- It is unlikely that companies' management would take advantage of information asymmetries to create financial distress. Any concerns around asymmetry of information could be addressed by further reporting requirements, in addition to the existing regulatory mechanisms and processes of performance monitoring.

The KPMG impact assessment concludes that Ofwat's proposals will result in very limited, if any, benefits for customers due to the extensive regulatory protections already in place. By contrast on the cost side, the more stringent provisions are expected to reduce equity shareholders' control rights and dividend payment stability and predictability. The impact on the required equity remuneration is assessed analysing: lower-than-expected dividend announcements in the water sector; the spread yield between investment grade preference shares and a comparable bond index; and the impact on cash-flow duration of deferring dividend payments. The estimated impact of reduction in control rights and dividend payment stability and predictability is quantified in a cost of capital **increase of 14-98bps.**

As a result, **the impact of raising the cash lock-up trigger and link dividend payments to measures of service performance are likely to result in consumer harm and additional costs allocated to customers.** As well as running counter to its duties under the Water Industry Act 1991, Ofwat's disproportionate measures will fail to achieve their stated effects. The proposed changes to dividend provisions, if implemented, would likely have the opposite impact on financial resilience than originally intended, as they would *undermine* investor confidence and *increase the level of compensation investors require*.

The consultation proposes to introduce a requirement for companies to hold two issuer credit ratings, or to agree an alternative, proportionate arrangement with Ofwat. As we have three credit ratings, this proposal does not represent any additional financial or administrative burden. We agree that in general having more than one credit rating is likely to provide a more balanced view of credit quality, as credit rating agencies have differing methodologies and approaches. At the same time, it is important to consider that credit rating maintenance involves a substantial investment of time and money and might not be appropriate for all companies. It would also be inappropriate to base regulatory action solely on the weakest rating.

Finally, **we agree with the proposals for notification in the circumstances of changes to ratings or outlook** – these represent a proportionate request given credit ratings are an important factor in determining financial resilience. We also support the proposal to notify Ofwat about planned rating withdrawals for information purposes, as long as the decision on which rating agency to choose remains with the company.

Proposals 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.

We have serious concerns with Ofwat's proposal to modify the cash lock-up licence condition and raise the trigger to BBB/Baa2 (with negative outlook). Ofwat has provided insufficient evidence of the alleged customer harm to justify the proposed interventions. Moreover, the cash lock up proposal will have unintended consequences and result in reduced equity investment in the sector at a time where additional funding is required.

Ofwat has not clearly articulated and evidenced the alleged economic problem or consumer harm its proposals are designed to address.

Ofwat has not provided evidence of a negative impact on customers based on the existing regulatory framework.

Ofwat has failed to provide evidence of customer harm that would support new regulation on financial resilience and it has not performed an assessment to identify and quantify the harm to customers (either relating to costs borne by customers, or the quality of services) based on existing regulation. Without the identification and analysis of this harm, the new regulation will not be sufficiently targeted and may result in an inefficient outcome. New, untargeted regulation could result in market distortions that *introduce* harm to customers – the opposite of Ofwat's intended outcome.

Ofwat sets out a series of proposed new regulatory mechanisms and changes to licence conditions but does not clearly articulate the problem it is trying to solve. Ofwat's main argument appears to be that poor financial resilience may impact operational performance and service delivery for customers. We agree with Ofwat that maintaining, improving and designing incentives around customer service levels is an important issue as we approach PR24. However, this is a non-sequitur as Ofwat does not provide evidence and analysis to support its assumption that declining financial resilience could lead to a deterioration in customer service levels and delivery.

There is no clear market failure to be addressed by Ofwat's proposed licence modifications.

The existing regulatory framework includes protections to minimise the impact on customers if a company falls into financial distress. Any new regulation is only justified if it addresses a clear market or regulatory failure, after taking into consideration the existing regulatory protections. Ofwat has not undertaken analysis to identify the market failure it is seeking to address. Further, Ofwat has failed to demonstrate that there is an economic problem or market failure which the change in lock up would address, whether there is harm to customers which would need to underpin any intervention and what the hurdle rate would be for regulatory intervention.

The existing regulatory framework is sufficient and the more appropriate tool to enhance financial resilience is a robust calibration of the notional company and allowed return.

Ofwat does not provide robust evidence that existing regulatory mechanisms (such as the existing cash lock up, shipwreck clause, IDOK) are insufficient to protect service delivery within the ringfence. Such evidence is required to support licence modifications.

