WSX-R03 – Ofwat's proposed gearing cap

Response to Ofwat's PR24 draft determination

Wessex Water
YTL GROUP

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Representation reference: WSX-R03

Representation title: Ofwat’s proposed gearing cap

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1. Summary

We firmly disagree with Ofwat on the need for further regulatory mechanisms relating to company capital structures proposed in the draft determinations. The financial structure and resilience of a company is the principal responsibility of its Board.

The draft determination does not justify the need for additional mechanisms. The license already includes cash lock up and dividend declaration clauses within, these are at least outcome focused. At the very least, more time is needed to consider the implications and effectiveness of the changes to the license made last year.

These are designed to ensure companies maintain a sufficiently resilient financial structure that enables efficient access to the debt markets so that they will be able to continue operations. The proposals in Ofwat’s draft determination set out an arbitrary focus on only one of the inputs to financial resilience, gearing.

Many of the arguments set out in our response to the 2023 licence changes become more poignant when considering these proposals, we therefore refer the regulator to that response which was emailed to Ofwat on 29 September 2022 16:15.

We further highlight two key points from that response below.

1. The draft determination fails to set out robust evidence that would support the necessity, benefits or proportionality of the proposals. Critically, it fails to adequately to carry out an impact assessment of the proposals on water companies themselves. 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).

2. 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 these proposals; 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 proposals 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.

Finally we note that, to the extent to which the regulator considers such a mechanisms is necessary where it has concerns over financial resilience of *specific companies* it applies any further mechanisms or license changes to *those companies specifically*, and not at an industry level. This would provide at least some protection against the adverse outcomes outlined above.