

Anglian Water

PR19 DRAFT DETERMINATION BOARD ASSURANCE STATEMENT



August 2019



DRAFT DETERMINATION BOARD ASSURANCE STATEMENT

1.1 Context and Background to this Board Assurance Statement

In the original Board Assurance Statement that accompanied our September 2018 Business Plan (which was subsequently updated in March 2019), we, the Board (the "Board") of Anglian Water Services Limited (the "Company") gave Ofwat a range of assurances in relation to the Business Plan. As noted in the original Board Assurance Statement, the Company's Plan was:

"developed following innovative and wide-ranging consultation, to ensure that it is the best possible plan to meet the requirements and expectations of our customers, wider stakeholders and the environment. It builds on the long term proposals for 2020 to 2045 set out in our recently updated Strategic Direction Statement. We believe that the planned investments over the forthcoming five-year period will ensure that we can continue to deliver our core services, whilst supporting sustainable housing growth and ensuring that the environment in which we operate is able to flourish, while at the same time pushing our business to reach the highest levels of customer service".

In its initial assessment of Plans (published on 31 January 2019) Ofwat praised the Company's Plan in relation to the convincing evidence that the Company had provided:

"to demonstrate a high quality, ambitious and innovative approach to customer engagement and participation";

"of how customer engagement has been reflected in the business plan and in ongoing business operations";

"of the effective use of a wide range of customer engagement techniques including innovative multi-stage willingness to pay research".

Ofwat also praised the Company for demonstrating:

"engagement with its customers on longer-term issues and its ongoing operations. This includes research on plan acceptability, resilience and intergenerational fairness".

"how it has taken the needs and requirements of future customers into account in its plan".

"a clear line of sight from the results of its customer engagement to the outcomes in its business plan. Its performance commitments are based on robust customer valuation research with incentives that reflect customer preferences and priorities".

The Board is therefore extremely disappointed that the Draft Determination published by Ofwat in July 2019 would not enable the Company to deliver the outcomes which customers and, indeed, wider stakeholders so clearly want. The Board therefore looks forward to Ofwat delivering a Final Determination which enables the Company to properly carry out its statutory functions and which secures the long-term resilience of the Company's systems on the basis set out in the Business Plan submitted by the Company.

The Board has continued to challenge management in order to satisfy itself that the assurance mechanisms used by the Company which support the costs and evidence provided in response to the Draft Determination, are robust. This includes the continuing work of third party assurers.

1.2 Ofwat's additional Board Assurance Requirements

In its Draft Determination, Ofwat has noted that:

"Anglian Water's Board has provided assurance that, based on the assumptions in its business plan, the plan is financeable on both the notional and actual capital structure and that the plan protects customer interests in both the short and the long term. The company has assessed financeability inclusive of legacy adjustments from the previous price review period. We set out in our methodology that we assess notional financeability before making reconciliation adjustments from previous control periods to maintain the incentives on management. However, Anglian Water sets out [how] its approach protects customers' interests and we accept its approach in these particular circumstances".

The Draft Determination sets out the following new requirements:

"The company should provide further detail and Board assurance that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Cost of capital technical appendix'.

[The Company must] "provide Board assurance to confirm how the financeability and financial resilience of the actual structure will be maintained in the context of our draft determination."

1.3 WACC

The Board has considered carefully Ofwat's request for Board Assurance on the cost of capital and financeability as set out above. We have fully considered analysis to assess the financeability of the Company on both the notional and the actual basis, taking into account potential future scenarios and a possible further reduction to the WACC.

Our conclusions are that, on both the notional and the actual basis, the Board cannot provide assurance that the company remains financeable at the level of WACC that Ofwat has set out in its Draft Determination, particularly after taking into account the increased risks represented by that Draft Determination.

As noted in our September 2018 Board Assurance Statement, the Board has relied upon work undertaken by specialist consultants, Arup (including an independent assessment of overall resilience, including financial resilience). Our September Business Plan and its supporting appendices provide assurance that the Company has stress tested our financial resilience against a range of extreme scenarios. Despite a low WACC assumed in our September Plan, the Board was able to provide assurance that the plan was financeable due to its commitment to re-invest dividends from the base-plan back into the Company. However, Ofwat has since made a number of interventions which have increased the overall risk in the plan. Ofwat has also proposed a further reduction in the WACC.

