SRN-DDR-053: Financial Resilience Plan

Draft Determination Response

28th August 2024
Version 1.0

Contents

1. Key messages 3
2. Context 3
3. An appropriate definition of financial resilience 4
4. Achieving our target level of financial resilience 4
5. Maintaining financial resilience under downside scenarios 6
6. Monitoring financial resilience 6

1. Key messages

- Our approach to long-term financial resilience considers financial resilience in the round, including financial metrics, liquidity and credit ratings – we believe it is important to ensure that any definition is appropriate for our specific circumstances, considering our turnaround, capital structure and PR24 risk exposure.
- In the medium term, we target credit ratings of Baa1/BBB+ (stable), which we believe provides adequate headroom to manage downside risks, whilst being aligned with the modified ringfencing requirement that will apply from April 2025.
- We recognise that the ability for us to attain our target credit ratings will depend on both a regulatory settlement that includes an appropriate calibration of risk and return and our own operational performance, including delivery of our turnaround.
- In the context of AMP8 and beyond, financial resilience will depend upon our exposure to financial risks, some of which are within our control, and some which are not – a fair and appropriate PR24 settlement is a critical enabler of financial resilience, without which we may not be able to deliver enduring improvements for our customers.
- Whilst we do not believe it is in the long-term interests of customers for Ofwat to specify a particular gearing level, in view of our target credit ratings we plan to reduce our gearing to at or below 70% over AMP8, subject to an appropriate calibration of risk and return.
- Subject to a fair and balanced PR24 settlement, including an appropriate calibration of risk and return and a cost of capital as set out in section 7.6 (WACC) of our DD response (SRN-DDR-009: Financeability), and their ability to obtain investment committee approvals, the company would seek to raise £650m of new equity in AMP8.
- We have a range of mitigations that would be available to us in the event of any challenges to financial resilience – those could include new equity, if supported by the risk-adjusted return available to shareholders at the time, and suspension of dividends.
- Our financial resilience is closely monitored, both internally and externally by stakeholders including credit rating agencies, debt investors and Ofwat

2. Context

We, and our shareholders, recognise the importance of financial resilience, a critical enabler for us to deliver our ambitious PR24 plan.

In the Draft Determination (DD), Ofwat assessed our plan as having demonstrated a sufficient level of ambition, but not having met its minimum quality expectations. As part of the Quality and Ambition Assessment (QAA), Ofwat noted:

“The company's PR24 business plan did not provide sufficient and convincing evidence to support the Board's assurance that it will be financially resilient on its actual structure during 2025-30 and in the long-term.”

Ofwat set out several conditions for us to improve our plan and move out of the ‘inadequate’ category, including a requirement that:

“The company should provide additional Board assurance, supported by a financial resilience plan and investor support, where appropriate, to demonstrate how it will maintain financial resilience in the control period and beyond in the context of our draft determinations.”

Whilst we do not agree with Ofwat’s conclusions in respect of the evidence we provided in our business plan, we set out in this document how we intend to address those concerns, including the actions we are taking to demonstrate how we maintain financial resilience, including under downside scenarios.

3. An appropriate definition of financial resilience

We define financial resilience as “the ability of a company to withstand unforeseen shocks and downside scenarios, which could be reasonably foreseen, whilst continuing to deliver an acceptable level of service to customers.” In our business plan[1], we set out that our approach to long-term financial resilience considers financial resilience in the round, including:

- Operational performance
- Cash flow volatility, including the impact on financial covenants
- Risks, including those that could have significant impact on the company, and the calibration of risk and return
- Liquidity
- Credit ratings

It is in both our shareholders’ and customers’ interest to ensure we are financially resilient. If we were not financially resilient, it would make it harder to attract and retain the capital needed to deliver our PR24 investment programme and achieve a successful turnaround for customers.

When considering financial resilience, we believe it is important to ensure that the indicators proposed are appropriate for our PR24 risk exposure including its specific circumstances, as well as our turnaround, rather than adopting a narrowly defined sector-wide approach.

