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SENT VIA EMAIL

5 October 2022

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

Dear Elinor,

We welcome the opportunity to respond to the consultation document issued by Ofwat on 28 July 2022.

As discussed at your recent meeting with our CFO, Alastair Cochran, we understand and support Ofwat's concerns about financial resilience in the sector. Ownership of a water company is a privilege. Water companies hold a monopoly position in respect of the supply of life's essential service. With that privilege comes great responsibility, including to maintain the resilience of these services in the face of risk. Our shareholders, Board and Executive are fully cognisant of this responsibility and take it very seriously. We recognise Ofwat's aim to ensure that money should not be taken out of a regulated company where that is needed to improve resilience (financial and physical) and performance for customers and the environment.

We agree that it is fully in the interests of both our shareholders and our customers that we have a capital structure that is financially resilient. As we have discussed, we at Thames Water are actively pursuing a path to improve our financial resilience as part of our wider Turnaround Plan and have recently reviewed our capital structure. As a result of this review our shareholders have agreed to put an additional £500 million of equity into the business unconditionally followed by a further £1 billion (subject to certain conditions) to support the delivery of our business plan for this AMP and accelerate our turnaround. Our shareholders have also acknowledged that further shareholder support may be required to improve financial resilience.

We fully support the proposal that companies should hold two issuer credit ratings and that companies must notify Ofwat about any changes to credit ratings. Two issuer ratings, rather than one, seems to us a more robust approach, and we agree that it is important that Ofwat is aware of changes to credit ratings, so that it has the opportunity to discuss the reasons for, and any implications, of this with the company in good time.

We also agree that money should not be taken out of a company when it should be deployed on things that would improve financial resilience and performance and the resilience of services for customers and the environment. We therefore appreciate Ofwat's underlying rationale for amending the licence to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, effective from 1 April 2025, but we are unable to support the specific proposal that has been put forward. In our view a cash lock up, applied as a consequence of a trigger expressed in terms of credit ratings, is neither an effective nor a proportionate remedy to the problem Ofwat considers it has identified.

We understand that Ofwat's intention is to use credit ratings as a proxy for financial resilience. However, they are not a good proxy as they reflect only the ability of the water company to repay debt (with a reasonable interest), rather than the ability of the company to withstand a wide range of crystalised risks, which are more typically borne by equity. Financial resilience, in terms of a company's ability to access liquidity and remain solvent, is better assessed by looking at a wide range of factors, including in particular those reported to Ofwat as part of the Condition P Ring-fencing Certificates and Long Term Viability Statements.

In our view it is also inappropriate for Ofwat to place heavy reliance on the judgement of a third party, such as a credit agency, in order to trigger such a serious measure as a cash lock up. Credit ratings can, for example, reflect a lack of confidence on the part of the ratings agencies in how changes to the regulatory regime will be operationalised (as happened in response to methodology changes in PR14). Triggering a cash lock-up on the basis of the rating of a single agency appears to us particularly lacking in robustness. In our opinion, as an expert, independent sectoral regulator, it is important that Ofwat itself own the judgement on company financial resilience that would trigger any such intervention and make that judgement in the round.

We consider that a blanket cash lock-up is too blunt a response to a perceived lack of financial resilience in a company. It would certainly punish company investors for the decisions that had resulted in the position. But in some circumstances, it could have significant and long-lasting negative consequences for a company's ability to remedy that position, including attracting new equity funding at a time when it may be most needed. Indeed, as we have discussed, a lock-up risks precipitating real financial difficulty for a company, closing off re-financing options, which we do not believe Ofwat has fully considered and appreciated.

More broadly, we think that the increased risk of being in cash lock-up because of Ofwat's proposed changes could also negatively impact investor perceptions of the sustainability of yield and consequently equity returns. Recognising that global investors have multiple choices as to which countries and sectors to invest in, we believe that this, in turn, would make it harder to attract equity into the UK water industry, unless it was reflected in the WACC. There is nothing to suggest that a BBB credit rating will never be associated with an optimal capital structure in the sector and yet Ofwat's current proposals would disincentivise it. By precluding a potentially efficient capital structure, then, the proposal comes with a cost, which Ofwat needs to take into account.