The Board can therefore only attest to the long term financial resilience of the Company when the balance of risk, and the level of WACC determined by Ofwat, enables the Company to finance the delivery of its business plan. The detailed rationale supporting these conclusions is set out below.

1.4 Notional Company Financeability

In 2018, Anglian Water carried out detailed analysis of the effects of a 2.4% WACC on the financeability of the Company. We shared this analysis with Ofwat, and subsequently published a paper, which showed that the notional company was only able to achieve a Baa1 level credit rating when legacy rewards were included. When legacy rewards were excluded, the Adjusted Interest Cover Ratio (AICR) was below the rating agencies recommended range (1.50x-1.70x), for Baa1.

1.4.1 Ofwat's statements on notional company financeability

In its risk and return technical annex to the Draft Determination, Ofwat said:

"Under the conditions of their licences, most companies are required to maintain an investment grade credit rating (i.e. BBB-/Baa3/BBB- (Fitch/Moody's/S&P) or higher). However, we also consider that an appropriate credit rating target should include sufficient headroom (i.e. be higher than BBB-/Baa3/BBB-) to protect against falling to a sub-investment grade credit rating following a deterioration in credit risk or potential cost shocks. We set out, in our initial assessment of business plans, that we apply a higher evidential bar in assessing whether a company demonstrates that the target credit rating is sustainable for long-term financeability and financial resilience where a credit rating of Baa2/BBB has been targeted for either the notional and the actual structures, given the lower levels of headroom to cost shocks".

Moreover, at PR14, Ofwat asked companies to explain the rating they were targeting. The Board understands that the majority of companies submitted their Business Plans to retain at least a Baa1 rating. Ofwat's Final Determinations for PR14 also reflected a Baa1 level of ratios.

The Board also understands that (i) Ofwat's approach to the funding of new debt is based on the average of the iBoxx £ Non-Financials A 10+ and iBoxx £ Non-Financials BBB 10+ and (ii) this combined index has 77% of the constituent debt issues with a rating of Baa1 or higher. Given this, the Board takes the view that it would be inconsistent for assessments of notional company financeability to target a lower (Baa2) rating. By definition, a company cannot be assumed to be able to raise new finance at the rates assessed through the iBoxx indices applicable to a strong Baa1 rating if, in reality, their financing costs are higher because their actual rating is at Baa2.

In September 2018, when submitting our Business Plan to Ofwat, the Board considered the question of financeability inclusive of legacy adjustments from the previous price review period and concluded that, once those were taken into account, and given the overall balance of risk and return considered at the time, both the notional and actual company were only just financeable.

The analysis supporting our conclusion in September 2018 has now been updated, including considering the increased risks now facing the notional company which are set out below.

When testing the financeability of the notional company at Ofwat's revised WACC (2.19%), the notional company does not achieve the target credit metrics consistent with a Baa1 level credit rating. Ofwat suggests that Pay As You Go (PAYG) rates can be changed to improve financeability if the level of WACC does not provide sufficient interest cover. However, the Board has been advised that both Fitch¹ and Moodys², two of the three rating agencies who determine the level at which Baa1/BBB+ ratings levels would be maintained, have publicly stated that they do not see PAYG as a means of improving financeability and any adjustment would be excluded from their calculation in making their ratings decisions. Accordingly, the analysis presented to the Board confirms that the Baa1 level credit rating is not supportable at the 2.19% WACC suggested at the Draft Determination. Following the publication of the Draft Determination, rating agency Fitch has informed us that they now consider a notional company should achieve a minimum AICR of around 1.60x (the middle of the Moody's indicated range) to be considered at BBB+ level rating.

Ofwat also asks that we consider a lower 'outlook' for WACC. At a WACC of 1.82%, the level indicated by Ofwat in its Draft Determination, the financeability analysis shows that the AICR ratios for the notional company fall to around 1.17x which would, as the Board understands, leave the notional company below investment grade and in the breach of its licence.

The Board therefore concludes that it cannot provide assurance that the Company remains financeable on a notional basis at the level of WACC that Ofwat has set out in its Draft Determination in circumstances where the Company is required to deliver a plan which is consistent with the Draft Determination.