Credit ratings are externally assessed indicators, widely relied upon by both debt investors and other market participants to make investment decisions. They provide a detailed insight into credit quality and underpin several licence requirements, including in respect of ringfencing and cash lock-up. Consequently, we believe credit ratings form an appropriate basis on which to consider financial resilience.

In the medium term, we target credit ratings of Baa1/BBB+ (stable), which we believe provides adequate headroom to manage downside risks, whilst being aligned with the modified ringfencing requirement that will apply from April 2025. We recognise that the ability for us to attain our target ratings will depend on both a regulatory settlement that includes an appropriate calibration of risk and return and operational performance, including delivery of our turnaround.

We note that Moody’s, in a recent sector report[2], signals that it may revise its assessment of two business risk factors in the sector downwards in view of the Draft Determination, which may result in tightening of ratio thresholds, making it more difficult to achieve our target credit ratings:

“If the draft framework is confirmed at FD, business risk would increase for the sector and we would consider revising our score for either or both of these factors when assessing companies' credit quality. Against this background, companies would need to strengthen their credit ratios to maintain their current credit quality.”

4. Achieving our target level of financial resilience

As set out in our business plan, the primary drivers of financial risks we face are operational performance (totex and performance commitments), the macroeconomic environment (interest rates and inflation) and the appetite of capital markets to invest into UK water.

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[1] Southern Water, SRN47 Resilience in the Round Technical Annex. 2 October 2023
[2] Moody’s: Ofwat’s draft determination increases sector risk, 14 August 2024

In the context of AMP8 and beyond, financial resilience will depend upon our exposure to those risks, some of which are within our control, and some which are not. More broadly, financial resilience at PR24 will depend on factors including

- The risk and return calibration implied by the PR24 Final Determination (FD), in particular whether the risk-adjusted return is sufficient to attract new debt and equity capital
- Operational performance, considering what level of performance is achievable by a notional company with our characteristics, and one undergoing a turnaround
- Cost of debt, specifically whether our actual cost of debt is fully funded by the allowance
- Capital structure, including gearing, dividend policy and other shareholder considerations

A fair and appropriate PR24 settlement is a critical enabler of financial resilience, without which we may not be able to deliver enduring improvements for our customers. Moody's recognise the importance of a fair return, noting in a recent sector note2 that it may revise its assessment of business risk in the sector upwards in view of the DD:

"However, the draft determinations create a less supportive framework for the water companies and constrain their ability to earn the allowed return. The regulatory regime's stability and supportiveness, as well as companies' ability to earn a fair return, are key factors under our rating methodology for regulated water utilities.

If the draft framework is confirmed at FD, business risk would increase for the sector and we would consider revising our score for either or both of these factors when assessing companies' credit quality."

In its recent rating action where it placed our rating on review for downgrade3, Moody's cited the risk and return calibration as the primary driver:

"The review for downgrade reflects our expectation that Ofwat's draft determination would, if not materially changed at the final determination stage, or through a subsequent appeal to the Competition and Markets Authority, result in severe Outcome Delivery Incentive (ODI) penalties and total expenditure (totex) allowances below the level needed to fund Southern Water's investment programme. Together with an allowed return that falls significantly short of Southern Water's actual cost of capital, such under-performance may challenge the company's ability to raise equity finance to maintain leverage at levels consistent with the current rating."

Furthermore, Fitch, in its recent report on the Draft Determinations4 considers that equity injections, likely to be required in view of the scale of PR24 investment programmes, will be largely contingent on the PR24 FD and that the risk-return balance will be a key consideration for shareholders' investment committees.

Our shareholders recognise the importance of providing appropriate support to our investment programme and ongoing financial resilience and have already provided significant support during AMP7 through c.£1.6bn of equity injections into the group.