The potential impact on the WACC highlights the link between this proposal, our response to Ofwat's consultation on it, and PR24. The proposal to prevent the regulated company from paying out dividends (of any form) if its credit rating dips to one notch above investment grade will effectively reduce the expected return to equity (on a stochastic basis taking account of a large number of possible scenarios some of which would include maintaining investment grade but not one notch above it). This in turn, depending on the magnitude of the effect, could mean that Ofwat would need to allow for a higher cost of equity in its allowed WACC at PR24 than would otherwise be the case, creating cost for customers that is not justified by the benefit Ofwat considers that its proposed licence modification would bring. It could also trigger a run on confidence in credit markets, with consequential negative impacts on a company's ability to access debt capital markets and its cost of debt.

If a company needs to reduce gearing to improve financial resilience the regulatory mechanisms should facilitate that transition, rather than militate against that company's ability to attract new equity. We believe it is possible for Ofwat to address these concerns and avoid these costs while still achieving its objective.

This could be done, for example, by setting out more clearly a process that would allow Ofwat to grade company financial resilience on the basis of a rounded assessment of factors that would give a good indication of the company's ability to withstand and recover from risk events. This could be supported through introduction of a 'comply or explain' obligation that would compel companies assessed by Ofwat as relatively high risk to provide an explanation to Ofwat should those companies intend to pay any dividend from the regulated company. Ofwat could then provide guidance setting out what this explanation would need to cover, including for example, the company's action plan to restore financial resilience, service resilience and/or improvements in performance. In Thames Water's case, this would build on the discussions already in train between us on our turnaround plan.

If Ofwat were able to give clarity on the factors it would take into account in assessing financial resilience and the sort of explanation and action plans it expected to see from perceived high risk companies intending to pay dividends, this would be helpful in building company and investor understanding of what was expected of them, and would help them to take the action Ofwat wanted to see upfront. In this way, the effectiveness of Ofwat's remedy would be amplified. As noted above, it would be important for this to recognise that there may be trade-offs, at least in the short term, in how money is spent as between improving financial resilience, improving physical resilience and improving performance. We do not believe it would be Ofwat's intention, for example, to put in place measures that would unduly distort company decision-making to favour short term improvements in financial resilience over physical resilience or performance issues.

We also understand and accept the principle behind Ofwat's proposal to modify the dividend policy licence condition, so that dividends take account of service delivery for customers and the environment. It is important that performance is assessed 'in the round' rather than with regard to the delivery of specific prescribed outcomes. It makes sense that investors receive returns that reflect the performance that their company delivers.

How Ofwat intends to operationalise this principle in practice will be critical and we will need to understand this before we know whether we can support the intended licence modification. We note that a company's profitability – and the funds from which dividends may be paid – is already a function of company's performance. Indeed, Ofwat's work to rebalance returns so that a greater proportion of return on regulated equity must be earned by companies through the outcome delivery incentive (ODI) regime, has strengthened the link between profitability and performance. It is possible that a further regulatory intervention limiting dividend payments on the basis of performance could amplify the impact of the ODI regime, and in particular create a further downside for non-performance.

Additional clarity on how the condition would operate in practice is therefore necessary as uncertainty regarding further regulatory intervention or limitation as to how and when returns should be distributed could impact on the WACC (by skewing expected returns further to the downside) or act to also disincentivise equity investment and increase uncertainties which could affect investor appetite. It is otherwise difficult for companies and their investors to understand the full scope and impact of this licence modification.

We have set out in Annex 1 to this letter our detailed assessment of each of Ofwat's proposals. We expand on our concerns over modifications of the cash lock up trigger, explaining our suggested alternative approach. We also comment on the other questions raised by Ofwat within its consultation, presented in the form of a response to each of the questions set out by Ofwat, as summarised in Box 1 on page 4 of the consultation which seek company views on its proposals.

To reiterate, we do understand and appreciate Ofwat's intentions in proposing these licence modifications. Indeed, Thames Water shares with Ofwat the objective of improving financial resilience, the resilience of our services and assets and our performance. It is in this spirit that we are raising concerns about the effectiveness of some aspects of Ofwat's proposals, and the potential for unintended consequences. And we offer what I trust will be seen as a constructive way forward that would be more effective, more nuanced and targeted and therefore less likely to entail significant cost and unintended consequences.

