

AffinityWater

AFW136 Affinity Water response to Ofwat's request for views on additional financial resilience protections



Contents

Affinity Water response to consultation on gearing cap	3
Introduction	3
Gearing is not an appropriate single measure of financial resilience	4
Affinity Water has gearing over 70% and is financially resilient.....	5
Regulatory role in financial resilience	6
The current financial resilience framework is sufficient	8
Thames Water.....	9
Further considerations.....	10
Licence modification is the only appropriate route if Ofwat persist with gearing restrictions	10
Regulatory inconsistency.....	10
The consequences of regulatory uncertainty	10

Affinity Water response to consultation on gearing cap

Introduction

The issue of financial resilience has been subject to significant consultation¹ over the last five years, culminating in a formal licence modification in March 2023.

We are therefore concerned that, despite an extensive engagement process which was concluded only last year, as well as the existence of other significant regulatory protections to mitigate financial risk, gearing is again being considered as a means to manage and penalise companies.

No evidence or supporting analysis accompanies the draft Determination to explain why the existing measures, including the ones only adopted last year, are insufficient or why it is now necessary to consider different approaches that have been previously ruled out by Ofwat.

It is also concerning that one of the potential (and arbitrary) restrictions in the draft Determination is a 'dividend lockup' for companies with gearing above 70% via alternative routes than a licence condition, either through company dividend policies or by applying downward adjustments to companies RCVs for any dividends paid by companies that have gearing exceeding 70%.

Such restrictions, unsupported by any evidence of their necessity or utility, set at arbitrary levels and applied in a uniform way across the industry without taking into account the specific circumstances of each company, are a serious cause for concern.

Previous attempts to introduce regulatory mechanisms to penalise companies for perceived high levels of gearing were either unsuccessful² or were abandoned³. It is not clear why Ofwat now consider it is appropriate to ignore the findings of the formal Licence Modification consultation and its conclusions, or indeed the CMA's advice during the PR19 appeals which shows that the assessment of financeability is highly individual for companies and blunt instruments like caps are inappropriate.

It is not clear what customer benefit will be delivered from such proposals, or if the potential negative consequences of any introduction have been appropriately considered. As set out in Chapter 2 of the Representation, such an introduction is likely to have the perverse effect of reducing the investability of the sector and creating disbenefits for customers by increasing the cost of debt and equity unnecessarily.

¹ Discussion Paper on Financial Resilience (Dec 2021), Licence Modification consultation (July 2022), Licence Modification in March 2023

² The Gearing Outperformance Sharing Mechanism (GOSM) was overturned by the CMA in the PR19 redeterminations and not included in PR24

³ As part of the Licence Modification process in March 2023

Gearing is not an appropriate single measure of financial resilience

As we have previously indicated through the lengthy consultation process on the licence modification, we fundamentally disagree with any approach that uses company gearing as a single measure of financial resilience.

Ofwat agreed with this position in 'Financial resilience in the water sector: a discussion paper' (December 2021), which stated that:

'There is no single measure of financial resilience. All else equal, high levels of indebtedness (measured as gearing and defined as net debt:RCV) can exacerbate the effects of a financial shock. That said, there are many other factors that are relevant to an assessment of financial resilience, including debt financing costs and the consequences on cashflows of adjustments for service performance.'

In the same document Ofwat also stated that:

'defining limits on gearing is unlikely to capture the full range of risks to financial resilience'

Ofwat repeated this exact conclusion in its 'Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers' (March 2023) when considering the same matter.

Moreover, the proposed imposition of a dividend lock up for companies that have gearing over 70% because they 'may' not be financially resilient is inconsistent with how Ofwat assess companies' financial resilience.

Ofwat assesses the financial resilience of water companies on an annual basis in the Monitoring Financial Resilience Report. However, it does not limit this assessment on the companies gearing. Instead, in the 2022-23 report Ofwat explained that:

'We collect and consider relevant financial data and non-financial information from a range of sources, over time and in the round, and apply judgement in forming our view on companies' financial resilience.'

