Securing Long-Term Resilience

Financeability in the round

Draft Determination Representations

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Representations within this document

Contents

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Financeability in the round

1. Actions

Answers to actions SRN.LR.C1 and SRN.LR.A3 to A8, including our assessment of financeability on the notional and actual financial structures, a KPMG report **(**TA_LR_Financeability of Southern Water's Business Plan following Draft Determination**)** used to support our Board Assurance, and evidence of shareholder support.

2. Summary

A summary of the key points covered in this representation are:

- We can finance the plan at a target credit rating of Baa2/BBB for both the actual and notional capital structures;
- We consider that a more appropriate target credit rating for the notional structure would be Baa1/BBB+. This is both consistent with the specification of the cost of debt included within the WACC, allows for greater than one notch headroom against the minimum investment grade threshold of Baa3; and supports financial resilience;
- We do not believe it is appropriate to include excess fast money within credit metrics, as this departs from rating agency methodologies;
- Restating credit metrics for the notional company excluding fast money (on the basis of credit rating agency methodologies) and correcting for an error in relation to pension deficit repair contributions results in metrics for the notional company that are much weaker than set out by Ofwat in the Draft Determination and cannot achieve a Baa1 rating;
- We believe the methodology adopted by Ofwat in setting the WACC has reduced the credit rating of the notional company relative to the current price control period.
- To achieve a Baa1 credit rating we believe the Cost of Equity as part of the allowed WACC would need to increase;
- Use of regulatory levers such as PAYG and run-off rates to achieve a Baa1 credit rating is not appropriate, as these cashflows are not taken into account by rating agencies;
- We have considered our financial resilience now and in the long term. We believe that our business plan demonstrates adequate resilience albeit with limited headroom as a result of the reduction in WACC at the draft determination;
- We have recently developed a series of mitigating measures to maintain sufficient financial headroom in support of SW's Baa2 target credit rating. These measures support the long term financial resilience of the company and help mitigate changes to our operating cash flow forecasts as a result of Ofwat's Draft Determination. We remain confident in our ability to execute this additional mitigation; and
- Any further reductions in WACC would cast the financeability and resilience of our plan into doubt for both the actual and notional company

3.Supporting Information

3.1 Action SRN.LR.C1

Ofwat action	How we have responded
We expect Southern Water to provide further detail and Board assurance setting out the steps it is taking to demonstrate that the company will maintain financial resilience in the long term within the context of its performance issues including matters covered by the penalty notice and our interventions to its business plan and that the company will be able to raise finance as and when required. We expect this to be accompanied by evidence of support from its equity investors and to be accompanied by independent assurance about the long term viability of the company, including its ability to maintain sufficient headroom with respect to its target credit rating.	Plan updated / Accepted

The Southern Water Board has continued to be actively engaged in the further development and refinement of our Business Plan to respond to the Draft Determination received in July.

Southern Water has fully considered all aspects of the Plan, including those that have been subject to challenge by Ofwat, and has provided further evidence as part of our representations and intervention responses where appropriate, which we fully support as the Board of Southern Water. The evidence presented in the representations and intervention responses has been subject to peer review, robust internal and independent external technical assurance as outlined in our Board Assurance Statement.

On this basis, we, the Board of Southern Water Services, confirm that we believe the company will be able to raise necessary finance as and when required to support our Business Plan (including our Draft Determination representations) on the basis of both a notional as well as actual financial structure at a target credit rating of Baa2. In making this statement the Board has considered the specific circumstances applicable to Southern Water and has made reasonable assumptions, supported by internal and external advice and assurance, which underpin this analysis of financeability.

This financial resilience is also based on the assumption that the Final Determination cost allowances materially reflect our Draft Determination representations, and that there is no further reduction in the industry WACC. Any further reductions in the WACC would cast the financing of our plan into doubt and would require extensive re-assessment of both our ability to raise debt, and our financial headroom.

The Baa2 credit rating is below the target credit rating of Baa1 that underpinned our IAP response. We do not believe a target credit rating of Baa1 is achievable under the notional structure absent an increase in the allowed cost of capital. We note that some companies have included either positive legacy adjustments, or excess fast money to achieve this. Following recent confirmation from Moody’s and Fitch of their treatment of excess fast money, we do not think this is an appropriate course of action. We would highlight that in switching from RPI to CPIH Ofwat have already brought forward cash flows.

We note that the credit rating of Baa2 under the notional financial structure is the result of Ofwat’s revised financial assumptions, which reduces financial headroom compared with Baa1, and is not consistent with the assumptions implicit in Ofwat’s own assessment of an appropriate cost of debt allowance to be included within the industry allowed WACC.

While we will be able to raise finance at the Baa2 rating based on the assumptions in our plan, we believe that regulatory financial assumptions should be consistent with at least a Baa1 rating in order to: maintain an appropriate level of financial resilience consistent with the nature of our business (an essential public service), and be consistent with the specification of the cost of debt, and with regulatory precedent.

Whilst we accepted the majority of Ofwat's challenge of £767m at the IAP stage, we believe that these representations on the draft determination, which at this stage necessarily reflect the majority of the remaining cost gap, are necessary and justified in light of business needs to support our customers as well as being consistent with Ofwat's methodology and regulatory precedent.

In the absence of material movement in the regulatory determination between draft determination and final determination, we would need to reassess financeability on the basis of the balance of risk given the stretching targets that have been set in relation to cost efficiency and performance commitments.

We considered Southern Water's financial resilience both over AMP7 and in the longer term based on our representations. Based on our representations, our recent £700m equity injection will enable us to maintain our financial resilience, now and in the long term, in the context of the company's performance. At the Baa2 credit rating achieved under our actual capital structure we believe we can maintain financial resilience under a foreseeable range of plausible AMP7 scenarios, provided Ofwat does not reduce the WACC.

We have also recently developed a series of additional mitigating measures to maintain sufficient financial headroom in support of SW's Baa2 target credit rating. These measures support the long term financial resilience of the company and help mitigate changes to our operational cash flow forecasts as a result of Ofwat's draft determination and penalty notice.

These measures are part of SW's overall, comprehensive plan to ensure resilience in the round to provide services for our customers while meeting the costs of penalties we incurred. They are also consistent with a transparent and robust capital structure in line with Ofwat's requirements.

3.2 Actions SRN.LR.A3 – A8

Ofwat action	How we have responded
We expect Southern Water to set out clearly the steps it is taking to maintain its long term financial resilience, both now and in the long term. We expect the company to provide Board assurance setting out the steps it has taken to demonstrate that the company will maintain financial resilience in the long term, taking account also of action SRN.LR.C1. We expect this to be accompanied by evidence of support from its equity investors and to be accompanied by independent assurance about the long term viability of the company including its ability to maintain sufficient headroom with respect to its target credit rating. In its future reporting, we expect Southern Water to apply suitably robust stress tests in its long term viability statements in 2020- 25. We will continue to engage with the company on issues associated with its long term financial resilience.	Plan updated / Accepted

Further detail on these points, and actions SRN.LR.A3-A8, is provided in our response below.