If you would like to discuss any aspects of our response further then please do not hesitate to contact me.

Yours Sincerely,

[redacted]

Cathryn Ross
Strategy and External Affairs Director

Annex 1: Detailed response to Ofwat's consultation on proposed modifications to strengthen the ring-fencing licence conditions

We set out below our detailed assessment of each of Ofwat's proposals, expanding on our concerns over modifications of the cash lock up trigger, explaining our suggested alternative approach and comment on the other questions raised by Ofwat within its consultation. It is presented in the form of a response to each of the questions set out by Ofwat, as summarised in Box 1 on page 4 of the consultation which seek company views on its proposals.

1. 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 section 2, box 3, proposed to take effect from 1 April 2025.

   We appreciate Ofwat's underlying rationale for amending the licence to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, effective from 1 April 2025, but we are unable to support the specific proposal set out by Ofwat. In our view a cash lock up, applied simply as a consequence of a trigger expressed in terms of credit ratings, is neither an effective nor a proportionate remedy to the problem Ofwat has identified.

   We set out below where we agree with Ofwat with regard to the importance of financial resilience, what our key concerns are regarding how it proposes to go about strengthening financial resilience in the sector and a suggested alternative approach which we believe would further strengthen financial resilience in a more proportionate manner and which would better operate in customers' long-term interests.

   Ofwat is correct to take a keen interest in the allocation of risk and return, and financial resilience

   Economic regulation seeks to align the interests of companies and their investors with those of customers and society by means of the allocation of risk. Ofwat's work in recent years has brought important increased scrutiny of, and challenge to, the industry on this.

   Ofwat's 'Back in Balance' work has reset the regulatory framework to better align financial (and to an extent reputational) incentives with delivery of outcomes and improvements in efficiency and innovation that will benefit customers. We see Ofwat's work on financial resilience as closely linked to this. It is important to ensure that equity-type risk in the sector is appropriately borne by shareholders and that shareholders act on the incentives this creates. Risks that should sit with shareholders, and which shareholders are remunerated for, should not be inappropriately passed on to customers, either financially or in terms of performance and resilience. There are circumstances in which it is appropriate for customers to bear risk, for example, where the allocation of a risk to shareholders that they are unable to manage leads to a risk premium on the cost of capital (and a cost to customers) with no attendant customer benefit through improved management of that risk. However, it is important for such decisions to be made consciously and to be clear where risk sits so that it can be provided for.

Thames Water's shareholders are conscious of the risk they bear and take this seriously; Ofwat's reforms mean that today's market and regulatory mechanisms work well, and are prompting action where this is required

We understand and support Ofwat's concerns about financial resilience in the sector. Ownership of a water company is a privilege. Water companies hold a monopoly position in respect of the supply of life's essential service. With that privilege comes great responsibility, including to maintain the resilience of these services in the face of risk. Our shareholders, Board and Executive are fully cognisant of this responsibility and take it very seriously. We recognise Ofwat's aim to ensure that money should not be taken out of a regulated company where that is needed to improve resilience (financial and physical) and performance for customers and the environment.

At Thames Water, we accept that our performance for our customers, communities and the environment needs to improve. The existing regulatory regime is causing our shareholders significant pain as a result. We accepted our final determination in PR19 expecting to incur outcome delivery incentive penalties. Through the conditional allowances, our ability to recover from our customers the cost of improving resilience in London's water network is contingent on a £300 million contribution from our shareholders. In accepting our final determination at PR19 we also understood that our costs, benchmarked as inefficient against Ofwat's models, and that the poor quality of our business plan means that every pound we spend over our price control allowances costs our shareholders 75 pence.

The root causes of this poor performance will take time to address. We have a turnaround plan of real breadth and depth in place to do this, a key element of which has been the development of a revised £11.5 billion business plan for the current regulatory period, unanimously approved by our shareholders, which is designed to significantly improve Thames Water's operational performance, deliver on its regulatory obligations, increase resilience and deliver better outcomes for its customers, communities and the environment. This represents a £2 billion increase in expenditure, compared to the £9.6 billion agreed in the water company's final determination for 1 April 2020 to 31 March 2025 and represents a major milestone in our turnaround journey.