The proposed gearing cap is a blunt approach that does not consider financial data and non-financial data from a range of sources, and does not use any judgement in forming a view on a company's financial resilience (contrary to Ofwat's own approach in assessing financial resilience). From the brief description of the proposed approaches under consideration in the draft Determination, it appears the intention would be to apply a gearing 'cap' uniformly across the entire industry without allowing any room for an individualised assessment of financeability.

Affinity Water has gearing over 70% and is financially resilient

Another clear way to illustrate that gearing is not an appropriate single measure of financial resilience is to more thoroughly consider the financial resilience of Affinity Water, a company with gearing above 70%.

The Monitoring Financial Resilience Report 2022-23 states that:

'The type of matters that we take into account and that can impact on a company's financial resilience long term, and that might lead to an increase in our prioritisation for monitoring and engagement include:

1. A weakening trend across key credit metrics, alongside lower credit ratings and the risk of downgrade.
2. The scale of investment needed to address current performance relative to financial headroom.
3. The complexity and risk presented by a financial structure or arrangement in place.
4. Risks associated with undertaking a large capital project or implementation of new systems and processes.
5. The impact of potential financial penalties or remedial measures including as a result of potential regulatory enforcement action.
6. A lack of transparency around key policies and reporting and falling below expectations, including in regard to dividend policies and LTVS.'

Regarding item 1, Affinity Water has strong credit ratings (Class A debt A3/BBB+/BBB+) in line with Ofwat's expectation and expectations of our lenders. The Monitoring Financial Resilience Report 2022-23 shows that in terms of lowest monitored credit rating as at 31 March 2023, there are **8** companies with lower ratings.

When considering the scale of investment needed to address current performance (item 2) we have outlined the relative size of our plan in below (item 4). In terms of performance, Affinity has been categorised as an 'average' performer since 2020/2021 in the annual Performance Reports published by Ofwat. Recent performance data for 2023/2024 demonstrates that our performance continues to improve and Affinity Water is one of the top performing companies in the sector.

Our financing structure (item 3), which is a Whole Business Securitisation, is well established and well understood by investors and regulators. The structure is designed to complement the regulatory environment as provided for in the Water Industry Act 1991. It is not complex and places significant limits on the level of financial risk that the company can be exposed to. For example; a limit on interest rate exposure; a limit on the amount of debt maturing in any AMP period; a limit on subordinate debt; covenant and **rating triggers to act as early warning indicators**; and various limits on risk taking.

We have a small amount of debt above the securitised structure ('Holdco') which represents less than c.2% of RCV. The income needed to service the Holdco debt has never been funded by dividends from the appointed business.

In terms of item 4, whilst our AMP7 business plan was the largest in our history, we have delivered on this over the last 4 years, despite significant challenges arising from the global Covid-19 pandemic and volatile macro-economic factors.

Whilst our AMP8 draft Determination is another step up in required statutory investment, it is a considerably smaller increase relative to other water and wastewater companies in the sector. Indeed, according to the draft Determination, Affinity Water are one of only two notional companies that do not require an equity injection to fund the increased investment in the notional world during AMP8 according to Ofwat's analysis.

Finally, taking both items 5 and 6 together, we have no material regulatory enforcement actions and no material concerns have been expressed about our Long Term Viability Statement or Dividend Policy.

The draft Determination highlighted the actual dividend yield provided in our September 2023 business plan being above the 4% expectation. Our Representation sets out that the lack of corporate financial theory underpinning the assumption that 4% dividend yield can be held constant across both the notional and actual capital structures when the relative equity differs.

Despite Affinity Water's gearing exceeding 70%, there are no significant concerns with the company's performance against the criteria set by Ofwat relating to 'matters that can impact a company's financial resilience', illustrating that gearing is not an appropriate single measure of financial resilience.

Regulatory role in financial resilience

The regulatory approach already exerts significant control over many of the elements that determine the level of financial resilience of companies.

The cost allowances that a company receives are set by the regulator, based on an assessment of those required by the efficient notional company, which is generally benchmarked to the upper quartile efficient level of costs. This indicates that at the start of a new price review period, three quarters of the industry face a financial resilience problem, as cost allowances do not cover anticipated costs. The issue exists even before the potential for miscalibration of the cost allowances, which could exacerbate the gap between the notionally efficient firm and the realities of water companies.

