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31st January 2022

Dear Ofwat

Re: Response to discussion paper on financial resilience

On behalf of Dŵr Cymru I am writing in response to *"Financial resilience in the water sector: a discussion paper"* published on 7th December 2021. We welcome the opportunity to contribute to a debate on financial resilience at this juncture in the price review cycle.

Pre-amble

Our responses to the 15 questions posed in the discussion paper are set out below. First, however, by way of context we set out our overall position on the challenge of formulating regulatory strategy to secure the financial resilience of service provision in the interests of customers.

We consider that the objective of safeguarding financial resilience whilst maintaining accountability and promoting efficiency is best achieved by striking a balance between the following principles:

- it is for companies to make their own decisions on financing and capital structure. Capital market forces play a powerful role in rewarding good choices and sanctioning bad ones. Market forces should only be inhibited or distorted in exceptional circumstances;

- regulators have an essential role to play in safeguarding financial resilience. To this end they must have the means to monitor companies' finances effectively and the tools to take timely and effective regulatory action where necessary.

As a general rule, therefore, we think the regulatory framework should:

- provide for all the reporting and disclosure that is necessary to enable Ofwat to be as informed as it needs. This should involve a combination of regular reporting obligations and the ability for Ofwat to require specific additional information quickly on an *ad hoc* basis when required. This is a question of balance: the framework should neither rely excessively on detailed regular reporting requirements to be met by all companies in all circumstances, nor rely solely on the occasional bespoke information requests that would accompany an investigation into a particular situation of concern; and

- set out clearly the boundaries within which companies' financing decisions should be made, but avoid requirements that positively prescribe certain behaviours or require the taking of specific actions.

We believe the regulatory arrangements to safeguard financial resilience have evolved in line with these principles. By way of further elaboration of our position we would like to share some internal briefing material that is relevant to this debate. We attach an internal paper that was prepared to provide colleagues with an overview of how the framework within which we operate and our financing structure (which is unique in some respects but also shares important features with other undertakers) interact and reinforce one another to maintain and safeguard credit quality, which is so important to the long term interests of customers.

Our final over-arching observation relates to an important issue which is raised by Mason and Wright in their paper and picked up in Ofwat's subsequent document relating to the divergence between the social and private costs of financial distress. Mason and Wright make the point that the social costs of company failure will exceed the private costs. We agree with this conclusion. However, there is an implied view that this divergence exists across the whole spectrum of "financial well-being", ranging from good health at one extreme through to bankruptcy at the other – see for example figure 1 on page 13 of their paper. We would question this characterisation. If a normal company in good financial health makes a mistake the regulatory framework generally operates to protect customers, and it is the firm's owners that bear the cost. This has happened on many occasions across the industry over the past 30 years. It is only where a company's finances are close to the "distressed" end of the "spectrum of financial well-being" that the divergence in interests opens up. Indeed, if private and social costs diverged across the whole of the spectrum there would be a case for direct intervention by the regulator in company decisions in all circumstances, not just when a financial situation is critical. But it is clear that this is not what is proposed.

In summary, we think the objective of financial resilience is best served by a regulatory framework that sets clear boundaries around company behaviour where required. However, it should be otherwise largely "permissive", it should ensure that Ofwat is made aware of any serious deterioration in a company's finances and it should equip Ofwat with the means to do whatever is necessary in order to protect the interests of customers.

Your sincerely

Eleri Rees

Strategy & Regulation Director

Response to specific questions

1. **Do you agree that it is not appropriate for providers of essential infrastructure to operate at, or be at risk of falling to, the lowest investment grade credit rating?**

We agree that, in general, it is not appropriate for providers of essential infrastructure to be operating at the lowest investment grade rating. However, as the discussion paper states, there is no single measure of financial resilience, and whilst this is a useful indicator we think consideration should be given to evidence on financial resilience "in the round" rather than focusing on credit ratings alone.

2. **Do you agree with the notion that a company should be taking actions to improve its credit rating well before it is downgraded to the lowest investment grade credit rating?**

See the answer to question 1 above. In general we think it is likely that a company would seek to achieve credit ratings somewhat above the lowest investment grade. All companies have to raise fresh capital fairly frequently either to re-finance maturing debt or to fund new investment, so a higher credit rating generally means lower debt servicing costs and therefore higher profits. Therefore, while we agree that a company should be taking actions to improve its credit rating, we believe that the incentives are already there to achieve this, and regulatory intervention is not generally required.

