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Ofwat
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28 September 2022

Dear Sirs,

Consultation on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers

Thank you for the opportunity to review and comment on the proposed modification to strengthen the ring-fencing licence conditions of the largest undertakers. We are in agreement with Ofwat that water companies must be able to demonstrate financial resilience and that any assessment must take into account many factors and financial metrics, as well as the specific circumstances of each company, in order to reach a robust evaluation.

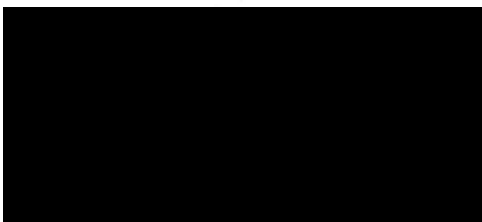
We have outlined below our overall position on the proposed modifications and have included our detailed response on the each of the proposals in the Appendix to this letter.

There are a number of the proposals that we welcome. We support the proposal to maintain investment grade credit ratings from two ratings agencies and a change to the licence to require water companies to notify Ofwat of changes to its credit ratings. We also support Ofwat's call for greater transparency on swaps and pensions liabilities, and its proposal to address improvements in information transparency outside of the licence framework.

However, we remain unclear about the problem the proposed modifications are aiming to address which we would expect to have been articulated and presented through a regulatory or customer impact assessment. In particular, we continue to have serious concerns that the proposed modifications to the cash lock-up trigger and the dividend policy licence provisions will not have the desired effect of improving the financial resilience of water companies – and that they do not sufficiently protect customers’ interests. Consequently, we believe the impact of the proposals are inconsistent with Ofwat’s customer and financeability duties and are an inappropriate delegation of Ofwat’s powers.

We would welcome a further opportunity to review and comment on any further iterations of the proposed licence modifications once Ofwat has had a chance to review and consider our representations, and those of other affected stakeholders. We appreciate the dialogue we have had with Ofwat so far and are very happy to discuss further if that would be useful.

Yours sincerely,



Chris Johns

Chief Financial Officer
(Via email)

*Appendix A: Yorkshire Water Licence Modification Response
Enc. Financial Resilience Paper*

Appendix A: Yorkshire Water Licence Modification Response

1. Introduction

- 1.1 This letter sets out the response of Yorkshire Water Services Limited (**Yorkshire Water**) to Ofwat's consultation paper of 28 July 2022¹ (the **Consultation Paper**), and the proposed licence modifications set out in the Consultation Paper (the **Proposed Licence Modifications**).
- 1.2 Yorkshire Water is grateful for the recent opportunity to participate in a roundtable discussion with Ofwat on 17 August 2022 and, as discussed during the meeting, agrees with Ofwat that water companies must be able to demonstrate financial resilience. Indeed, Yorkshire Water has repeatedly sought to proactively engage with Ofwat on how best to approach the nuanced and multi-faceted analysis required for a robust assessment of financial resilience,² taking into account an array of factors, including a range of financial metrics, as well as the specific circumstances of each company.³
- 1.3 Yorkshire Water supports a number of the Proposed Licence Modifications set out in the Consultation Paper – as we detail below in **section 2** of this letter.
- 1.4 However, Yorkshire Water continues to have concerns that the proposed modifications to the cash lock-up trigger set out in section 2 of the Consultation Paper (the **Cash Lock-Up Modification**) and the dividend policy licence provisions set out in section 3 of the Consultation Paper (the **Dividend Policy Modification**) will not have the desired effect of promoting the financial resilience of water companies – and that they do not sufficiently protect customers' interests.
- 1.5 In relation to both modifications, we endorse conclusions in the enclosed paper prepared by John Earwaker (the **Financial Resilience Paper**). We set out our specific concerns about the Cash Lock-Up Modification and Dividend Policy Modification in **sections 4** and **5** of this letter respectively.
- 1.6 In summary, in relation to the **Cash Lock-Up Modification**, Yorkshire Water is concerned that:

¹ <https://www.ofwat.gov.uk/consultation/consultation-on-proposed-modifications-to-strengthen-the-ring-fencing-licence-conditions-of-the-largest-undertakers/>.