3.3 Our Assessment of the financeability of the notional company

Ofwat has reduced the WACC by 21bps, from 3.30% to 3.08% (real, CPIH-deflated), driven by reductions in the estimated risk free rate (RfR) and an updated assessment of beta.

The 21bps reduction in the WACC at DD is driven by a reduction in the RfR allowance, which has fallen due to changes in market conditions, as well as due to the move to using RPI-linked debt to derive the RfR, instead of nominal gilts as used in the 'early view'. Ofwat has also updated the beta evidence where asset betas have fallen due to increased gearing for the comparator sample (although optically the effect is offset by a slight increase in the debt beta to 0.125). These factors are the predominant drivers of the 56bps reduction in the Cost of Equity at DD.

The Cost of Equity allowance is now at historically low levels; all else equal, the reduction is expected to be significantly credit negative relative to the current regime, reduce financial resilience across the sector and will likely pose a material financeability challenge for the notional company. Credit Rating Agencies have raised concerns that Ofwat's implicit target credit rating has fallen from A3 at PR09 to Baa2 at PR19. As an example, this direction of travel has led Moody's to place the sector on negative outlook.

In this context the notional financeability test is a key cross check on the regulatory assumptions underpinning the price control. It is critical that financeability tests are meaningful, binding and robust as a cross check on the calibration of the PR19 regulatory framework.

This section is structured as follows:

- The importance of a Baa1/BBB+ rating for the notional company
- Commentary on Ofwat's approach to the assessment of notional company financeability at DD.
- Our assessment of the financeability of the notional company
- Our assessment of the financeability of the actual company, including stress testing to demonstrate financial resilience
- A letter of support for SW's 2020-2025 Business Plan from its equity investors, **Greensands Hol**dings Limited

3.3.1 The importance of a Baa1/BBB+ rating for the notional company

At the IAP most companies targeted a Baa1/BBB+ rating for the notional company. Ofwat has not specified the credit rating it is targeting in its financeability assessment at Draft Determination and suggests that for the notional company this is a matter for company Boards. However, the regulatory parameters and assumptions which underpin the notional company, including the cost of capital, are determined by Ofwat. In our view it is the regulator's duty to ensure that the notional company can achieve the target rating.

Although not specifying either a target rating or explicitly stating thresholds applied in its own financeability assessment, Ofwat has nonetheless indicated a strong preference over the course of PR19 (as well as in previous price controls) for companies to target a Baa1 rating or above, and has challenged companies which have targeted ratings below this level for the notional company.

For example, across the sector where companies have targeted a credit rating below Baa1 they have been asked to provide further evidence that this target is reasonable for the notional company in the context of its investment plans and the need for long-term resilience.

Specifically, Ofwat has stated that:

> *"At the initial assessment stage we set actions for Portsmouth Water who targeted three notches headroom to the minimum investment grade (A3 (S&P)) and four companies that targeted one notch headroom (BBB, Baa2 and/or BBB (Fitch, Moody's, S&P)) in their original business plans. We asked each of the companies to provide further evidence to support its view that this target is reasonable for the notional company in the context of its proposed investment and maintaining long-term resilience. In revised business plans each of the companies now targets two notches headroom."*

> *"Our assessment requires a need for careful consideration of the evidence and assurance companies provide where a lower credit rating is targeted, because lower target ratings indicate a lower level of headroom to potential cost shocks."*

Ofwat challenged our plan as follows at IAP:

> *"The company targeted a credit rating for the notional company that is one notch above a minimum investment grade… the company should provide evidence to support its view that this is reasonable for the long term financeability of the notional company or actions that could be taken to secure the long term financeability of the notional company."*

The notional financeability test is in part designed to check that notional company is able to achieve the credit rating of the index used to set the cost of debt allowance.

Ofwat sets the cost of new debt using an average of the IHS Markit iBoxx 'A' and 'BBB' rated GBP non-financials indices for bonds with 10 years or more to maturity. The average of the 'A' and 'BBB' indices is BBB+ (or for Moody's Baa1).

The notional test for water companies is therefore focussed on whether a BBB+ or Baa1 rating can be achieved for the notional company (assuming no out- or under-performance), based on the regulator's financing assumptions and parameters.

If the notional company cannot achieve this rating based on rating agency methodologies (Moody's, S&P, and Fitch), its assumptions and the resulting financial projections are not consistent with the cost of capital, implying that higher returns or cashflows are required. We therefore agree with Ofwat that as a matter of principle the notional company should be able to achieve a Baa1 rating, based on market tests.

Further our licence applies a lockup on distributions where the regulated company is rated at a Baa3 negative outlook. In this context in our view it is appropriate to target Baa1 to ensure that the company has a measure of headroom and resilience above this threshold.

However, we show that the notional company cannot achieve a Baa1 rating based on Ofwat's Draft Determination, and the position of the notional company deteriorates further once the proposed further 37bps reduction in the WACC at Final Determination is taken into account.

3.3.2 Overstatement of key credit metrics and departures from rating agency methodologies in Ofwat's financeability assessment at Draft Determination

Ofwat departs from rating agency methodologies in its calculation of key credit metrics

It is critical that financeability is assessed based on market-based tests. In practice this means carrying out an assessment consistent with the approach adopted in the market by rating agencies and by proxy lenders.

Ofwat states in its Draft Determination that *"we consider that Southern Water's draft determination is financeable for the notional structure."* Ofwat's conclusion is based on Southern Water's notional structure and the projected credit metrics implied by its Draft Determination. However, the metrics considered in the DD are not consistent with those applied in rating agencies' methodologies; this departure means that Ofwat's financeability tests are not market-based and undermines the robustness of the financeability test as a cross-check on the parameters of the PR19 framework.

Ofwat has recently proposed in its July decision on strengthening the regulatory ring-fencing framework that the licence condition for companies to maintain an investment grade credit rating should be enhanced, based on the ratings actually assigned and methodologies applied by named rating agencies. In its decision Ofwat acknowledges that "*credit ratings are helpful for monitoring Appointees because they provide a widely recognised and independent, forward-looking view of an Appointee's financial strength and resilience*[1]" and that "*credit ratings provide an important indicator of a company's financial resilience*".

However, Ofwat does not reflect or consider these widely recognised and independent methodologies – which are binding on companies through the Licence - in its own financeability assessment. As a result there is a disconnect between the licence obligations to maintain investment grade ratings based on specific agencies' methodologies and the approach adopted by Ofwat in its financeability assessment at the Draft Determination, which does not explicitly simulate or present the approaches applied by any individual rating agency.

