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Severn Trent Water Limited

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John Russell
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Dear John

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

I welcome the opportunity to respond to Ofwat's consultation on licence modifications in relation to financial resilience. We agree that water companies should have the financial resilience needed to meet customers' service needs at all times.

At Severn Trent we pride ourselves in maintaining a high level of financial resilience. This is reflected in our low level of regulatory gearing (one of the lowest in the sector in Ofwat's Financial Resilience Report 2020-21), our stable credit rating two notches above the investment grade threshold and a responsible and limited use of financial derivatives. Ofwat also recognised us as an industry leader on financial resilience in its most recent Financial Resilience Report.

We are also delivering leading operational performance for our customers. Ofwat recognised our service performance in December 2021 by placing Severn Trent in the sector-leading category in its Service and Delivery Report. The Environment Agency awarded us 4-star status (the top grade) in July 2022 for environmental performance for the third year in a row. We are also the second placed large water and sewerage (WaSC) company on the DWI's water quality compliance risk index (CRI).

We recognise the changes to Ofwat's proposals since the financial resilience discussion paper in December 2021. In particular, we welcome Ofwat's decision to drop the direct link between annual service performance and the cash lock-up licence condition and the refined wording of the licence condition text on the link between service performance and dividends.

The Severn Trent Board met on Friday 30 September. We understand Ofwat's concerns about financial resilience in the sector and we take comfort that Ofwat's proposals are not aimed at us. However, we are disappointed by the extent of the licence modifications Ofwat is proposing and that they will be as painful for Severn Trent as they are for the highly geared companies. We are also not clear what benefits the proposed licence modifications will achieve. That said, our Board accepts Ofwat's proposed licence modifications, although we suggest some improvements below to mitigate the issues they create, which we hope you will take account of.

Our detailed responses to each of the five proposed licence modifications are:

1. **"modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook [i.e. up one notch from now] proposed to take effect from 1 April 2025".**

We accept this licence modification, however we urge Ofwat to consider our views below. In particular, the proposal puts too much weight on third party credit ratings. The credit ratings are defined and calculated by the credit rating agencies using metrics that do not always take account of the specific features of the water sector. In Ofwat's recent consultation on the draft PR24 methodology (pages 104-105) it uses a wider set of metrics than those used by the credit rating agencies to assess financeability, including metrics with different definitions to those used by the credit rating agencies.

An example of how the credit agency metrics are not always a good indicator of financial resilience for the water sector is shown in the following box.

Example of how the credit agency metrics are not always a good indicator of financial resilience for the water sector

The current high inflation is leading to a severe deterioration in the FFO (Funds from Operations) / net debt metric used by S&P, which is measured differently from Ofwat's version of FFO / net debt. The deterioration is due to inclusion of (non-cash) index-linked debt accretion within S&P's FFO calculation, meaning S&P's FFO understates the cashflows available to service net debt.

We modelled the effect of a ten-percentage-point increase in inflation, on the notional company, using assumptions of 33% index-linked debt and 60% gearing. The result was a 3.0 and 2.3 percentage point decrease in years 1 and 2 of S&P's FFO / net debt metric, reflecting higher index-linked debt in year 1 and a partially offsetting increase in revenue in year 2. This decline would technically result in a one notch reduction in the company's credit rating, despite underlying gearing improving by 3.5 and 6.3 percentage points in years 1 and 2.

With 50% index-linked debt the effect is even sharper with a 5.4 and 6.0 percentage point decrease in S&P's FFO / net debt ratio for years 1 and 2, technically resulting in a two-notch reduction in the credit rating.

We do not think Ofwat intends for its cash lock up condition to apply due to high inflation making third party metrics, which Ofwat does not design, deteriorate while underlying financial resilience remains strong.

A potential solution to this issue is for Ofwat to include some text in the licence allowing companies to request Ofwat not to apply the cash lock up if they consider a credit rating change does not reflect their underlying financial resilience and giving Ofwat the discretion not to apply the cash lock up if it agrees. To this effect, we propose some amendments to Ofwat's proposed licence modification below:

Suggested amendment to Ofwat's proposed licence modification on the cash lock up

P27 The "Cash Lock-Up" provisions set out in paragraph P28 apply in any circumstances:

P27.1 where neither the Appointee or any Associated Company which issues corporate debt on its behalf holds an Issuer Credit Rating which is an Investment Grade Rating; or

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P27.2 where the Appointee or any Associated Company which issues corporate debt on its behalf:

P27.2.1 holds one or more Issuer Credit Ratings and one or more such Issuer Credit Ratings is not an Investment Grade Rating; or

P27.2.2 holds an Issuer Credit Rating which is one notch above the Lowest Investment Grade Rating (i.e. BBB at Fitch or Standard & Poor's or Baa2 at Moody's, or equivalent) and:

P27.2.2.1 the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P27.2.2.2 the rating outlook is negative.

P27.3 The Appointee can request Ofwat not to apply the "Cash Lock-Up" provisions set out in paragraph P28 if it considers the Issuer Credit Rating change does not reflect its underlying financial resilience. Ofwat has the discretion not to apply the "Cash Lock-Up" provisions set out in paragraph P28 if it judges that the Issuer Credit Rating change does not reflect the underlying financial resilience of the Appointee.

We also suggest that if Ofwat takes forward this licence modification it uses the higher of a company's two issuer credit ratings for the cash lock up condition, rather than the lower one as currently proposed. This will mitigate, to an extent, the concern about relying on third party credit ratings, by at least taking account of both third party credit ratings rather than one.

2. **"modify the dividend policy licence condition to require that dividend policies and dividends declared or paid should take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term".**

We accept this licence modification, however, we think it would be more transparent if Ofwat published its proposed guidance on dividends before making the licence modification. We note there are some clarifications of Ofwat's approach to dividends on page 27 of the consultation document, although not full guidance.

We support Ofwat's view that dividend decisions are the responsibility of the boards of water companies. As a responsible, financially resilient company our Board considers our long-term investment needs, our long-term financial resilience and our long-term service delivery for customers and the environment when deciding our dividend policy. At PR19, we aligned our dividend policy for 2020-25 with Ofwat's latest expectations.

We recognise Ofwat's need to send a strong signal to those companies for which it has concerns about dividend policies. We also recognise that Ofwat has included the words "over time" compared with its December discussion paper, in the new licence condition wording: "that dividends declared or paid take account of service delivery for customers and the environment *over time*, including performance levels, and other obligations."

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

We accept this licence modification. We supported it in our 31 January response to the financial resilience discussion paper.

4. **"modify the licence to require companies to notify us about any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals), with reasons for the change, where applicable".**

We accept this licence modification. We supported it in our 31 January response to the financial resilience discussion paper. However, we propose that notification within ten, rather than five, working days would reduce the risk of a technical licence breach without diluting the intention of the condition.

5. **"bring other ring-fencing provisions in Wessex Water's licence up to the current industry standard".**

We have no comments on this proposal.

Separately to the proposed licence modifications, Ofwat's consultation mentions that Ofwat will be engaging with companies on updated reporting requirements for swaps and pension liabilities shortly. We support more transparency on the use of swaps and on pension liabilities and would welcome the opportunity to help define appropriate disclosure.

We look forward to working with you constructively on Ofwat's proposed licence modifications for financial resilience and hope you will take into account our points above.

Yours sincerely

[redacted]

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