To support delivery of this new business plan, our shareholders have agreed to put an additional £500 million of equity into the business unconditionally followed by a further £1 billion (subject to certain conditions) to support the delivery of our business plan for this AMP and accelerate our turnaround. Our shareholders have also acknowledged that further shareholder support may be required to improve financial resilience.

The sector has proved itself to be financially resilient in the face of significant shocks

Not only have our shareholders stepped up to support Thames Water in dealing with a series of company-specific risks as outlined above, but the sector has also proved to be resilient to the two biggest exogenous shocks since World War Two; the Global Financial Crisis and the Covid-19 global pandemic. This was noted by Mason and Wright in the paper[1] commissioned by Ofwat for its December 2021 discussion paper.

[1] "A report on financial resilience, gearing and price controls", prepared for Ofwat by Professor Robin Mason and Professor Stephen Wright, 3 December 2021

We understand that Ofwat is concerned about the relatively high levels of gearing of some companies, and we recognise that there is a discussion to be had about the optimal capital structure of individual companies. This should – and does – take place within companies, taking account of the specific nature and level of risk in those businesses. Given the risks it faces – and about which Ofwat has been increasingly clear in recent years – it is fully in the interests of shareholders to adopt a capital structure that is financially resilient.

Ofwat also contend that companies have stepped back from public commitments to improve resilience, and that ratings have fallen over time. However, it is important to recognise the impact of rising cost pressures, particularly on energy and construction costs which companies are having to manage as these risks sit with them (either temporarily where covered by inflation, or on a permanent basis where cost increases exceed general inflation). In managing these risks, companies are demonstrating their financial resilience and benefits of having headroom within their rating to the minimum investment grade required in the licence.

As part of our response to your initial wide-ranging consultation in December 2021 regarding financial resilience in the sector we highlighted areas where we considered Ofwat's initial analysis or conclusions were unconvincing. In support, we include an additional KPMG report[2] to assist in the understanding of financial resilience and which considers whether any new mechanisms could improve financial resilience in the sector.

A cash lock up, with a trigger based on credit ratings, is not consistent with the fundamental regulatory principle that companies are best placed to make decisions over financing and capital structure

As Ofwat makes clear in its consultation, one of the fundamental principles for regulation in the water sector is that it is for investors and companies to determine the capital structure that allows them to best finance their investment programme, and this is consistent with an incentive-based regulatory framework that allows investors and companies to bear the risks and take the rewards of their adopted approach.

We fully support that principle. It is companies who are best placed to make decisions over their capital structure and financing arrangements, bearing the risks and rewards arising because of those decisions. Equally, it is important that companies are financially resilient and rewarded appropriately for efficient and effective delivery of services which customers expect. Access to debt and equity capital, at efficient cost, is essential so that companies can deliver the investments required to maintain and enhance the services they provide.

We believe that Ofwat's proposal to modify the cash lock up trigger is inconsistent with this principle. The threat of regulatory intervention would fundamentally change the balance of risk and reward, and reduce the attractiveness of the sector to investors. 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'[3]. Of particular relevance,

[2] Analysis of financial resilience, KPMG, June 2022
[3] https://committees.parliament.uk/event/14279/formal-meeting-oral-evidence-session/

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

Rather than being beneficial and helping attract investment to the sector as Ofwat claims, we think that the increased risk of being placed in cash lock-up because of Ofwat's proposed changes could otherwise negatively impact investor perceptions of the sustainability of yield and consequently equity returns. Recognising that global investors have multiple choices as to which countries and sectors to invest in, we believe that this, in turn, would make it harder to attract equity into the sector, unless it was reflected in the WACC. There is nothing to suggest that a BBB credit rating will never be associated with an optimal capital structure in the sector and yet Ofwat's current proposals would disincentivise it. By precluding a potentially efficient capital structure, then, the proposal comes with a cost, which Ofwat needs to take into account.

In addition to the concerns we note above there would also be a direct impact through a reduction in the tax shield. For example, if we assume that the sector needs to de-gear by 5% as a proxy for meeting the one notch higher rating required in order to pay dividends, this could reduce the tax shield (and thereby increase the tax allowance) for the sector by c.£75m, and so increase bills.

