Wessex Water
Response to Ofwat consultation on ring-fencing licence conditions

1. Executive summary

1.1 We have carefully considered the proposals set out by Ofwat in its *Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers* (the "**Consultation**").

1.2 Overall, we strongly disagree with three aspects of Ofwat's proposals as set out in the Consultation, namely:

(A) The proposal to modify the cash lock-up condition to raise the cash lock-up trigger to BBB/Baa2 with negative outlook (as set out in section 2 of the Consultation) (the "**Cash Lock-Up Proposal**").

(B) The proposal to modify the dividend policy licence[1] condition to require that dividend policies and dividends declared / 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 of the Consultation) (the "**Dividend Declaration Proposal**").

(C) The proposal to align the ring-fencing provisions in Wessex Water's licence with those of other water companies (as set out in section 4.3 of the Consultation) (the "**Wessex Water Alignment Proposal**").

1.3 We do not believe there is a need for any of these provisions. As regards both the Cash Lock-Up Proposal and the Dividend Declaration Proposal, we are particularly worried by the extent of the intrusion by Ofwat into the capital structure of water companies[2] – the Consultation fails to recognise the magnitude of this intrusion and wholly fails to justify it. Similarly, we also do not believe that Ofwat has established to the necessary standard that there is a need for either of these provisions.

1.4 The Cash Lock-Up Proposal represents a material change from the current position for most licence holders and creates a highly intrusive regulatory mechanism that would turn on a granular, finely-balanced distinction between different credit ratings <u>within</u> the investment grade bracket (and by reference to ratings criteria that are not consistent between ratings agencies). For the reasons set out below, we do not believe that it is appropriate or effective for credit ratings to be used in this very granular way. To be justifiable, the proposal would need to be supported by compelling evidence to show that (i) companies with investment grade ratings are not financially resilient (or are at high risk of not being so); (ii) that existing regulatory and corporate protections are not sufficient

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[1] References in this response to licences are to instruments of appointment granted pursuant to the Water Industry Act 1991.

[2] References in this response to water companies are to companies holding an appointment as a water and / or sewerage undertaker under the Water Industry Act 1991.

protect financial resilience; and (iii) that the costs of implementing such a proposal are outweighed by the benefits. The Consultation fails to provide evidence for any of these propositions. On the contrary, there is a range of evidence showing that such a proposal is unnecessary, disproportionate and carries significant costs.

1.5 The Dividend Declaration Proposal comprises the inclusion in water companies' licence conditions of vague and poorly defined new parameters for dictating dividend distribution, which would be highly subjective. These new parameters do not, in their proposed form, specifically exist under the current guidance and it is highly inappropriate to seek to include such vague requirements in water company licence conditions – these conditions need to be precise, verifiable and therefore objectively enforceable. In practical terms, it would be very difficult for a water company to demonstrate that it had adequately complied with these required parameters when making decisions on dividend distribution. Since it is company directors who are ultimately responsible for the solvency of their business (and thus whether or not to pay dividends), such parameters place undue and uncertain restrictions on directors' duties and responsibilities. As with the Cash Lock-Up Proposal, the Dividend Declaration Proposal also carries significant costs for water companies that the Consultation has failed to consider.

1.6 The Consultation fails to set out robust evidence that would support the necessity, benefits or proportionality of the Cash Lock-Up Proposal or the Dividend Declaration Proposal. Critically, the Consultation fails adequately to carry out an impact assessment of the proposals on water companies themselves (in particular for the Cash Lock-Up Proposal). This is particularly important given the far-reaching consequences of each – contrary to the Consultation's assumptions, these proposals will have a significant cost impact and will, in effect, further cement Ofwat's very significant influence over companies' capital structures (thereby risking inefficient market outcomes).

1.7 Finally, in respect of both the Cash Lock-Up Proposal and the Dividend Declaration Proposal, we see a high risk of unintended consequences that would in fact undermine financial resilience in the sector and increase the potential for consumer harm. In particular, investors with a mandate to invest in investment grade companies are likely to be highly dis-incentivised to invest in water companies that, while investment grade, are prevented by regulation from paying dividends under the Cash Lock-Up Proposal; the proposal may also incentivise companies to retain cash in the business to maintain headroom above the higher lock-up threshold, thereby dis-incentivising management from investing in customer service (the opposite of Ofwat's stated objectives). Similarly, the Dividend Declaration Proposal would create significant dividend uncertainty as a result of the inherently subjective nature of the proposed policy parameters - clarity of licence terms is very important for investors (whether debt or equity). In turn, this undermines investor ability to assess and price the risk attached to future dividend distributions, undermining water company financial resilience and their ability to attract capital.

