Southern Water

Ensuring water for life

IAP Technical Annex 4

Securing long-term resilience

1. SRN.LR.A1

Ofwat action	How we have responded
The company should provide a commitment that it will, by 22 August 2019, prepare and provide to us an action plan to develop and implement a systems based approach to resilience in the round and ensure that the company can demonstrate in the future an integrated resilience framework that underpins the company's operations and future plans showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework. The action plan should work toward understanding the baseline resilience risk of the water and wastewater operational activities as well as steps that will improve resilience (operational, financial and corporate).	Accepted

Our detailed response

We commit to providing the action plan on resilience in the round by 22 August 2019. As a milestone in the development of the action plan we aim to share with Ofwat work in progress on the framework we are developing in May.

2. SRN.LR.A2

Ofwat action	How we have responded
The company's assessment of financial stress scenarios extends only to 2025. The company should commit to demonstrating that its assessment of financial resilience extends beyond 2025 in its next Long-Term Viability Statement.	Accepted

Our detailed response

We confirm that the period covered by our next Long Term Viability Statement will extend beyond 2025.

3. SRN.LR.A3

Ofwat action	How we have responded
Clarify that the possible outcome of all extant regulatory investigations have been taken into account in the company's assessment of financial resilience.	Accepted

Our detailed response

We clarify and confirm that the possible outcome of all extant regulatory investigations has been taken into account in making our assessment of financial resilience.

4.SRN.LRA4

Ofwat action	How we have responded
The company has noted the possibility of additional equity investment as a financial risk mitigation measure. Please explain the steps and risk management approaches the company has taken to ensure equity will be available if such support is required.	Plan updated

Our detailed response

An equity injection is part of our toolbox for ensuring we can respond to and mitigate forecast challenges and unforeseen shocks. Our Business plan assumed the completion of our strategic refinancing through which £700m of equity was injected into Southern Water from our shareholder, Greensands. We are pleased to confirm this equity injection has been completed.

We did not specifically reference any additional equity being injected outside of this transaction, however the provision of further equity always remains a possibility should that be the most appropriate solution to any downside situations. Having reset our capital structure as part of this strategic refinancing and reducing our gearing below 70% by the end of AMP6, and our interest costs by £425m from AMP7, we would not anticipate further equity injections being required unless significant downside risk materialises that cannot be mitigated through other means. Our flexible dividend policy, integrated approach to risk management, and our current financial headroom provide a stable base from which we can respond to, and mitigate most challenges.

As a privately-owned company we have easy access to, and the ability to share information quickly with our owners (the Greensands Group). As a group of professional infrastructure investors (on behalf of institutional investors such as pension funds, and sovereign wealth funds) they are well aware of the challenges we can face as a business, and they take a very long term view as to what is in the best interests of our business as opposed to purely focussing on the next quarter's earnings' per share (EPS). This behaviour has been most recently demonstrated in the context of our strategic refinancing where the Greensands Group raised £700m of funds that have been injected into Southern Water Services to ensure we can continue to be financially resilient through AMP7 and beyond.

The steps taken to ensure this type of support is available involves significant and independent work by both the Southern Water Board, and the Greensands Board. There are two ways in which we can increase the equity base of the operating company.

1. Through the application of a flexible dividend policy that is solely at the discretion of the Southern Water Services Board; and
2. Through the injection of additional equity from Greensands into Southern Water Services that involves independent decision making at both levels.

As a private company with a single owner, Greensands (which in turn has a close-knit set of professional infrastructure investors as shareholders), we are well placed to discuss, analyse, and react to these types of situations versus publicly listed companies with additional layers of bureaucracy and diverse shareholding groups. That being said, both types of investors (some within the same institutions) will undertake a similar set of decisions in assessing whether further equity would be appropriate in their own circumstances. This could include, but not be limited to, their investment mandate, fiduciary obligations, history of investment in the sector, views on the sector's regulation, financial prospects of the RegCo, and current value of their equity investment. No matter what the ownership structure is, this can be a complex set of decisions.