1 Fitch: "Ofwat Price Review Intensifies Pressure on UK Water Sector, July 2019"

2 Moody's: "Ofwat tightens the screws further, July 2019"

1.4.2 A level of WACC that could support financeability for the notional company

Were Ofwat to consider that Baa2, or Baa3 were the appropriate credit ratings, then this would create an upward pressure on the cost of capital, which would require an upward adjustment to the WACC.

The minimum level of WACC that we believe is required to support financeability remains at the 2.4% that we used at the time of our September 2018 Business Plan submission, including assessing the benefit of legacy rewards.

Since the September 2018 Business Plan submission, the overall risks facing companies have increased significantly. Many of these risks arise as a result of Ofwat's approach to the Draft Determination, including:

- Major challenges on Totex and very stretching efficiency targets;
- Proposed changes to WACC including the change of methodology in calculating the cost of embedded debt, and the extended 'halo' effect on the cost of new debt;
- Upper-quartile targets and downside-skewed ODIs: an averagely performing company now faces significant penalties
- Reduction to the assumed value of legacy rewards;
- Removal of ex-ante allowance of any residual difference between the Ofwat and company view of required totex;
- Less favourable cost sharing rates.

Other risks which are also relevant to the cost of capital include:

- An unprecedented loss of confidence in the sector from markets and credit rating agencies; and
- Significant macroeconomic risks including from Brexit.

Based on the analysis presented to the Board, the views of the rating agencies referred to above, and the balance of evidence available to the Board, we believe the WACC range for a notionally geared company to achieve the range of the credit metrics assumed with a Baa1/BBB+ credit rating, would need to be 2.4% to 2.85%. The rating agencies state a range of ratios for their assessment of Baa1 and, as a Board, we have considered the factors which would enable the company to stay within this range throughout AMP7.

The 2.4% WACC used in our September 2018 Plan was against a backdrop of a more balanced overall risk and return scenario. If this balance of risk and return were restored at the Final Determination, as we propose in our representations on the Draft Determination, a WACC of around 2.4% could still allow the notional company to finance the delivery of a plan which is substantially similar to our September 2018 Plan. Given the risks for AMP7, the Board wants to see the company aiming to be within the ratio range for Baa1, not at the bottom of this range.

1.5 Actual Company Financeability

The analysis relating to the financeability of the actual Company presented to the Board replaces the notional company's 60% gearing level with the Company's actual gearing level. The Board has taken into account the fact that the ultimate owners of the business have already committed to reducing leverage and constraining dividend income over the price review period. The Board has also considered the importance of retaining the flexibility to take mitigating actions in response to severe shocks, as set out in our financial resilience assessments and statements within our September 2018 Business Plan and its supporting documents.

When testing the indicative WACC of 2.19% as proposed by Ofwat in the Draft Determination, for the actual company, credit ratios also fall below the required range for our company specific Baa1 credit rating (1.30x-1.50x AICR). The Credit rating for Anglian Water has been at least Baa1 level since privatisation and given the constraints now presented by Ofwat's selection of Iboxx index for financing of new debt, we believe Baa1 is the minimum rating that Anglian Water should target to remain financeable in the long-run.

The Board therefore concludes that, based on the business plan contemplated by Ofwat in the Draft Determination, the actual Company is not financeable at the WACC level proposed by Ofwat in the Draft Determination and given the level of risk represented by Ofwat's Draft Determination position. The actual Company would also not therefore be financeable at the suggested further reduction to a WACC of 1.82%.

1.6 Financial Resilience

The Board has also considered the financial resilience of the actual Company. In considering this issue, the Board has reviewed a final draft of the text prepared in response to Action ANH.LR.A2. The Board understands that the query response will be submitted to Ofwat on 22 August 2019. In its draft response, the Company states that:

We have stress-tested our financial resilience against a range of extreme scenarios, as we set out in our September Business Plan and its supporting appendices. Furthermore, we have taken a number of proactive steps to address Ofwat's comments, including a commitment to de-gear to the mid-70s during AMP7, and accepting Ofwat's gearing sharing mechanism.

We are concerned about the financeability of the notional and actual company, in the light of Ofwat's current proposed Weighted Average Cost of Capital (WACC), the wider balance of risk and return, and recent reports reflecting on this from credit rating agencies.

This is the Board's view on the financial resilience of the actual Company.

This DD Board Assurance Statement was approved by the Board on 14 August 2019.

Signed by members of the Board of Directors for Anglian Water Services Limited

