United Utilities Water

Response to Ofwat’s Consultation under sections 13 and 12A of the Industry Act 1991 on proposed modifications to strengthen the ring-fencing conditions of the largest undertakers

28 September 2022

United Utilities

Water for the North West

1. Executive Summary

United Utilities Water welcomes the opportunity to comment on Ofwat's 'Consultation under sections 13 and 12A of the Industry Act 1991 on proposed modifications to strengthen the ring-fencing conditions of the largest undertakers'.

As we highlighted in our January response to Ofwat's 'Financial resilience in the water sector: a discussion paper', we are pleased that Ofwat remains firmly focussed on the financial resilience of companies in the sector for the long-term, and this objective very much aligns with UUW's approach over many years. We consider such measures are important in the sector retaining the trust and confidence of its customers, investors and other stakeholders.

We also support Ofwat's proposals that companies, in submitting their PR24 price review business plans, should articulate their dividend policies for the Appointee company in clear terms (as UUW did at PR19), including consideration of factors which could lead to an adjustment in the level of dividend paid out.

We are pleased to note that Ofwat's proposals have been adjusted since its first consultation in response to comments received from stakeholders. In particular, we welcome the following features of the original and revised proposals:

- In relation to the dividends provision, Ofwat's clarification that performance/service delivery should be considered 'in the round' and that service delivery for customers and the environment should be taken account of 'over time.' It is important to recognise that equity investors are likely to consider it reasonable to expect a stable dividend even if not every target is being met in every year and that given companies are set a wide range of stretching performance targets, some areas of underperformance and ongoing improvement are likely in any given year.

- UUW remains supportive of the proposed requirement to maintain investment grade credit ratings with two different credit ratings agencies.

- UUW is accepting of the proposed requirement to notify Ofwat of any changes in rating and support that Ofwat is avoiding the cash lock-up trigger being linked to specific measures of service performance. We are also accepting of the principle that additional reporting of swaps and updated reporting requirements on swaps and pension liabilities should be included in future annual performance reports (APRs) and look forward to further engagement with Ofwat on this point.

However, there are other areas where Ofwat has not modified its proposals in the way we had promoted. We continue to believe that our previous comments are well founded and that Ofwat should consider further adjusting its proposals to reflect these points.

We consider that the views of current and potential equity holders need to be carefully considered by Ofwat in reaching its conclusions. Whilst we note that the proposals are 'credit positive' for debt investors at the Appointee company (as highlighted in Moody's 29 July report: "Ofwat's strengthening of ring-fence positive for OpCos, but negative for HoldCos"), the anonymised views of debt investors canvassed by Ofwat express a degree of caution, with 4 out of 9 'positive' respondents to the raising of the cash lock-up threshold expressing some concern for equity investment. Anecdotally we are also aware of that a number of equity investors in the public markets have expressed concern in respect of the proposed changes to both the credit rating trigger threshold and the dividend provision. More broadly, the head of Global Investors Association - Lawrence Slade – is on record as having told an inquiry into Ofwat's powers by the House of Lords Industry and Regulators Committee investor concerns remain over the level of regulatory intervention in the water sector.

Given the challenges that the sector needs to address and related investment needs, it is important that Ofwat satisfies itself that it has taken adequate account of the views of equity investors in relation to its proposed

changes, including in relation to the proposed changes on dividend expectations. We are concerned about the potential for these proposals to put upward pressure on the cost of capital with regard to: a) equity investor sentiment with regard to increased uncertainty and volatility of future dividends; and b) additional headroom that companies will sensibly need to consider to ensure that they remain comfortably above the new, tightened trigger, the assessment of which would sit outside of companies' control. For companies to have ready access to equity markets to support future financing, it is important that the equity proposition is attractive to investors and that there is confidence that equity investors can expect returns commensurate with the level of risk that they bear.

With regard to the proposed licence modifications, we continue to advocate that the existing cash lock-up threshold (Baa3/BBB-) should remain in place, but that a trigger to submit a resilience plan be introduced at a higher ratings threshold (Baa2/BBB). This approach would ensure that company Boards agree a robust plan to avoid any further deterioration in financial resilience, with Ofwat having powers to introduce cash lock-up if such a plan was deemed to be inadequate and/or if companies failed to demonstrate sufficient progress in achieving the resilience plan outcomes over the specified timescales.