² We note the following recent engagement we have had with Ofwat in this regard: (a) various meetings, discussions and correspondence with Ofwat on financial resilience through 2021 post-CMA; (b) our detailed letter in relation to long-term financial resilience of Yorkshire Water, sent to Ofwat on 13 December 2021; (c) our response to "Financial resilience in the water sector: a discussion paper", sent to Ofwat on 31 January 2022; (d) sector CFO roundtable discussion focused on the potential financial resilience consultation on 18 January 2022, followed by further meetings between appropriate officers of Ofwat and Yorkshire Water on 19 January and 17 February 2022; (e) our contribution to Ofwat's PR24 Future Ideas Lab, "Assessing financial resilience", in July 2022; and (f) a further constructive company roundtable discussion focused on financial resilience, held remotely, between Ofwat and Yorkshire Water on 17 August 2022.

³ See section 1.1. of the Ofwat Consultation.

- (a) ***The Cash Lock-Up Modification is a de facto and inappropriate delegation of Ofwat's powers and obligations to credit ratings agencies and is therefore wrong in law*** – The proposal inappropriately conflates credit ratings, which are currently used as a back-stop licence protection, with a multi-faceted assessment of financial resilience and is inconsistent with Ofwat's own position that a range of information and sources must be taken into account when assessing the financial resilience of a water company.⁴

The Financial Resilience Paper notes that the wisdom of relying on credit rating opinions was questioned when ratings agency opinions were first introduced as a back-stop to trigger licence provisions.⁵ The Cash Lock-Up Modification goes far beyond these previous considerations by seeking to use rating agency opinions to define the boundaries of financial resilience and to incentivise company decisions. The ratings process is independent from Ofwat decision-making and should not substitute Ofwat's responsibilities as a regulator and decision-maker.

There are particular concerns about using credit ratings agencies opinions in this manner:

- (i) the proposed changes create a more uncertain environment for companies through the use of credit ratings as a binary assessment of financial resilience with hair triggers such as outlook changes or being placed on watch;
- (ii) credit ratings are a narrow assessment compared to the scope of a full financial resilience assessment; and
- (iii) the use of the lowest rating from those selected by Ofwat for monitoring leaves companies exposed to the risk of a rogue rating and/or ratings agencies determining ratings on a relative and not absolute scale.

Finally, during the PR19 redetermination process before the CMA, Ofwat demonstrated that it had a clear understanding of these concerns and their relevance to the use of credit ratings as now envisaged in the Consultation Paper.⁶

- (b) ***From the analysis and evidence presented in the Consultation Paper, the Cash Lock-Up Modification does not achieve Ofwat's stated intention of increasing financial resilience in the water industry and it is inconsistent***

⁴ See pages 8–9 of the Consultation Paper, where Ofwat states that its assessment of financial resilience has taken into account a range of financial measures, such as interest cover, gearing, liabilities not reflected in gearing such as swap mark-to-market valuations and pension obligations, as well as other information, such as disclosures published in annual performance reports (APRs), operational performance and the potential consequences of enforcement action.

⁵ See Financial Resilience Paper, section 4.2.

⁶ See Financial Resilience Paper, section 5.4. See, for example, CMA comments at the hearing held on 22 July 2020.

with Ofwat's customer and financeability duties – The Cash Lock-Up Modification limits Ofwat's assessment of financial resilience to credit ratings, despite instances showing agencies' opinions to sometimes be inaccurate – and indeed far from the complete picture of financial resilience. Rather than benefitting customers, it will negatively impact them – and rather than improving financeability in the sector, it will make water companies less investable.

- (c) **Ofwat has failed to adequately state reasons for the Cash Lock-Up Modification or undertake any impact assessment as would be reasonably expected under its statutory duties** – Ofwat has not adequately established that the Cash Lock-Up Modification would achieve the stated effect set out in the Consultation, nor that the additional headroom which the Cash Lock-Up Modification would require generates any tangible benefit to water companies' financial resilience or to customers. It has not shared its impact assessment, meaning that respondents to the consultation cannot robustly reply. Indeed, the Cash Lock-Up Modification will give rise to higher costs to the detriment of customers.

- 1.7 In relation to the **Dividend Policy Modification**, Yorkshire Water understands the context in which it has been proposed and the need for water companies to lead the way on this issue. However, Yorkshire Water is concerned that the Dividend Policy Modification as proposed in the Consultation Response is not the correct way to address the issue, that sufficient safeguards already exist, and that it may have unintended negative consequences on the water sector and for customers. Yorkshire Water is concerned that the proposal has the unintended potential to reduce the attractiveness of the water industry to investors, which is contrary to Ofwat's the financeability and investability duties. Yorkshire Water is also concerned that the measure will increase the overall cost of servicing the capital that finances the sector, contrary both to Ofwat's financeability and customer duties. Yorkshire Water is also concerned that this measure will not achieve the effects sought by Ofwat, as the protections it seeks already exist through various other more effective means. Ultimately, Yorkshire Water does not think that the Dividend Policy Modification is in the interests of current or future customers.
- 1.8 For the reasons given in this response, Yorkshire Water is unable to support the Cash Lock-Up and Dividend Policy Modifications. Those modifications do not support Ofwat's customer, resilience or financeability duties – and indeed the changes will likely have the effect of harming investment in the water sector, contrary to the financeability duty and raising costs to customers in breach of the customer and reliance duties.
- 1.9 We would welcome a further opportunity to review and comment on any further iterations of the Proposed Licence Modifications once Ofwat has had a chance to review and consider our representations, and those of other affected stakeholders.
- 1.10 The remainder of this response considers these points in more detail.