Secondly, the regulator sets the parameters that determine the risk and return balance and again any miscalibration of this will create penalties that affect the company's ability to raise revenue.

An example of this is in the setting Performance Commitment levels, where Ofwat have historically targeted upper quartile levels, meaning that at the start of any price review period, three quarters of companies are not delivering the required performance targets and are effectively exposed to a downward skew in the risk and return balance. Similarly, there is not a symmetrical application of performance incentives (with many 'penalty only' measures) in the current regulatory framework, which contributes to the over exposure of penalty risk for companies. The exposure to financial penalties ultimately affects a company's ability to maintain financial resilience.

Finally, a key duty of the regulator is setting the allowed return. The CMA noted that setting the WACC is the primary factor for ensuring that an efficient firm can finance its functions.

Ofwat's allowed WACC at PR19, which the CMA increased in its redetermination, was in effect a regulatory miscalibration that did not reflect either the appropriate market cost for debt or equity. Again, this affects companies' ability to manage financial resilience as it calls into question the investability of the sector and could lead to a lack of equity investment.

Despite the extensive analysis and recommendations outlined in the PR19 CMA Appeals, Ofwat's approach to setting the WACC at PR24 selectively ignores many of the findings and risks repeating the mistakes of PR19.

Ofwat have previously cited concerns with financial resilience at Southern Water and the current situation at Thames Water as evidence that high gearing is a problem. However, in both of these cases it is not the level of gearing that has caused the issues at these companies, rather it is a failure to live within upper quartile cost allowances set by the regulator, a failure to meet upper quartile performance commitment levels and the realisation of downward skewed return on regulated equity.

The regulatory focus on the financeability of the notional company is simplistic and does not take account of the multitude of factors affecting financial resilience.

The gap between the efficient notional company and the real-world is now so large that notional company financeability does not translate into actual company financial resilience. It is implausible to assume this is solely the result of a difference between companies actual capital structures and the regulatory specification of the notional capital structure.

A clear example of this is the decision by Ofwat to reduce the notional company gearing to 55% for PR24, despite it not reflecting the realities of companies' actual capital structures. In the Final Methodology consultation, many companies highlighted that even at a 60% gearing level (which was consistent with PR19 and the CMA redeterminations) the efficient notional company would not maintain Baa1/BBB+ credit ratings, which points to factors outside of actual capital structure causing a financeability problem.

To overcome this issue, Ofwat has assumed that the notional company could simply access notional equity to achieve the lower gearing level.

Unlike the notional equity issuance that the regulator 'secured' in the notional world, in the real-world de-gearing depends on equity injections from investors. However, investors will not be forthcoming if the job of equity is to plug structural gaps in financial resilience inherent in the regulatory settlement.

Given the sole discretion that Ofwat have in setting the vast majority of factors that influence financial resilience, it is surprising that Ofwat attribute any concerns with company financial resilience solely to one of the only factors management and shareholders can influence i.e. gearing.

Under the current system of economic regulation, the role of equity is to support capital investment, equity is not designed to plug structural gaps in financial resilience inherent in the regulatory settlement. It is unlikely that equity will be forthcoming until Ofwat provide the conditions necessary to secure real world financial resilience.

The current financial resilience framework is sufficient

The existing regulatory framework, which has recently been strengthened, already contains significant protections that seek to insulate the regulated company and customers from the risk of financial distress. These include: licence requirement to maintain investment grade credit rating, cash lock-up, Special Administration, Ofwat's finance duty and risk allocation mechanisms that should, in theory, provide a fair balance of risk and return for companies.

Moreover, the 2023 licence modification introduced a licence requirement to ensure that dividend policies and dividends 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. From 1 April 2025 it will also see the cash lock up increase to Baa2/BBB with negative outlook (from Baa3/BBB- with negative outlook).

This extensive existing framework is sufficient and much more sophisticated than any proposed gearing cap. We are concerned that Ofwat has not provided any evidence or analysis as to why (i) this framework is insufficient (despite having been further strengthened only last year) or (ii) a gearing cap would be an appropriate addition to the existing control framework (after having been ruled out only last year).

