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## **Southern Water Services Limited - Response to Ofwat's Financial Resilience Licence Modifications Decision and response to the related Consultations**

We are writing in response to Ofwat's decision dated 20 March 2023 under sections 13 and 12A of the Water Industry Act 1991 to modify ring-fencing licence conditions ("Decision") and to provide a comments on the draft guidance notes.

We understand and acknowledge the degree of public concern around the perceived performance of the sector, and we agree that dividends paid to shareholders should take account of the objectively measured performance delivered for customers and the environment, as well as financial resilience. Our current dividend policy reflects these proper considerations.

While the Southern Water Services ("SWS") board concluded that it would not appeal the Decision to the CMA, our board remains of the view – per our feedback to the July consultation - that the Decision makes the UK water industry more uncertain – and hence risky - for equity investors and this will negatively impact the availability and/or cost of equity. This is likely to have a detrimental impact on customers and other stakeholders, given the impact of a higher cost of capital on customer bills as well as given the needs for water companies to raise significant amounts of new capital to fund the step-change in investment levels which is required across the industry over the short, medium and long-term.

Moreover, as set out in our original consultation response, the licence modifications are not, in our view, aligned with the principles of best regulatory practice as they are not targeted at a specific market failure, not transparent in guidance and not proportional as benefits to customers are unlikely to outweigh cost.

Publication of the final guidance notes on the operation of the Decision provides Ofwat with an opportunity to clarify its intentions and redress some of the investment concerns. Reassurance that Ofwat's objective is not to seek to effectively control dividends would be in the best interest of customers and the environment and we urge Ofwat to clarify its overall objectives. We are committed to delivering for our customers and the environment. However, our future success depends on continued access to capital.

To provide further reassurance that once issued, Ofwat would not seek to modify the guidance notes (A2: draft Information Notice on factors Ofwat considers in assessing a dividend declared or paid and A3: Draft guidance on requests in respect of the cash lock-up licence conditions) at some point in the future in a way that is unduly prejudicial to the interests of investors, it would be helpful for Ofwat to clearly specify the process it would follow to modify the guidance notes to ensure that the process is transparent, well-understood and that stakeholder feedback is duly considered.

We welcome Ofwat's acknowledgement in its draft guidance that companies in turnaround may require "...an expectation of cash returns in the shorter term to help secure new investors who are prepared to invest to support a turnaround"<sup>1</sup> and we would ask Ofwat to explicitly acknowledge that this continues to apply to SWS following the £1bn invested into the Southern Water group in 2021 by funds managed by Macquarie Asset Management.

This letter is sent with the approval of the Board of Southern Water.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Stuart Ledger', with a long horizontal stroke extending to the left.

**Stuart Ledger**  
Chief Financial Officer

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<sup>1</sup> Ofwat (March 2023), Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers

# Southern Water Services Limited - Response to Ofwat's request for comments on licence modification guidance

## Response to A2 Information notice – guidance on factors Ofwat considers in assessing dividend declared or paid

### (1) Introduction

Southern Water's existing strong and transparent dividend policy already adopts considerations related to performance, financial resilience and investments. Clarifying how the Dividend Policy Licence Modifications will be applied and limiting the regulatory discretion in their application would help improve investor confidence and provide reasonable assurance under what circumstances shareholders can expect a dividend from their investment, which represents a major equity value driver.


We recognise and appreciate the specific reference to companies in turnaround in the guidance but request that Ofwat defines how it will determine that a company is in turnaround for the purposes of applying the guidance. Additionally, it would be helpful for Ofwat to confirm explicitly that decisions on the amount and timing of dividends will remain the responsibility of Boards, and that Ofwat does not plan to intervene in this process except for extreme and specifically defined circumstances.

The process to amend the guidance document should also be clearly laid out to improve transparency. By specifying the process that it would follow and allowing for companies and investors to comment on the necessity and impact of any proposed changes, Ofwat would promote transparency and improve trust with industry stakeholders. At the least this process should involve a full public consultation, with a minimum period of at least two months and effective engagement with companies, investors and other stakeholders.

### (2) Ambiguity in relation to accounting for service delivery, investment needs and managing risks

Throughout the guidance document, Ofwat uses subjective language including 'significant', 'poor', and 'sufficient', without providing appropriate definitions to these terms. This affords Ofwat material discretion in the practical assessment of whether dividend payments comply with the new licence conditions. The guidance document should clearly define when the regulator would intervene in a company's equity distributions, while permitting Boards to continue fulfilling their duties on a "business as usual" basis, as long as they provide a robust justification.

Some examples given in the guidance document suggest that intervention may be appropriate when a dividend would result in customer harm or where the benefits to customers in restricting a dividend outweigh the costs. Without specific parameters to justify intervention, we do not believe that this degree of discretion is appropriate in a transparent and incentive-based regulatory regime.



Specific examples of subjective definitions include those set out below. We request Ofwat clarifies that these are not meant as justification for intervention and that Boards continue to decide on dividends:

- **Financial resilience:** Ofwat has significantly enhanced its monitoring of financial resilience across the sector but has stopped short of defining criteria for how companies will be assessed as to whether they are sufficiently financially resilient to pay a dividend. The guidance should make clear that such judgements in relation to financial resilience remain the principal responsibility of boards.
- **Performance:** Ofwat clarifies that companies should “consider all areas of underperformance alongside outperformance”<sup>2</sup> and that “failure to deliver on a single performance commitment does not necessarily mean that a dividend declared or paid does not take account of performance ... [but that] the company should be able to demonstrate that overall is has delivered against the majority of other commitments”<sup>3</sup>. While we support this approach in general, and performance is already factored in our dividend policy, guidance from Ofwat on when it would expect to intervene under this criterion would be helpful.
- **Investment:** While companies recognise and appreciate that reinvesting cash from operations back into the business is an essential source of funding for enhancement capex, clarity is needed so that boards can continue to decide on the most optimal split of debt and equity for funding new investments.
- **Timing:** Similar to ambiguous definitions, there is also a lack of clarity on time periods that should be considered. Ofwat says ‘past and future’, which leaves a discretion to intervene and undermines a transparent and incentive-based regulatory regime. Ofwat should clarify that it is the responsibility of boards to determine the appropriate time period that should be considered in relation to decisions on paying dividends and to clearly explain that decision.