For example, Ofwat's calculation of AICR as presented in the DD departs significantly from Moody's methodology, and includes the impact of PAYG adjustments in the calculation of the ratio. Ofwat appears to attach weight to adjustments, or regulatory levers (e.g. departures from natural depreciation rates), which rating agencies will look through where they are not comparable across companies. It is on this basis that Ofwat considers PAYG adjustments which increase cashflows in AMP7 above the natural accounting rate to be credit positive, irrespective of the rating agency treatment. However, excess fast money (the difference between PAYG and opex) is normally looked through by rating agencies and excluded from coverage metrics, such as AICR.

This treatment has been confirmed post DD by both Moody's and Fitch. For example, Moody's states:

> *"The regulator views the adjustment of PAYG and run-off rates as economically equivalent to the change in indexation measures, because they involve a trade-off between fast money (received*

[1] Ofwat is proposing to modify of company licences to change the named entities in the definitions of "Credit Rating Agency" to "S&P Global Ratings", "Moody's Investors Service, Inc" and "Fitch Ratings, Inc", and to define the "Lowest Investment Grade Rating" as "*an Issuer Credit Rating of BBB- by S&P Global Ratings or Fitch Ratings, Inc or an Issuer Credit Rating of Baa3 by Moody's Investors Services*"

> *through revenue through the detriment of RCV growth) and slow money (increased RCV growth with lower short-term revenue). However, we believe that there is a key difference: the switch to CPIH is a permanent change that applies to all companies in a similar way, while PAYG and run-off rates are partly within companies' control and can change between periods, distorting comparability between companies and over time. We will continue to remove the regulatory depreciation as well as excess PAYG to calculate company-specific AICR ratios[2]."*

Ofwat's inclusion of excess fast money in AICR shows materially improved metrics compared to the Moody's methodology and overstates the financial headroom available under this metric.

Similarly, Ofwat has selected the Moody's definition of FFO/Net Debt (which is the primary metric for S&P) and presented this in its DD. Moody's FFO/Net Debt is typically higher than S&P's, as it does not adjust for accretion on index-linked debt. It is not clear how Ofwat can have assessed financeability on a robust basis without explicit consideration of the primary metrics considered by Moody's and S&P's in their credit assessment.

As Ofwat's methodology departs from methodologies applied by lenders and rating agencies in practice, it is not clear how Ofwat has concluded that licence holders are able to finance their activities, in particular whether they can:

- Access capital markets at a reasonable cost reflected in the allowed rate of return, based on the regulatory determination;
- Maintain a comfortable investment grade rating (Baa1/BBB+) as a key part of this.

Ofwat has omitted funded pension deficit repair costs (PDRCs) from the financial projections it has assessed for the notional company, which artificially inflates coverage metrics

Ofwat has omitted pension deficit repair costs from its financial projections in their DD model while still including the corresponding revenue; this has the effect of understating costs. Ofwat has justified this change by stating:

> *"Where business plans include pension contributions that are not funded through the price control, we consider these a matter for companies and their investors and not customers. Therefore, we have excluded the movement in pensions provisions from our financial model when assessing notional financeability."*

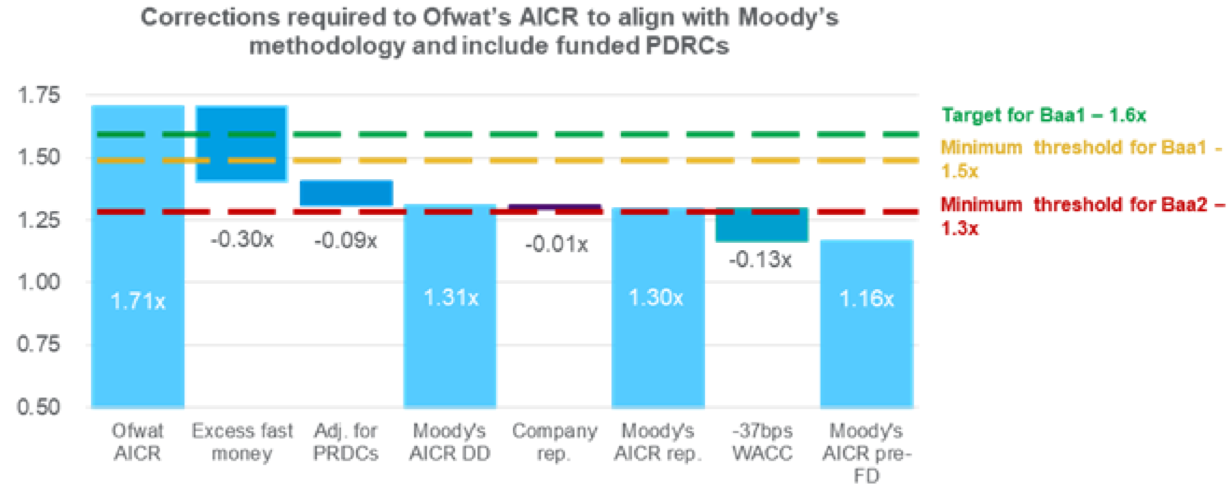
For the notional company in the base case, we in general assume that SW would be funded for efficiently incurred costs and that there would be no out- or under-performance of the regulatory settlement. As such SW should incur costs equal and opposite to the corresponding revenue allowance for pension deficit repair costs. These PDRCs explicitly allowed for by Ofwat are set out in information notice 13/17.[3]

[2] Moody's Investor Service, Ofwat tightens the screw further, 26 July 2019
[3] https://www.ofwat.gov.uk/wp-content/uploads/2015/11/prs_in1317pr14pension.pdf

By excluding these costs from the model, but including the revenue, Ofwat is creating outperformance in the base case, which is not consistent with the basis on which the allowance has been set or the actual pension deficit repair costs incurred by SW.

The omission of these costs creates artificial headroom under Ofwat's DD financeability assessment and overstates credit metrics. We note that Ofwat has changed its treatment of funded pension deficit repair costs since the early DD for fast-track companies; for example funded pension deficit repair costs are included in Severn Trent's DD model and as a result the projected metrics therein are not overstated. An analysis of Moody's AICR (1) excluding excess fast money; and (2) including funded pension deficit repair costs demonstrates the extent to which notional projections are materially overstated by Ofwat based on the DD WACC and the signalled reduction in WACC at FD to reflect market data as at June 2019.

Figure 1 Corrections required to Ofwat's AICR to align with Moody's methodology and include funded PDRCs



We therefore consider that Ofwat's approach is flawed and does not provide a robust basis for assessing the financeability of the notional or actual company. In the following section we correct for these errors and demonstrate that a financeability assessment for the notional company on the basis of market tests leads to the conclusion that an increased cost of capital is required at the Final Determination to support a Baa1 rating and the financial resilience of the sector.

3.3.3 Our assessment of the financeability of the notional company, based on corrected credit metrics

Our assessment of the financeability of the notional company is set out below, consistent with the rating methodologies applied by Moody's and S&P. This corrects Ofwat's ratios to reflect rating agency methodologies and includes funded pension deficit repair costs in financial projections.