3. **We welcome views on our option not to define limits on capital or financing structures at this time and whether it might be necessary to define limits for companies where financial resilience does not improve.**

We agree that limits on capital or financing structures should not be defined by Ofwat as a matter of course. If and when a company contravenes or is likely to contravene a relevant licence obligation (e.g condition P12 – "adequacy of financial resources and facilities") as a result of which financial resilience is threatened, Ofwat should use its enforcement processes and powers (potentially including the seeking of statutory undertakings from the undertaker) to bring about whatever remedial action it considers necessary in the circumstances. This could include limits on capital structure, but other measures may be more appropriate. The point is that it would be a matter for Ofwat to decide in that specific situation. It is important that Ofwat has the flexibility and the discretion to require the implementation of the solutions that are right for the case in hand.

We also note that there is an expectation in the market that third party providers under Direct Procurement for Customers (DPC) arrangements will adopt highly-geared financing structures. It would be odd if limits on capital structure were to be imposed on undertakers but not on those which whom they contract to provide essential infrastructure under the DPC framework.

4. **We welcome views on amending the existing trigger level for the cash lock-up conditions to a higher credit rating and the potential for the trigger to be linked to measures of service performance.**

See earlier responses. From our perspective this is not an issue of significant concern. Under the terms of our financing, "cash lock-up" provisions are triggered at a higher credit rating. It seems likely that other companies have the same restrictions. However, we do not see a need to impose a separate restriction in the licence. There is a risk that this could prevent a healthy company from making distributions in certain circumstances, which would create problems of its own. If and when

Ofwat considers that financial resilience is threatened it should use its powers of investigation and enforcement to secure whatever undertakings it thinks appropriate including, potentially, restrictions on cash distributions from the appointed business.

5. **We welcome views on a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.**

See the answer to 4 above. It is very possible that undertakings given by a company that was in breach of licence obligations thereby jeopardising financial resilience would include just such a plan. However, this should be a matter for Ofwat in the specific circumstances prevailing at the time, when it has the benefit of the prevailing context and all relevant facts, not as a pre-ordained response to a change in credit rating.

6. **We welcome views on a requirement for additional board assurance statements when dividends or other distributions are declared or made, and credit ratings are below the targets stated for the notional capital structure at a price review.**

We do not support additional board assurance requirements. Undertakers already have a range of obligations relating to financial resilience, notably under condition P of the instrument of appointment, including:

- a requirement to ensure that it has in place adequate financial resources and facilities to carry out its functions;

- a requirement to ensure that it has the resources that would be sufficient to enable a special administrator to maintain service delivery; and

- the obligation to pay dividends only in accordance with a policy that in Ofwat's opinion will not impair the undertaker's ability to finance its functions.

It is not clear to us that the additional board assurance proposed either provides Ofwat with information it would otherwise not have or could not easily obtain. Undertakers are not permitted to pay dividends or make distributions that would threaten the adequacy of financial resources for the appointed business. They also have fiduciary duties under company law that would have a strong bearing on such decisions. Where Ofwat has any doubts as to information provided by an undertaker or requires a "deeper dive" into an area of concern it can use undertakers' licence existing obligations, including condition M, to obtain what it needs.

Finally, whilst we support the use of the notional capital structure in Ofwat's methodology for setting price controls, we do not think it should be used as a benchmark to regulate actual capital structures. Taken to its logical conclusion, this would imply that it was for Ofwat to determine the capital structure to which undertakers should aspire and that regulatory tools should be used to encourage companies to emulate it, which violates one of the fundamental principles set out in the pre-amble above.

7. **We welcome views on a requirement for companies to maintain two investment grade issuer credit ratings.**

We do not support this proposal and propose an alternative. For one, as Ofwat notes, issuer credit ratings entail additional cost to undertakers. More importantly, it is not clear that issuer credit ratings offer any additional insights that are not already provided by the credit ratings of debt instruments. Where there is particular concern that a company has taken or is taking decisions that threaten financial resilience, Ofwat has the ability to obtain undertakings which could include the procurement of an additional issuer credit rating if that were considered desirable in the circumstances.

One way of meeting these concerns would be to use an "either/or" construction for any enhanced obligation. For example, undertakers could be obliged to provide either a second issuer credit rating or to show that listed debt instruments equivalent to at least 50% of RCV possessed such a rating.

8. **We welcome views on a requirement for companies to formally notify us of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals).**

We support this proposal as it furnishes Ofwat with relevant information in a timely fashion. However, we do not think any new regulatory provisions are necessary as companies already have general disclosure obligations: Ofwat just needs to notify companies that it wants this information and they will be required to supply it under existing licence provisions.

9. **We welcome views on removing dispensations from the requirement to maintain an investment grade credit rating.**

We do not have a strong view on this proposal. It is a matter for Ofwat and the companies concerned.

10. **We welcome views on the need to align the licence to our broader expectations for dividend policy.**

We do not believe a change in the licence is necessary. Condition P29 states that:

"The Appointee shall declare or pay dividends only in accordance with a dividend policy which, in the written opinion of Ofwat, will not impair the ability of the Appointee to finance the Appointed Business."