### (3) Asymmetry of guidance

There are two specific areas in the guidance where Ofwat’s approach is asymmetric, with respect to under and outperformance.

- **Inflation:** Under the existing regulatory framework equity investors derive natural benefit from high inflation and bear the downside of the low inflation. However, the guidance document alters this risk exposure by seeking to reduce the upside while keeping the downside unchanged. The treatment of inflation under the guidance document introduces asymmetry into equity returns because Ofwat explicitly states that payment of dividends in high inflationary environment should be restricted while low inflation will prohibit a company from paying dividends naturally.

One of the primary benefits for investors allocating capital to the regulated utilities sector, in particular pension funds and life insurance companies that have liabilities which increase with

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<sup>2</sup> Ofwat (2023), Decision under sections 13 and 12A of Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers, page 52

<sup>3</sup> Ofwat (2023), Decision under sections 13 and 12A of Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers, page 52

inflation, is in retaining full exposure to inflation. The asymmetry introduced by the guidance document reduces value to these investors. Our view is that the specific reference to restricting dividends in high inflationary environment should be removed.

- **Performance:** In the case of company performance, there is a similar asymmetry introduced in the guidance document. Ofwat states that it “would not expect a company to consider future outperformance in the level of dividend” but “if a company anticipates underperformance across a range of areas in future periods, the board should consider whether the funds would be better utilised in addressing that underperformance.”<sup>4</sup> Again we believe this asymmetry should not be codified in the guidance.

Such risk asymmetry would require a cost of capital uplift as a notional company, performing broadly in line with its price control settlement, will not be able to distribute a CAPM-derived real allowed equity return, and hence investors will not be fully remunerated for the risk they take. To avoid the need to adjust an allowed return, Ofwat should amend the guidance to be symmetrical by requiring boards to consider both future under- and outperformance in the round.

## Response to A3 – Draft guidance on requests in respect of the cash lock-up licence conditions

### 1) Grace period

Having taken the decision to modify the cash lock-up licence condition, we acknowledge and welcome an introduction of the grace period as a new mechanism that has not been included in Ofwat’s previous consultations.

While the grace period is a constructive development, Ofwat retains the discretion to shorten or remove it. We would like to see Ofwat set out in the guidance clear procedural steps that it would follow to shorten the period and the circumstances in which it might do so. To reduce the degree of regulatory discretion and a perceived regulatory risk, a clear statement of reasons should be required to be published by Ofwat before a decision to shorten the grace period is applied.

### 2) Notification of permitted payments that would be restricted in cash lock-up

During the grace period Ofwat requires “reasonable notification”<sup>5</sup> for payments that would be restricted in cash lock-up. However, it is unclear what this means in practice. Clarification should be provided as to what specific payments would still be permitted and assurance should be provided that paying down maturing debt or continuing spending capex will remain permitted.

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<sup>4</sup> Ofwat (2023), Decision under sections 13 and 12A of Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers, page 53

<sup>5</sup> KPMG (2022), Financial Resilience: Impact Assessment, page 57

### 3) Request to disapply lock-up or for exception to make restricted payment during cash lock-up

We support the explicit mention of attracting new equity during a turnaround period as a valid exception for which restricted payments during cash lock-up could be permitted. We also agree that such exception would be in the best interests of customers and in line with Ofwat's statutory duties. As with the guidance on the Dividend Policy Modifications, greater clarity of how Ofwat determines that a company is in turnaround is required. Where new equity has been recently invested by shareholders, as in the case of Southern Water, the guidance should provide some assurance in relation to the ability to make distributions, given the exceptional circumstances related to the execution of a turnaround plan.

Additionally, we request that Ofwat publish more specific guidance in relation to cases where a cash lock-up is triggered by events outside of a company's control. For instance, when a rating downgrade to Baa2/BBB negative outlook is driven by a perceived increase in regulatory risk or a change in rating methodology, investors could lose cash control rights with no or limited regard for actual performance or actual financial resilience. A disapplication of a cash lock-up in such cases is warranted to ensure that the risks are allocated to parties best placed to manage them.

Where systemic factors could impact the entire sector, such as for example the reaction of S&P to the period of high inflation, Ofwat may be met with multiple companies entering the grace period at the same time. Greater guidance as to such situations is warranted and would help alleviate confusion and provide transparency.

## Conclusion

An objective approach to the licence modifications would benefit companies, investors, and customers by promoting transparency and increasing the understanding investors have over ability to distribute dividends. Consistent with the corporate governance principles, the dividend policy modification guidance document should underline the rights and responsibilities of boards to determine matters related to dividends and make clear that intervention is only warranted in extreme circumstances.

Ofwat should also address the asymmetry implied in the draft guidance related to the treatment of inflation and performance.

The cash lock-up licence modification guidance should shift towards an objective rules-based set of criteria as opposed to a subjective approach where the grace period could be reduced at a regulatory discretion.

The sector is approaching the next price review period PR24 with increased risks, lower returns and a need for significant new investment, while some companies are in the middle of implementing their turnaround plan. The licence modifications risk undermining investor confidence and Ofwat has the opportunity to reduce this risk and improve the sector's attractiveness to private capital, by appropriately adjusting its guidance documents.