

29 September 2022

Financial Resilience Consultation
Ofwat
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By email [REDACTED]

Dear colleagues

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

This is a reply from the Pennon Group water undertakings of South West Water and Bristol Water on Ofwat's proposals to make licence amendments relating to financial resilience. The joint reply reflects that this consultation runs in parallel to the separate consultation on terminating the Bristol Water Licence and modifying the South West Water Licence to incorporate the activities in the Bristol Water area.

We welcome Ofwat's review and focus of financial resilience across the sector. Ensuring a resilient and financeable sector in the face of significant required continued investment is fundamental.

What is less certain, in our opinion, is that amending Licences as proposed would support a financial resilience outcome – and indeed there may be unintended consequences that would not deliver improved financial resilience in practice.

There are specific licence areas that are considered as part of the consultation (modifying the dividend policy condition, modifying cash lock up conditions, and the credit ratings conditions) that are one-size-fits all proposals rather than being targeted at the specific company circumstances that put financial resilience at risk.

Fundamentally, we do not believe the Licence needs to be amended to strengthen these areas and we set out in our response where we believe these aspects are already adequately considered from a Licence perspective but propose alternative approaches that could more clearly target these areas.

Turning to the dividend policy, we believe existing legal and regulatory frameworks regarding dividend policies take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term.

This reflects a principles-based approach to dividend and executive remuneration policies that leave the ownership and accountability for the policy with the Board's of water companies. We consider that proposed modifications to this area of the licence are unnecessary. Whilst we support Ofwat's wide intentions around financial resilience we believe that these aspects are already captured within the Board Leadership, Transparency and Governance expectations and the existing related Licence condition. The specific drafting proposed on dividends would create a conflict with the duties of Boards under the Companies Act and would increase uncertainty for investors, because it would require Ofwat to make interventions and judgements on the application of the dividend policy which must sit with company Boards. The consultation does not make clear the criteria for such judgements, which could cause confusion and uncertain which is not in the interest of any stakeholder. We believe any intervention by Ofwat could conflict both with the Companies Act and price review assumptions on returns. We do believe however that Ofwat should ask company Boards to make an explicit affirmation that they have met the dividend policy expectations of licence condition P30 annually as part of the Board Leadership, Transparency and Governance objectives and principles reporting required under condition P2. This would provide clarity on the importance of a dividend policy and a route for Ofwat to challenge companies based on their specific dividend policies, rather than the more subjective wording proposed in the consultation.

Considering the credit rating condition changes, Pennon has empirical evidence that obtaining a credit rating is not a proxy for financial resilience. Indeed South West Water has, and has had for considerable time, the most efficient, effective financing in the sector without having had a credit rating. Whilst, as part of the Licence merger condition, we have agreed to obtain a credit rating from 2025, we do not consider it to be a necessary aspect of financial resilience and therefore question the rationale for obtaining a second rating.

We recognise the issues Ofwat face in taking action on financial resilience, but the practical challenge with this is that every situation which concerns Ofwat is likely to be different. Whilst Ofwat would take proportionate action and agree not to impose cash-lock up where the circumstances were not an issue of financial resilience and companies had sufficient plans in place, the increase in the amount of judgement and decisions Ofwat would be faced with would be less transparent and the outcome for investors less clear than current. Therefore, we have significant concerns with the proposals relating to ring-fencing and credit ratings in the consultation. It is clear from the summary of respondents' views to the December 2021 financial resilience discussion paper that there are many others who share these concerns. We conclude that Ofwat's financial resilience interventions should be more targeted to specific companies, rather than applying a "one size fits all" approach across the entire water sector.

We are not convinced that an approach that is less targeted and focuses on a standard set of enhanced credit rating requirements will benefit sector financial resilience, compared to the alternative of using existing regulatory requirements such as Long Term Viability Statements to agree targeted and proportionate action where a company has a specific resilience issue. Our concerns are:

- Ofwat have also at price reviews recognised the limitations of individual rating agency views and metrics. However, this consultation contradicts this position, as the regulatory framework will take significant action potentially based on the opinion of one rating agency, and this could be an opinion about the quality of the regulatory framework rather than a consequence of company decisions. This would be the lowest rating of those held by a company, which can diverge significantly based on the judgement of the individual agency. Whilst Ofwat would take this into account in whether to apply cash-lock up in practice, this would not be transparent or understood by investors. We note that different rating agencies

have different views on financial resilience, which by definition suggests one of those views is not correct, or at least less correct. By focussing on the lowest rating this allows for significant impacts on companies to be potentially driven by a less correct rating view which we believe could lead to an unjust outcome for companies and their broader stakeholders.