The key metrics and thresholds set out by Moody's in its sector guidance are presented in the Figure below:

Figure 2 Key metrics and thresholds set out by Moody's

Weight	Factor	Sub-weight	Sub-factor	Assessment
50 %	**Business risk profile**	15%	Stability of regulatory environment	Unchanged since downgrade of regime
		5%	Asset ownership	Unchanged but operational pressures
		15%	Cost and investment recovery (sufficiency and timeliness)	Unchanged (except at the margin)
		5%	Revenue risk	Unchanged (except at the margin)
		10%	Scale and complexity of capital programme and assets conditio	Totex scaled back, significant scrutiny
10	**Financial policy**			Capital restructuring – no change in rating

Weight	**Leverage and coverage ratios**	Sub-weight	Baa1 ☑	Baa2 ☑	Baa2 ☑	Baa3
40 %	Adjusted Interest Coverage Ratio	12.5 %	> 1.5x	> 1.3x	1.3x -	< 1.2x
	Net Debt / RCV	10 %	< 70%	< 70%	70% -	> 85%
	FFO / Net Debt	12.5 %	> 10%	> 9%	6 - 9%	< 6%
	RCF / Net debt	5%	> 6%	> 6%	4 - 6%	< 4%

The table below sets out S&P's credit metrics corresponding to the "excellent" business risk profile category (which includes SW).

Figure 3 S&P's credit metrics corresponding to the "excellent" business risk profile

S&P financial risk assessment	Modest	Intermediate	Significant	Aggressive	Highly leverage
Rating	AA	A+/A	A-	BBB	BBB-/BB+
FFO/Net debt	23-35%	13-23%	9-13%	6-9%	<6%
Net debt/EBITDA	2-3x	3-4x	4-5x	5-6x	>6x
FFO/cash interest	5-8x	3-5x	2-3x	1.5-2x	<1.5x
EBITDA/interest	7-13x	4-7x	2.5-4x	1.5-2.5x	<1.5x
CFO/Net debt	20-30%	12-20%	8-12%	5-8%	<5%
FOCF/Net debt	10-20%	4-10%	0-4%	-10 – 0%	<-10%
DCF/Net debt	7-11%	3-7%	0-3%	-20 – 0%	<-20%

S&P's latest rating rationale indicates that SW could be downgraded if FFO/ Net debt falls below 8%. A threshold of 8% could therefore be considered to be the minimum FFO/Net debt that is consistent with maintaining the current (and target) BBB+ credit rating.

Key financial assumptions underpinning our company representation

- Financial projections and our analysis of risks are based on our company representation position
- We have included the Draft Determination WACC proposed by Ofwat in our financial projections
- We have based our forecast inflation on Ofwat's assumptions for CPIH and RPI
- We have included the PAYG and run-off rates set out in the Draft Determination in our financial projections
- Actual financeability is underpinned by a transformational equity injection of £700m as part of our strategic refinancing (completed earlier this year)
- We are taking additional steps to ensure financial resilience of the actual company through additional mitigation (set out in detail below)
- If our gearing is above 70% in AMP7 we understand that there will be a financial impact as part of our PR24 package taking effect from 1 April 2025. We can commit to quantifying, assessing, planning mitigating, and publishing these impacts as part of our APR during the AMP.

Financeability assessment for the notional company (DD WACC) – base case projections

The notional company is likely to achieve a weak Baa2 rating, driven in particular by AICR below the 1.5x threshold set by Moody's for Baa1 (which will constrain the overall rating).

Table 1 Key metrics for the notional company – base case projections

	AMP7					
	20-21	21-22	22-23	23-24	24-25	Avg
Adjusted Interest Cover Ratio (AICR) (Moody's	1.35x	1.33x	1.30x	1.28x	1.27x	1.30x
AICR (including excess fast money)	1.71x	1.81x	1.68x	1.52x	1.45x	1.63x
Net Debt / RCV (Moody's)	60.6%	61.6%	62.8%	63.7%	64.0%	62.5%
FFO / Net Debt (S&P)	10.3%	10.6%	10.1%	9.4%	9.1%	9.9%

- In the Base Case under the notional financing structure and based on Moody's rating methodology, SW achieves metrics consistent with a weak Baa2 rating. This represents a deterioration from the IAP, where SW was able to achieve a solid Baa2 rating, driven by the 21bps reduction in the WACC and exacerbated by tightening of rating agency thresholds following Moody's downgrade of the sector in 2018.
- The rating is constrained by AICR, which is below the 1.5x threshold stipulated by Moody's for a Baa1 credit rating, and on average below the 1.3x target AICR set out by Moody's for Baa2.
- It is likely that by the end of AMP7 the Baa2 rating for the notional company would be at risk, as AICR falls below the 1.3x threshold.
- The projected metrics above over-state the financial headroom available to the notional company, as we estimate that at Baa2 we would incur an additional 20bps over and above the notional cost of debt set out in Ofwat's DD WACC.

Ultimately the credit rating of Baa2 under the notional financial structure is the result of Ofwat's revised financial assumptions and parameters, which reduce projected metrics relative to Baa1 thresholds, and are not consistent with the assumptions underpinning Ofwat's own assessment of an appropriate cost of debt allowance to be included within the industry allowed WACC.

The Baa2 rating implies reduced financial headroom available for management of risk in a regulatory environment where business and operational risks are increasing as a result of changes to the design and calibration of the regulatory framework, in particular Ofwat's approach to cost assessment and an increasingly negative skew on performance commitments and ODIs.

Overall, the analysis of the notional company in the base case suggests that the 21bps reduction has resulted in a cost of capital that is too low, however we will submit a compliant plan and adopt the DD WACC in our plan on the assumption that Ofwat accepts our representations on the DD as a package.

While the notional company will be able to raise finance at the Baa2 rating based on the assumptions in our plan (including our DD representations), Ofwat's DD cannot achieve a Baa1/BBB+ rating and therefore fails its own financeability test. We believe that regulatory financial assumptions should be consistent with at least a Baa1 rating in order to maintain an appropriate level of financial resilience consistent with the nature of our business (an essential public service), the specification of the cost of debt allowance, and with regulatory precedent. We have set out in detail above the importance of a Baa1 rating for the notional company.

This financeability and resilience challenge should primarily be solved through an increase in WACC; it cannot be remedied through adjustments to PAYG or run off rates, as rating agencies look through these adjustments.

Decomposition of Moody's AICR for the notional company (base case financial projections)

Notional credit metrics are predominantly driven by the WACC. We have carried out a full decomposition of AICR (Moody's) below, which demonstrates that financial headroom for the notional company is almost entirely driven by the assumed cost of capital.