This provision already provides Ofwat with considerable discretion to influence dividend decisions.

11. **We welcome views on enhancing the transparent reporting of the use of swaps and how this could be best achieved.**

We have struggled with the characterisation of swaps in the discussion paper as financing decisions that somewhat create significant additional risks for undertakers and their customers. For us, we make extensive use of swaps, generally to convert fixed interest liabilities into index-linked commitments. This is often more cost-efficient than issuing index-linked debt directly. Further, since it better aligns our debt servicing commitments with the price control framework, and the duration of swap arrangements matches the term of the underlying instrument and are intended to be held to maturity, this strategy reduces risk for both the company and its customers. The fact that our swaps may be significantly "out of the money" when "marked to market" at any point in time is not considered to be a cause for concern since the implied liability converges to zero over the life of the swap.

Similarly, we do not recognise the implication in the discussion paper that swap counter-parties would be able to "cash-in" their paper gains in the unlikely event that a special administration order were made, crystallising the liability that would otherwise have converged to zero over time. Although we do not have visibility of the detail of other companies' financing arrangements, in our case our financing terms prevent the rights of one sub-group of senior creditors (e.g the senior bondholders) being subordinated to those of another (e.g swap counter-parties).

That said, as set out in the pre-amble above, we support the disclosure of any information that Ofwat reasonably requires in order to monitor the financial position of companies. We understand that companies' statutory financial reporting obligations include comprehensive disclosure requirements in relation to swaps, so one solution may be to replicate those obligations in the Regulatory Accounting Guidelines.

12. **We welcome views on whether disclosure requirements should be set for companies to increase the reporting of holding company debt levels (for example to state holding company gearing levels) in their Annual Performance Reports.**

This is another example where we think a case-specific approach is likely to be more effective than blanket reporting requirements that seek to capture all the relevant information Ofwat would want, given the myriad of different corporate structures that there are in the industry. Companies could report a figure for the gearing of their holding company, but this would need to be defined and without more information on the context it is doubtful whether this would provide significant insights.

All undertakers are required to obtain undertakings from their parent companies that are intended to support the financial resilience of the appointed business and preserve the regulatory ring-fencing arrangements. It is entirely legitimate for Ofwat to seek specific information relating to the finances of holding companies as part of its role in regulating these matters. This may well vary from case to case, but it is likely to be a much more effective approach than common reporting requirements applied to the whole industry.

13. **We welcome views on the option to improve the transparency of pension deficit reporting.**

We do not have a strong view on this issue but would not object if Ofwat asked companies to provide more detail regarding pension deficits with the Regulatory Accounts.

14. **We welcome views on the expectation that PR24 business plans should include a board assured assessment of financial resilience.**

We have no objection to the inclusion of a board assured assessment of financial resilience being included with our PR24 business plan, provided it is proportionate and relates to the actual business, not the notional company.

15. **We welcome views on how the incentives framework around capital structure should evolve at PR24 taking account of the other views set out in this paper and the scope to which companies should provide voluntary sharing arrangements at PR24.**

See "pre-amble" above, together with our specific responses to the previous 14 questions, especially numbers 3 and 6. We do not see a contradiction between legitimate regulatory concerns regarding financial resilience and the objectives of a well-run profit-maximising company. The divergence between the private and social costs of distress only arises where a company's finances begin to be under significant stress – the “right hand extreme” of figure 1 in the Mason and Wright paper. In normal circumstances a company in good financial health is naturally incentivised to make efficient financing decisions which is consistent with the interests of customers. Therefore, we do not see a need to create particular incentives to influence decisions on capital structure. Ofwat should be provided with the information it requires to monitor financial health, and to identify situations where a company may be drifting towards the “zone of concern”. Where necessary, on a case-by-case basis, it should use the measures available to it to effect remedies to any problems identified.

Appendix:

How the Legal and Regulatory Framework Interacts with Dŵr Cymru's Financing Structure to Support Credit Quality and Customers' Long-Term Interests

A Background Briefing Paper

1. Summary Overview

1.1 Introduction

When Glas Cymru acquired Dŵr Cymru Welsh Water (DCWW) in 2001 the bedrock of its strategy was the establishment and maintenance of the high level of credit quality that its founders believed could be achieved given the legal and regulatory framework within which it operated. As a water and wastewater undertaker financed exclusively by debt DCWW would only be able to achieve its core objective of delivering high quality services to customers and the environment at the lowest possible cost by being able to access finance at very competitive rates of interest. DCWW operates in a highly capital-intensive sector. If long-lived assets cannot be financed with low-cost finance customers face much higher bills for their services.