- The requirement to obtain and hold two Issuer Credit Ratings does not consider whether it is possible for companies without debt issued to have such ratings, whether the ratings agencies will be willing to provide ratings as required by Ofwat, and what the costs of doing this may be. Ofwat acknowledge that “the costs of maintaining two credit ratings may be disproportionate for smaller companies” and that Ofwat may permit alternative arrangements where there is convincing evidence the requirement is disproportionate. However, Ofwat present no evidence as to the costs of these proposals to all companies.
- Ofwat have not produced a Regulatory Impact Assessment, despite the significant impact on water and sewerage companies of the proposals. In such circumstances Ofwat’s policy¹ suggests that the costs and benefits, including the change to the regulatory burden, should have been explicitly set out.
- Financial resilience depends on decisions taken by companies and by Ofwat. Ofwat have the Finance Duty to consider in price review decisions, for which companies have an appeal route to the CMA if they feel this duty is not being met. Ofwat also have a role in monitoring on-going financial resilience, in order to protect consumers on specific company financial and service performance and also to inform the notional price review decisions.
- The selection of Baa2 negative watch as the trigger for “cash lock up” marks a significant change compared with the current trigger level. Cash lock up is an extreme measure which may itself be triggered by regulatory decisions on the price control parameters, and if used in situations which are not exceptional financial distress, risks threatening companies’ access to finance rather than securing it. As evidence of this, this would have been the outcome during the CMA review for Bristol Water at PR19, the negative watch on Baa2 recognising the uncertainty surrounding the outcome. As the CMA amended the original determination, the uncertainty and negative watch was removed. It would not have been appropriate to have the regulatory framework trigger cash lock up in such circumstances, in advance of the statutory appeal route against Ofwat determinations being exhausted. As this is the outcome of Ofwat’s proposals, they are clearly not in the public interest as they present an additional barrier to company references to the CMA. If this increases risk to investors and the cost of capital, it will have the opposite to the intention stated by Ofwat. Although not Ofwat’s intention for the extended rating requirement to capture such circumstances, it would be a very difficult decision for Ofwat to ignore a rating position once codified in the licence, particularly when faced with a challenge to financing assumptions in a determination.

In our response to the PR24 draft methodology consultation, we set out analysis of the potential detrimental impact that the combination of different incentive mechanisms may have on long-term investment and investor appetite for the water sector. We believe these proposals could add additional risk. We would ask Ofwat to consider delaying the implementation of the widely disputed aspects of this consultation and to reconsider them in the light of the final PR24 methodology and approach. For instance, we took the view that equity investors would welcome a significant increase in competition, which ratings agencies have traditionally seen in the short term as an uncertainty and potential instability of the regulatory regime. Ofwat’s proposals on financial resilience could become a barrier to progress change in the sector, if just driven by rating agency actions. Given this, it will be important that Ofwat considers financial resilience measures alongside the appropriate PR24 balance of risk and return on capital, with suitable stress tests.

¹ [Policy statement on IA \(ofwat.gov.uk\)](https://www.ofwat.gov.uk/policy-statement-on-ia/)

On requiring two ratings, Ofwat offer the option of not imposing this condition where the cost or inconvenience is sufficient – we think there are disadvantages with the burden of proof being proposed at an unknown cost and practicality. It would be easier to acknowledge that Ofwat could require two ratings where they have concerns and the impact and cost of such a requirement is carefully assessed as part of the financial resilience plans discussed at the earlier consultation. Ofwat can also take action with the proposal, which we agree with, for companies to notify Ofwat on change of ratings.