Table 2 Decomposition of Moody's AICR for the notional company

	AMP7					
	20-21	21-22	22-23	23-24	24-25	Avg
Retail (margin, post-financeability, depreciation)	0.07x	0.07x	0.07x	0.06x	0.06x	0.07x
Return on capital	1.29x	1.27x	1.24x	1.22x	1.21x	1.25x
Tax	(0.01x)	(0.01x)	(0.01x)	(0.01x)	(0.01x)	(0.01x)
Moody's AICR	1.35x	1.33x	1.30x	1.28x	1.27x	1.30x

We have a number of concerns with the methodology adopted by Ofwat in setting the WACC, which we believe is driving a deterioration in the credit quality of the notional company relative to the current price control period. Specifically below we address the following errors:

- The weight placed by Ofwat on discount dividend models (DDMs) and the resultant estimates of total market return (TMR)
- Ofwat's beta analysis
- The asymmetric risk resulting for the step change in totex efficiency and Ofwat's calibration of performance commitments and outcome delivery incentives
- Ofwat's adjustment for the 'halo effect'; and
- Ofwat's treatment of swaps.

Ofwat's use of DDMs to estimate TMR

Ofwat continues to place significant weight on forward looking DDMs, resulting in lower and more volatile estimates of TMR. We do not agree with this approach. PwC's analysis indicates that nominal TMR changed by 420bps over the eight-year period between 2008 and 2016[4]. This variation is more than the allowed real cost of equity itself and therefore highly significant.

[4] KPMG Project Stoddart https://www.ofwat.gov.uk/wp-content/uploads/2018/04/Kelda-Project-Stoddart-KPMG-Report-Final-160518-clean-final.pdf

The TMR also fails to capture the return required for volatility in within-year TMR. This should be corrected if any weight is to be placed on the DDM. The analysis carried out by our economic advisers KPMG[5] shows that an uplift of 75bps-150bps to the TMR is appropriate, to account for volatility. This has not been reflected in Ofwat's latest TMR estimates.

PwC's assumption that dividends will grow at the same rate as nominal GDP is a strong supposition. The relationship between dividends and GDP has historically been highly imperfect, and there is no robust means to test whether this assumption truly reflects investors' expectations. In our view the approach adopted under-estimates dividend growth and as a result the DDM approaches under-state TMR.

Ofwat's beta analysis

Ofwat's beta analysis focuses on short term data which under-estimates beta and excludes relevant comparators. Ofwat is also predominantly using just Severn Trent and United Utilities (a narrow set of data points) to inform its analysis of beta. While direct evidence from listed UK water companies is likely to be the most appropriate evidence for setting the beta, wider evidence including international, coupled with relative risk assessment and beta decomposition to position water companies against the best available evidence on beta risk. In contrast, Ofgem has noted it is including other empirical evidence e.g. companies like SSE and Pennon (in addition to looking at the listed water companies).

The asymmetric risk resulting from the step change in totex efficiency and Ofwat's calibration of performance commitments and outcome delivery incentives.

The step change in totex efficiency and the calibration of performance commitments and incentives at DD negatively skews the overall balance of risk and reward and increases asymmetric risk, which is not priced in the WACC. It is also not clear that Ofwat has sought to estimate the impact of changes to the risk dynamics of the PR19 framework and whether an adjustment for expected under-performance is required.

Ofwat's adjustment for halo effect

Ofwat has increased its adjustment for the 'halo effect' from 15bps to 25bps at DD, which is applied to the cost of embedded debt and new debt to reflect company outperformance. Recent analysis in water and energy including by the CMA shows no outperformance when comparison of network company and benchmark index is undertaken on a like-for-like basis, namely, controlling for differences in tenor and rating. The analysis carried out by the CMA e.g. as part of the British Gas appeal in RIIO ED-1 shows that there has not been a halo effect since 2011 in regulated utilities which is supported by recent analysis at RIIO-2 as well. In the Final Determination the CMA notes:

> *"Any analysis of the halo effect needs to be treated with some caution, since it depends on factors such as the time period selected for the analysis; the approach taken with any outlier observations; differences between debt in the regulated entity and that at a Group Company level (non-regulated business); together with the approach taken with some debt that has unusual lengths of maturity (either short or very long)."*

A number of factors may influence this reduction, including changes to the credit ratings and capital structures of the DNOs, together with changes to external market conditions. The CMA's Final Determination

[5] Ibid.

contains an analysis of the halo effect up to 2014 (i.e. the spread between actual network debt positions and the market benchmark (iBoxx)), which indicates zero halo values from 2009 to 2014. Similarly the ENA has more recently carried out analysis of the halo effect for energy networks and found no evidence of the halo effect based on data up to 2019.Ofwat has not adjusted for rating and tenor in its analysis of the halo effect. We also believe that systematically under-funding the cost of debt would result in an increase in an investor's required cost of equity.. This increased risk to equity (effectively a premium for expected financing under-performance) is also not priced in Ofwat's estimation of allowed returns at DD.

Ofwat's exclusion of swaps

The exclusion of swaps from the estimate of the embedded cost of debt where companies have entered into these purely to hedge interest or inflation risk perspective in line with treasury policy/standard corporate financial management (as highlighted by Anglian in its August 2019 paper on notional financeability), could understate the embedded cost of debt allowance across the sector under Ofwat's 'balance sheet' methodology.

Conclusion

Ofwat's allowed return is not adequately supported by market evidence and benchmarks; in our view the under-estimate of the cost of capital is the primary driver for notional company financial projections not being consistent with a Baa1/BBB+ credit rating.

Financeability assessment for the notional company with a further 37bps reduction in the WACC – base case projections

Ofwat has indicated that based on the latest market data (June 2019) WACC would fall by 37bps at FD, in addition to the 21bps reduction at DD. The table below sets out the impact on base case projections for the notional company if all else equal the WACC falls by 37bps as indicated by Ofwat.

Table 3 Key metrics for the notional company – further reductions in WACC

	AMP7					
	20-21	21-22	22-23	23-24	24-25	Avg
Adjusted Interest Cover Ratio (AICR) (Moody's)	1.21x	1.19x	1.16x	1.13x	1.12x	1.16x
AICR (including excess fast money)	1.59x	1.69x	1.55x	1.38x	1.30x	1.50x
Net Debt / RCV (Moody's)	60.8%	62.1%	63.6%	64.7%	65.3%	63.3%
FFO / Net Debt (S&P)	9.8%	10.1%	9.5%	8.8%	8.4%	9.3%

Financial projections taking into account a further reduction in the WACC by 37bps (in addition to the 21bps reduction at DD) would indicate a rating for the notional company of Baa3 (a one notch downgrade relative to DD and two notches from Baa1), as financial projections are below the minimum 1.30x threshold required for

AICR at a Baa2 rating[6]. This is not consistent with a solid investment grade credit rating (Baa3 is the minimum investment grade rating) and projected metrics and financial headroom would not be commensurate with the risks to which the business is exposed and support financial resilience.