We note that the existing regulatory framework has a number of mechanisms which provide protection to customers when a company falls into financial distress. Furthermore, we have a Whole Business Securitisation (WBS) arrangement in place which includes additional covenants and protections, which reduces the risk of financial distress impacting customers. Ofwat's proposals risk duplication or partial replication of measures already in place. We deem the existing regulatory protections to be sufficient, and any changes should be well-signalled and sufficiently evidenced.

The definition of financial resilience implied by Ofwat is over reliant on rating agencies' credit metrics and debt financeability and does not consider impacts on equity capital and financeability.

Ofwat has based its proposals on too narrow a definition of financial resilience.

Our licenced regulated activities are funded by a mix of equity and debt capital. Ofwat's proposed increase in the cash lock-up relates solely to credit ratings, which are an assessment of debt financeability only. Ofwat does not consider the role of equity investment in financial resilience, companies cannot be resilient if they cannot attract equity investment. The proposed lock-up threshold could result in reduced equity investment in the sector which is required for ongoing investment in the network to maintain customer service levels.

In its annual Monitoring Financial Resilience Reports (MFRR) Ofwat sets out a range of factors which should be considered to evaluate financial resilience in the sector. These factors include credit ratings, gearing, dividends paid, RoRE, swaps and pension liabilities.

It is therefore not clear to us why Ofwat's proposed regulation is based on credit rating agencies' assessment alone. Cash-lock up provisions place excessive emphasis on credit ratings. Other appropriate factors must be considered, such as the strength of cash flows, operational performance, corporate governance, access to debt and equity finance, shareholder mix and strategy. In our view, a broad assessment of financial resilience provides a rounded perspective on this matter, something that Ofwat already has all the powers to undertake.

A credit rating assessment is inherently focussed on debt financeability but does not consider equity. Ofwat fails to account for the detrimental impact of potential dividend restrictions on equity financeability, at a time where there is likely to be a significant requirement for new capital in the sector to support infrastructure investment. It also doesn't assess the uncertainty this brings for new equity; what further changes to the licence on dividends or cash lock-ups should new equity assume for the future? This uncertainty increases the required return for new equity and limits availability of those willing to invest.

Ofwat states that the cash lock-up would strengthen the regulatory ringfence. However, Ofwat was does consider the implications for cash *entering* the ringfence. If equity investors have a higher risk of not receiving dividend payments from the regulated company it will be more difficult to attract equity investment *into* the ringfence. In consequence the proposals do not achieve Ofwat's stated objective.

The change in the lock-up threshold is arbitrary.

The current cash lock-up threshold is set at a clear level – the trigger from investment grade to sub investment grade. It is accepted that companies with a sub-investment grade rating will have a reduced access to capital markets. However, the justification for the proposed change in the lock-up condition from BBB-/Baa3 (negative outlook) to BBB/Baa2 (negative outlook) is less clear. A BBB- rating does not restrict a company's ability to access capital markets, nor does it materially impact the pricing of debt in the sector. This is supported by KPMG's analysis of credit spreads in the sector[4]:

- *"The analysis of the credit spreads in the UK water sector indicates that there is no consistent differential in the Baa1/BBB+ and Baa2/BBB spreads for 10Y tenor debt. As a result, it is not clear that there would be a material change to debt pricing as a result of Ofwat's proposals which in turn and in isolation might be passed through to customers."*

  *"Importantly there are limited instruments at the Baa2/BBB level meaning it is difficult to draw robust comparisons between pricing at each credit rating level, without compromising the likeness of instruments within samples. As a result of this limit on sample size, **there is insufficient data to conclude whether a pricing differential exists in the sector**."* (emphasis added)

The provision is more concerning still, if one considers that it would apply to a BBB/Baa2-rated company under review for possible downgrade or on "Credit Watch" or "Rating Watch" with a negative designation. It implies that a company merely "under observation" by only one of the rating agencies is subjected to the dividend lock-up for a significant period of time (3-6 months), whilst waiting for its position to be reassessed. If, at the following assessment, the rating agency determines that a downgrade is not necessary, Ofwat's policy will have imposed restrictions and costs on the company's shareholders and sent a wrong signal to the market. Earwaker notes in his report that *"Where previously one could rationalise that the licence's rating requirements are only a back-stop measure, and something that does no more than recognise that real-world consequences follow from the real-world delineation between having an investment-grade rating and having a non-investment grade rating, the one notch change to Baa2/BBB gives the rating agencies' opinions a very different status."*[5]

Ofwat should conduct its own independent assessment of financial resilience and take a more holistic view by considering, alongside credit metrics, companies' ability to retain and attract equity capital, strength of cash flows, operational performance, corporate governance, shareholder mix and strategy.

