Water UK response to Financial resilience in the water sector: a discussion paper

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Summary

Water UK is the representative body and policy organisation for water and wastewater service providers across the UK. We welcome the opportunity to respond to Ofwat's discussion paper on financial resilience in the water sector. This response represents the considered and consolidated views of Water UK's members, and should be read alongside our forthcoming response to the separate discussion paper on risk and return[1].

We agree that water companies should have the financial resilience needed to meet customers' needs at all times, and we start from considering those needs in the long-term. This is in line with Ofwat's PR24 principles and objectives[2] and broader direction of travel signalled in recent PR24 discussion papers, including on the development of long-term delivery strategies to be tested against a range of scenarios aimed at capturing, in part, some uncertainties facing the sector.

The need for substantial, sustained new capital investment is well known and well documented. Work by the National Infrastructure Commission (NIC)[3] suggests that £21bn of new investment would be required to address the supply demand imbalance in water resources. More recently, there has been significant focus on the need to invest to improve river quality, including through reducing water abstraction and reducing the harm from combined sewer overflows[4]. In addition, Water UK's own work on achieving Net Zero suggests some £2-4bn of investment will also be required[5].

This will require the sector to attract and retain new and long-term capital in a competitive and international market for that investment, with much of that needed precisely in the next five-year period.

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[1] https://www.ofwat.gov.uk/consultation/pr24-and-beyond-discussion-paper-on-risk-and-return/

[2] See: https://www.ofwat.gov.uk/wp-content/uploads/2021/05/PR24-and-Beyond-Creating-tomorrow-together.pdf pp.3 in which Ofwat sets out its desire to 'focus on the long term'

[3] See: https://nic.org.uk/app/uploads/NIC-Preparing-for-a-Drier-Future-26-April-2018.pdf pp.4

[4] EAC, 2021, Water quality in rivers, see: https://committees.parliament.uk/publications/8460/documents/85659/default/ The summary of the report notes: *'The sewerage system is overloaded and unable to cope with the increasing pressures of housing development, the impact of heavier rainfall, and a profusion of plastic and other non-biodegradable waste clogging up the system. Successive governments, water companies and regulators have grown complacent and seem resigned to maintaining pre-Victorian practices of dumping sewage in rivers. There has been investment in the network since privatisation, but underlying problems have not been resolved and capital investment has not kept pace with housing and other development pressures on the drainage and treatment network.'*

[5] See: https://www.water.org.uk/routemap2030/wp-content/uploads/2021/03/Water-UK-Net-Zero-2030-Routemap-Summary-updated.pdf pp.7

Without that investment, the detriment to consumers and the environment would be very significant[6] (for example the NIC report notes that the impact of not investing could be c.£40bn) and we consider that PR24 needs a greater focus on supporting this investment. Indeed, one of the reflections on last price review has been that there was too strong a focus on short-term bill reductions[7].

We also note that one of the fundamental underlying principles of UK water sector regulation since privatisation, and a reason behind the success of the model, has been that it has been accepted that companies, their shareholders, and their management teams are best placed to make decisions about raising finance and designing efficient capital structures.

It is in this broader context that we consider the specific proposals in the discussion paper. Our overarching question is whether the proposals would help, or hinder, the greater focus on supporting investment that is needed at PR24 to meet the long-term needs of customers.

Our overall observation is that we do not recognise the concerns expressed in the discussion paper which have led Ofwat to make a series of proposals for potential interventions. For Ofwat to consider implementing measures along the lines consulted on would be an unprecedented step, not only in the water sector but across all regulated sectors, which would need an overriding and compelling case underpinned by the strongest possible evidence.

However, Ofwat's present argument in support of intervention, as set out in the discussion paper, appears to rest on an assumed correlation between specific individual and unrelated cases of operational failures and financial stress. In the case study Ofwat cites of this assumed correlation, causation is not established, and Ofwat offers little else as evidence of customer harm more broadly across the sector.

Given that a number of the measures that have been consulted on would risk unintended consequences or side effects that are not in the customer interest, a much stronger evidence base would be required to justify interventions of this nature, and in particular to justify any changes to companies' operating licences.

Turning to the specific proposals, our main comments are:

- We agree that financial resilience is a wider concept than focusing on one specific metric. Companies would welcome engagement with Ofwat around defining financial resilience in way which considers a range of factors, including regulatory protections, corporate governance arrangements, credit rating methodologies and measures of equity financial resilience. We support the proposal **not to set pre-determined limits on capital structure**, which could reduce companies' flexibility to address changing circumstances and investment programmes.

[6] This is for example why regulators including Ofwat at PR04, PR09 and PR14 as well as the CMA have tended to 'aim-up' in setting the allowed cost of capital as, given the essential services companies provide, the detriment to consumers and the environment is greater if the return is set too low than if it is set too high, see for example the CMA redeterminations from the PR19 water appeals at: https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf pp.1094-6

[7] For example the EAC 2021 report on Water quality in rivers raised this concern and this was raised by the disputing companies in the PR19 CMA redeterminations where the CMA did increase both levels of investment and the allowed return

- We consider the **appropriate level for the cash lock-up condition should remain unchanged** at the lowest investment level credit rating with a negative designation.

- We support companies being required to submit a financial resilience plan to Ofwat when they are one notch above the minimum investment credit rating with a negative outlook as a proportionate way of monitoring companies' financial resilience.

- We do not support **linking the cash lock-up condition to service performance** because service performance can be temporarily affected by a range of external factors, an intervention along these lines would be disproportionate, and it would be difficult to define appropriate performance thresholds. We consider Ofwat has other, more appropriate, tools to improve service performance, in particular the effective calibration of the outcome delivery incentive (ODI) framework.

- We support Ofwat's view that decisions about dividends are the responsibility of the boards of water companies, and note that investors in water companies accept a lower equity return for dividend stability as that often matches their own cashflow needs. At PR19, companies aligned their dividend policies for 2020-25 with Ofwat's expectations. Therefore, we do not consider Ofwat needs to put its expectations on dividends into the licence or formally link dividends to service performance.

- We support companies notifying Ofwat of changes to credit ratings, increased transparency on the use of swaps and increased transparency on pension obligations.

- Related to financial resilience, we remain very concerned that Ofwat are exploring **further a potential reduction in the notional company gearing assumption**. As we will explain in our separate response to the separate discussion paper on risk and return, we consider the economic rationale for adopting a notional structure does not support Ofwat's proposals to adjust notional gearing because the level proposed would not represent an efficient water company.