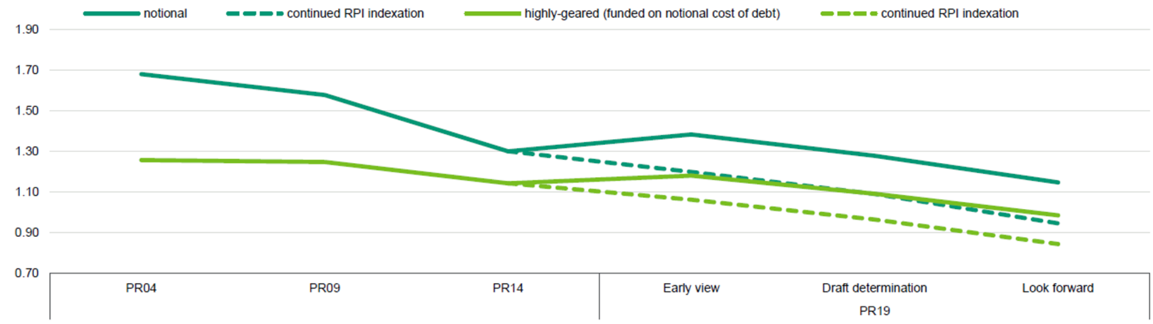
We note that our analysis of the impact on a further reduction in WACC is consistent with Moody's, which states

> *"the full cut of nearly 60 bps [in the cost of capital compared to IAP] would mean cash returns 140 bps lower than in the 2015-20 period. As a result, the adjusted interest coverage of a company financed in line with the regulator's assumption would fall to 1.15x in the next period from 1.3x in the current period".*

Moody's also highlights in its analysis of the DD that, in the absence of the transition to CPIH, AICR for the notional company (taking into account an additional 37bps reduction at DD) would fall below 1.0x. This is not consistent with an investment grade credit rating and in our view highlights that any further reductions in WACC would not be financeable or support a sustainable, resilient regulatory framework for our business.

Figure 4 Moody's analysis of the AICR for the notional company

AICR of the notional company will be significantly weaker, leaving very little financial flexibility



The dotted line indicates where the AICR would be on a like-for-like real RPI return basis. The shift to CPIH indexation for 50% of the March 2020 RCV as well as all new RCV additions will provide additional cash flows in comparison, but only at the expense of lower RCV growth over time. The notional company is being funded at the regulatory cost of capital; for PR19, where the cost of capital is based on a blended RPI-CPIH inflation, the above calculation assumes that the inflation-linked funding is raised in the same RPI-CPIH proportion
Source: Moody's Investors Service

66 https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1124483

3.4 Our Assessment of the financeability of the actual company

3.4.1 Introduction

We have developed a robust financial plan that supports the company's overall business plan. Our financial plan as revised at the IAP and in response to our Draft Determination is focused on our customers' priorities and is financeable and resilient, albeit to a lesser extent following reductions in the WACC, on the basis of both notional and actual capital structures.

We have a long history of successfully accessing capital markets to finance our activities on an ongoing basis and can rely on these markets to provide long-term and cost-effective financing for a RCV-regulated water and sewerage company.

We have lived through significant market challenges in the past and are confident that we can continue to attract investor demand for debt and equity into AMP7 and beyond, provided the sector's regulation remains held in high regard by these investors.

We are required to maintain investment grade credit rating as a licence condition. An issuer is considered to be investment grade if its credit rating is Baa3 or higher by Moody's, or BBB- or higher by S&P and Fitch; an investment grade rating typically indicates a low risk of default on debt.

Ensuring that our plan is financeable for the actual company is therefore a critical component of fulfilling our licence obligations. An investment grade credit rating is also fundamental to ensuring that we can meet the overall financing requirements of our plan, retain appropriate headroom without excessive financial risk, and hence deliver on our obligations and commitment to customers.

- We have in place a robust, well-established, securitised capital structure that supports our ability to raise additional capital when needed, ensures our long term resilience, reduces likelihood of default and protects our ability to deliver for customers at minimum risk.
- We strongly believe the securitisation of our business to be an important safeguard for customers and helps to align the interests of our customers and investors.
- We have already implemented a substantial increase in the equity of Southern Water which will be used to reduce debt to 70% of RCV by April 2020, and reduce our interest cost by c£425m in the decade to 2030. This has been achieved through our shareholders, members of the Greensands Group, subscribing for £700m of additional equity in the regulated company. This capital injection supports the financeability of our plan over AMP7 and well beyond at reduced financial risk and enhances our flexibility to withstand shocks. It also ensures that we can deliver the operations and service levels that our customers expect now and over the long term with additional confidence and protect customers from potential adverse developments

In this section we:

- describe the additional steps we are currently taking to enhance our financial resilience;
- set out our assessment of financeability for our actual structure,
- assess our long-term resilience (including in light of the additional mitigation we are putting in place to protect long-term resilience);
- assess the financeability of our actual structure in the event of a further 37bps reduction in the WACC at the Final Determination; and
- set out our position on why Ofwat's gearing outperformance mechanism: (1) will not, in practice, apply to us; and (2) is flawed and lacks a valid theoretical foundation.

3.4.2 Overview of the additional steps we are undertaking to enhance resilience (our 'additional mitigation')

We have recently developed a series of additional mitigating measures to maintain sufficient financial headroom in support of SW's Baa2 target credit rating. These measures support the long term financial resilience of the company and help mitigate changes to our operating cash flow forecasts as a result of Ofwat's Draft Determination and penalty notice.

These measures are part of SW's overall, comprehensive plan to ensure resilience in the round to provide services for our customers while meeting the costs of penalties we incurred. They are also consistent with a transparent and robust capital structure in line with Ofwat's requirements.

We remain committed to demonstrating our financial resilience and undertaking any necessary mitigating actions:

- Following our agreement to make customer reparations totalling £123m over the next 5 years, alongside changes to our financial projections arising from the DD, we have drafted an action plan in order to enhance our financial resilience
- We met with our three Rating Agencies on 25 June 2019
  - Moody's has taken the decision to downgrade Southern Water from Baa1 to Baa2, and to keep the company under review for further downgrade
  - Fitch remains at BBB+ with a stable outlook following a downgrade in December 2018
  - S&P has downgraded SW to BBB+ from A-, with negative outlook
- Our additional mitigation aims to repair and enhance our financial resilience ahead of our Final Determination being received. This would be achieved by amending the terms of some of Southern Water's inflation-linked swaps.
- Subject to obtaining the necessary approvals we and our financial advisers are confident that the overall transaction will be successfully implemented.

Our additional mitigation aims to amend Southern Water's inflation-linked swaps in two ways:

We would raise cash through some of our long dated inflation linked swap transactions:

- [redacted]
- [redacted]

The upfront cash amount raised would then be used to reduce our interest costs and lower gearing. The objective of this would be to support and improve coverage metrics such as our AICR.

[redacted]

- [redacted]
- [redacted]
- [redacted]

3.4.3 Financeability assessment for the actual company

The key thresholds set out by Moody's and S&P for the actual company are presented below.