It is inappropriate for Ofwat to outsource the assessment of financial resilience to a third party.

The use of credit ratings as the indicator for the cash lock-up threshold effectively outsources the assessment of financial resilience to a third part. This is captured by Earwaker who highlights in his report that "*Ofwat as regulator is not directly responsible for the judgments that are being made about appointees' credit quality. This matters because the opinions that rating agencies issue have real consequences under the terms of Ofwat's licence design and yet Ofwat cannot exert any form of control over the timeliness, thoroughness or accuracy of a rating agency's analysis"*[6].

Moreover credit rating agencies are not affiliated with Ofwat and often have divergent views of regulatory risk. For example, Ofwat was critical of the Moody's and Fitch assessments of the impact of PR19 on regulatory risk, noting that: "*In 2018, Moody's and Fitch increased their assessment of business risk, leading to a tightening of guidance for adjusted interest cover and gearing. These credit rating agencies set out they had changed their view of the stability and predictability of the regulatory regime alongside an expectation of*

[4] Ibid, section 1
[5] Earwaker (2022), Ofwat's Proposed Financial Resilience Licence Modifications: An Assessment, page 13
[6] Ibid page 12

more volatile cash flow resulting from more revenue at risk through incentive mechanisms. […] We do not agree that regulatory risk has increased."[5]

Each rating agency also takes a slightly different approach to assessing water companies. The S&P rating is Class A, Moody's is a Corporate Family rating and Fitch is an Issuer Default rating. This inconsistency could result in different levels for cash lock up across the sector. Earwaker notes that a "*specific credit rating does not equate directly to financial resilience"*[7] It is therefore inappropriate to measure financial resilience and apply a cash lock-up solely on a credit rating.

We also note that the three main credit rating agencies do not use the same qualitative and quantitative criteria in their determination of companies' credit rating[8] and that, ultimately, the determination of credit ratings does involve a certain degree of judgement and subjectivity that is not accounted for in the published methodologies. The subjectivity applied by the rating agencies when evaluating credit worthiness should not be the deciding factor of whether we enter a cash lock-up and are unable to pay dividends to our shareholders.

We note that given the divergence of views of rating agencies, this can lead to different rating outcomes. Southern Water currently maintains three credit ratings, in respect of which there is currently a two-notch difference between the S&P and Fitch ratings (each BBB+) and Moody's (Baa3). Where a company maintains multiple credit ratings (as it will be required to do so under these proposals), it would appear to be disproportionate to base cash-lock up action solely on a single credit rating, particularly where that rating could be a comparative outlier compared to the views of other rating agencies in relation to credit quality.

The cash lock-up trigger should not be based on the lowest of the credit ratings held.

We also disagree that the cash lock-up trigger should be based on the worst credit rating held. This places too much emphasis on only one credit rating opinion, even if the level of this rating is inconsistent with the other two agencies' opinion. This is consistent with Earwaker's view that *"the 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 or 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.*[9]

We also consider this provision to unduly penalise companies, like Southern Water, which holds three credit ratings because, all else equal, these companies are more exposed to obtaining a lower rating from one of the three agencies and trigger the cash lock-up condition as a result. This appears counter-intuitive, as holding three credit ratings should provide a more balanced view of credit quality, which should not be penalised by the regulator.

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[5] Ofwat (2020), Reference of the PR19 final determinations.
[7] Earwaker (2022), Ofwat's Proposed Financial Resilience Licence Modifications: An Assessment, page 12
[8] For example, Moody's excludes from its financeability metrics the additional short-term cash-flow coming from a PAYG rate above its "natural" rate. This is not consistent with the approach adopted by S&P.
[9] Earwaker (2022), Ofwat's Proposed Financial Resilience Licence Modifications: An Assessment, page 15

Contrary to Ofwat's duties, the proposals will have unintended consequences and result in risk to equity investment, undermining licensees' financeability, and introduce distortions that will ultimately lead to increased costs for customers.

The proposals will have unintended consequences and will lead to increased costs for customers.

The requirement for investment in the sector is currently at unprecedented levels due to operational, climate change and environmental challenges. 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.