1.8 As regards the Wessex Water Alignment Proposal, we do not agree with the proposal for the same reasons that we raised with Ofwat during their prior consultation on this suggestion. The Consultation justifies the proposal on the basis of "*the reasoning set out in our July 2020 consultation and conclusions documents*", with which we disagreed at

the time and continue to do so. The Consultation does not appear to raise any new evidence or justification for the proposal. Our objections to the proposal are only enhanced by our objections to the Cash Lock-Up Proposal.

1.9 Additionally, we note that the Consultation also proposes to modify the current licence conditions to:

(A) Require water companies to hold two issuer credit ratings (or to seek Ofwat's agreement to an alternative arrangement). In principle, we support Ofwat's proposals in this area, provided that the cost implications of the ratings in question are appropriately considered by Ofwat as part of its broader financeability assessment and Ofwat remunerates the cost of holding two ratings.

(B) Require water companies to notify Ofwat about any changes to credit ratings (including changes in rating and / or outlook, new ratings assigned or planned withdrawals). Wessex Water's rating agency reports are already publicly available and we do not have a concern with an obligation to notify Ofwat of any changes to our credit ratings.

2. The Cash Lock-Up Proposal

2.1 The Cash Lock-Up Proposal gives rise to a highly intrusive sanction (cash lock-up resulting in an inability to pay dividends without regulatory approval) even though the company in question will remain investment grade (and thus financially resilient). This represents a material restriction on the ability of water companies and their directors to manage their own capital structures: directors will well understand if they perceive the company to be close to falling below investment grade and that certain decisions the company might take could then lead to a drop below investment grade and a breach of the licence. This is a judgement for them to take, not Ofwat.

2.2 We fail to see how this is a necessary approach given:

(A) There is no evidence to suggest that companies with an investment grade rating are not financially resilient (or are at risk of being so).

(B) Credit ratings are not designed to be used in the manner proposed by Ofwat. Using what are finely-balanced assessments of the relevant investment grade credit rating, and even 'intra-notch' changes in such a rating (e.g. from BBB to BBB with negative outlook), as the basis to trigger a lock-up assumes a level of precision and objectivity in intra-investment grade credit ratings that they simply do not possess or claim to possess.

(C) The proposal will lead to a significant cost impact on water companies, which the Consultation fails to consider (or, at the very least, significantly underestimates).

(D) The proposal leads to a clear risk of unintended consequences, which the Consultation fails to consider.

(E) The proposal is a disproportionate response to the perceived risks to financial resilience.

There is no evidence to suggest that companies with an investment grade rating are not financially resilient

2.3 The current lock-up condition[3] recognises a distinction between water companies with investment grade ratings and those with non-investment grade ratings. Such a distinction is clear, and well understood in the water industry and the financing sector. It reflects the fact that, where companies have non-investment grade ratings, they are likely to have more limited access to market funds and therefore, in principle, potential lower financial resilience.[4] On the other hand, companies with investment grade ratings are, by definition, capable of attracting market financing and should therefore be treated as financially resilient overall.

2.4 Using credit ratings in this way, as part of the assessment of the financial resilience of water companies, while not perfect, is proportionate, reflects the reality of the relationship between financing and credit ratings, and is workable in practice.

2.5 The Consultation also explicitly recognises that companies with investment grade ratings are financially resilient: an Investment Grade Rating (as defined in the current licence condition) "*enables companies to maintain efficient access to capital*".[5] .

2.6 However, Ofwat goes on to suggest that, in its view, a rating of BBB-/Baa3 "*is insufficient for an essential public service*",[6] and that therefore the Cash Lock-Up Proposal is appropriate. In particular, it raises concerns that (i) there is an increased probability of downgrade to sub-investment grade at BBB-; (ii) there is a threat to capital access at lower investment grades; and (iii) that there is a higher cost of debt at lower credit ratings. However, the evidence cited in the Consultation does not support these propositions.

(A) Probability of downgrade to sub-investment grade. The evidence cited at page 14 of the Consultation (i) relates to downgrade probability across all company sectors; and (ii) contrary to the Consultation's assertion that it is relying on "*empirical evidence*", is based on a model rather than empirical data. To assess the risk of a ratings downgrade in the present context, the focus should be on the actual downgrade probability of *water* companies (including when taking into account the current licence conditions) or at the very least utility companies (which operate in a regulatory and economic environment very different from other corporates). When looking at the transition rates of water utilities rated BBB- over a three year period, only 4.7% were downgraded while 9.6% were

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[3] For all water companies other than Wessex Water, which does not have a current lock-up condition.

[4] That said, the Consultation recognises that, "*while most investors were primarily invested in investment grade debt as required by the mandates, some had exposure to high yield debt (i.e. sub-investment grade debt rated BB+/Ba1 or lower)*", suggesting that water companies can maintain access to capital at sub-investment grade ratings.