- In their latest report on Southern (June 2019), Moody's indicated that an AICR comfortably above 1.1x would stabilise a Baa2 rating. The implied minimum threshold for investment grade correspondingly shifts to 0.9x.
- S&P's latest rating rationale indicates that SW could be downgraded if FFO/ Net debt falls below 8%. A threshold of 8% could therefore be considered to be the minimum FFO/Net debt that is consistent with maintaining the current (and target) BBB+ credit rating.

The actual company is likely to achieve a solid Baa2/BBB rating, driven in particular by AICR comfortably above the 1.1x threshold set by Moody's for Baa2 and gearing materially lower than 75%.

Table 4 Financeability assessment for the actual company (DD WACC) – base case projections

	AMP7						AMP8					
	20-21	21-22	22-23	23-24	24-25	Avg	25-26	26-27	27-28	28-29	29-30	Avg
(AICR) (Moody's)	1.19x	1.24x	1.24x	1.20x	1.21x	1.22x	1.32x	1.30x	1.31x	1.31x	1.28x	1.30x
Net Debt / RCV (Moody's)	71.8%	71.3%	70.8%	70.4%	69.8%	70.8%	69.5%	69.2%	68.8%	68.5%	68.2%	68.8%
FFO / Net Debt (S&P)	7.2%	8.5%	8.3%	8.2%	8.2%	8.1%	10.0%	10.1%	10.3%	10.5%	10.6%	10.3%

- Moody's has currently assigned a rating of Baa2 negative outlook to SW. Moody's has indicated that an adjusted interest coverage ratio comfortably above 1.1x and leverage not exceeding the 75% gearing covenant (net debt/ RCV) within its financing structure would stabilise the rating at Baa2.
- Overall our financial position has weakened since IAP, driven by lower WACC and PAYG at DD, Ofwat's penalty and potential additional fines. This is offset by our additional mitigation and we believe we will be able to raise financing at the Baa2 rating based on the assumptions in our plan.
- AICR: SW is projected to achieve an average of 1.2x cover across AMP7. This provides headroom against Moody's requirement of 1.1x for a 'stable' outlook at Baa2.
- Net debt to RCV: Projected level of gearing is comfortably within the target gearing range for Baa2 and below the 75% threshold set out by Moody's, following the successful capital injection as part of our strategic refinancing.
- FFO / Net Debt: SW achieves FFO / Net debt >8%, which is above S&P's >8% requirement for 'stable' outlook at the current rating (BBB+).

3.4.4 Analysis of the financial resilience for the actual company

We have carefully considered the risks we face, and have tested our financeability under a wide range of severe, reasonable, and plausible scenarios. This process builds on the risk analysis we regularly undertake, most recently captured in our Long Term Viability Statement for 2018/19.

We have developed severe but plausible scenarios that cover the principal risks facing the business to stress test our plan and ensure we are resilient to the risks we face.

The assessment of financial risk is predicated on current performance and the financial and operational impacts, in severe but plausible and reasonable scenarios, of the principal risks identified in the Southern Water annual report. These include the impacts of:

- incidents, for example severe weather, cyber security or a major operational event, resulting in additional operating costs and/or remedial capital investment
- potential Totex under-performance relative to AMP7 allowances

- potential Outcome Delivery Incentive (ODI) penalties associated with our current business plan performance commitments
- The principal risks have been monetised with reference to our risk weighting of likelihood and financial impact.

An overview of the specific downside scenarios we have modelled is set out in the table below.

Figure 5 Overview of the specific downside scenarios modelled

Ofwat scenarios	
Ofwat High inflation	Decrease of 90 bps in RPI and 110 bps in CPI from forecast trajectories
Ofwat Low inflation	Increase of 110 bps in RPI and 90 bps in CPI from forecast trajectories
Ofwat totex underperf	10% Totex overspend throughout
Ofwat ODI penalty	ODI penalty equal to 3% of average AMP7 Regulated Equity
Ofwat combined scenario	Combined scenario of a 10% Totex overspend, £150m ODI penalty and £25m retail overspend
[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
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[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]	[redacted]

We have carried out reverse stress testing to determine ex ante the financial headroom available under our actual financing structure to withstand persistent under-performance on both totex and ODIs with reference to minimum investment grade credit rating thresholds for Moody's AICR and S&P FFO/ Net Debt.

The results were compared to severe but plausible scenarios we have developed for both ODIs and Totex to assess the likelihood of a shock that could result in a sub-investment grade credit rating.

Taking into account Ofwat's Draft Determination and the steps we are taking to enhance resilience through additional mitigation, base case financial projections indicate financial headroom above these minimum investment grade thresholds in all years of AMP7.

Table 5 Reverse stress testing of AICR and FFO / Net Debt

	Moody's AICR	S&P FFO / Net Debt
AMP7 average	1.22x	8.08%
Minimum threshold for investment grade credit rating	0.90x	6.00%
ODI shock (assuming no lag in the application of the penalty) (£m, nominal)		
Average annual shock	34.77	85.27
Shock over AMP7	173.87	426.35
Shock as % of average AMP7 Regulated Equity	1.49%	3.65%
Headroom vs Southern severe but plausible ODI case	72.26	324.74
Totex shock (post-sharing) (£m, nominal)		
Average annual shock	90.39	221.66
Shock over AMP7	451.97	1,108.30
Shock as % of average AMP7 Totex	10.73%	26.30%
AMP7 Headroom vs Southern severe but plausible Totex case	324.74	964.78

For ODI and Totex, the magnitude of the shock required to reduce projected metrics below investment grade thresholds significantly exceeds the severe but plausible scenarios we have developed - for the most sensitive metric, AICR under the ODI shock, there is headroom of £72m. This supports our conclusion (tested in detail below through modelling company-specific downside scenarios) that we are resilient to plausible but severe shocks.

An overview of the impact on key credit metrics under each of these downside scenarios we have considered is set out below:

Figure 6 Impact on key credit metrics under downside scenarios

	AICR (Moody's)	Net debt/RCV (Moody's)	FFO/Net debt (S&P)
Base Case			
Base Case: Further mitigation	1.22	71%	8.07%
Ofwat Scenarios			
Ofwat High inflation	1.01	71%	7.25%
Ofwat Low inflation	1.47	71%	8.75%
Ofwat totex underperf	0.97	73%	7.11%
Ofwat ODI penalty	1.08	71%	7.70%
Ofwat combined scenario	0.59	74%	6.03%
[redacted]			

We can maintain financial resilience against our Baa2 target credit rating, albeit with less headroom due to the continued reduction in the allowed WACC, in all but the most severe scenarios where, in the implausible absence of any mitigation, we would face some issues. In these scenarios the mitigation plans we have in place, combined with the very low probability of occurrence, mean that they do not impact the Board's ongoing assessment that the regulated company is financially resilient. This process builds on the work we regularly undertake, most recently captured in our Long Term Viability Statement.

We have also recently developed our resilience action plan, which in practice we believe significantly improves our ability to manage and mitigate any risk that crystallises. All else equal this would reduce the financial impact of these scenarios.