To date this strategy has been successful: DCWW's debt is amongst the highest rated in the water and wastewater sector, and recent bond issues have continued the trend of tapping into low-cost sources of finance.

However, on the face of it there is no automatic guarantee that DCWW's credit quality will be maintained at the same high level indefinitely. After all, many high-profile corporate failures have involved companies that enjoyed a "golden era" at some time or other before deterioration set in, finance became expensive or unavailable, and collapse became inevitable to the detriment of creditors and customers, so why not DCWW? The evolution of each corporate failure is different: however, in general, one or more of the following contributing factors will play a role in bringing about a company's demise:

- wider market developments that reduce demand for the company's goods or services (the ***wrong product***);
- a failure to keep up with market levels of efficiency as a result of which the firm cannot trade profitably at the market price (the ***wrong level of cost***);
- a failure to maintain the level of product quality or customer service that the market demands (***the wrong level of quality***); or
- corporate decisions that critically weaken the financial position of the company, such as the removal of value through high dividend payments, unwise diversification strategies, or adverse transfer pricing measures (the ***wrong strategic decisions by owners/managers***).

1.2 Purpose

This paper explains why the potential for any corporate failure in the water and wastewater sector is very small, and further why this is an even more remote prospect for DCWW because of its unique structure and characteristics.

1.3 Summary

In a nutshell, the basis for this conclusion resides in the fundamental effects of, and the interaction between:

- the **legal and regulatory framework** within which water and wastewater services are provided and regulated, which recognises their essential nature, provides the means to identify and remedy any emerging problems early, and thereby serves to secure their continuity and financial viability; and

- the **structure of the Glas Cymru corporate group** (of which DCWW is the main element) and the way in which it is **financed**, all of which has been designed with the sole purpose of securing the long-term delivery of the services its customers require at the lowest possible cost.

Thus, for example:

- there is little or no risk of DCWW running into difficulty on account of the fact that it is delivering the “wrong product” or its services are becoming obsolete. Water and wastewater services are essential, and their delivery is characterised by strong monopoly features;

- all important aspects of service performance are monitored and regulated. Two independent expert regulatory bodies oversee drinking water quality and environmental performance. They have the powers to obtain whatever information they require and a range of tools to support enforcement when necessary;

- the price level for water and wastewater services is set by the independent economic regulator, Ofwat, which compares costs and service performance between companies and calculates the revenues that it judges are sufficient to enable them to finance their functions at the required level of service. Companies whose cost efficiency or service performance lags their peers know by how much they must improve to catch up and have a strong incentive to do so. This may take the form of competitive out-sourcing of certain operational and other activities, as was the strategy employed by DCWW during the 2000s;

- a suite of legal and regulatory requirements is in place to ensure that each water company has and retains the financial and other resources it requires to deliver the water and wastewater services, and that these are protected by detailed financial ring-fencing and transfer pricing provisions. These requirements are the subject of annual and ongoing reporting obligations, so that the regulator is able to monitor closely companies’ financial health and prospects;

- this regulatory oversight is reinforced and complemented by ongoing scrutiny by credit ratings agencies.[1] As well over 50% of the industry's capital is financed by long term debt, most of which is public, the ratings agencies provide a central role by monitoring water company performance and assigning credit ratings. DCWW's credit ratings are consistently among the strongest in the industry;

- DCWW is a wholly-owned subsidiary of Glas Cymru, a not-for-profit "company limited by guarantee" (CLG). Since Glas has no shareholders, there is no scope for the financial well-being of DCWW to be threatened by capital re-structuring or excessive dividend distributions. Other than to a very limited degree,[2] diversification into non-water and wastewater activities is not permitted under the Glas structure. All financial surpluses are available either to reduce net debt or to deliver customer benefits, whether in the form of enhanced services or reductions in bills. Not only is there no risk of "asset-stripping", therefore: there is no *means* by which this could be done; and

- DCWW's creditors enjoy a range of rights and powers that provide them with information about the performance and well-being of the company and certain tools that can be used in the event of certain lapses in performance.

In short, the very nature of water and wastewater services, the operation of the legal and regulatory framework, and DCWW's unique corporate structure mean that the conventional routes by which corporate failure may occur – the wrong product, the wrong level of cost or service, or bad strategic decisions – are effectively blocked. And since customers' interests and the maintenance of high credit quality go hand in hand – low-cost services cannot be delivered without low cost finance – the range of provisions and measures that protect the latter will also secure the former.