2. Yorkshire Water supports a number of the Proposed Licence Modifications

- 2.1 Recognising the importance of financial resilience in the water industry, Yorkshire Water welcomes a number of Ofwat's proposals in the Consultation Paper.
- 2.2 Yorkshire Water supports Ofwat's proposal to maintain investment grade credit ratings from two ratings agencies, as set out in section 4, box 5 of the Consultation Paper. As Yorkshire Water has outlined to Ofwat previously and as also explored below at **section 4**, financial resilience should be measured via a multitude of factors and sources of information. An obligation on water companies to maintain credit ratings from two agencies increases one of the many sources of information required for water companies and Ofwat to monitor financial resilience and is to be welcomed.
- 2.3 Similarly, Yorkshire Water supports a change to the licence to require water companies to notify Ofwat of changes to its credit ratings, as set out in section 4, box 6 of the Consultation Paper, whilst noting such actions are a matter of public record with the publication of updates by credit ratings agencies. This similarly assists Ofwat in monitoring information relating to water companies.
- 2.4 Yorkshire Water also supports Ofwat's call for greater transparency on swaps and pensions liabilities, and its proposal to address improvements in information transparency outside of the licence framework.
- 2.5 In relation to the Cash Lock-Up Modification, Yorkshire Water also welcomes Ofwat's decision to adjust its earlier proposal to link the cash lock-up to service performance.

3. Legal framework

- 3.1 While well known to Ofwat, the statutory, specific and public law duties to which Ofwat must have regard provide a useful analytical framework for considering the Cash Lock-Up and Dividend Policy Modifications. This is particularly the case where Ofwat is exercising its new statutory powers to impose licence modifications on licensed companies for the first time. We set them out below.

Ofwat's statutory duties

- 3.2 Ofwat's primary duties relevant to a licence modification process include:
 - (a) **S.2(2A)(a) Water Industry Act 1991 (WIA91) – the customer duty** – this obliges Ofwat to have regard to the interests of customers in relation to the provision of water and wastewater. The duty is to current *and future* customers (see s.2(2a) WIA91). This means in practice that the customer duty goes hand-in-hand with the resilience duty to protect the long-term interests of the licenced company, its assets, and the services provided to customers;
 - (b) **S.2(2A)(c) WIA91 – the financeability duty** – this obliges Ofwat to ensure that (i) the notionally efficient firm is able to earn profits in line with those that

rise in a competitive market; and (ii) that the efficient firm's cash flows should be consistent with it being able to raise finance on reasonable terms – e.g. to *maintain an investment grade credit rating*; and

- (c) **s.2(2A)(e) WIA91 – duty to further the resilience objective** – the resilience objective includes securing the long-term resilience of water supply and sewerage systems, as well as promoting long-term planning and investment (which intertwines with the (future) customer duty). Ofwat has a related further secondary duty to ensure that water companies contribute to the achievement of sustainable development (see s.2(3)(e) WIA91).

Duties when modifying a licence

3.3 When modifying a licence, Ofwat must, amongst other things:

- (a) **give appropriate weight to its statutory duties** (s.12F(4)(a) and (b) WIA91). Under this heading Ofwat must have regard, and give appropriate weight, to each of its various statutory duties outlined above;
- (b) **ensure its decisions to impose a licence modification are not based, wholly or partly on an error of fact** (s.12F(4)(c) WIA91);
- (c) **ensure that the licence modification achieves the effect stated by Ofwat** (s.12F(4)(d) WIA91); and
- (d) **ensure that the licence modification decision is not otherwise wrong in law** (s.12(4)(f) WIA91). Under this heading, Ofwat must have regard to public law duties, as detailed below, as well as other legal foundational principles relevant to water companies, such as those derived from company law (e.g. directors' duties).