We believe there are advantages to this approach. It would provide for a more rigorous evaluation of proposed company actions (and subsequent delivery) to secure resilience for the long-term, rather than placing too much reliance on credit ratings produced by credit ratings agencies in effectively monitoring and policing financial resilience. Credit quality is not synonymous with financial resilience; ratings typically would only span a ratings assessment horizon of 3 to 5-years and variables within the ratings assessment can also be outside of a company's control (e.g. sector risk profile of regulatory environment). Furthermore there are circumstances where action could be taken to support short term credit ratings which would be negative in respect of long term financial resilience. These are potentially material considerations which mean that Ofwat will need to retain oversight of companies' approach to financial resilience.

In our January response to Ofwat's discussion document, we queried whether there was a need to amend the existing dividend provisions within the licence, as it is questionable whether enforcement through the licence is actually required to solve the identified issues. Additionally, we highlighted that simplistic associations between performance – especially short term performance – and dividend might also be problematic given the degree of subjectivity that this might imply.

Having reviewed the proposed changes in relation to this licence condition, we consider the proposed expansion of factors which require consideration when paying dividends to be broadly consistent with those already undertaken by UUW and as committed to in our PR19 business plan.

Where companies do not deliver in line with the determination, existing arrangements mean that there is already a thorough sanctions regime in place across a range of measures, including ODI penalties for underperformance on customer service and/or specific environmental performance measures and potential fines for breaches of statutory obligations. The impact of these penalties is felt by shareholders. We believe that these remain the appropriate measures, especially where companies otherwise have a strong track record of delivery.

However, we do recognise there are some instances where it might be appropriate for a company to restrict dividends for sound corporate finance reasons. Examples of this might include where the capital structure is weak and overall performance is poor. In these circumstances, restricting dividends may be one of a number of steps necessary to support the company's turnaround plan. This is because paying dividends in such circumstances might reasonably be expected to materially reduce the company's capability to return to a strong performance for customers and the environment. We believe that such circumstances would be relatively rare, and exceptional for any well run company with a strong track record of delivery for customers and the environment, and a robust and resilient financial structure.

UUW remains supportive of the proposed requirement to maintain investment grade credit ratings with two different credit ratings agencies, as this represents best practice. This on the basis that this is imposed for all companies. We note with some concern the proposed discretion for Ofwat to consider accepting just one rating

if deemed in Ofwat's judgement proportionate. We strongly believe that any such dispensation should be strictly limited to small WOCs only, and this being subject to the proviso that clear benefits to customers in maintaining just one rating can be demonstrated to offset those customers not being afforded the same level of protection. For other companies, a consistent approach which enforces against a "level playing field" should be adopted.

UUW is accepting of the proposed requirement to notify Ofwat of any changes in rating within 5 working days of the change or a rating withdrawal taking place. As a practical matter, it would be useful to see this timescale extended to 10 working days. This would better enable companies to furnish Ofwat with the applicable credit ratings agency publication(s) and any context arising from a thorough internal review.

2. Cash lock-up and credit ratings

Q1 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 section 2, box 3, proposed to take effect from 1 April 2025.

As outlined in our January response to Ofwat’s decision document, although the ratings scale is continuous in nature, there is a significant ‘red line’ between investment grade and sub-investment grade ratings when it comes to investor appetite for debt and, hence, a companies ability to secure new borrowings on an ongoing basis. However, we do not see any material distinction with regard to ratings in the BBB band. We therefore believe that the licence conditions in respect of credit ratings is already appropriately calibrated within the current licence conditions.

The existing trigger level already operates on a company’s lowest rating, thus offering some degree of contingency and protection, particularly if the requirement to maintain two ratings is implemented, as quite often a company will be split rated. It is therefore possible that a company could be faced with a lock-up on the back of one agency taking ratings action whilst maintaining stronger ratings with another agency. There are also certain variables within the ratings process outside of each company’s control (e.g. changes in the regulatory environment). In such circumstances, we would contend that there is no easy way to determine which agency’s opinion may be correct, and therefore the trigger has been prudently set with the objective of a company avoiding a downgrade to sub-investment grade.