1.4 Structure of Paper

Section 2 below describes in more detail the legal and regulatory framework and draws out certain aspects of the way it operates. Section 3 describes the unique characteristics of DCWW and its parent, Glas Cymru, focusing in particular upon the comprehensive long term arrangements into which it has entered with its investors. Finally, section 4 "joins the dots" by working through a number of hypothetical corporate failure scenarios and showing how the combination of, and interaction between, the legal and regulatory framework and DCWW's unique financing structure operate to deal with any emerging difficulties before they become too serious, and in doing so uphold the rights of creditors and protect the interests of customers.

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[1] Namely Moody's, Standard and Poors (S&P) and Fitch Ratings.

[2] In 2016 the company made a small modification to its single purpose status. With the consent of bondholders, a new holding company was created outside the "Glas Group" to enable the making of investments in water industry related services and businesses. However, the potential commitment is capped at £100m, which represents less than 2% of DCWW's RCV.

2. The Legal and Regulatory Framework for Water and Wastewater Services in England and Wales

2.1 The 1991 Water Industry Act

The institutional and regulatory framework for water and wastewater services in England and Wales was originally established by the 1989 Water Act prior to privatisation that year of the ten former regional water authorities. The relevant provisions of that legislation were then consolidated into the 1991 Water Industry Act ("WIA") which (with various amendments) remains the centrepiece of the legal framework for the delivery of water and wastewater services today.

Parts I and II of the WIA contain the main provisions for the economic regulation of the sector, including:

- the appointment and regulation of companies holding "appointments" under the WIA to provide water and/or wastewater services, often referred to as "appointees" or "undertakers"; and
- the duties of the "Secretary of State" and the "Water Services Regulation Authority", commonly known as "Ofwat". For most purposes "the Secretary of State" means the Welsh Government for undertakers whose areas of appointment are wholly or mainly in Wales, including DCWW.

2.2 The Appointment of Undertakers

The power to appoint undertakers rests with the Secretary of State, or, in accordance with a general authorisation granted by the Secretary of State, Ofwat. The Secretary of State has a duty to ensure that there is, at all times, an undertaker for every part of England and Wales for each of water and wastewater services. This means that in the limited circumstances in which an undertaker's area may be reduced or its appointment terminated (see below), another undertaker must take over straight away. Other parts of the Act set out the various duties and obligations to which undertakers are subject (e.g the duty to supply water for domestic purposes), together with certain powers and rights with which they are provided (e.g the power to lay pipes in streets) to enable them to carry out their statutory functions.

2.3 The Instrument of Appointment

The "Instrument of Appointment" (often referred to as the "Licence") contains "Conditions of Appointment" relating to the economic regulation of undertakers by Ofwat. For DCWW[3], these include:

- charges and the setting of price/revenue controls by Ofwat every five years, including provision for Ofwat's price determinations to be referred to the Competition and Markets Authority ("CMA") for re-determination (condition B – see section 2.7 below);

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[3] Although the conditions of appointment of undertakers all follow the same basic structure, there are some differences.

- obligations to prepare and publish accounting information in line with Ofwat's requirements, including third party audit (condition F). The so-called "regulatory accounts" require undertakers to disclose information that is additional to, and qualitatively different from, the information the companies are required to publish in any event with their statutory accounts;

- "ring-fencing" provisions designed to ensure there is no cross-subsidy between the undertaker and any associated company and that no transfer of assets to an associated company takes place that would prejudice the undertaker's ability to carry out its functions. These provisions also include obligations in relation to dividend policy, the prohibition of diversification into other business areas by the undertaker, a requirement for the Directors of the company to certify that the undertaker has sufficient financial resources and facilities to carry out its functions for at least the next 12 months, and an obligation to maintain certain credit ratings (condition P and condition F2);

- restrictions on the disposal of certain assets without Ofwat's consent, and a requirement in any event to ensure that such disposals are on "arms-length" terms. In addition, the undertaker is required to ensure that it has at all times sufficient rights and assets such that, if a Special Administrator (see below) were appointed to carry out the undertaker's business, it would have what it needed to fulfil this requirement (condition K and condition P);

- an obligation to provide Ofwat with any information that it reasonably requires in order to enable it to carry out its functions (condition M);

- termination of the appointment (condition O – see section 2.6 below); and

- certain obligations on the undertaker's owners (procured by means of legal undertakings) regarding their conduct, including a requirement to refrain from any action that might cause the undertaker to breach any of its obligations under the Act (condition P).

Conditions of Appointment are enforceable by Ofwat under the WIA. In general they may be modified by Ofwat with the consent of the undertaker, or by Ofwat following a reference to the CMA. Although the basic content of the Conditions of Appointment has remained broadly the same in the 31 years since privatisation, there have been numerous modifications over the course of that period as economic regulation has evolved. One area that has seen particular development is the strengthening of ring-fencing in general together with certification by undertakers that they have everything they need to carry out the statutory functions of delivering water and wastewater services.