[5] Consultation, p.13.

[6] Consultation, p.14

upgraded.[7] In other words, upgrades are twice as likely as downgrades in this sector.

(B) Threats to capital access at lower investment grades. The Consultation suggests that debt investors (as the principal source of investment for water companies) indicated a "*reduced willingness*" to invest in water companies rated BBB-/Baa3. However:

(i) As a general point, the fact that debt investors have a "*reduced willingness*" to invest in a company with a BBB- rating does not of itself mean that such companies cannot access capital efficiently (as above, the Consultation in fact recognises that any investment grade rating allows companies to maintain efficient capital access).[8] Ofwat has not quantified any reduction in willingness in order assess whether it would result in a materially reduced ability on the part of water companies to access capital.

(ii) The Consultation states that debt investors "*said a BBB- rating would not be considered appropriate for a UK water company over the long term*" (emphasis added). Similarly, some investors "*added that the relative value of the investment is considered alongside the trajectory of the rating*" and that therefore "*they are willing to invest in BBB- companies…if they assess that the BBB- rating is transient*". Consistent with this, 9 of the 11 investors surveyed suggested that "*operating at BBB-/Baa3 into the long-term did not provide appropriate / sufficient headroom to absorb shocks*". These responses suggest that, if there is any reduced willingness to invest in BBB- rated companies, it typically only arises where such a rating persists over the long-term. The Cash Lock-Up Proposal does not address that dynamic since it would apply prematurely - as soon as a rating of BBB/Baa2 with negative outlook is hit. In light of the evidence, the Consultation does not explain why triggering a lock-up as soon as the relevant threshold is reached would be appropriate.

(iii) The Consultation notes that "*credit ratings were only an input into each debt investor's credit assessment process which was the ultimate decider of debt positions taken*", and that debt investors "*look at a broad range of other factors, such as, their own assessment of key metrics, projections, cash flow modelling, ESG, sustainability and climate scores*".[9] This suggests that debt investors look at a range of evidence when

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[7] See 'BBB' Category Transition Rates By Subsector (1981-2020), S&P 2020 Annual Infrastructure Default And Rating Transition Study, p. 23. Cited in the KPMG Impact Assessment Paper, p.11.

[8] It is noteworthy in this context that South West Water does not currently have a credit rating at all and in its response to the December 2021 discussion paper claimed to have no issues with capital access: "*South West Water has not to date required a credit rating to access efficient debt finance to support its operations. […] Where we have had debt capital issuances, we have not required a credit rating to access the markets*"

[9] Appendix A2 of the Consultation.

considering investments and that a rating of BBB-/Baa3 of itself would not be sufficient to reduce their willingness to invest.

(C) Higher cost of debt at lower credit ratings. The Consultation suggests that there is an increased cost of debt at lower credit ratings within investment grade, and in particular an increase in spreads at BBB-/Baa3 than at higher credit ratings. However, the evidence on the correlation between lower credit ratings and higher cost of debt is not clear-cut.[10] In fact, the KPMG Impact Assessment Paper (provided alongside this response) finds that:[11]

(i) When comparing water companies against the iBoxx benchmark, tenor rather than credit rating explained the majority of over-performance against the benchmark.[12] To the extent there credit ratings had an effect on pricing, this was driven by differences between credit rating categories (for example A-rated water company debt versus the iBoxx A/BBB benchmark), rather than differences within each rating category (for example BBB+ versus BBB).

(ii) There remains a significant level of variation in issuance yield even after controlling for tenor and credit rating. This variation is due to a number of factors such as the introduction of particular debt covenants. The evidence cited by Ofwat does not appear to recognise these external factors.

(iii) Analysis of the spreads for 10Y tenor debt in the water sector reveals no meaningful and consistent differential in the Baa1/BBB+ and Baa2/BBB spreads. Lower rated instruments have at times priced inside those with a better rating, demonstrating that credit rating is not the sole meaningful factor.

(iv) Analysis of the movement in spreads of issuer instruments following a rating action (i.e. comparing the spread the day before and after a downgrade, upgrade or movement in outlook) found minimal movements in spreads, in the region of -3.4bps to +18.9bps.[13]

The data therefore does not support a conclusion that there is a materially higher cost of debt at lower credit ratings. In particular, the data cited by Ofwat appears to materially over-estimate the differences in cost of debt between different credit ratings without controlling for factors that might result in that variance, such as debt covenants.

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[10] Moreover, a reduction in the cost of debt does not translate to a reduction in the cost of capital – as the risk profile of the asset base overall is unchanged, there is simply a transfer of value from equity investors to debt investors.