The Licence change proposed itself may have significant drafting errors. It appears to:

- Only allow companies to have two Issuer Credit ratings and holding three could be a breach of the drafting
- The cash lock up drafting would appear not to apply to the lowest investment grade rating (e.g. Moody's Baa3). As drafted it only applies to an Issuer Credit rating that is not an investment grade or is on negative watch at Baa3 or Baa2)
- We do not understand why preference shares have been included within the licence drafting. Preference shares are considered by Ofwat as debt for the purposes of regulatory treatment (such as in the calculation of gearing). Inclusion of preference shares within dividends in dividend policy not explained and not in previous consultation. The drafting appears to bring preference shares within cash lock up as well as dividend policy, which we do not believe to be Ofwat's intention, or it was not considered in the December consultation or this consultation and therefore has not been properly considered within the consultation. If this is the intention, it should feature as part of the Regulatory Impact Assessment. We believe a consequence of this could impact market valuations of such assets and may not be compatible with underlying bond documentation.

On this basis we do believe there are other routes available to Ofwat to strengthen financial resilience and you should consider these as an alternative to the Licence modification. It was always the intention that the revised approach to making licence charges would be based on reaching a considered view with the industry, and we made our previous proposals following constructive discussions. It may be difficult to achieve that in the absence of evidence of the costs and benefits in a Regulatory Impact Assessment and Licence wording drafting that is consistent with the intention of the proposals. We provide responses to the specific consultation questions in an annex to this letter.

Yours sincerely

Paul Boote
Chief Financial Officer

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1. We welcome views on our proposal to modify the cash lock-up licence condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, as set out in box 3, proposed to take effect from April 2025.

We disagree with the proposal.

- There is little logic in the selection of Baa2 negative watch as a level of increased financial resilience risk that should require the extreme regulatory measure of “cash lock up” as part of ring fencing. The triggering of cash lock up has significant consequences, and if used in situations which are not exceptional financial resilience issues, this could risk financial resilience rather than securing it.
- Some of the factors affecting credit ratings are outside of management control, including rating agency views of uncertainty of regulatory changes. As evidence of this, this would have been the outcome during the CMA review for Bristol Water at PR19, the negative watch on Baa2 from Moody’s being driven by the uncertainty surrounding the outcome. As the CMA replaced the original determination in part because of financial resilience considerations, the uncertainty and negative watch was removed following its decision. It would not have been appropriate to have the regulatory framework trigger cash lock up in such circumstances, in advance of the statutory review route for Ofwat determinations being concluded. As this would be the outcome of Ofwat’s proposals, they are clearly not in the public interest as they present an additional barrier to company references to the CMA. If this increases risk to investors and the cost of capital, it will have the opposite to the intention stated by Ofwat.
- Our responses to the December 2021 financial resilience consultation made balanced proposals which we believe are worth further consideration. For instance, Bristol Water suggested that the removal of the “negative watch” criteria would provide an appropriate strengthening of the cash lock up provision. Alongside removing the requirement to have two or more ratings from the proposals, this would remove the risks we identify in the consultation.
- Ofwat reject a reliance on resilience plans. We believe this could be supplemented with a specific licence requirement that allows a cash lock-up provision to apply at Baa2 negative watch, following a consultation that a resilience action plan proposed by a company was not in line with Ofwat guidance, having considered the dividend policy that the company has in place. This would provide a stepped stage in regulator and licence action in advance of the blunt tool that is the cash-lock up provision. It would clearly then not apply in the circumstances where it is the ratings agency view on Ofwat or the uncertainty surrounding an appeal to an Ofwat price determination that had caused negative watch or review for potential downgrade on what was otherwise a financially resilient Baa2 rating.

If the licence change modification to apply at higher levels of rating than the lowest investment grade was implemented, it would need to be supported by greater focus on calibration of risk and returns at PR24. The band for Baa2 (e.g. for Moody’s adjusted AICR up to c1.3x – 1.5x compared to 1.0x assumed for absolute minimum investment grade rating for Baa3 financeability stress testing at PR19) is a much stronger requirement for PR24 than PR19, given that a review for potential downgrade from Baa2 would trigger the proposed cash lock up position, and this could merely be triggered by ratings agencies expecting higher ratios as a result of changes in the regulatory framework.

The licence drafting proposed will require amendment for it to achieve the consultation intentions. It currently appears to:

- Only allow companies to have two Issuer Credit ratings and holding three would be a breach.

- The cash lock up drafting would appear not to apply to the =lowest investment grade rating (e.g. Moody's Baa3). As drafted it only applies to an Issuer Credit rating that is not an investment grade or is on negative watch at Baa3 or Baa2)
- The drafting of the licence appears to include preference dividends within the provisions, which has not been consulted on previously, and should not be included in cash lock-up.