3.4 **Public law duties** – in addition to its specific statutory duties, Ofwat must also have regard to its duty to uphold general public law principles. Public law principles relevant to a licence modification process include:

- (a) **general duty to state reasons for decision:** where a public authority such as Ofwat makes a decision, it must give reasons for that decision. Moreover, public bodies should state reasons in sufficient detail to enable the reader to know how it has reached its conclusion on the “*principal important controversial issues*”;
- (b) **duty to avoid uncertainty:** public authorities such as Ofwat are under a general duty to uphold the principles of legal certainty. Terms that are vague and unclear are liable to be quashed; and
- (c) **duty not to delegate a power unlawfully:** a public authority such as Ofwat cannot delegate its functions (whether expressly on a or *de facto* basis) unless it has specific authority to do so.

3.5 By reference to the above legal obligations, and for the reasons set out in the remainder of this letter, Yorkshire Water is concerned that:

- (a) The Cash Lock-Up Modification is **wrong in law**. It would in effect **improperly delegate** to credit ratings agencies **Ofwat's own statutorily delegated powers and obligations to properly consider the financial resilience of water companies in the round**.
- (b) The Cash Lock-Up and Dividend Policy Modifications, as currently proposed, do not sufficiently demonstrate that Ofwat's statutory duties have been discharged and / or are suitably weighted against one another in the round. On the contrary, the **Cash Lock-Up and Dividend Policy Modifications** would likely lead to an **unintended negative impact on customers** and on **the financeability (particularly investability) of water companies**, in breach of those duties.
- (c) Additionally, Ofwat **has not demonstrated that the Cash Lock-Up and Dividend Policy Modifications achieve Ofwat's stated and intended objectives**, nor has Ofwat **adequately stated the reasons for the modifications**. Indeed, in spite of being encouraged to do so by Yorkshire Water, Ofwat has not published any impact assessment of the Cash Lock-Up Modification in relation to the sector as a whole. As a result, Ofwat has not demonstrated that those changes are in the best interests of customers. In addition, the failure to provide the requisite impact assessment means that interested stakeholders have not been afforded an adequate opportunity to comment on Ofwat's underlying reasoning.

3.6 We consider these points in more detail in **section 4** below.

4. Ofwat's proposed Cash Lock-Up Modification

4.1 Yorkshire Water cannot agree with Ofwat's Cash Lock-Up Modification proposals as contained in the Consultation Paper. There are three main reasons for this conclusion, which we explore in detail below:

- (a) the Cash Lock-Up Modification is a de facto and inappropriate delegation of Ofwat's powers and obligations to credit ratings agencies;
- (b) the Cash Lock-Up Modification does not achieve Ofwat's stated intention of increasing financial resilience in the water industry and it is inconsistent with Ofwat's customer and financeability duties; and
- (c) there have been significant procedural issues in the way that Ofwat has so far consulted.

The Cash Lock-Up Modification is a de facto and inappropriate delegation of Ofwat's powers and obligations to credit ratings agencies

4.2 The Cash Lock-Up Modification would inappropriately delegate Ofwat's duties to further financial resilience in the water sector to credit ratings agencies. The proposal to tie investment grade-level water companies' freedom to distribute dividends directly to their lowest credit rating makes the water industry, and particularly its ability to distribute profits, much more dependent on the opinions of

ratings agencies – and indeed on the individual opinion of just one ratings agency. This *de facto* delegation of Ofwat’s duties as regards the financial resilience of the water is especially problematic in practice when dividend policies are tied to the lowest published rating –⁷ that means that each and every ratings agency can effectively step into the regulatory shoes of Ofwat to disincentivise dividends.⁸ This is inappropriate because:

- (a) as explored more below at paragraph 4.6, the assessment of financial resilience is much wider than just the factors taken into account in a credit rating agency’s opinion;⁹
- (b) credit ratings agencies have produced ratings in the past that have not accurately reflected the positions of individual of water companies;¹⁰
- (c) relatedly, credit ratings agencies have been shown to put water companies on negative outlook or on review for a downgrade with no actual subsequent downgrade – so such outlooks are even more inappropriate for these purposes;¹¹
- (d) credit ratings agencies’ views are based on short-term horizons (generally no more than five years), which is an inappropriate measure of financeability for an industry characterised by long-term investments and debt instruments;
- (e) credit ratings agencies inevitably base their decisions on less information than is available to water company boards and to Ofwat;
- (f) moreover, there is untoward circularity in this proposal as the decisions of credit rating agencies are heavily influenced by Ofwat publications and decisions, including on other regulated entities and the sector as a whole. For instance, during the PR19 CMA redetermination, Moody’s put all appellants on a ‘negative outlook’ for a considerable period of time and only returned companies back to ‘stable outlook’ after the CMA reached its final decision.

