FINANCIAL RESILIENCE AND INVESTABILITY

FINANCIAL RESILIENCE CAN BE RESTORED TO THE SECTOR UNDER THE EXISTING FRAMEWORK. IT PRINCIPALLY REQUIRES THE RESTORATION OF INVESTOR CONFIDENCE IN THE REGIME BY ENSURING A FAIR BALANCE OF RISK AND RETURN.

WHERE WE ARE

Since privatisation levels of debt in the sector have risen to around 70% of sector gearing and stabilised. At the same time there is significant variation across companies. Some have adopted securitised debt structures, many have not and there is a wide variety of different ownership structures. A quarter of the sector currently have financial structures with gearing above 75% almost all of the other three quarters have gearing at or below 70%. As the water commission noted in its call for evidence however, 'debt financing has an important role to play' and the structures for the three quarters of companies are not materially different from other regulated infrastructure businesses.

At this moment around three quarters of the sector hold equity equivalent to two full years of revenue from customers. At the same time there are already several significant regulatory protections in place. Water companies are legally required to hold two investment grade credit ratings, water companies must annually complete financial resilience stress testing to ensure that the businesses can withstand reasonable future shocks, company dividends must be linked to performance and companies cannot increase debt and pay this out through dividends. At the same time there are protections provided for customers through the regulatory ring-fence and special administration if things go very wrong. Most water companies therefore have a substantial level of financial resilience already.

At the same time over the last 10 years the sector has been unable to meet the total expenditure (totex) and performance targets set on average. This is particularly stark for 2020-24, where companies are spending £4bn more than the 2019 price review (PR19) final determination totex allowances[i] and incurring substantial service performance penalties. Most of this overspend, coupled with financial penalties needs to be funded by shareholders.

Consequently, regulatory returns for 2020-24 are lower than the cost of equity assumed in PR19. Eight companies experienced negative returns in 23/24, and seven did not pay a dividend at all.[ii]

Currently, two companies have credit ratings below investment grade and two more are in dividend lock up.

This would all be fair enough if the UK Water sector was a demonstrably poor performer compared to other countries or indeed if a fair sample of companies were able to live within the cost allowances and meet the service performance targets set by the economic regulator. This would imply that it was simply bad management on behalf of the companies that was driving this overspending and service penalties. But neither of these is the case.

The PR14 and PR19 settlements have thus clearly not been a 'fair bet' for companies in terms of an equal distribution of over and under performance. It is critical PR24 and future price reviews do not repeat this error.

Directly related to this, the regulatory regime has itself been downgraded by the ratings agencies twice in the last 5 years reflecting a view that the regime offers reduced stability and predictability.[iii] We believe the financial distress outlined is connected to this decline in confidence in the regulatory regime.

All of this matters enormously because, based on the legally binding targets that the industry has to deliver in the next two decades, we will need to attract substantial new equity and debt finance. This will not arrive if investors cannot see a way to a fair return.

WHERE WE WANT TO BE

We need a sector that is financially resilient for the long term. We need sufficient equity buffer and protections in place to ensure the essential services can continue even under unexpected scenarios. This is largely already the case but targeted action may be needed on some of the companies.

The large increase in capital investment required over the next 25 years will also need a combination of debt and equity financing. For investors to participate, they need confidence there is a reasonable chance of receiving a fair return on their investment. Indeed, if we can positively encourage these investors then we can attract that capital at a relatively low cost to consumers. These investors will compare the water industry with other investment options, energy and other infrastructure projects, both in the UK and overseas. So the relative views of the stability and predictability of the regime by independent rating agencies is also critical.

If these challenges are addressed, the investment introduced should ensure long run financial stability while delivering the ambitious programmes we need.

In any sector there will always be high performers and companies delivering less well. But in a stable, long-term sector such as water it surely must be the case that at an industry level on average the performance and totex targets set in the Final Determination are achieved. This should result in higher returns for high performers and lower ones for underperformance.

Achieving this would mean average returns and dividends at a level competitive with other sectors – taking account of relative risks – and debt and equity raised would be at an efficient cost to customers. At the same time we should see service performance improving across the sector as well as companies becoming more efficient.

Making the sector thus investable would bolster financial resilience by ensuring sufficient capital flows into the sector. This, combined with existing protections on dividend lock up, performance linked pay and credit rating requirements would ensure companies remain financially resilient.

HOW DO WE GET THERE

Issue	Recommendation for
Concerns that water companies are not all **financially resilient**	**Ofwat:** Set a sufficient allowed return that balances risk and reward – see recommendations below. Companies with access to capital under a stable regulatory system will be more financially resilient. **Ofwat:** Set a commitment and roadmap for restoring Ofwat's Regulatory Regime original Aaa credit rating.[iv] The government could mandate this through the Strategic Policy Statement or legislation. **Ofwat:** Use existing recent licence changes on linking dividends to performance and dividend lockup before financial distress to monitor financial resilience. Alternative options: **Government:** Create independent supervisors to review and report on financial resilience of companies. These would need to be independent of both the companies and Ofwat to be able to meaningfully report on financial resilience.

Issue	Recommendation for
The overall regulatory settlement does not provide a **fair return** or represent a 'fair bet' to make the water sector investable	**Government:** Set explicit regulatory requirement for Ofwat in the Strategic Policy Statement to ensure price controls can be met by an average company **Ofwat:** Set the cost of capital methodology so that it enables in-period adjustments as market data, such as the risk-free rate and new debt costs, evolve through indexing. This would reduce the risk of in-period financial resilience challenges, provide greater certainty to investors as well as quickly passing on to customers any gains from lower costs of financing. This would mirror the approach taken by Ofgem. **Ofwat:** Set the methodology for calculating the cost of capital outside of the price review regulatory cycle. This will remove the ability for Ofwat to use allowed returns as an affordability lever at the expense of investability in the price review setting process. Alternative options: **Government:** The methodology and cost of capital could be set by an external body, with a wider scope than just the water sector. Any third-party body would need to have the confidence of investors and customers that it was competent and independent of Ofwat, Government and Companies.

IMPACT ON CUSTOMERS, THE ENVIRONMENT AND WIDER SOCIETY

The ambitious capital programme set out in the long-term strategies of the industry will deliver considerable benefits to customers in terms of new water resources and the reduction of storm overflow spills for example.

The doubling of capital investment will feed into economic growth both locally and nationally. It will support industrial expansion and housing growth, in line with Government priorities. But this ambitious capital programme will only be deliverable if the water sector is a sufficiently attractive investment opportunity for the required capital. The recommendations here will boost investability and hence financial resilience.

WAY FORWARD

While some of the issues will be covered in the CMA PR24 appeal process, a wider consideration of the need and benefits for equity and debt investment and the balance of risk and reward is well overdue.

This investment will come from multi sector and international investors, who will consider the water sector risks and returns before deciding whether, and at what cost, they will invest. Retaining their confidence is critical to procuring the investment at an efficient cost, thus delivering benefits for customers while minimising the impact on bills.

The Cunliffe review should therefore focus its recommendations on creating stable financial regulation to provide confidence in the water sector. This will require a balanced approach with controls where appropriate but also ensuring a fair return to investors.

[i] Ofwat Water Company Performance Report 23-24 WCPR24

[ii] Ofwat MFR Report 23-24 MFR24
[iii] Moody's 22/5/18 & 18/11/24
[iv] i.e. as per Moody's top grading pre-2018.