2.4 The Duties and Functions of Ofwat

Ofwat is a non-ministerial government department. Its Chairman and members are independent of ministers and may only be removed for incapacity or misbehaviour. Its duties are set out in the WIA, and include the requirement to exercise and perform its powers and duties in the manner it considers best calculated to:

- further the "consumer objective", which is to protect the interests of consumers, wherever appropriate by promoting effective competition;

- secure that the functions of undertakers are properly carried out; and

- secure that undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions.

A glance at Ofwat's website provides immediate evidence of how intensively and extensively the water and wastewater sector is regulated. Ofwat has an annual budget of approximately £30m and employs well over 200 permanent staff. As well as setting price controls (see section 2.7 below), monitoring company performance and developing competition, Ofwat engages in a variety of work programmes, including the promotion of innovation, resilience, and sustainability.

2.5 The "Quality Regulators"

As well as its dedicated economic regulator, the water sector in England and Wales has two "quality regulators".

All water companies are subject to a comprehensive and strict water quality regulatory regime. DCWW typically tests over 200,000 drinking water samples for regulatory purposes and is obliged to supply only water that meets statutory "standards of wholesomeness". The **Drinking Water Inspectorate** ("DWI") is part of DEFRA and acts as a technical assessor on behalf of the Secretary of State and the Welsh Government in respect of the quality of drinking water supplies. As such, it can take enforcement action in the event that a water undertaker is in contravention of regulatory requirements concerning the "wholesomeness" of water supplies. It can also bring court proceedings against a company for supplying water that is "unfit for human consumption".

Water companies are also subject to similarly extensive and detailed environmental regulation. In Wales, **Natural Resources Wales** is responsible for the control of water pollution and the maintenance and improvement of the quality of controlled waters, including the regulation of discharges to those waters.[4] The principal environmental legislation relevant to undertakers includes the Water Resources Act 1991 (the "WRA"), the Environmental Protection Act 1990 (the "EPA"), the WIA and the EPR. Under the EPR it is a criminal offence to knowingly cause or knowingly permit a water discharge activity, including the discharge of sewage or trade effluent, unless it is authorised by an environmental permit from NRW. The principal prosecuting body is the NRW, which has a wide range of enforcement powers available to it. All of DCWW's water abstractions and wastewater discharges are therefore subject to detailed ongoing environmental regulation.

2.6 Termination of an Appointment and Special Administration

Under condition O of the licence, DCWW's appointment can be terminated by the giving of 25 years' notice by the Welsh Government, provided a replacement appointment is ready to come into effect on the date the notice expires. Towards the end of such notice period the undertaker can require Ofwat to carry out a review of price controls and, on the assumption that a Termination Notice had *not* been given, to determine what controls should be in place starting on the 1st April immediately preceding the date on which the termination notice is to expire. In making a replacement appointment and in deciding on what price controls should be in place for the new undertaker, the Welsh Government and/or Ofwat have a duty to ensure that the interests of the

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[4] The equivalent regulator in England, including those parts of DCWW's area that are located in England, is the Environment Agency.

creditors of the existing undertaker are not unfairly prejudiced as respects the terms on which the new undertaker could accept property, rights and liabilities from the existing undertaker.

An appointment may also be effectively terminated as part of the implementation of the "Special Administration" regime established under part II of the WIA. Where a company holding an appointment gets into financial difficulty, there is a serious shortfall in service performance, or the company is failing to co-operate following a termination notice, the Secretary of State or Ofwat may petition the High Court for a Special Administration Order. In addition, if at any time any organisation seeks to have an appointee wound up, a court is bound to make a Special Administration Order instead.

Under the WIA, in making such an Order the High Court is required to appoint a "Special Administrator", who would be charged with managing the affairs, business and property of the undertaker for the achievement of the purposes of the Special Administration Order and in such a manner as to protect the interests of the members and creditors of the undertaker. The "purposes" of an Order include:

- rescuing the undertaker as a going concern, if possible; or
- transferring to one or more new undertakers as much of the business of the undertaker as is necessary to ensure that its functions continue to be carried out; and
- in any event securing that those functions are carried on in the meantime.

It is therefore not open to the Special Administrator to accept an offer to purchase the assets of the Appointee on a "break up" basis in circumstances where the purchaser would be unable properly to carry out the functions of an undertaker. During the period for which a Special Administration Order is in force no steps may be taken to enforce security over the undertaker's assets without the consent of the Special Administrator or the leave of the court.

When either a termination notice has been served, or a Special Administrator has been appointed, the WIA provides for the making of a "Transfer Scheme" for the transfer of property, rights and liabilities from the existing undertaker to the new undertaker(s).[5] A Transfer Scheme cannot take effect until is has been approved by the Secretary of State or Ofwat. They, in turn, may make modifications to the scheme with the consent of each of the existing and the new undertaker. In addition, whilst a Special Administration Order is in force the WIA allows the Secretary of State, with the consent of the Treasury, to make grants or loans to the undertaker.