4.3 Further, the Cash Lock-Up Modification mandates that lock-up will come into effect when *any* of a water company’s credit ratings is below the specified levels, giving each credit ratings agency a significant amount of power over the water companies. Any rogue rating could activate lock-up.¹²

4.4 The Consultation notes that licensees can ask Ofwat for permission to make distributions even if below the ratings threshold and therefore considers that the proposal will not mean over-reliance on credit ratings as a metric.¹³ This is not an adequate safeguard as it: (i) excessively inhibits a water company’s ability to

⁷ Financial Resilience Paper, section 4.2.

⁸ Financial Resilience Paper, section 4.5.

⁹ See also Financial Resilience Paper, section 4.1.

¹⁰ Financial Resilience Paper, section 4.3.

¹¹ Financial Resilience Paper, section 4.5.

¹² Financial Resilience Paper, section 4.4.

¹³ See page 21 of the Consultation Paper.

operate its equity and debt financing (including the payment of dividends) in the normal course of business whilst it is operating at investment-grade credit ratings levels (which, as evidenced above in paragraph 4.2(f), may be for a considerable period of time); and (ii) gives inappropriately wide discretion to Ofwat while providing no indication as to the circumstances in which permission for e.g., dividends, would be granted. As a result, investors/creditors are unlikely to be reassured that this proposed measure would adequately protect their interests.

- 4.5 In short, as we have clearly evidenced, an accurate view of a water company's financeability and financial resilience has to be based on a broader set of factors than simply the credit rating that the company receives from a limited number of credit rating agencies.¹⁴ It is inappropriate to place de facto determinative responsibility for a cash lock-up (a measure to protect financeability and financial resilience) upon a credit rating decision of a single credit rating agency.

The Cash Lock-Up Modification does not achieve Ofwat's stated intention of increasing financial resilience in the water industry, and it is inconsistent with Ofwat's statutory duties

- 4.6 Yorkshire Water agrees with Ofwat that a wide range of information and sources must be taken into account when assessing the financial resilience of a water company.¹⁵ Indeed, as Yorkshire Water has previously submitted, credit ratings are only one such source and do not take account of a range of factors relevant to financial resilience. In its paper written with Interpath, "Assessing financial resilience",¹⁶ Yorkshire Water demonstrated that financial resilience should be assessed with regard to an overall balance between a water company's profits and cash generation, governance and controls, liquidity and debt servicing, equity and investors, financing profile and structures and other relevant factors such as pension schemes and stakeholder relationships. While Ofwat has made statements apparently endorsing the position that a range of information must be taken into account in assessing financial resilience, in reality, the Cash Lock-Up Modification runs contrary to these principles. As we demonstrate below in more detail, the Cash Lock-Up Modification (a) inappropriately limits the assessment of financial resilience to credit ratings; (b) places overreliance on credit ratings, which have proven in numerous instances to provide an inaccurate perception of debt markets' views on creditworthiness; (c) will impact customers; and (d) has been advanced without the required level of evidence needed to implement such a change, such as an impact assessment that has been subject to challenge.

¹⁴ For more context to the assessment framework necessary to assess financial resilience, please see Yorkshire Water's and Intralinks' July 2022 paper "Assessing financial resilience" available at [Interpath Talkbook Template \(ofwat.gov.uk\)](https://www.ofwat.gov.uk/interpath-talkbook-template).

¹⁵ See pages 8–9 of the Consultation Paper, where Ofwat states that its assessment of financial resilience has taken into account a range of financial measures, such as interest cover, gearing, liabilities not reflected in gearing such as swap mark-to-market valuations and pension obligations, as well as other information, such as disclosures published in annual performance reports (APRs), operational performance and the potential consequences of enforcement action.

¹⁶ Please see Yorkshire Water's and Intralinks' July 2022 paper "Assessing financial resilience" available at [Interpath Talkbook Template \(ofwat.gov.uk\)](https://www.ofwat.gov.uk/interpath-talkbook-template).

- (a) **Financial resilience is more than just credit ratings:** Firstly, the Cash Lock-Up Modification inappropriately conflates credit ratings with a multi-faceted assessment of financial resilience. Ratings agencies measure specific metrics, and ratings are viewed as determining credit worthiness,¹⁷ and not financial resilience in the round – which, as mentioned above, is a product of a wide range of assessment factors.