For this reason, whilst we believe further equity injections are an important part of our "financial resilience" toolkit, it is not something that we rely on as a "cure all". We are firmly of the belief that prevention is better than a cure, which is why across the business we focus on forward looking Key Performance Indicators that allow us to avoid as much potential difficulty as possible.

5. SRN.LR.A5

Ofwat action	How we have responded
Please explain how the company has taken account of the risks associated with its current credit ratings of Baa2 (negative) with Moody's and A- (stable) with Standard and Poor's and its plan to achieve higher ratings in the period from 2020 onwards.	Plan updated

Our detailed response

Our current credit ratings are as follows:

S&P	Fitch	Moody's
A-	BBB+	Baa1 (negative outlook)

Overall, we believe this set of credit ratings to be consistent with, and well above the minimum required to meet our obligations under our instrument of appointment. We are not actively targeting higher credit ratings in the period versus the above. We will keep our credit ratings under review to ensure that we both continue to demonstrate the financial resilience our customers expect and to ensure we remain in line with peer companies.

With regards to Moody's, the Baa2 Corporate Family Rating (CFR) has been removed following the prepayment of all of our Class B debt.

Our actions to date, the financial headroom we have, and our integrated approach to risk management will ensure that we remain a financially resilient company over the long term. We believe this is in the best interests of our customers and will underpin the delivery of our operational performance commitments and customer service. Whilst credit ratings are part of our assessment of financial resilience, they are not the only part. Credit Rating Agency methodology takes into account various country, sector, and macro issues in both qualitative and quantitative assessments.

Moody's

Moody's negative outlook reflects:

1. Southern Water's exposure to the likely cut in allowed returns from 2020, as guided by Ofwat in its final PR19 methodology;
2. The company's plan being categorised as requiring significant scrutiny in Ofwat's initial assessment; and
3. Ongoing enforcement actions on the company's past performance and data reporting in relation with its wastewater treatment plants.

The outlook could be stabilised if:

- Financial metrics from 2020 are above 1.3x AICR (as per Moody's own methodology) and not exceeding low 70s in percentage terms for net debt to RCV; and
- The risk exposure of Southern Water's capital structure remains manageable and does not impair the company's financial flexibility in comparison with industry peers, taking into account any additional measures management or shareholders may be willing to implement to mitigate the company's exposure and timing of the same.

Following completion of our strategic refinancing, our base case business plan submission targeted an AICR of 1.3x and 70% net debt to RCV. As noted in our IAP response, there remains a risk to those forecasts as a result of legacy enforcement issues. We are developing mitigating actions to the impact of those issues in parallel.

In Moody's own words, factors that could lead to a downgrade:

"The rating could be downgraded if, taking into account such measures as management and shareholders may implement, it appears that Southern Water will likely have insufficient financial flexibility to accommodate the expected reduction in allowed returns and more challenging efficiency targets at PR19." Furthermore, downward pressure could result from:

1. Unexpected, severe deterioration in operating performance that results in the company remaining persistently in breach of its distribution lock-up triggers;
2. A material change in the regulatory framework for the UK water sector leading to a significant increase in Southern Water's business risk; and/or
3. Unforeseen funding difficulties.

We have taken specific action to address 1 and 3. Point 1 is picked up in our current business transformation. Point 3 has been addressed through our recent signing of a £330m Revolving Credit Facility that can be used to backstop upcoming debt maturities.

Standard & Poor's

We are currently rated A- with a stable outlook. The stable outlook reflects our continued forecasts for our FFO to debt (S&P methodology) to exceed 7%.

What could cause negative rating action?

In S&O's own words:

"We would consider lowering the ratings if SWS recorded a pronounced weakening in operational performance measures as monitored by the regulator--which could lead us to revise upward our FFO-to-debt guideline for the ratings--or if the company was unable to maintain the credit ratios mentioned above (SWS: 7% FFO to debt). Weaker ratios could result if the regulatory determination for AMP7 is materially worse than in the business plan the company has submitted to the regulator."

Again, we are mitigating these operational risks by continuing to undertake our business transformation programme to ensure that we are brilliant at the basics.

Conclusion

We are not actively targeting a change to our credit ratings as part of our financial resilience strategy for AMP7 and beyond. We are continually looking to improve operational performance and customer service levels, consistent with our incentive based regulatory framework. This is completely aligned with what would be positive for our credit metrics.