2.7 The Price Review Framework

The regulation of price levels for water and wastewater services plays a central role in the day-to-day operation of the legal and regulatory framework, and therefore warrants more detailed attention as it is here that the viability of undertakers and therefore their ability to meet their obligations to their creditors is substantially determined.

As noted above, in carrying out its functions Ofwat is obliged to further customers' interests both now and in the long term, whilst ensuring that companies can finance their functions. The former

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5 Under similar provisions a Transfer Scheme was used to transfer the property, rights, and liabilities of the Welsh Water Authority to DCWW on 1st August 1989, prior to flotation.

would tend to imply lower prices, whilst the latter would tend to imply higher prices, so there inevitably exists a degree of tension between the two policy objectives. Striking the right balance between them is one of the main challenges of the price control regime.

Since privatisation over 30 years ago the industry has operated on a system of five-yearly price controls, incorporating an annual indexation mechanism. The methodology for designing and determining those controls has evolved considerably since the original controls set by the Secretaries of State pre-privatisation were reset by Ofwat in 1994. However, the basic principles have remained very broadly the same. Price controls for "wholesale" services are set by Ofwat in order to recover a level of revenue sufficient to cover three basic "building blocks":

- a return on capital employed, calculated as the estimated "weighted average cost of capital" ("WACC") applied to the "Regulatory Capital Value" (RCV), Ofwat's assessment of the value that the providers of debt and equity have invested in the business;

- a return *of* capital, calculated as a portion of the RCV that is "run off" or "amortised" in the year; and

- a proportion (the "Pay as You Go" share) of what Ofwat judges to be the level of expenditure that the undertaker requires in order to carry out its functions. The remainder of that expenditure is added to the RCV at the end of the year and is therefore remunerated in subsequent years by means of the return on RCV and future "RCV run-off".

Price controls for retail services are set on the basis of an assessment of the "costs to serve" retail customers plus an allowed profit margin.

In order to arrive at its view of efficient levels of expenditure for each company Ofwat undertakes extensive benchmarking analysis between companies, especially in relation to so-called "base expenditure" which comprises ongoing operating expenditure and capital maintenance. This means that Ofwat may not allow a company the full level of expenditure it says it requires if Ofwat's judges that the efficient level of cost is lower. In these circumstances, a company must either rise to the challenge of reducing its costs in line with the target set by the regulator or accept that the implied "cost inefficiency" will effectively reduce its return on capital during the five-year period.

There is, however, a "cost-sharing" mechanism embedded within Ofwat's price-setting methodology, which means that companies do not bear the entire risk of over-spends. At the end of the five-year period any over- or under-spends are effectively shared with customers. In general, companies will end up bearing a little over a half of any over-spend, with the remainder being recovered from customers in the subsequent five-year price control period.

As well as the periodic re-setting of price controls every five years, condition B of the licence allows for interim adjustments to be made within a five-year period to reflect specific changes in circumstance (the "IDOK" provisions). These include, for example, a significant new or amended legal requirement. For price controls to be adjusted a materiality threshold must be met. Interim determinations may be positive or negative and are subject to appeal to the CMA.

2.8 Summary Analysis – the "Essentiality" of Water and Wastewater Services

The overview of the legal and regulatory framework presented above demonstrates that the "essentiality" of water and wastewater services has played a central role in shaping sector policy. This manifests itself in three inter-related themes, all of which are supportive of undertakers' ability and propensity to meet their obligations to creditors over the long term, and thereby the continued access to low-cost finance necessary to secure best value services for customers, viz:

- the **continuity** of services and **universal service** obligations. The law requires that there is an undertaker in place in every area in England and Wales. Every undertaker is subject to a set of legal and regulatory obligations designed to secure the delivery of the required services, even in circumstances where it may be uneconomic. Although there is some competition for certain of the activities carried out by undertakers, they operate very much as regional monopolies. Performance is monitored closely by dedicated regulatory institutions equipped with extensive statutory powers, supported by comprehensive disclosure and reporting obligations on all undertakers. Ofwat is obliged to ensure that allowed price can cover the efficient costs of service delivery. If an undertaker is failing, either in terms of financial or service performance, and notwithstanding the provisions that are in place to provide early warning of deterioration and to prevent such an occurrence, the Special Administration regime provides the framework for the continuation of the water and wastewater services. Initially, this would take place under the auspices of the court-appointed Special Administrator, with either rescue of the undertaker as a going concern or transfer of its business to one or more new undertakers providing the ultimate solution. There is therefore no prospect of cessation of the business in the way that a BHS or Carillion may just "shut up shop" one day. As a matter of public policy water and wastewater services are regarded as essential, and the legal and regulatory framework is designed to ensure that they continue to be delivered in all circumstances;