As well as running counter to its duties under the Water Industry Act 1991, Ofwat's disproportionate measures will fail to achieve their stated effects. The proposed changes to dividend provisions, if implemented, would likely have the opposite impact on financial resilience than originally intended, as they would *undermine* investor confidence and *increase the level of compensation investors require*. The proposals will reduce equity investor's control rights and introduce uncertainty around dividend payments in the future (which will increase the duration of cashflows to equity). All else equal 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 (1) priced in the allowed cost of equity at future price controls, resulting in increased costs to future customers; or (2) if not factored in price controls, will deter commitment of new capital to the sector, resulting in a flight of equity.

In their report, KPMG conclude that *"based on the analysis performed for this paper there may be some small benefits of Ofwat's proposals (…) This report also assessed potential costs of Ofwat's proposals due to a change in equity value arising from agency costs, reduced ability to respond to clientele effects, impact of delays in cash flows on equity value and restricted ability to adopt the optimal capital structure. These effects (…) would all else equal increase costs and the returns required by equity investors in the sector which would have to be funded by customers (…) On balance, the proposals are therefore likely to result in costs to customers which materially outweigh the potential benefits."*[10].

Further regulatory constraints on dividend policy are likely to discourage new equity injections to improve the sector's financial resilience and support the investment required over PR19 and beyond. The proposed changes increase risk to equity- both directly from the measure but also from the perception that Ofwat will fine companies on subjective grounds if they disagree with dividend assessments.

By contrast under current regulation new capital has been committed to the sector in a number of cases. Notably, in September 2021, a fund managed by MAM acquired a majority stake in Greensands Holdings Limited, the holding company of Southern Water via a £1.1 billion injection of new equity, including £530 million invested as new equity into Southern Water. The injections have given Southern Water additional funding required to accelerate improvements in both operational and financial performance.

This is evidence that the market is functioning efficiently. In the case of Southern, MAM acquired an underperforming company and supported the management team's turnaround plans by injecting equity to *inter alia* de-lever, fund increased investment, improve customer service and ultimately improve financial resilience. This was publicly acknowledged and supported by an exchange of letters between MAM and

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[10] Ibid, section 1

Ofwat, where Ofwat acknowledged that MAM should earn a fair return on their investment (i.e., dividend yield) provided the turnaround was delivering. The proposed changes set out in the licence consultation, given SW's Baa3 rating, contradict this.

Whilst the possibility of payment remains subject to Ofwat's approval, this puts a very different complexion on the transaction and we are concerned that these proposals would deter other investors from investing new equity into the sector in a similar scenario.

Ofwat does not provide a clear quantification of the proposals' impact on customers

There is a high bar for the introduction of new regulation and it is critical that an impact assessment is performed to fully understand the costs and benefits of the proposals. We are concerned that Ofwat has not considered the costs to customers associated with these proposals and that there are likely to be minimal benefits and significant costs.

The objective to protect the interests of customers is one of Ofwat's primary duties and has not been given due regard within the Consultation. Ofwat has assumed that the introduction of the cash lock-up will result in additional investment which will in turn benefit customers. However, it does not necessarily follow that increased cash available will result in additional investment or improved customer service levels. Agency theory states that the interests of shareholders and management may not always align and excess cash may be used in non-value generative activities. This theory is a key driver of dividend payments, to prevent the inefficient use of cash by management.

To justify the introduction of new regulation Ofwat needs to provide evidence that the benefit of the increase in cash lock-up and dividend policy changes outweigh the costs. However, Ofwat has not performed a cost benefit analysis to assess the potential impact of its proposal.

We commissioned KPMG to undertake an impact assessment[11] to better understand the potential costs and benefits of Ofwat's proposals. The KPMG impact assessment concludes that Ofwat's proposals will result in very limited if any benefits for customers, due to the extensive regulatory protections already in place. However, there are material costs to the proposals which would be passed to customers. KPMG estimates, that the proposals could increase the allowed cost of capital by 14-98bps, based on analysis of dividend signalling, preference shares and duration of cash flows[12]:

- Dividend signalling: *"The uncertainty around future cash flows to equity and restriction of dividend payments implied by Ofwat's proposals will have an impact on value in the water sector and result in an increased return required by equity investors. As a result analysis of dividend signals and impacts on stock price can be used to approximate the impact of Ofwat's proposals on value (…) The **reduction in the equity value is equivalent to an estimated 18-22bps on the cost of capital** based on UU and SVT."*
- Preference shares: *"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***