In summary we are concerned that Ofwat's proposals lack an impact assessment regarding the likely impact of the proposed licence modification on the cost of capital. Ofwat has not quantified the benefits and link between the amended cash lock-up trigger and the purported improvement in financial resilience and therefore has failed to show how its proposed licence modification would achieve, in whole or in part, the effect stated in its consultation. We believe that this is inconsistent with regulatory best practice.

In this context, a group of water companies commissioned KPMG to consider the potential benefits and costs of the key proposals set out in Ofwat's financial resilience licence modification consultation. Its report[4] assesses firstly whether there is a market failure which supports new regulation of financial resilience. Secondly, it considers the potential benefits of the proposals as set out by Ofwat in its consultation. Thirdly, it considers the potential costs of the proposals drawing on academic theory and historic sector data.

The report finds no clear inefficiency or market failure related to the level of financial resilience that justifies the introduction of the proposed new regulation and that, on balance, the proposals are "*likely to result in costs to customers which materially outweigh the potential benefits*". KPMG's report is included as part of our response to this consultation.

[4] Financial Resilience: Impact Assessment, KPMG, 29 September 2022

Companies are already incentivised to address high gearing where this is an issue, but the story for equity can be challenging

Where an individual company's circumstances do suggest that de-gearing would be sensible, this could be challenging to achieve.

To be clear, the story for equity in the water sector today is not always a compelling one. Ofwat's messaging, regulatory policy and decision-making over the last decade has consistently increased investor risk and driven down base returns. We recognise that this has been important in improving that alignment of investor and company interests with those of customers and society; companies need to work harder to do more of what matters for customers and society if they are to enjoy upside. Logically, there must be a limit to this; there must be a point at which Ofwat considers that the sector is 'back in balance'. But this is not apparent to investors, who observe a trend of increasing risk and lower returns.

Linked to this, we are very supportive of Ofwat's emphasis on the need to focus on the long term and will reflect this in our forthcoming business plan for PR24. It would be helpful if Ofwat could be clearer about how the regulatory regime will treat some of the large, lumpy, long term projects we need to deliver such that investors can be confident that risks will be remunerated over the long term. Furthermore, we think it is important to stand back and look across the emerging PR24 policy framework – PCs, ODIs, totex allowances, the bioresources controls – and consider the outturn balance of risk and reward this creates, and whether it adds up to an environment conducive to increased equity investment.

Ofwat's proposals for a more sensitive and broader cash lock up trigger to be applied have unintended consequences and do not act in the customer interest

We support the underlying rationale for Ofwat's proposed modification to raise the cash lock-up trigger to BBB/Baa2 with negative outlook, effective from 1 April 2025. But we are unable to support the specific proposal set out by Ofwat. In our view a cash lock up, applied as a consequence of a trigger expressed in terms of credit ratings is neither an effective nor a proportionate remedy to the problem Ofwat has identified.

We support Ofwat's use of credit ratings as one indicator of financial resilience and support the licence requirement to maintain investment grade. However, and as Ofwat will be aware, directors are under a legal obligation to take a much broader set of parameters into account when assessing financial resilience. Furthermore, credit ratings reflect both objective and subjective factors, including the ratings agencies' views of how Ofwat may operate the regulatory regime.

In our view it is also inappropriate for Ofwat to place heavy reliance on the judgement of a third party, such as a credit agency, in order to trigger such a serious measure as a cash lock up. Credit ratings can, for example, reflect a lack of confidence on the part of the ratings agencies in how changes to the regulatory regime will be operationalised (as happened in response to methodology changes in PR14, see below). Triggering a cash lock-up on the basis of the rating of a single agency appears to us particularly lacking in robustness. In our opinion, as an expert, independent sectoral regulator, it is important that Ofwat itself own the judgement on company financial resilience that would trigger any such intervention and make that judgement in the round.

Whilst views of rating agencies are helpful, it is important that Ofwat takes a broader view in its assessment of financial resilience, it seems wholly inconsistent for Ofwat to say that its "*assessment of financial resilience takes account of a range of information and the specific circumstances of each company*" but then to defer to the views of the three rating agencies, and, in effect, the agency with the lowest rating.