2. We welcome views on our 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, as set out in box 4.

We disagree with this proposal, but note, that in our view, the existing framework of regulatory provisions, which considers RORE delivery and Company Law provides an established framework that allow Directors to make appropriate judgements on dividends.

We have concerns that in practice this would create significant uncertainty for investors. Whilst Ofwat would engage with companies where there were concerns and have dialogue over a longer time period than a company's single year dividends and performance, this would not be transparent and inevitably involves Ofwat judgement about when to take action and when the Board's dividend judgements were reasonable. A long-term perspective on performance and dividends is required, and this is consistent with a RoRE focus on returns more over the AMP rather than individual years. Retrospectively assessing how historical dividends are perceived does not support long-term investment in the sector. This conflicts with the Company Act primacy for Board's to make these trade-offs, which is why the dividend policy expectations were for companies to set out at PR19, based on Ofwat's expectations. This provides Ofwat with sufficient routes to take targeted action, including the transparency part of the Board, Leadership, Transparency and Governance principles already codified in the licence. The specific clause as proposed would require clear consequences and appeal routes for investors to consider, mechanisms which would be disproportionate to Ofwat's intention to encourage companies to have clear dividend policies that consider the factors companies signed up to consider at PR19.

Instead, Ofwat should ask company Boards to make an explicit affirmation that they have met the dividend policy expectations of licence condition P30 annually as part of the Board Leadership, Transparency and Governance objectives and principles reporting required under condition P2. This would provide clarity on the importance of a dividend policy and a route for Ofwat to challenge companies based on their specific dividend policies, rather than the more subjective wording proposed in the consultation.

Condition P2 already states:

P2 The Appointee must:

P2.1 meet the objectives on board leadership, transparency and governance set out in paragraph P3, and

P2.2 explain in a manner that is effective, accessible and clear how it is meeting the objectives set out in paragraph P3.

With Condition P3.3 specifically stating:

P3.3 The Board of the Appointee's leadership and approach to transparency and governance engenders trust in the Appointee and ensures accountability for their actions.

The provisions that relate to this Board leadership, transparency and governance objective refers to:

“

ii. An explanation of dividend policies and dividends paid, and how these take account of delivery for customers and other obligations (including to employees); “

Therefore the licence provisions are already aligned in requiring dividends that reflect incentive regulation and other matters in P30, with the company dividend policy and transparency expectations as noted in P2 and P3 above being sufficient to allow Ofwat to take action where necessary. Specific affirmation already exists in South West Water and Bristol Water Annual Performance Reporting so our proposal would provide additional positive affirmation that condition P3.3 and P30 were aligned.

We disagree with the inclusion of preference shares within the definition of dividends within the licence condition. Preference shares have been treated by Ofwat as debt within the regulatory framework (such as within reporting of actual financial ratios and regulatory gearing). Ofwat have not explained why for the first time preference shares should now be included within the equity dividend policy which was not intended to include historical preference shares. If Ofwat do want to include future preference shares within the dividend policy to avoid the unlikely situation that companies use preference rather than ordinary shares to avoid the requirements of the dividend policy, then there should be an antecedent date included in the clause.

3. We welcome views on our proposal 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 set out in box 5.

We disagree with this proposal:

- South West Water has achieved an efficient and financially resilience capital structure without having any public credit rating. This has traditionally been achieved through tranches of debt finance below the benchmark size for a public credit rating, and therefore the proposed licence will constrain the ability of South West Water to access debt finance efficiently.
- We have accepted that from 1 April 2025 at the latest we will obtain a form of rating and will need to agree with Ofwat the form that this will take. This will come with additional direct and indirect costs, but this cost will increase significantly with a requirement to hold two credit ratings.
- The requirement to obtain and hold two Issuer Credit Ratings does not consider whether it is possible for companies without debt issued to have such ratings, whether the ratings agencies will be willing to provide ratings as required by Ofwat, and what the costs of doing this may be. Ofwat acknowledge that “the costs of maintaining two credit ratings may be disproportionate for smaller companies” and that Ofwat may permit alternative arrangements where there is convincing evidence the requirement is disproportionate. However, Ofwat presents no evidence as to the costs of these proposals to all companies and the burden appears strong that exceptions may not be agreed. Although Ofwat suggests in the question that an alternative arrangement could be agreed with Ofwat if proportionate, the text requires “convincing evidence that it is disproportionate”.
- Given that Ofwat have not set out costs and benefits of this proposal, including the potentially practical and significant direct financial cost and indirect regulatory burden cost within a Regulatory Impact Assessment, it is not possible to assess what convincing evidence of a disproportionate burden would be proportionate.