[11] KPMG Impact Assessment Paper, section 4.2

[12] See further section 4.2 of the KPMG Impact Assessment Paper.

[13] KPMG Impact Assessment Paper, page 37.

2.7 In sum, the evidence on which Ofwat relies in the Consultation does not establish that companies with (lower) investment grade ratings are not financially resilient and, in particular, that a rating of BBB-/Baa3 is, of itself, insufficient to maintain access to efficient capital. In fact, there is a range of evidence to suggest that companies with a rating at this level remain financially resilient and can maintain access to efficient capital at costs not materially higher than those with higher ratings. Consequently, the Consultation fails to adduce a robust evidence base for the Cash Lock-Up Proposal.

2.8 Wessex also notes that, as regards the perceived potential risks to "headroom", the Consultation states that "[Ofwat's] *long standing approach is that companies are best placed to make decisions over their financing and capital structure arrangements, including a target credit rating which provides them with a robust level of headroom to allow for financial flexibility*".[14] To the extent that there is an efficiency advantage to be gained from moving away from the lowest investment grade rating, whether that is to service debt more efficiently or to secure additional "headroom" to avoid slipping out of investment grade, these incentives already operate on a water company organically and, as Ofwat appears to recognise, it should be the company's responsibility to act on them, rather than regulation seeking to replicate their effect.

It is wrong to rely on the finely-balanced distinction between investment grade credit ratings to draw conclusions on financial resilience and to impose far-reaching restrictions on a company's ability to distribute dividends as a result

2.9 The Cash Lock-Up Proposal proposes a trigger for lock-up that would occur when a company is rated BBB/Baa2 with negative outlook, from the current trigger of BBB-/Baa3 with negative outlook. We are seriously concerned such an approach represents a disproportionate reliance on the finely-balanced assessment of credit ratings agencies about the relative credit worthiness of companies <u>within</u> the investment grade. Wessex Water makes the following observations in particular:

(A) Credit ratings are fundamentally not designed (or generally used) for assessing financial resilience. They are measures of a firm's creditworthiness i.e. an opinion from the rating agency about the likelihood that a company's creditors will be paid when promised in full. On the other hand, financial resilience is concerned with the ability of a water company to fund its operations.

(B) There is a significant difference between (i) the 'thick red line' distinction between the lowest investment grade rating (BBB-/Baa3) and non-investment grade ratings, and (ii) the distinction between two investment grade ratings. The latter assessment is incredible finely-balanced – for example, the difference between Baa2 <u>with</u> a negative outlook and Baa2 <u>without</u> a negative outlook will turn on very specific credit rating criteria, which are not consistent across the rating agencies.[15] Such a reliance on the minutiae of credit ratings methodology within

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[14] Consultation, p. 8.

[15] Credit rating agencies use different methodologies to calculate credit ratings in the UK water sector. For example, S&P focuses on cash flow-based ratios (Funds From Operations to Net Debt ("FFO to debt") while Moody's and Fitch place emphasis on the balance sheet ratio (Net Debt to Regulatory Capital Value) and interest covers. There are many examples of differing rating agency views for the same credits. One of the most recent ones is Northumbrian Water,

the overall investment grade is, given that such criteria will then dictate the cash lock-up being triggered (or not), wholly inappropriate. This is surprising, given that the Consultation *does* recognise that there can be "*diverging views between ratings agencies on the same company*", highlighting the challenges of assessing financial resilience by reference to credit ratings alone.**[16]**

(C) Ofwat recognises that an assessment of financial resilience "*takes account of a range of information including disclosures made in annual performance reports, statutory accounts, interim reports (where available), credit rating reports and other public information*".**[17]** This reflects the fact that "*there is a degree of judgment to an assessment of financial resilience*".**[18]** Given the range of information that Ofwat uses to assess financial resilience (and thus risks to that resilience), and a recognition that such an assessment requires judgment, Ofwat has failed to explain the Cash Lock-Up Proposal's total reliance on the granular differences between two investment grade ratings (which necessarily eliminates any judgment).

The Cash Lock-Up Proposal will lead to a significant cost impact on water companies

2.10 The Consultation seeks to identify potential benefits to the Cash Lock-Up Proposal. However, it wholly fails to consider adequately or in any detail the cost to water companies of the proposal. Changes to the regulatory framework that reduce the certainty of future dividend payments are likely to deter investment into the water industry and drive up the required return on investment to account for this elevated risk profile. This equates to an increased cost of capital for water companies, with a corresponding risk that this translates into increased costs to consumers through higher prices and/or a reduction in investment/service quality. The expected cost to water companies associated with the proposal is significant and outweighs any putative benefits.