By way of example, when Ofwat initially introduced the ODI regime at PR14, rebalancing returns substantially away from base returns through the allowed WACC and towards more performance-driven returns, the ratings agencies were unsure of how the regime would be operated in practice and did not take ODIs into account in their ratings. There is a significant risk that companies may be placed into cash lock-up as a result of some such subjective judgement by rating agencies, which could even be a consequence of concern regarding lack of understanding of regulatory changes, rather than with specific regard to the financial resilience of a company.

We understand that Ofwat's intention is to use credit ratings as a proxy for financial resilience. However, they are not a good proxy as they reflect only the ability of the water company to repay debt (with a reasonable interest), rather than the ability of the company to withstand a wide range of crystalised risks, which are more typically borne by equity. Financial resilience, in terms of a company's ability to access liquidity and remain solvent, is better assessed by looking at a wide range of factors, including in particular those reported to Ofwat as part of the Condition P Ring-fencing Certificates and Long Term Viability Statements.

This issue, and illustrative examples of how it may be difficult to apply the proposed trigger in practice is considered further by First Economics in its report[5] on Ofwat's proposals, which is provided in support of our response. The report concludes that "*Equity investors, quite naturally, place great importance on the return of and on their investment, and I believe that a regulator should have a very high bar before it takes action to block such payments. I consider that Ofwat is wrong to have come to the conclusion that a single rating action from a single rating agency automatically meets this threshold.*"

As highlighted above, raising credit ratings requirements and/or imposing new criteria for the cash lock-up threshold would represent a significant departure from established sector precedent, given the relative stability in this area of the licence over many AMPs. A sudden change in policy could be considered by rating agencies and investors as introducing material regulatory uncertainty and instability. This can have unintended consequences of:

- Disincentivising investment by redistributing funds towards de-gearing (to improve the rating and exit the lock-up) away from accelerated investment to improve service to customers, communities and the environment (as shareholders may not be able to afford both).

- Creating rigidity in companies by incentivising a short-term focus on managing credit ratings to the detriment of managing performance and investment levels

[5] Ofwat's proposed financial resilience licence modifications: An assessment, John Earwaker, September 2022. See http://www.first-economics.com/financialresilience.pdf.

whereby issues might arise only in the medium-longer term, with a detrimental impact on customer service and the environment.

- Disincentivising investment where shareholders are seeking to invest in a long-term turnaround proposition (and deliver an eventual uplift in ratings) for the benefit of customers and looking to have discretion over a progressive level of yield from delivering performance improvements, but are prevented by rigid service and credit rating thresholds.

- Penalising equity through dividend lock up for having a capital structure that is efficient but which results in a BBB credit rating.

- Exposing equity to increased risk around the perception of the regulatory regime. For example: Moody's putting the sector on negative outlook during the PR19 process due to anticipated changes to regulation and a reduction in regulatory transparency and consistency.

- Ultimately, making the sector appear more risky and less transparent, which could cause a sector downgrade and drive up the cost of capital for actual and notional capital structures, which would ultimately increase costs to customers.

In essence, we consider that a blanket cash lock-up is too blunt a response to a perceived lack of financial resilience in a company. It would certainly punish company investors for the decisions that had resulted in the position. But we do not believe simple punishment is Ofwat's intention and that Ofwat would prefer to put in place a framework that would enable and encourage companies to improve the company's position, ultimately benefitting customers and the environment. In some circumstances, a blanket cash lock-up could have significant negative consequences for a company's ability to remedy that position, including attracting new equity funding at a time when it may be most needed. Indeed, as we have discussed, a cash lock-up risks precipitating real financial difficulty for a company, closing off re-financing options, which we do not believe Ofwat has fully considered and appreciated.

Overall, it seems to us that there are significant potential downsides from Ofwat's proposal, and that no corresponding financial resilience benefit has been demonstrated or set out in the consultation as arising from the specific measures that Ofwat proposes. Many of these consequences would cause significant harm to customers, communities and the environment in a backdrop of affordability and encouraging investment for the longer term being key priorities for PR24.