Thames Water

We note that the main development since Ofwat previously considered financial resilience and the potential for a gearing cap in March 2023, has been the current situation at Thames Water. It is therefore reasonable to assume that the gearing cap proposals are connected to the recent events at Thames Water.

For the avoidance of doubt, we are not making comment on the specific situation at Thames Water but rather using this live example to highlight issues in a wider sense.

It seems unlikely that Thames Water operating company gearing over 70% by itself has caused, or would cause, financial difficulties for a water company. A more pertinent issue is if the company fails to generate the necessary cashflows (for whatever reason) from the regulatory settlement.

Even if gearing was 50%, a company that doesn't (for whatever reason) perform in line with its regulatory settlement would encounter financial difficulties.

In theory, a 50% geared company is more financially resilient, but in practice, gearing headroom is **not** a valid mitigation against failure to meet the demands of a regulatory settlement.

Debt and equity investors will not invest in a company (regardless of gearing) if they believe that there is a structural gap between its costs and its revenue that cannot be solved by a high performing management team.

In any event, we note that the specific circumstances of an individual company cannot be used to draw conclusions about the entire industry in circumstances where the assessment of financial resilience is highly individualised and should have regard to a variety of financial and non-financial metrics (as per Ofwat's own practice to date). Extrapolating a concern and remedy for the entire industry based on the specific circumstances of a single individual company is not best regulatory practice.

Further considerations

We see no evidence that the introduction of a gearing cap is necessary or desirable, nor any analysis or serious thought about the possible negative consequences for applying such a blunt instrument has been properly considered.

However, if such a policy continues to be pursued, we would like to draw attention to a number of additional points.

Licence modification is the only appropriate route if Ofwat persist with gearing restrictions

We are strongly opposed to any consideration of a gearing “cap” being introduced through regulatory policy routes (i.e. dividend guidance or RCV adjustments) rather than going through the right and proper process of a licence modification consultation.

A licence condition amendment provides a clear framework for meaningful consultation and scrutiny and a defined process for appealing any subsequent decisions on a licence modification. We consider that, if this policy is to be pursued, a formal licence modification route is the most appropriate option for ensuring that the necessary consideration and clear-eyed analysis is applied and a thorough understanding (and justification) for the need for it is set out.

We believe this is necessary given the previous ‘regulatory policy’ approaches relating to GOSM, which were either removed by the CMA in the PR19 appeals, or did not operate as intended for non-appellant companies.

Regulatory inconsistency

We note that Ofgem are considering introducing a gearing cap at 75% in the recent consultation on the energy and transmission reviews. It is deeply concerning that there not only appears to be regulatory inconsistency between the two approaches, but that there has been no consideration or justification as to why the water industry warrants a lower gearing “cap” than energy.

Despite the considerable negative skew in risk and return in water compared to the energy industry, the energy industry is widely recognised as being a higher risk sector. It is therefore difficult to understand the possible justifications for introducing a lower gearing level than a related, but riskier, regulated industry.

The consequences of regulatory uncertainty

We have outlined elsewhere in our draft Determination Representation that we are concerned by the potential for rating agencies to downgrade the stability and predictability of the regulatory framework, which would lead to increased business risk and all else equal, lower credit ratings. Among other things, the potential downgrade is linked to the re-introduction of gearing “cap” considerations.

This shows a real-world impact on debt funding due to regulatory uncertainty.

In addition, we note that this regulatory uncertainty also has a detrimental impact on equity funding. As things stand, equity investors are being asked to consider investing capital into water companies, but there is a lack of certainty on a material issue in the regulatory framework, which makes the investment decision very difficult.

Continual interventions in capital structure are an observable impediment to equity investability. As highlighted in the recent report on Investability for Water UK ([appendix AFW142](#)) investors want stability in the regulatory approach. Interventions in gearing levels disrupt this, and arguably the low levels of equity transactions in the period between the introduction of GOSM in 2018 through to the CMA final decision on the removal of GOSM for appealing companies, demonstrate this.