2.11 More specifically, the KPMG Impact Assessment Paper suggests that:

(A) There are limited benefits to customers of the Cash Lock-Up Proposal. First, it is not clear that in the event of a bankruptcy, dead weight costs would be borne by customers. Second, a potential reduction in the cost of debt as a result of Ofwat's proposals is unlikely to be passed through to the customer bills (because the reduction in cost of debt would not translate materially into a reduced cost of debt

rated Baa1 / Stable by Moody's and BBB+/Negative by S&P. The negative outlook from S&P reflects its expectation that the company is unlikely to achieve FFO to debt of over 9% by the end of the current price control, while the table outlook from Moody's reflects that it expects the company to maintain interest cover above 1.5x and gearing below 72%. Depending on the pay-as-you-go and run-off rates and company performance on opex and ODIs, a gearing of around 72% could translate in a wide range of FFO to debt metrics, which may or may not satisfy S&P criteria for a BBB+ rating. This example demonstrates how many moving parts there are in the credit rating agency assessments.

[16] Indeed, Ofwat notes that "*this is why we do not rely on any single source of information*" when assessing financial resilience – p.9.

[17] As reflected in the range of factors taken into account by Ofwat in its annual Monitoring Financial Resilience report (see for example the 'key metrics' dashboard on slide 5 of the 2021 report).

[18] As also reflected in the approach of debt investors – see Appendix A2 of the Consultation.

allowance). KPMG estimates that the annual benefit to customers from Ofwat's proposal to tighten the cash lock-up could be assessed at about 0-2 basis points.

(B) On the other hand, there would likely be material costs for water companies associated with Ofwat's proposals, arising from higher agency costs, reduced ability to respond to clientele effects (i.e. the fact that certain assets are tailored to the preferences of certain investor groups), and a restricted ability to adopt the optimal capital structure. These restrictions could impact on water companies' cost of capital, projected cashflows and equity value. Across both the Cash Lock-Up Proposal and the Dividend Declaration Proposal, these associated costs are estimated to be between 14 basis points and 98 basis points (calculated based on analysis of preference shares, dividend signalling and duration of cash flows).

2.12 Given the significant degree to which the costs of the proposal outweigh the benefits, Ofwat has clearly failed to assess properly the proportionality of the proposal, and the extent to which it impacts negatively on financial resilience and companies' ability to finance the proper carrying out of their functions.

The Cash Lock-Up Proposal will lead to a number of unintended consequences

2.13 In Wessex Water's view there is some risk that the Cash Lock-Up Proposal will lead to reduced financial resilience. A cash lock-up requirement restricting dividends is likely to discourage equity investors from committing capital within the regulatory ring-fence, thereby reducing the pool of available equity capital. This is the case both for companies that may in fact have resilience issues – for whom equity investment would be an important means of re-establishing that resilience (as recognised in the Consultation in respect of Southern Water, for example) – and for companies that trigger the lock-up but that are fundamentally resilient – for whom a lack of continuing equity investment as a direct consequence of the lock-up could prompt resilience issues that may not otherwise have arisen. These risks are wholly consistent with the feedback that Ofwat has previously received and the impact assessment described above.[19]

The proposals are a disproportionate response to the perceived risks to financial resilience, and would not wholly achieve the effects claimed

2.14 While the Consultation looks to frame the Cash Lock-Up Proposal as simply supporting the pre-existing licence conditions in order to safeguard financial resilience, the proposal in fact represents a very significant broadening of Ofwat's influence over company capital structures. Wessex Water understands that Ofwat's rationale for the proposal is, at least in part, to act pre-emptively to prevent *future* reductions in financial resilience rather than address specific identified market failures or other structural problems. Given the

[19] See, for example, the responses to Ofwat's December 2021 discussion paper. Ofwat notes that 31 out of 32 respondents disagreed with amending cash lock-up to trigger at a higher credit rating. The most common reason cited (by 20 respondents) was that the proposal would "*undermine or destabilise investor trust/confidence in UK regulated utilities (by introducing uncertainty/instability to dividends)*", with some respondents also making the related observation that "*the proposal would increase the level of compensation or return investors require for the regulatory risk (… related to dividend uncertainty and instability)*" (p.40).

proposal's far-reaching consequences, Wessex Water therefore questions its proportionality in light of the lack of specific identified consumer harm or market failure.

2.15 More specifically Wessex notes the following:

(A) Utilities have historically been one of the most resilient sectors globally in terms of the probability of default (indeed, Wessex Water is not aware of any water company defaulting in the UK water sector; nor has the "Special Administration" regime ever been used for a water company).