We believe our current ratings reflect an efficient balance and do not attract any premium in relation to our own debt issuance costs (In any event, customers via bills fund the allowed WACC and any residual deviation is a risk for our shareholders).

Having just completed our strategic refinancing we believe our capital structure has been significantly strengthened following the injection of significant equity to reduce both our gearing and ongoing interest costs.

We monitor financial resilience (and credit ratings) continually and have an active participation on these matters with our Executive Leadership Team and Board.

6. SRN.LR.A6

Ofwat action	How we have responded
The company should set out: - how the company will achieve the planned reduction of gearing to 70% or lower referred to in its plan; - the company's assessment of the impact of the gearing outperformance mechanism for PR19 on its financial metrics in case the planned gearing reduction is not achieved; and - outline associated risk management / mitigation approaches identified by the company to provide assurance on long term financial resilience.	Plan updated

Our detailed response

How will the company achieve the planned reduction of gearing to 70% or lower referred to in its plan?

We have carried out a strategic re-financing. Our gearing by 31st March 2020 will be ~68% of RCV.

What is the company's assessment of the impact of the gearing outperformance mechanism for PR19 on its financial metrics in case the planned gearing reduction is not achieved?

When we report our gearing at our balance sheet date of 31 March 2020, we expect gearing will be materially below 70%. The outperformance sharing mechanism should not then apply.

We do not agree with Ofwat's gearing outperformance mechanism on principle, but accept that if our gearing goes above 70% we may have payments to make at PR24. We explain this below.

We do not support the simple thesis that higher gearing means higher risk, we believe that each company, situation, and capital structure must be assessed on its merits. We are firmly of the view that our "Whole of Business Securitisation (WBS)" provides significant protections to creditors and customers that build and enhance the restrictions and obligations placed on us by our instrument of appointment. Our target level of gearing is informed by a combination of factors including: business risk, allowed WACC, size of capital programme, peer companies, and credit rating agency views.

In addition, gearing is only one aspect of financial resilience, our strategic refinancing has also significantly reduced our swap interest costs from 2020 – 2030. On top of this a key WBS principle is to ensure continuing access to significant liquidity via a committed Revolving Credit Facility (RCF) and a Debt Service Reserve Liquidity Facility (DSRLF). We have recently renewed our £330m RCF and £103m DSRLF[1] for a period of 5 years (with two optional 12-month extensions at our request). These facilities form the cornerstone of our financial resilience in downside scenarios and allow us to mitigate and manage liquidity whilst we respond to challenges.

[1] The facilities refinanced were a £330m RCF, £102.5m DSRLF, and £45m Operating and Maintenance Reserve Liquidity Facility

We would emphasise that 70% is our long-term gearing target and our actual gearing might deviate in the short term. This will also be re-assessed at appropriate intervals as the macro-environment develops. The current situation of prolonged, low interest rates has given rise to certain pinch points as the allowed WACC falls faster than our embedded debt. These have been addressed as part of our strategic refinancing, we now have a single tranche of securitised debt at Southern Water Services that can be as much as 75% of RCV.

As part of our business plan submission we have chosen to adopt Ofwat's proposed gearing outperformance mechanism. We do not agree with the premise, it is at odds with corporate finance theory, and does not contribute towards financial resilience, however we have chosen not to pursue these technical arguments as part of our overall business plan as we understand the importance to Ofwat as part of your vision for the future of the sector. We support the other principles that form part of this "putting the sector back in balance" vision that include changes to dividend policy, executive pay, and governance.

If our gearing is above 70% in AMP7 we understand that there will be a financial impact as part of our PR24 package taking effect from 1 April 2025. We can commit to quantifying, assessing, planning mitigating, and publishing these impacts as part of our APR during the AMP.

Set out the associated risk management / mitigation approaches identified by the company to provide assurance on long term financial resilience.