The potential impact on the WACC highlights the link between this proposal, our response to Ofwat's consultation on it, and PR24. The proposal to prevent the regulated company from paying out dividends (of any form) if its credit rating dips to one notch above investment grade will effectively reduce the expected return to equity (on a stochastic basis taking account of a large number of possible scenarios some of which would include maintaining investment grade but not one notch above it). This in turn, depending on the magnitude of the effect, could mean that Ofwat would need to allow for a higher cost of equity in its allowed WACC at PR24 than would otherwise be the case, creating cost for customers that is not justified by the benefit Ofwat considers that its proposed licence modification would bring. It could also trigger a run on confidence in credit markets, with consequential negative impacts on a company's ability to access debt capital markets and its cost of debt.

Stopping dividends in a wider range of circumstances simply accumulates cash in the business, but does not address how the cash will be used to improve service and asset health (as shareholders may still choose not to reinvest). We believe it is more effective for regulation to directly target the incentivisation of service delivery and investment levels if Ofwat consider these are the most salient areas of concern.

Given all of these concerns, there is no doubt that increasing the risk of being in cash lock-up as a result of Ofwat's proposed changes would negatively impact investor perceptions of the sustainability of yield and consequently equity returns. This in turn would make it harder to attract equity into the sector (unless it was reflected in the WACC), while effectively increasing protection for bond holders.

As Ofwat is aware, the debt provided to water companies often comes with covenants designed to protect bond holders by placing restrictions on what companies can do (e.g. in the form of requirements to maintain certain ratios), and we have argued that these act to protect customers too. In previous discussions, Ofwat has accepted this, but has also noted the potential for these protections to create rigidities in company governance structures that could be unhelpful. It therefore seems to us counter-intuitive that Ofwat is now contemplating the introduction of such rigidities with a cash lock up applied when reaching a certain rating threshold.

Extending the threshold is likely to have a limited impact on protecting customer service levels, but could have unintended consequences of reducing financial flexibility and deter new equity investment at a time when investment requirements are projected to increase to meet long-term challenges associated with climate change, population growth and environmental pressures.

Overall, we are therefore concerned that Ofwat's proposals for a more sensitive cash lock up trigger could have unintended consequences, by making it more challenging for companies to attract equity should they need to address financial resilience concerns.

If a company needs to reduce gearing to improve financial resilience the regulatory mechanisms should facilitate that transition, rather than militate against that company's ability to attract new equity. It is possible for Ofwat to address these concerns and avoid these costs while still achieving its objective. We explore our suggested alternative approach in the section below.

Ofwat should instead introduce a 'comply or explain' obligation to support financial resilience

We are supportive of increasing transparency to ensure that financial structures and risks to long term viability are clearly understood - both to investors and to wider industry stakeholders including our customers.

In the section above we described our concerns regarding the costs and risks associated with introducing a cash lock up trigger. To avoid these unintended consequences, and to achieve its financial resilience aims, we consider that it would be more appropriate for Ofwat set out more clearly a process that allows it to grade company financial resilience on the basis of a rounded assessment of factors that would give a good indication of a company's ability to withstand and recover from risk.

This could be supported through introduction of a 'comply or explain' obligation that would compel companies assessed by Ofwat as relatively high risk to provide an explanation to Ofwat should those companies intend to pay any dividend from the regulated company. Ofwat could then provide guidance setting out what this explanation would need to cover, including for example, the company's action plan to restore financial resilience, service resilience and/or improvements in performance. In Thames Water's case, this would build on the discussions already in train between us on our turnaround plan.

If Ofwat were able to give clarity on the factors it would take into account in assessing financial resilience and the sort of explanation and action plans it expected to see from perceived high risk companies intending to pay dividends, this would be helpful in building company and investor understanding of what was expected of them, and would help them to take the action Ofwat wanted to see upfront. In this way, the effectiveness of Ofwat's remedy would be amplified. As noted above, it would be important for this to recognise that there may be trade-offs, at least in the short term, in how money is spent as between improving financial resilience, improving physical resilience and improving performance. We do not believe it would be Ofwat's intention, for example, to put in place measures that would unduly distort company decision-making to favour short term improvements in financial resilience over physical resilience or performance issues.