[11] KPMG (2022), Financial resilience – impact assessment
[12] Ibid, section 1

__yields is equivalent to 45-98bps on the cost of capital__, based on analysis of preference shares in the sector."

- Duration of cash flows: *"Duration of cash flow analysis, based on the Xia-Brennan model, considers how shifting dividends to future periods increases the equity payback period, which is equivalent to increasing 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."*

Additionally, we consider that the introduction of restrictions to dividend distribution is likely to worsen investors' view of regulatory risk. This regulatory risk is correlated to the wider political and economic environment, and therefore cannot be diversified. In other words, regulatory risk is a *systematic risk* that needs to be priced in the cost of equity. The increase in regulatory risk following the introduction of Ofwat's proposals can be proxied by a one-notch downgrade in the "stability and predictability of regulatory environment" qualitative factor of water companies' credit rating assessment. Using this methodology, **we estimate that an increase in regulatory risk would require a further cost of equity uplift of 43bps, or a 17bps increase in the cost of capital, over and above estimates set out in KPMG's impact assessment.**

Proposals 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.

The proposed dividend provision is generic and does not detail the criteria that Ofwat intends to employ to assess whether any dividend distribution is compliant with the licence. We note that our dividend policy already takes into account both financial and non-financial performance, including financial resilience, levels of customer service and wider stakeholder interests:

"Our dividend policy is formulated to ensure a fair balance of reward between customers and investors. To deliver on our vision for the successful delivery of our Business Plan for 2020–25, all stakeholders must share in success: customers benefitting through enhanced service and lower bills, and shareholders earning a fair return.

When proposing payment of a dividend the Directors of Southern Water Services Limited, acting independently in accordance with their directors' duties and in accordance with the Company's Licence, will apply the following principles:

1. *Determination of a base level of dividend, based on an equity return consistent with our most recent Final Determination and our actual level of gearing. This recognises our management of economic risks and capital employed.*

2. *In assessing any adjustment to the base level of dividend, __we will take into account our financial and non-financial performance__. This would reflect our overall financial performance as compared to the final Business Plan for 2020–25 as agreed by Ofwat and would __explicitly consider a qualitative assessment of customer service levels and how customers share in our successes__.*

3. *We will **consider our financial resilience ahead of any dividend decision**, and whether any financial outperformance should be re-invested to benefit our customers. This consideration will also include taking into account the interests of our employees, other stakeholders, and our pension schemes. **Our dividend policy is intended to support the financial resilience** and investment grade credit ratings of the business and ensure continued access to diversified sources of finance. As part of step three we carry out an assessment of: a) headroom under debt covenants; b) the impact on the company's credit rating; c) the liquidity position and ability to fulfil licence conditions; d) key areas of business risk.*

4. *We will be transparent in the payment of dividends and will clearly justify the payment in relation to the factors outlined above.*

5. *We will publish our Dividend Policy annually (as part of the Annual Report) and highlight any changes."* [13] [emphasis added]

Our dividend policy is consistent with, and supportive of Ofwat's stated objectives on financial resilience, quality of customer service and environmental performance. It is therefore not clear how the proposal would improve financial resilience. The proposed licence modification introduces another element of uncertainty and confusion, and a perceived risk that Ofwat will fine companies on subjective grounds if Ofwat disagrees with company dividend assessments.

We believe our existing dividend policy provides adequate consideration to financial and non-financial performance and therefore we do not think any licence modification is needed.

Proposals to modify the licence to require companies to hold two issuer credit ratings, or to seek our agreement to an alternative arrangement, if proportionate.

As we have three credit ratings, this proposal does not represent any additional financial or administrative burden. Generally, we agree that having more than one credit rating would provide a more balanced view of credit quality, as credit rating agency methodologies and approaches differ. At the same time, it is important to consider that credit rating maintenance involves a substantial investment of time and money and might not be appropriate for all companies. Additionally, if more than one credit rating is required, it would be inappropriate to base regulatory action (e.g. the cash lock-up) solely on the weakest rating. Financial resilience and credit ratings cannot be seen as equivalent, as set out in the Earwaker paper, and as a result we disagree with the proposed changes to the cash lock up threshold. However, if the proposals are implemented a more appropriate basis for regulatory action would be the strongest rating given Ofwat's requirement for more than one rating.

[13] sws-investor-report-for-mar22.pdf (southernwater.co.uk)

Proposals to 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.

We agree with the proposals for notification in the circumstances of changes to ratings or outlook – these represent a proportionate request given credit ratings are an important factor in determining financial resilience. We also support the proposal to notify Ofwat about planned rating withdrawals for information purposes, as long as the decision on which rating agency to choose remains with the company.