Tideway

Official

Ref: [redacted]

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

By email: [redacted]

29 September 2022

Dear Ofwat colleagues,

**CONSULTATION ON PROPOSED MODIFICATIONS TO STRENGTHEN THE RING-FENCING LICENCE CONDITIONS OF THE LARGEST UNDERTAKERS – TIDEWAY'S RESPONSE**

Please find below Tideway's response to Ofwat's consultation on financial ring-fencing.

Tideway recognises the importance of financial resilience in the water sector. We understand Ofwat's concerns regarding instances of poor transparency and of companies acting in ways that may be detrimental to financial resilience. In our view it would be wholly appropriate for Ofwat to take action where such concerns exist, using its powers of information gathering and enforcement, supported by existing licence requirements.

We are concerned, however, that by targeting restrictive measures at all of the largest undertakers, including those acting responsibly in relation to financial resilience, the proposals set out in this consultation are likely to damage the ability of companies in the sector to finance themselves in future. Our detailed responses to the proposals are set out in the annex to this letter.

As with the discussion paper published in December 2021, we note that the proposals are aimed at the 17 largest appointed water companies, as opposed to Tideway. We consider however that the proposals, if implemented, are likely to have a chilling effect on the ability of the sector to continue to attract equity. The participation of a wide range of equity investors in the procurement process for the Tideway project was a key factor in driving down the impact on customers' bills. We are concerned that the proposals may impact the success of future competitive procurements via licensed (SIPR) or contractual (DPC) approaches.

We note Ofwat's intention to engage separately with companies on updated reporting requirements on swaps. We look forward to reviewing the proposals and would appreciate any information Ofwat can provide on how they have been developed.

Yours sincerely

[redacted]

Matthew Parr

Director of Strategy & Regulation

## ANNEX – TIDEWAY RESPONSE TO OFWAT PROPOSALS

<table>
<tr><td colspan="2">We welcome views on our proposals to:</td></tr>
<tr><td>1. 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.</td><td>
• Tideway is concerned that this measure represents a fundamental change in the economic conditions faced by the sector and risks undermining and destabilising investor trust in regulation.<br><br>
• Companies’ Boards are responsible for adopting financing approaches that they consider are best placed to drive efficiency, delivery for customers and the environment, and resilience against the individual risks they face. Introducing the proposed measure risks distracting Boards from these objectives and instead focusing their attention on conforming to the expectations of rating agencies at any point in time.<br><br>
• In some cases, firms may be compelled to target an inefficiently high credit rating in order to avoid the risk that short-term downward fluctuations in ratings or outlook force them into a cash lock-up position.<br><br>
• The proposed approach may be particularly damaging when rating agencies introduce changes to their methodology that are unrelated to business performance. Specifying that the cash lock-up is triggered based on a company’s lowest credit rating, rather than as a function of all the ratings it holds, further increases this risk.<br><br>
• Credit ratings are one factor that Ofwat will naturally want to take into account when assessing companies’ financial resilience. However, they are not a proxy for resilience but rather an indicator of one aspect of it. Particularly when read alongside the proposals in Ofwat’s PR24 methodology consultation, we believe that the proposed approach relies too heavily on rating agencies’ views. We consider that Ofwat should not put too much reliance on a company’s position within the investment grade spectrum as it is not prudent or reasonable to rely excessively on rating agency methodologies.<br><br>
• We believe that current ring-fencing arrangements strike an appropriate balance between the views of rating agencies, and other factors impacting and indicating financial resilience, and do not see a case to change them. If Ofwat suspects that despite achieving an investment grade credit rating, a company is not pursuing a sustainable approach to distributions, we would encourage it to use its existing powers to scrutinise that company’s financing approaches and plans, and if necessary to take action.
</td></tr>
<tr><td>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</td><td>
• Tideway is concerned that this measure introduces an additional and unnecessary control over the financing of companies.<br><br>
• We note Ofwat’s clarification in the consultation document that companies should take account of performance ‘in the round’, both across performance measures and over time. It is likely however that in future there will be
</td></tr>
</table>

| | |
|---|---|
| over the long term, as set out in section 3, box 4 | disagreements between companies and Ofwat over the weight that should be given to a particular measure (or set of measures), or over the details of how performance is measured. While such disagreements may impact ODI outcomes under current arrangements, under the proposed arrangements they could also negatively impact the company's ability to ensure shareholders receive a reasonable return on their investment.<br>• We see a risk that the market views this proposal as Ofwat having an ability to control or oversee company dividend decisions. This risks materially reducing equity investment in the sector, increasing the cost of equity and ultimately leading to higher bills for customers.<br>• As with the cash lock-up modification proposal, there is a risk that linking dividends more strongly to industry-wide performance metrics leads companies to unduly prioritise these metrics, at the expense of putting in place arrangements that are resilient to the particular challenges they face. This could negatively impact financial and other forms of resilience.<br>• When determining a dividend/distribution, companies' Boards must follow the principles of the Corporate Governance Code which require them to promote the long-term sustainable success of the company. We consider that this requires companies to act in a way consistent with Ofwat's aims in proposing the new measure, while avoiding the risks set out above.<br>• The provisions of the Corporate Governance Code are supported by existing requirements in the licence regarding dividend policies, and in the RAGs regarding reporting of dividend decisions. As above, we would encourage Ofwat to use its existing powers to investigate any instances of poor transparency or questionable compliance, rather than introducing new requirements with potentially damaging effects. |
| 3. 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. | Tideway notes that the costs of this measure may be significant, particularly for smaller companies and licensed firms with non-standard business models. We ask Ofwat to consider the costs and benefits for different companies before deciding whether and how to implement this measure. |
| 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, as set out in section 4, box 6. | Tideway has a positive relationship with Ofwat and we would expect to share any relevant information on ratings at the earliest appropriate stage. The information is already published by rating agencies. Given this, we see limited benefit in the proposed requirement. |
| 5. 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 | No comment |

| | |
|---|---|
| consultation on regulatory ring-fencing licence modifications. | |