(B) Ofwat already has significant information available to monitor performance, financial resilience, and levels of investment under the current regulatory requirements. Notably, the Consultation acknowledges that "*Where we identify companies at higher risk, we engage with them […]. Such engagement commences well before a company's credit rating is at risk of falling to the lowest investment grade*."[20] Against that background, the Consultation does not explain why the Cash Lock-Up Proposal is necessary as a further 'early warning sign'. Ofwat's pre-existing engagement, coupled with the pre-existing cash lock-up mechanism, already provide it with sufficient oversight and water companies with sufficient incentive to engage early on these issues.[21]

(C) There is no evidence of poor service for customers linked to financial resilience or levels of distribution.[22] The Consultation notes that "*it is vital that companies have access to the financial resources necessary to deliver their obligations and commitments to customers*"[23] but does not establish that this is a systematic issue with water companies. In any event, customer service is directly regulated by Ofwat through the calibration of totex allowances and the incentive framework in addition to extensive reporting requirements on operational performance and service levels. Financial resilience is a very poor proxy for service levels (for example, a financially resilient firm could still choose not to invest in service levels since that benefits customers rather than the firm, particularly in a monopoly market with no switching risk); therefore the appropriate intervention in pursuit of service levels is direct regulation of service levels themselves (as is already the case).

2.16 Where there is no clear evidence of a market failure or compelling problem that requires a solution, it is, in Wessex Water's view, fundamentally disproportionate to intervene in

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[20] Consultation, Box 2.

[21] Wessex Water therefore disagrees with the Consultation's characterisation of the MFR report 2021 as evidence for its statement that "*current mechanisms are not working as they should*". The report states that "*most companies maintain adequate levels of financial resilience*" and cites examples of companies "*taking action to strengthen financial resilience*", and choosing not to pay dividends for reasons including "*economic uncertainty and to support resilience*" (p.6)

[22] And, moreover, no evidence that a poor credit rating leads to poor customer service.

[23] Consultation, p. 8.

the market in the proposed manner in circumstances given that the proposed intervention comes with material costs (as explained in paragraph 2.10 *et seq.* above).

2.17 Additionally, Wessex Water notes that requiring water companies to retain cash rather than distributing it to investors does not of itself guarantee or even encourage improved operational performance or service levels. Where dividends are restricted in this way (and it is important to stress here that the Cash Lock-Up Proposal is likely often to be triggered in the absence of any identified funding need within the business), there are effectively four options for management:[24]

(A) Spending the cash on operating or capital expenditure. To the extent that it would be value-generative, it is likely that the company would have used the cash in this way irrespective of a dividend restriction.

(B) Spending the cash on debt repayments. There is no evidence that levels of gearing have any bearing on customer service levels or operational performance.

(C) Holding cash on the balance sheet. Simply holding cash on the balance sheet is generally an inefficient use of funds, and does not appear to achieve any regulatory objective for Ofwat.

(D) Buy back of shares. The repurchasing of shares is unlikely to have any impact on the level of operational performance and customer service provided by the business and therefore does not achieve the desired effects of Ofwat's proposals.

2.18 Finally, Wessex Water notes that one of the effects claimed in the Consultation for the Cash Lock-Up Proposal is that companies will be encouraged to engage earlier with Ofwat on financial issues and can resolve such issues sooner.[25] However, it is difficult to see that the proposal would in fact reliably lead to this effect:

(A) First, and as explained above, there is no evidence that companies even at the lowest investment grade credit rating are at any noticeably greater risk of decreasing financial resilience than other companies carrying investment grade ratings.

(B) Second, and as a consequence, Ofwat has effectively set the lock-up level at too high a rating (i.e. BBB/Baa2 with negative outlook) for it to be a practical early warning mechanism. Instead, the clear risk is that the lock-up will simply be triggered prematurely by a range of companies that remain fundamentally financially resilient and are not at material risk of losing that resilience. Wessex Water notes, in this context, that the CMA in PR19 used a benchmark of BBB for an efficient company with the notional capital structure, and that many companies (including Wessex Water) have sought to operate on the basis of a BBB capital

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[24] While this is also the case under the current conditions, the difference is that the higher lock-up threshold means the dividend restrictions are far more likely to be triggered when a company is at a very low risk of compromising its financial resilience.

[25] See, for example, p.21 of the Consultation.

structure more generally.[26] Thus, the proposal fails to increase the level of comfort that Ofwat seeks over potential losses of financial resilience; whilst on the other hand, leading to a potentially significant proportion of water companies being subject to the lock-up (or incentivised to seek additional headroom above the lock-up and thus adopting sup-optimal financing structures). This in turn leads to a high risk of unintended consequences (as explained above).