It is important to note that financial resilience and credit quality are not synonymous. Credit ratings indicate to lenders the risk that a borrower will not honour its financial obligations as promised. Such ratings reflect both the likelihood of default and the scale of any financial loss suffered in the event of default and typically only span a rating assessment of 3 to 5 years.

However, financial resilience pertains to the risk that events outside of the company’s control may cause its financial headroom to be eroded (albeit temporarily) over a longer time-frame. For a company to be financially resilient, then its financial headroom should be sufficient to ensure that reasonable expectations for such risks, coupled with appropriate company actions, should enable the company to not breach the floor value of investment grade, and thereafter to be able to recover its financial headroom.

We therefore continue to believe that the proposals we made in response to Ofwat’s previous consultation remain appropriate. These were that the existing cash lock-up threshold (Baa3/BBB-) remains in place, but that a trigger to submit a resilience plan be introduced at a higher ratings threshold (Baa2/BBB) to ensure that company Board’s agree a robust plan to avoid any further deterioration in financial resilience, with Ofwat having powers to introduce cash lock-up if such a plan was deemed to be inadequate and/or if companies failed to demonstrate sufficient progress in achieving the resilience plan outcomes over the specified timescales.

We believe that this provides for a more rigorous evaluation of proposed company actions (and subsequent delivery) to secure resilience for the long-term, rather than relying on credit ratings produced by credit rating agencies which typically would only span a ratings assessment horizon of 3 to 5-years.

In addition, we consider that the views of current and potential equity holders need to be carefully considered by Ofwat in reaching its conclusions. Whilst we note that the proposals are ‘credit positive’ for debt investors at the Appointee company (as highlighted in Moody’s 29 July report: “Ofwat’s strengthening of ring-fence positive for OpCos, but negative for HoldCos”), the anonymised views of debt investors canvassed by Ofwat express a degree of caution, with 4 out of 9 ‘positive’ respondents to the raising of the cash lock-up threshold expressing some concern for equity investment. Anecdotally we are also aware of that a number of equity investors in the public

markets have expressed concern in respect of the proposed changes to both the credit rating trigger threshold and the dividend provision. More broadly, the head of Global Investors Association - Lawrence Slade – is on record as having told an inquiry into Ofwat's powers by the House of Lords Industry and Regulators Committee investor concerns remain over the level of regulatory intervention in the water sector.

Given the challenges that the sector needs to address and related investment needs, it is important that Ofwat satisfies itself that it has taken adequate account of the views of equity investors in relation to its proposed changes, including in relation to the proposed changes on dividend expectations. We are concerned about the potential for these proposals to put upward pressure on the cost of capital with regard to: a) equity investor sentiment with regard to increased uncertainty and volatility of future dividends; and b) additional headroom that companies will sensibly need to consider to ensure that they remain comfortably above the new, tightened trigger, the assessment of which would sit outside of companies' control. For companies to have ready access to equity markets to support future financing, it is important that the equity proposition is attractive to investors and that there is confidence that equity investors can expect returns commensurate with the level of risk that they bear.

In the event that Ofwat determines it will proceed with its proposed changes then we would wish to take this opportunity to draw Ofwat's attention to a possible weakness in the drafting of P27.2.2 which means that potentially a company that has ratings of – say - BBB+ and Baa3 is not subject to cash lock-up. This could be corrected by amending the Condition as follows (in red below):

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

3. Updating the dividend provision in company licences

Q2 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.

In our January response to Ofwat's discussion document, we queried whether there was a need to amend the existing dividend provisions within the licence, as it is questionable whether enforcement through the licence is actually required to solve the identified issues. In AMP7, we have already seen examples of companies eschewing dividends and instead choosing to reinvest into the company to improve performance and service to customers. Increased transparency and disclosure about company dividend policies and the reasoning behind Boards' decisions on dividends are a feature of company reporting during AMP7. This transparency is acting effectively to ensure that companies and their boards are accountable to customers and other stakeholders for their decisions and the long term impact this can have on the company. In our view, this may obviate the need for formalisation through the relatively blunt instrument of licence enforcement.