In any case we believe the proposal is not in the wider public interest in terms of trust and confidence in the regulatory framework and Ofwat’s monitoring of financial resilience:

- It is a fundamental principle of the regulatory framework that companies retain the risk that they must correct financial resilience from their actual financing decisions. Ofwat have the Finance Duty to consider in price review decisions, for which companies have an appeal route to the CMA if they feel this duty is not being met. Ofwat also have a role in monitoring on-going financial resilience, in order to protect consumers on specific company financial and service performance and also to inform the notional price review decisions. Ofwat have also at price reviews recognised the limitations of individual rating agency views and metrics. However, this consultation contradicts this position, as it requires companies to obtain two ratings. The regulatory framework will trigger significant action potentially based on the opinion of one agency, and this could be an opinion about the quality of the regulatory framework rather than company financing risk. This risks being perceived as Ofwat outsourcing their financial resilience role to unaccountable third parties, removing Ofwat's price review decision from the financial resilience consequence of them.

Whilst we accept there are benefits from consistency from all companies having one credit rating, a requirement to have two ratings or a requirement that includes cash lock up provisions above minimum investment grade levels will add further risk given the market power and influence rating agencies have given their market concentration.

4. We welcome views on our proposal 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, as set out in box 6.

We agree with the principles behind the proposal. In particular we see that this proposal helps to mitigate the requirement to hold two separate Issuer Credit Ratings, and would support our view that Ofwat should take targeted action on financial resilience where there are company specific risks that have not been resolved through financial resilience plans.

However, we have concerns with the drafting of the licence change because it refers to an Issuer Credit Rating, and in combination with the other proposals in this consultation it may not always be linked to a publicly available rating from a rating agency, particularly under option (c) in the licence which states:

“(c) a rating assigned by a Credit Rating Agency to the Appointee or any Associated Company, for so long as Ofwat has determined in writing that this rating sufficiently reflects the creditworthiness of the Appointee;”

There is a potential conflict between the requirement to hold two Issuer Grade Credit Ratings and the need to have Ofwat agreement that a particular rating qualifies as an Issuer Grade Credit Rating, with this clause. As soon as the proposed requirement to have two Issuer Credit Ratings applied, then there would be a need to have Ofwat agreement that it qualified under option (c) (on the basis that it would not be linked to a rating as based on issuing debt at the point of the licence coming into force if it did not exist in advance). Similarly, companies may have one rating of option (a) as an issuer of debt that has been publicly issued and rated or (b) or a corporate family rating, but require a second rating to be of a different type of Issuer Credit Rating.

This suggests that the Licence changes will require a period of time specified before implementation, or an implementation process set out as part of the Licence changes. Where there are implementation issues, it would be unreasonable for Ofwat to impose cash-lock up or notification requirements on day one. These issues have not been considered by Ofwat and will need to be carefully agreed before implementation, should Ofwat proceed with the proposals as drafted. Particularly where companies only have a rating on debt that has been issued, Ofwat's agreement will be needed for how the two Issuer Credit Ratings will be achieved, and whether the cost of achieving and maintaining this issue rating is disproportionate.

Our preference as noted above would be to proceed with the notification and amended dividend policy proposals to include a requirement to positively affirm through the Licence reference to the existing Board, Leadership, Transparency and Governance requirements, but consult further on the investment grade level and number elements of the consultation to consider the regulatory impact and also to consider transitional issues. Such transitional issues would include where there are different individual ratings. For instance, where a Family rating has a weaker rating than the Appointee issue rating, Ofwat's proposals suggest that the weaker rating dominates, even if it is less relevant as an assessment of financial resilience. Ofwat will potentially be faced with a large number of transitional issues based on the consultation proposals, and it is difficult to see that this will achieve any benefit to financial resilience or regulatory clarity as a result.