Our approach to long term financial resilience is underpinned by our regular and detailed consideration of forecast cash flows, risks, liquidity and operational scenarios that form part of our business as usual risk management process. This is co-ordinated by the executive and regularly reported on to the Executive Leadership Team, Board, and Investors. Our WBS structure puts in place a number of obligations and restrictions on our actions that are regularly reported on. This includes investor reports, liquidity facilities, and credit ratings. In downside scenarios, a key aspect of mitigation is our flexible approach to dividend policy that is intended to support our target credit ratings where required. This has been evident historically, most notable when we had a significant revenue shortfall in AMP5.

Assurance is evidenced via our three lines of defence model. This includes a sophisticated and experienced internal group treasury function and internal audit team. On top of this we have an annual external audit that includes review of our long-term viability assessment. As a WBS company since 2003, financial resilience is at the heart of our decision making and is fundamental to our long-term success. For this reason, it is of significant prominence in the discussions and decisions of our Board and Executive Leadership Team.

7.SRN.LR.A7

Ofwat action	How we have responded
Please explain how the company has taken account of the risks associated with capital for the business raised as debt elsewhere in the corporate group.	Plan updated

Our detailed response

Southern Water Services has recently undertaken a strategic refinancing to significantly enhance the financial resilience of the company. This was achieved through an increase in equity, and a reduction in ongoing interest costs from 2020 – 2030. The detail as follows:

- £450m of equity inject to prepay all Class B debt
- £425m reduction in swap interest costs from 2020 – 2030

In total, our shareholders have injected equity of ~ £700m into Southern Water Services as part of this process.

Our shareholders, the Greensands Group, have been transparent with us and our regulator Ofwat in evidencing the sources of these funds throughout the process. We believe this co-operation and transparency is a significant benefit as a result of being privately owned.

We are aware that the source of our equity has been via third party borrowings at the Greensands Group ("Holding Company") level. Our Group structure now consists of:

- A £450m investment grade debt at a MidCo; and
- A £700m private debt at a holding company without a credit rating

We would emphasise that whilst we believe a benefit of being privately owned is the transparency our shareholders bring to the entire group, we would also emphasise that we don't believe this type of financing is unheard of with public companies either. The difference being that the capital structure of investors in public companies are practically beyond Ofwat's scrutiny.

Given this transparency, Southern Water Services through its financial and legal advisors has been ensuring that its own financial resilience, compliance with legal obligations, and service delivery to customers are entirely unaffected.

The cash injected is equity and has no conditions attached. It forms part of our equity cushion and will receive a return via capital growth and dividends to an extent allowed by our financial and operational performance.

This legal structure has been further bolstered by our continually improving corporate governance. We have entirely separated our Southern Water Services and Greensands Boards. Independent Non-Executive Directors (INEDs) make up our largest single group. We have adopted Ofwat's "Putting the Sector Back in Balance" principles and have ourselves committed to ensuring we embody ethical business practices.

To conclude, we operate Southern Water Services as if it were a standalone publicly-listed company. Through the transparency of our group structure we are aware of the Greensand's capital structure and will continually monitor its development and ensure it poses no risk to us. Currently, we are entirely comfortable that it legally and practically poses no risks.

8. SRN.LR.A8

Ofwat action	How we have responded
The company should clarify and provide board assurance that the assessment of financial resilience set out in the business plan remains current in the context that the financial restructuring was finalised after business plan submission	Plan updated

Our detailed response

As confirmed earlier in this response and in our overarching Board statement, our strategic refinancing has been completed. We have undertaken a fresh assessment of our financial resilience consistent with our latest forecasts to the end of AMP6, and our revised IAP submission. We confirm that both our actual and notional capital structures remain financeable with an adequate level of financial resilience. The Board has been supported by KPMG LLP in reaching our conclusions
(see *Annex 11:IAP_TA11_LR_KPMG_Finaceability Report*) and we explicitly confirm that we have considered all extant regulatory investigations in reaching this conclusion.

9. SRN.LR.A9

Ofwat action	How we have responded
SRN.LR.A9: The company should provide a commitment to work with the sector to develop robust forward looking asset health metrics and provide greater transparency of how its asset health indicators influence its operational decision making	Accepted

Our detailed response

We commit to working with the sector in line with Ofwat's request. Please note Southern Water Services received notice of this requirement from Ofwat on the 20 March 2019, separate to the IAP feedback.

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