Additionally, we highlighted that simplistic associations between performance – especially short term performance – and dividend might also be problematic given the degree of subjectivity that this implies.

Having reviewed the proposed changes now incorporated into the proposed licence condition, we welcome the proposed expansion of factors which require consideration when paying dividends. We believe that the approach envisaged by Ofwat is broadly consistent with those already undertaken by UUW and as committed to in our PR19 business plan.

As part of PR19, we set out a clear and transparent AMP7 dividend policy which included our approach and conditions for when we would pay base dividends and outperformance dividends. Full details are available in price review document S7006 – "Capital Structure and Dividend Policy". In making decisions on both the base level of dividend and outperformance dividends, the Board considers the company's financial resilience, the company's performance against its statutory obligations and the company's performance against the final determination for AMP7, across a range of measures over time. It also considers the impact that payment of the dividend would have on its ability to serve stakeholders and broader considerations that the Board has committed to in AMP7 as part of its 10 core ten principles on gearing, dividends and benefit sharing.

Where companies do not deliver in line with the determination, existing arrangements mean that there is already a thorough sanctions regime in place across a range of measures, including ODI penalties for underperformance on customer service and/or specific environmental performance measures and potential fines for breaches of statutory obligations. The impact of these penalties is felt by shareholders. We believe that these remain appropriate measures for most performance issues, especially where companies otherwise have a strong track record of delivery.

However, we do recognise there are some instances where it might be appropriate for a company to restrict dividends for sound corporate finance reasons. Examples of this might include where the capital structure is weak and overall performance is poor. In these circumstances, restricting dividends may be one of a number of steps necessary to support the company's turnaround plan. This is because paying dividends in such circumstances might reasonably be expected to materially reduce the company's capability to return to a strong performance for customers and the environment. We believe that such circumstances would be relatively rare, and exceptional for any well run company with a strong track record of delivery for customers and the environment, and a robust and resilient financial structure.

4. Additional licence changes and other mechanisms that support financial resilience

4.1 Maintaining two investment grade credit ratings

Q3 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.

UUW remains supportive of the proposed requirement to maintain investment grade credit ratings with two different credit ratings agencies, as this represents best practice. This is on the basis that this is imposed for all companies.

In light of the proposed minimum credit ratings requirements and current dispensations, we were somewhat surprised at Ofwat’s comment that “We are in active discussions with South West Water about them obtaining a rating” with the clear implication being that South West Water might benefit from a dispensation to only procure a single rating.

We note with some concern the proposed discretion for Ofwat to consider accepting just one rating if deemed in Ofwat’s judgement proportionate. We strongly believe that any such dispensation should be strictly limited to small WOCs only, and this being subject to the proviso that clear benefits to customers in maintaining just one rating can be demonstrated to offset those customers not being afforded the same level of protection. For other companies, a consistent approach which enforces against a “level playing field” should be adopted.

4.2 Notifying us of changes to credit ratings

Q4 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.

UUW is accepting of the proposed requirement to notify Ofwat of any changes in rating within 5 working days of the change or a rating withdrawal taking place. As a practical matter, it would be useful to see this timescale extended to 10 working days. This would better enable companies to furnish Ofwat with the applicable credit ratings agency publication(s) and any context arising from a thorough internal review.

As we highlighted in our January response, it is important that companies should be free to choose which agencies they procure their ratings from with the freedom to change between providers, subject to the requirement at all times to maintain the minimum of two ratings. Such flexibility should help to maintain competitive tension between ratings providers, thus keeping down the not insubstantial costs that companies incur. UUW currently procures ratings from all 3 agencies – Moody’s, Fitch and S&P and we continue to periodically assess the ratings agency panel on cost-benefit grounds.

4.3 Wessex Water

Q5 We welcome views on our proposal 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 modifications.

As we have highlighted in our response to the proposed licence modifications, we believe that there should be consistency in each company's licence in respect of such material provisions, and as we advocated previously with regard to credit rating provision a 'level playing field' should be maintained across companies in relation to such provisions. In that context, we believe it important that all company's licences, including Wessex Water's, be amended consistently to incorporate the same provisions.

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