Conclusions

2.19 The Cash Lock-Up Proposal is an intrusive regulatory mechanism that places a disproportionate reliance on what is a granular, finely-balanced distinction between different credit ratings within the investment grade bracket (exacerbated by the fact that there is no consistent approach by ratings agencies to assessing marginally differing grades within the investment grade bracket). To be justifiable, it would need to be supported by compelling evidence to show that (i) companies with investment grade ratings are not financially resilient (or are at high risk of not being so); and (ii) that the costs of implementing such a proposal are outweighed by the benefits. The Consultation fails to provide either. On the contrary, there is a range of evidence showing that such a proposal is wholly unnecessary, and carries significant costs.

2.20 Finally, we see real risk of the proposal resulting in unintended consequences that would decrease financial resilience and, indirectly, increase the potential for consumer harm. In particular, investors with a mandate to invest in investment grade companies are likely to be highly dis-incentivised to invest in companies that, while still investment grade, may be prevented by regulation from paying dividends.

3. The Dividend Declaration Proposal

3.1 The Dividend Declaration Proposal involves amendments to the current licence conditions to require Wessex Water to take into account additional parameters when considering dividend distributions. Wessex Water is concerned that these proposals have not been sufficiently targeted and will present difficulties in their practical application. In particular:

(A) The proposed parameters for dictating dividend distribution are not defined and are inherently subjective. It is inappropriate to codify general policy parameters of this type in licence conditions – which should by their nature be clear and objectively enforceable.

(B) Ofwat has failed to explain how the Dividend Declaration Proposal represents a proportionate response to the identified issues.

[26] CMA: Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations (17 March 2021).

(C) The Dividend Declaration Proposal will have a detrimental cost impact on water companies, undermining their ability to maintain financial resilience and leading to a risk of unintended consequences.

The suggested dividend policy parameters are not defined and are inherently subjective

3.2 The Consultation proposes requiring water companies in their licence conditions to adhere to the following additional parameters (*inter alia*) when considering dividend distributions: "*service delivery for customers*" and the "*environment over time*".[27] These parameters draw on Ofwat's expectations set out in separate Ofwat guidance (albeit they do not appear to be referred to in these precise terms in those documents).[28]

3.3 These parameters are not further defined, and their meaning and application appears highly subjective. Wessex Water is concerned that, in practical terms, it would be very difficult for a water company to demonstrate or reassure itself that it had complied with these required parameters when making decisions on dividend distribution; while, on the other hand, there could be significant scope for differences of opinion as to whether the parameters had been correctly accounted for.

3.4 Given the vague nature of the suggested parameters, Wessex Water is doubtful that the proposal will achieve Ofwat's objective of ensuring that dividend decisions are "*much more clearly explained and better linked to performance outcomes*".[29]

3.5 Further, since it is company directors who are ultimately responsible for the solvency of their business (and thus whether or not to pay dividends), the parameters place undue and uncertain restrictions on directors' ability and responsibility to manage the company in question appropriately. This directly undermines Ofwat's stated aim of the proposal to remove "*the potential for ambiguity*".[30]

3.6 Wessex Water is therefore concerned by Ofwat's proposal to incorporate these general policy objectives into licence conditions. For the reasons explained above, the proposed parameters by their nature require subjective assessments to be made and it is possible for reasonable people to have differing interpretations of what is required to meet the specified standards. By contrast, it is important that licence terms are clear and objectively enforceable: vague or subjective conditions are less capable of being enforced effectively and consistently, and there are (potentially significant) sanctions that arise where licence terms are breached.

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[27] Consultation, p.29

[28] E.g. the PR24 draft methodology and the 'Board, Leadership, Transparency and Governance Principles'.

[29] Consultation, p.26

[30] Consultation, p.27

Ofwat has failed to explain how the Dividend Declaration Proposal represents a proportionate response to the identified issues

3.7 The Consultation explains that the Proposal will "*strengthen the regulatory ring fence in the licence and improve protections for customers and the regulated company*".[31]

3.8 The Consultation makes various statements as to the reasoning for updating dividend policy conditions – for example, that it "*better enables*" Ofwat to act and "*sends a strong signal to the industry and stakeholders about our expectations*".[32] However, the Consultation does not provide any real evidence to support this reasoning on how the current licence conditions are failingand, therefore, why the regulatory ring fence needs strengthening.

3.9 The failure to provide any specific supporting evidence is exacerbated by the fact that the Consultation recognises that water companies have already accepted Ofwat's expectations on dividend policy as set out in PR19, and that these expectations have been broadly incorporated into company dividend policies for the applicable period (2020 – 2025), as reflected in Ofwat's 2020-21 MFR Report.[33]

3.10 In its MFR Report for 2020-21 cited in the Consultation, Ofwat referenced "*areas where companies should do more to show how levels of dividends declared / paid reflect levels of service delivered*".[34] However, the MFR Report contains little detail on the precise issues that Ofwat has identified as of potential concern beyond noting that, for example, dividends should be "*explained in relation to performance delivery for customers*" and that, where "*companies did reference* [performance] *delivery for customers, most only made general statements such as overall good performance but without sufficient explanation or evidence to support this conclusion*".[35] Overall, the report refers to a generic issue that "*the application of the dividend policy and the explanation of the dividend paid*" is not meeting Ofwat's (general) expectations.[36] Wessex Water makes two observations in this regard:

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[31] Consultation, p.27.