Subject to a fair and balanced PR24 settlement, including an appropriate calibration of risk and return and a cost of capital as set out in section 7.6 (WACC) of our DD response (SRN-DDR-009: Financeability), we would approach our shareholders to commit up to £650m of new equity, which

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[3] Moody's: Rating Action: Moody's Ratings places Southern Water on review for downgrade, 30 July 2024
[4] Fitch Ratings: UK Water companies after the Draft Determination, 26 July 2024

would maintain gearing at or below 70% across AMP8. Our current expectation is that an injection of new equity would take place during the financial year ending March 2027 at the latest.

The current macroeconomic environment is very different to that at PR19, and investors have many more opportunities to deploy capital at higher risk-adjusted returns than proposed by the Draft Determination.

When considering a proposal for new equity, as well as the PR24 settlement and risk/return calibration, we expect that shareholders' investment committees would typically also consider :

- Yield and total return (IRRs) compared to market returns for equity investments in the water sector, considering institutional requirements for yield, noting that yield in the UK water sector is expected to be relatively low or zero for the foreseeable future given the scale of the enhancement investment programmes
- Relative value compared to equity opportunities in other infrastructure sectors, including energy, both within and outside the UK
- Relative value compared to other infrastructure asset classes e.g. investment-grade debt, where yields have risen significantly since the start of AMP7

5. Maintaining financial resilience under downside scenarios

As set out in section 4, we define financial resilience most broadly as "the ability of a company to withstand unforeseen shocks and downside scenarios, that could be reasonably foreseen, whilst continuing to deliver an acceptable level of service to customers".

We assess resilience to downside scenarios annually as part of our long-term viability statement, as part of which we consider mitigations that would be available to us in the event of any challenges to financial resilience. Those include:

- Operational levers, for example:
    - Managing working capital
    - Reducing discretionary spend
    - Reviewing the spend profile of our capital programme
- Financial levers, for example:
    - Considering new sources of debt funding
    - Engaging with ratings agencies and banks to discuss short-term impacts and renegotiate/obtain waivers for covenants

Where we are at risk of not achieving our medium-term credit ratings of Baa1/BBB+ (stable), for example if gearing were to rise (on a sustained basis) above the 70% threshold that we consider appropriate in view of our target ratings, or we otherwise believe financial resilience is challenged, we would take appropriate actions to ensure it remains financially resilient. Those actions could include operational changes, dividend retention or new equity, if supported by the risk-adjusted return available to shareholders at the time.

More broadly, in assessing any adjustment to the base level of dividend, we take into account all aspects of our performance, including delivery for customers, and consider this in the round.

As part of our response to Ofwat's Draft Determination, we also assessed the resilience of both the notional and actual company to withstand a range of downside scenarios. The findings from these stress tests were presented in SRN-DDR-009: Financeability. They demonstrate that there is sufficient but limited financial headroom under the majority of stress test scenarios, but it highlights the need for a well-balanced Final Determination from Ofwat.

6. Monitoring financial resilience

Our financial resilience is closely monitored by external stakeholders, including auditors, credit rating agencies, debt investors and Ofwat.

As part of our year-end financial reporting, we conduct Going Concern and Long-Term Viability Assessments. These assess the extent to which the company has access to sufficient liquidity in the shorter-term and the financial capacity to access funding requirements in the longer-term (respectively) along with considering resilience under a number of severe, but plausible downside scenarios. These assessments are assured by our Board and reviewed by our Auditors.

Credit rating agencies closely monitor our performance and assess risk on a regular basis – as part of their assessment they consider business risk (e.g. macroeconomic environment, regulatory framework and operational performance) and financial risk (e.g. credit metrics such as gearing and interest cover ratios, and liquidity).

Our debt structure provides additional monitoring through financial covenants, where we are required to report publicly both historical and forward-looking credit ratios, providing investors with an early view of financial performance and expectations.

Ofwat monitors financial resilience, through regular annual processes (e.g. Monitoring Financial Resilience Report) and as part of other processes including the price review and direct engagement.

We monitor financial performance, including financial covenants and credit ratings, on a regular basis and review the financial risk profile on a quarterly basis, supplemented by dynamic risk escalation processes.