- restrictions on the disposal or re-deployment of **assets** and other resources which are vital to the provision of services. One of the ways in which business continuity may be jeopardised is by means of stripping a business either of the physical assets it requires or its financial resources, e.g by the payment of excessive dividends. As described above, a range of measures are in place to ensure that the undertaker retains what it requires in order to be able carry out its functions. In particular, certain assets may not be disposed of without the consent of Ofwat, transactions with associated companies must be at "arms-length", dividends may not be paid if they would prejudice the financial well-being of the undertaker, directors are required periodically to give certificates testifying to the well-being of the company, and the ultimate corporate owners of undertakers are required to give undertakings that support and complement these measures. The combination of these provisions and measures is intended, *inter alia*, to prevent the sort of asset-stripping that would be of concern to long term creditors as well as Ofwat and customers in general precisely because it could compromise the ability of the undertaker to carry out its statutory functions and service its debts; and

- the principle that companies should be able to **finance** the proper carrying out of their functions. This manifests itself most directly in the duty on Ofwat to exercise its powers in the way best calculated to enable undertakers to finance their functions which underpins, in particular, its approach to the setting of price controls. However, it is also the guiding motive that underpins many of the unusual sector-specific regulatory arrangements described above. For example, diversification by DCWW is not permitted because if it branched out, say, into aviation or fashion retailing – both competitive and unpredictable sectors – this could put its finances at risk for reasons that had nothing to do with the water and wastewater business. Similarly, the requirement to maintain certain minimum credit ratings is consistent with the aim of ensuring that undertakers can readily access capital markets to finance their functions. It also means that undertakers are subject to detailed ongoing scrutiny by the analysts at the credit ratings agencies.

By way of conclusion, it is worth drawing attention to a further important feature of the legal and regulatory framework, namely its propensity to evolve in response to opportunities to strengthen the efficacy of the three inter-related principles of continuity of service, ring-fencing of assets, and financing of functions. The provisions outlined earlier in this section were not all in place when the framework was established with privatisation in 1989. Though the basic principles were well-established and enshrined in the law and the licence, numerous modifications and refinements have been made over the past 30 years in order to make the framework even more robust. Two examples – one early and one recent – serve to illustrate this point:

> Although some elements of “ring-fencing” were enshrined in the framework from the beginning, certain components were missing. There was potential for transactions between undertakers and associated companies within the same corporate group to be one-sided in favour of the latter. There was also scope for diversification to take place, either by the company holding the appointment or elsewhere within the corporate group, that could put the finances of the undertaker at risk. Ofwat was quick to express concerns, and in 1992 the WIA was amended[6] so as to give Ofwat a new statutory duty to protect the interests of water and wastewater customers in relation to both transfer pricing and diversification. This provided the regulator with the justification to introduce some of the ring-fencing measures referred to in section 2.3 above, which indeed have been further refined and strengthened over the following 28 years.

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6 The amendment was made by s50 of the 1992 Competition and Service (Utilities) Act.

Various high profile events both within the sector and elsewhere during the latter part of the 2000s led to an increasing focus on the importance of resilience. This featured prominently in the 2010-15 coalition government's white paper "Water for Life"[7] published in 2011 and culminated in the creation of a new statutory duty on Ofwat to further a "resilience objective".[8] As part of its response to this broader policy development, Ofwat created a new "Financial Monitoring Framework" in 2015, which was designed to provide all stakeholders with a regular and comprehensive suite of information that would:

• enhance visibility and transparency of financial and capital structures in the sector;

• assist Ofwat in monitoring the financial stability of the businesses that it regulates and enable other stakeholders to consider and challenge the sector in its identification and management of risk;

• identify financial, structural and systemic risk which may impact on service delivery over time and prove harmful to customers; and,

• help Ofwat in determining when it needs to use the regulatory tools available to it to intervene to protect customers' interests.

Such is the paramount importance of securing the continuity of the services and the viability of service provision, therefore, that new opportunities to improve performance monitoring and reinforce ring-fencing are constantly being sought. The Covid-19 pandemic has confronted the sector with a new and unprecedented challenge to which it is regarded as having responded well. Nonetheless, Ofwat and others have taken a keen interest in the various issues that it has raised for water companies and will undoubtedly be looking to see what lessons can be learned from the experience and what measures could be taken to strengthen the resilience of service provision yet further.

7 "Water for Life": CM8230 published in December 2011.
8 The new duty was inserted into the WIA as section 2A(e) by the 2014 Water Act and came into effect on 1st April 2015.