Any changes to the regime should aim to improve outcomes for customers

We do understand and appreciate Ofwat's intentions in proposing these licence modifications. Indeed, Thames Water shares with Ofwat the objective of improving financial resilience, the resilience of our services and assets and our performance.

It is in this spirit that we are raising concerns about the effectiveness of some aspects of Ofwat's proposals, and the potential for unintended consequences. We offer an alternative way forward that we believe would be more effective, more nuanced and targeted and therefore less likely to entail significant cost and unintended consequences - and one which would result in better outcomes for customers.

2. 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 section 3, box 4.

Thames Water's overall objective is to pay a progressive dividend commensurate with the long-term returns and performance of the business, after considering the business's current and expected regulatory and financial performance, regulatory restrictions, management of economic risks and debt covenants. In assessing the dividend to be paid, the Directors are required to ensure that:

- Payment of a proposed dividend should not impair short term liquidity or compliance with our covenants;
- Payment of a proposed dividend should not impair the longer-term ability to finance the Company's business, including access to both debt and equity capital;

- An assessment is made to determine if the payment of a dividend reflects the Company's performance against the final determination for AMP7 and its commitments to customers and other stakeholders;
- An assessment is made of the impact that payment of the dividend may have on its commitments and obligations to customers and other stakeholders as a supplier of essential services, which includes customer commitments, environmental commitments, community commitments, employees and pension members; and
- An assessment of the long-term financial resilience of the Company.

Our external shareholders did not receive a dividend in the 2021/22 financial year, the fifth consecutive year, underlining their commitment to re-investing cash flow into delivering improved performance for customers. Pages 108 to 110 of our Annual Performance Report 2021/22 provide a detailed assessment of the factors that our Board took into account when determining whether it was appropriate to make a dividend distribution. This expressly included service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term.

We think that it is entirely reasonable that, in considering whether or not to pay a dividend, the Directors have regard to service delivery for customers and the environment, investment needs and financial resilience (in addition to their existing fiduciary duties). We note that Directors already take into account these considerations when taking decisions about payment of dividends as set out above.

We therefore understand and agree with the principle behind Ofwat's proposal to modify the dividend policy licence condition, so that dividends take account of service delivery for customers and the environment. We anticipate that the assessment regarding service delivery for customers and the environment, investment needs and financial resilience must be made 'in the round' rather than with regard to the delivery of specific prescribed outcomes. It makes sense that investors receive returns that reflect the performance that their company delivers.

How Ofwat intends to operationalise this principle in practice will be critical and we will need to understand this before we know whether we can support the intended licence modification. We note that a company's profitability – and the funds from which dividends may be paid – is already a function of company's performance. Indeed, Ofwat's work to rebalance returns so that a greater proportion of return on regulated equity must be earned by companies through the outcome delivery incentive (ODI) regime, has strengthened the link between profitability and performance.

It is possible that a further regulatory intervention limiting dividend payments on the basis of performance could amplify the impact of the ODI regime, and in particular create a further downside for non-performance. There are also significant incentives and penalties for companies failing to comply with environmental and customer service delivery standards as part of the price control and normal enforcement tools. An intervention in the dividend policy linked to failure to fulfil those standards, where Ofwat and/or the EA have already taken enforcement action, would effectively lead to a double dip in terms of penalising the company.

Additional clarity on how the condition would operate in practice is therefore necessary as uncertainty regarding further regulatory intervention or limitation as to how and when returns should be distributed could impact on the WACC (by skewing expected returns further to the downside) or act to also disincentivise equity investment and increase uncertainties which will affect investor appetite. It is otherwise difficult for companies and their investors to understand the full scope and impact of this licence modification.

3. 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 section 4, box 5.

   We agree with this proposed modification, it is sensible for companies to hold more than one rating and this provides additional information upon which to form an opinion on financial resilience. If the cost of acquiring a second rating is disproportionate for some companies then we would support inclusion of an exceptions process whereby maintenance of a single rating can be agreed with Ofwat.

4. 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 section 4, box 6.

   We agree with this proposed modification.

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

   We do not have any comments to make on this part of the consultation, matters relating to Wessex Water should be subject to discussions directly between Ofwat and Wessex Water as appropriate.