In the Consultation Paper, Ofwat rejects the views of the majority of respondents to the Consultation that its proposals are overly reliant on credit ratings in assessing financial resilience.¹⁸ However, as noted in the Financial Resilience Paper, the one notch change to BBB/Baa2 materially changes the status of the ratings agencies' opinions compared to the status quo: "*Ofwat is no longer just codifying the practical steps that it expects a company to take as it uses all reasonable endeavours to stay at investment-grade. It is going further and saying that it will harness the rating agencies' published output both to "incentivise" companies and to define what is ultimately a much less tangible boundary between deemed financial resilience and non-resilience.*"¹⁹ And indeed, an incorrect credit rating will have a greater a punitive effect on water companies than it would have under the current framework.²⁰

- (b) **The Cash Lock-Up Modification's inappropriate overreliance on credit ratings:** Secondly, there are numerous examples of how, in practice, credit rating agency opinions do not accord with how the debt markets view a specific water company's "credit" – i.e. financial risk and resilience – as seen by the way in which individual water companies' debt is priced by the market. For example:

- (i) Despite Moody's rating Severn Trent Baa1 and Yorkshire Water Baa2 following the CMA's PR19 Final Redetermination, the spread to benchmark gilts showed similar spreads on two comparable long-term bonds issued by the two companies.²¹
- (ii) When a company has split credit ratings (i.e. where one credit rating agency is an outlier by comparison to other agencies – say where one rating is lower than others), lenders will not default to perceiving the company's creditworthiness by virtue of the lowest rating. Lenders will instead look at the specifics of rating agencies' differing opinions and form their own views²² – and therefore the outlier rating will tend to be discarded in favour of lenders' views.

¹⁷ Financial Resilience Paper, section 4.

¹⁸ Consultation Paper, p. 21.

¹⁹ Financial Resilience Paper, section 4.2.

²⁰ Financial Resilience Paper, sections 4.2 and 4.4.

²¹ As described in detail in Yorkshire Water's letter to Ofwat dated 13 December 2021.

²² Financial Resilience Paper, section 4.4.

- (c) **The Cash Lock-Up Modification will impact customers:** Thirdly, credit ratings are also used in financeability assessments, which impact water companies' allowable revenues. Given that the notional company target rating was agreed at PR19 to be two notches above the current licence cash lock-up trigger, Ofwat's proposal to increase the credit rating level in the Cash Lock-Up Modification, without also increasing the credit rating of the notional company by the same increment, is entirely inappropriate. By not doing so, the Cash Lock-up Modification proposal fails to address the impact that this would have on costs to customers and is contrary to both Ofwat's customer and financeability duties.
- (d) **No impact assessment and a lack of evidence:** Finally, as we explore below in more detail at paragraph 4.12, Ofwat has failed to demonstrate that it has conducted a robust impact assessment. It has provided no analysis demonstrating that the Cash Lock-Up Modification would result in benefits to customers, or indeed that the detriment to customers would be outweighed by an improvement to financial resilience of water companies. As explored in more detail in the Financial Resilience Paper, the purported benefits to water companies' financial resilience have been overstated.²³ Put simply, Ofwat has not demonstrated that the Cash Lock-Up Modification will have its stated intention of increasing creditworthiness, or that Ofwat has suitably balanced the customer, resilience and financeability duties against one another.

4.7 There are several key (and unintended) consequences of the above issues, all of which run contrary to Ofwat's duties:

- (a) Water companies will be restricted in the choices available to them when deciding upon their optimal capital structure.
- (b) For many companies, it imposes a new regulatory covenant, which for the avoidance of doubt is stricter than the covenants creditors expect, thereby having a material adverse impact on the cost of equity given the higher risk of being in lock-up.
- (c) As equity assets, water companies are currently attractive to investor groups precisely because their dividends are stable. Water companies would become less attractive to such investors due to the Cash Lock-Up Modification.
- (d) Taken together, these factors will diminish the attractiveness of water companies to equity investors and make them less investable.

4.8 Ofwat states in the Consultation Paper that it *"does not expect resilient companies to be impacted by our proposal and we are not convinced that they need to increase levels of headroom to accommodate this proposal"*.²⁴ Yet clearly, **all** water

²³ Financial Resilience Paper, section 4.1.

²⁴ See pages 19–20 of the Consultation Paper.

companies (and their equity investors) are concerned. The Consultation Paper details that “no water company or equity investor that responded to the discussion paper expressed support for raising the trigger to BBB/Baa2 with negative outlook” – and indeed that only one respondent supported raising the trigger to BBB-/Baa3.²⁵ The entire water industry recognises the investability issues that will come with the Cash Lock-Up Modification.