[32] Ibid.

[33] Consultation, p.26. For example, Wessex Water's current dividend policy requires consideration of the following factors: (i) the company's current and projected performance in delivering the level of service customers expect from an efficient water and sewerage company and that where that level of service has not been delivered, that customers have been adequately compensated; (ii) that the company is delivering the required quality and environmental outputs and making sufficient investment in its infrastructure to maintain and, where necessary, increase resilience; (iii) that the correct amount of tax has been paid; (iv) that the company has met any unexpected additional expenditure needs that may have arisen during the year to date, as new operational risks emerge; (v) the level of regulatory gearing and its comparison with Ofwat's expectations pertaining at the time; and (vi) the sufficiency of distributable reserves.

[34] Consultation, p.28.

[35] MRP report 2020-21, p.30.

[36] See MFR Report 2020-21, p.31.

(A) The Dividend Licence Proposal is not targeted at addressing the concerns in the MFR Report. The proposal requires water companies to declare / pay dividends in accordance with a policy that takes account of the additional suggested metrics (e.g. customer service delivery and the environment over time). It does not require companies to provide specific additional explanation or evidence to support its conclusions that it has complied with these parameters. In other words, from a transparency perspective, the proposal seems more focussed on the design of dividend policies than on changing the way in which individual distribution decisions are made.

(B) By extension, introducing these additional parameters into the licence condition does not ensure that water companies are under specific obligations to explain their dividend decisions by reference to these parameters (rather they simply need to take them into account).

3.11 The Consultation notes that "*most respondents to our discussion paper did not support updating the licence text on dividend policy*", with the primary reason for this being that respondents felt that the perceived issue is already covered by existing regulatory guidance and principles, and that the proposal would lead to unnecessary regulatory intervention.[37] The Consultation does not engage with the substance of these objections, simply expressing a view that it would be 'best practice' to align licence conditions with the expectations that companies have already agreed to meet. The Consultation does not explain why such an approach would represent best practice in these circumstances; in particular, it fails to explain how the proposal would "*remove ambiguity*" or "*promote the importance of explaining dividend decisions clearly*" (as above, the proposal in any event fails to meet these objectives).

3.12 Finally, Wessex Water notes that Ofwat has failed to demonstrate that an increase in cash held in the regulatory ring-fence (i.e. in circumstances where Ofwat enforces the Dividend Declaration Proposal and dividends are withheld as a result) would actually result in additional investment benefitting customers and operational performance. Since Ofwat already sets target customer service levels and there are reporting requirements in place with companies providing information on both ODIs and totex, concerns about the level of customer service could be addressed more efficiently through direct ODI calibration and totex allowances in the context of price reviews (PR24 in the most immediate instance). The Consultation does not appear to have considered this (or other) alternatives – indeed, it does not weigh the proportionality of the Dividend Declaration Proposal against any other, potentially less intrusive mechanisms.

The Dividend Declaration Proposal would have a detrimental cost impact and would lead to unintended consequences

3.13 The proposed change has significant costs and unintended consequences that are not adequately identified and considered by Ofwat. Specifically, the proposal risks creating significant dividend uncertainty as a result of the subjective nature of the proposed policy parameters - clarity of licence terms is very important for investors (whether debt or

[37] Consultation, p.27

equity). In turn, this undermines investor ability to assess and price the risk attached to future dividend distributions.

3.14 As a consequence, the proposed parameters are likely to dis-incentivise investors, risking the unintended consequence of decreasing financial resilience. The Consultation does not appear to have considered either an impact assessment of the proposal on water companies themselves or, therefore, the extent to which the proposal has a detrimental impact on companies and their ability to finance the proper carrying out of their functions. However, the expected cost to water companies associated with the proposal is significant and outweighs any putative benefits.

3.15 In particular, and as explained above in respect of the Cash Lock-Up Proposal, there would likely be material costs for water companies associated with Ofwat's proposals, arising from higher agency costs, reduced ability to respond to clientele effects, and a restricted ability to adopt the optimal capital structure. These restrictions could impact on water companies' cost of capital, projected cashflows and equity value. Across both the Cash Lock-Up Proposal and the Dividend Declaration Proposal, these associated costs are estimated to be between 14 basis points and 98 basis points (calculated based on analysis of preference shares, dividend signalling and duration of cash flows). These costs far outweigh any customer benefits.