- 4.9 Instead, rather than furthering the financial resilience objective (and customer duty) by ensuring that the cost of water companies’ financing remains steady, the Cash Lock-Up Modification will likely give rise to higher costs, with no evidence of customer benefit. The Consultation Paper incorrectly suggests that the Cash Lock-Up Modification does not require licensees to increase headroom. To the contrary, even to keep the level of headroom constant would result in higher costs to customers.
- 4.10 As a result, the Cash Lock-Up Modification, as proposed, does not support Ofwat’s financeability duty, is in breach of its public law duties and would likely have a detrimental effect on water customers if implemented due to higher costs of financing (and therefore likely higher bills for customers).
- 4.11 Finally, on technical points, firstly, the text of the proposed condition applying the Cash Lock-Up Modification is inconsistent in the Consultation Paper. Under the drafting in the body of the Consultation Paper, a company will be in lock-up if (a) it has a speculative-grade/junk rating (P27.2.1); (b) it has a BBB/Baa2 rating that is on review for possible downgrade, is on “Credit Watch” or “Rating Watch” with a negative designation (P27.2.2.1); or (c) it has a BBB/Baa2 rating and the rating outlook is negative (P27.2.2.2).²⁶ However, the text being consulted on in Annex A3 of the Consultation Paper changes condition (c) to having a BBB/Baa2 rating and “the rating outlook has been changed from stable or positive to negative”.²⁷ The latter wording would mean that a company with a BBB/Baa2 rating on negative outlook when the Cash Lock-Up Modification comes into force would not be captured. Even more fundamentally, companies with BBB-/Baa3 ratings (i.e. worse ratings than BBB/Baa2 with negative outlook) at the time that the Cash Lock-Up Modification comes into force are not captured under either formulation presented in the Consultation Paper. This means that the current wording of the Cash Lock-Up Modification does not fully cover the extent of Ofwat’s intentions. Secondly, we believe the current drafting does not fully take account of the inherent position that exists in the sector of companies having issuer and issue ratings and should reference whatever rating underpins debt issuance.

There have been significant procedural issues in the way that Ofwat has so far consulted on the Cash Lock-Up Modification

- 4.12 During the roundtable discussion of 17 August 2022, Yorkshire Water asked Ofwat to present the results of any impact assessment that Ofwat had conducted in relation to the costs and benefits of the proposal. Ofwat stated that it had conducted an

²⁵ See page 16 of the Consultation Paper.

²⁶ See page 25 of the Consultation Paper.

²⁷ See page 55 of the Consultation Paper.

analysis across sectors when formulating the proposed cash lock-up trigger, but that it did not intend to publish its analysis. Ofwat is under a public law duty to give adequate and intelligible reasons for its decisions – and its impact assessment thus has to be open for stakeholder scrutiny. As it currently stands, stakeholders are unable to effectively comment on the reasons for the Cash Lock-Up Modification because Ofwat’s impact assessment has not been made available. Yorkshire Water is concerned that the same issue that arose during the PR19 deliberations on gearing outperformance sharing mechanism are relevant again here. It is not the intention of Yorkshire Water to repeat the findings of the CMA on this issue in full. However, the CMA found there that Ofwat had presented “*weak evidence of a regulatory gap*” that such a mechanism was needed.²⁸ The CMA found that it had “*not been presented with evidence demonstrating that either the risks or consequences of these companies experiencing financial failure are likely to be large.*”²⁹ Yorkshire Water considers that this applies equally to the Consultation Paper, which has similarly not demonstrated the impact on water companies and references the CMA findings only to support this concern.

Conclusion on Ofwat’s proposed Cash Lock-Up Modification

- 4.13 On the basis of these concerns, Ofwat’s proposed Cash Lock-Up Modification is not consistent with its statutory duties. The modification will have an overall negative and unjustified impact on costs to water companies (and ultimately their customers) and should therefore be withdrawn.

5. Ofwat’s proposed Dividend Policy Modification

- 5.1 Yorkshire Water understands that the Dividend Policy Modification is intended to enable companies and boards to consider performance widely and take into account relevant factors when taking decisions about paying dividends to shareholders. Yorkshire Water appreciates the clarification made by Ofwat at the August 2022 roundtable discussions that it is seeking to avoid provisions that are overly prescriptive and based on an inappropriately narrow set of criteria. Similarly, Yorkshire Water is cognisant of the wider context in which the proposal is made, in particular the need for leadership by companies on this issue, and Ofwat’s view that the proposals are at the modest end of the options available to it.
- 5.2 However, notwithstanding Ofwat’s intentions and the relevant context, Yorkshire Water’s view is that the Dividend Policy Modification:
- (a) would reduce the attractiveness of the water industry to investors, contrary to Ofwat’s financeability duty;
 - (b) would undermine the servicing of investor capital, further undermining Ofwat’s financeability duty;

²⁸ CMA PR19 redetermination final report, paragraph 9.1223.

²⁹ CMA PR19 redetermination final report, paragraph 9.1223.

- (c) will not achieve the effects sought by Ofwat, as the protections it seeks already exist through various other more effective means; and
- (d) is ultimately not in the interests of water customers.

The Dividend Policy Modification has the potential to reduce the attractiveness of the water industry to investors, contrary to Ofwat's financeability duty

- 5.3 Yorkshire Water supports the promotion of service delivery, environmental protection, and performance obligations in the water industry. It considers the current framework for the promotion of those goals to be important in upholding service levels for current and future water customers – and indeed for promoting resilient water companies over the longer term.
- 5.4 However, the Dividend Policy Modification is not an appropriate method through which to promote these goals. In fact, the Dividend Policy Modification has the potential to lead to too much regulatory intervention on dividend policies and will be viewed negatively by potential investors. Equity investors in the water industry are long-term investors that require steady returns over the longer-term to justify their investments. Given the nature of the conditions that are included in the Dividend Policy Modification there is potential for the changes to lead to volatility in dividend payments. This is likely to dissuade equity investors from continuing to invest in the water industry, which indicates that the Dividend Policy Modification is contrary to Ofwat's financeability duty.
- 5.5 It is clear that the water industry agrees with Yorkshire Water regarding its rejection of the Dividend Policy Modification: only 1 of 25 respondents to the January 2022 financial resilience consultation supported the need to align the licence more closely to Ofwat's expectations on service delivery and performance obligations in the way envisaged in the Dividend Policy Modification.

The Dividend Policy Modification will undermine the realisation of returns for capital supporting companies,, further undermining Ofwat's financeability duty

- 5.6 Yorkshire Water continues to work within the existing policy guidance provided by Ofwat when considering and proposing dividends. However, it is also important for the cost of capital for the whole industry, and hence in the best interests of consumers, that operating companies are able to service capital used to support companies, provided always that it is done in a way that conforms with the policy that Ofwat has established. Indeed, given the political pressure on the sector at present, water companies also need support from Ofwat for these dividends, where appropriate, reflecting the benefit to consumers of keeping overall cost of capital as low as possible whilst maintaining financial resilience.

The Dividend Policy Modification will not achieve the effects sought by Ofwat, as the protections it seeks already exist through various other more effective means

- 5.7 Yorkshire Water also considers that the Dividend Policy Modification is an unnecessary duplication of regulation, because:

- (a) At PR19 dividend policies were refreshed. It is unclear what additional protection the Dividend Policy Modification seeks to give above the dividend policy protections added during that recent refresh, and as a result, Yorkshire Water does not consider that there is any need for change.
- (b) Relatedly, Yorkshire Water considers that even if the Dividend Policy Modification were to offer additional protection, the application of additional transparency and disclosure during the PR19 refresh should first be assessed over the full AMP7 period, rather than be amended mid-AMP. Yorkshire Water does not consider that enough time has elapsed since the previous change to assess whether it has had the desired effect.
- (c) Service obligations are already provided for within the framework of outcomes-based regulation. The ODI regime provides adequate incentive to ensure service levels are efficiently upheld through challenging performance commitments. The Dividend Policy Modification is not an effective means of upholding service levels – the ODI regime is already extremely complex and linking dividends to service levels in the same way would increase the complexity, inaccuracy, and subjectivity of such measures.
- (d) Further, beyond these extra protections specific to the water industry, a number of the issues that Ofwat is seeking to address with the Dividend Policy Modification are already covered in sufficient detail in the existing requirements in regulatory accounting guidelines and BLTG principles, and the proposed Dividend Policy Modification appears to be introducing a level of unnecessary ambiguity into the licence.
- (e) Finally, in addition to other existing regulatory protections, directors on the boards of water companies are also subject to the usual company law duties in awarding dividends, including those under sections 170 to 174 of the Companies Act 2006.

5.8 The above protections are all more effective ways of upholding service levels, environmental protections, and performance obligations – and they work together to ensure that water companies are already sufficiently incentivised to achieve these goals.

Conclusion on the Dividend Policy Modification

5.9 Yorkshire Water therefore is unable to agree to the Dividend Policy Modification as it is inconsistent with Ofwat’s relevant statutory duties and should be withdrawn.