Based on the scenarios set out above, we have sufficient headroom to remain liquid given our ability to limit distributions, draw down on the Revolving Credit Facility (RCF), the Debt Service Reserve Liquidity Facility

(DSRLF) and access capital markets. We believe we are able to maintain an investment grade rating in all plausible scenarios considered:

- [redacted]
  - [redacted]
- We have carried out extensive analysis of our risk exposure. In our view a number of the scenarios modelled (for example the scenarios set out by Ofwat in its position statement on ‘Putting the Sector Back in Balance’ are not plausible, based on our stochastic analysis of risk as well as our historical performance. In particular, we believe that the Ofwat Totex and Combination scenarios do not constitute plausible shocks.
  - We would experience a significant financeability challenge that would require mitigation under Ofwat’s combined scenario, including 10% Totex and retail cost underperformance and an ODI penalty of 1.5% in each year of AMP7. This scenario combines a number of outcomes that are extremely unlikely.
  - Totex under-performance of 10% based on the Ofwat scenario without effective business mitigation could result in a significant deterioration of key credit metrics (e.g. AICR persistently below 1.2x.) and could imply a credit rating downgrade. We have carried out robust analysis of risk which indicates that this level of over-spend relative to allowances is unlikely.
  - P10 ODIs scenarios would likely result in a downgrade of at least one notch to Baa3 relative to base case, however, the calibration of this scenario does not take into account correlations between each ODI P10 and as a result does not constitute a combined P10 or a likely outcome.
- Where scenarios are of short duration (e.g. the Ofwat ODI scenario) or relate to high inflation, our experience is that rating agencies would ‘look through’ these shocks as exceptional or one-off shocks – especially where combined with a reactive and prudent dividend policy – which ultimately are non-recurring and do not indicate sustained under-performance. For example we have in recent high inflationary environments had an AICR of 0.7x, however Moody’s did not downgrade us from Baa1.

We will need to re-assess the financeability and resilience of our plan if the outcome of the Final Determination results in significant changes to financial projections for the next AMP.

Overview of the associated risk management / mitigation approaches to secure long term financial resilience and our approach to equity support

Having recently completed our strategic capital structure exercise where our shareholders facilitated new equity of £700m, which has been used to significantly reduce our financial risk, we have demonstrated that equity represents one of the key tools that we can use to support our financial resilience. In planning our latest mitigating measures to ensure continued resilience at our Baa2 target credit rating we have looked at all options including both debt and equity. In moving forward with our chosen solution, which includes bringing forward cash flows related to inflation linked swaps and bonds, we have carefully considered the pros and cons of all these different options. We believe our chosen option represents the optimal balance between these various pros and cons, not least those specifically relating to costs and execution.

We have recently developed our resilience action plan to enhance our ability to anticipate, withstand, prevent, adapt to and/or rapidly recover from disruptive challenges.

We believe that the improvements we are making to our approach to resilience will significantly improve our ability to manage and mitigate downside risk, and that as a result we will be able to reduce the financial impact of the downside scenarios above.

Our approach to long term financial resilience is underpinned by our regular and detailed consideration of forecast cash flows, risks, liquidity and operational scenarios that form part of our business as usual risk management process. This is co-ordinated by the executive and regularly reported on to the Executive Leadership Team, Board, and Investors. Our Whole Business Securitisation (WBS) structure puts in place a number of obligations and restrictions on our actions that are regularly reported on. This includes investor reports, liquidity facilities, and credit ratings.

In downside scenarios, a key aspect of mitigation is our flexible approach to dividend policy that is intended to support our target credit ratings where required. This has been evident historically, most notable when we had a significant revenue shortfall in AMP5.

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

Financeability assessment for the actual company with a further 37bps reduction in the WACC – base case projections

Ofwat has indicated that based on the latest market data (June 2019) WACC would fall by 37bps at FD, in addition to the 21bps reduction at DD. The table below sets out the impact on base case projections for the actual company if all else equal the WACC falls by 37bps as indicated by Ofwat.

Table 6 Financeability assessment for the actual company with a further 37bps reduction in the WACC – base case projections

	AMP7						AMP8					
	20-21	21-22	22-23	23-24	24-25	Avg	25-26	26-27	27-28	28-29	29-30	Avg
(AICR) (Moody's)	0.99x	1.08x	1.10x	1.10x	1.12x	1.08x	1.37x	1.37x	1.37x	1.36x	1.34x	1.36x
Net Debt / RCV (Moody's)	71.8%	71.3%	71.1%	70.5%	70.0%	70.9%	69.5%	69.2%	68.8%	68.5%	68.2%	68.8%
FFO / Net Debt (S&P)	6.7%	8.1%	7.9%	7.8%	7.9%	7.7%	10.1%	10.3%	10.5%	10.6%	10.8%	10.5%

- This further reduction in WACC would reduce AICR to 1.08x on average over AMP7, which is below the 1.1x minimum threshold for Baa2 and indicates a Baa3 rating. This is consistent with the rating that would be achieved by the notional company at this WACC.
- Our conclusions on financeability and resilience are predicated on the absence of any further reduction in the industry WACC and as a result credit ratings falling below Baa2.
- Any further reductions in the WACC would cast the financing of our plan into doubt and would require extensive re-assessment of both our ability to raise debt, and our financial headroom, for both the notional and actual companies.

3.4.5 Treatment of the gearing outperformance mechanism

We note that Ofwat has retained its "gearing outperformance mechanism"; we are targeting gearing below 70% by our balance sheet date of 31 March 2020 and believe that this mechanism will not apply to Southern Water. We nonetheless believe that conceptually this mechanism is not supported by economic or financial theory:

- In economic terms, the rationale for the Ofwat's proposals must be the identification of market failures that require regulation in the first place.
- The implied premise of the new mechanism is that gearing above a certain level is a market failure, which needs to be explicitly regulated. However, Ofwat does not consider whether any such form of sharing of higher required returns to equity due to leverage is actually observed as an efficient outcome in competitive markets.
- If stress testing indicates that a company's finances are not sufficiently resilient, robust mitigating actions will have to be set out up front. However, Ofwat does not appear to have considered whether the mechanisms already in place might be effective in addressing these concerns.
- We do not support the simple thesis that higher gearing means higher risk. We believe that each company, situation, and capital structure must be assessed on its merits. We are firmly of the view that our "Whole of Business Securitisation (WBS)" provides significant protections to creditors and customers that build and enhance the restrictions and obligations placed on us by our instrument of appointment. Our target level of gearing is informed by a combination of factors including: business risk, allowed WACC, size of capital programme, peer companies, and credit rating agency views.
- In addition, gearing is only one aspect of financial resilience, our strategic refinancing has also significantly reduced our swap interest costs from 2020 – 2030. On top of this a key WBS principle is to ensure continuing access to significant liquidity via a committed Revolving Credit Facility (RCF) and a Debt Service Reserve Liquidity Facility (DSRLF). We have recently renewed our £330m RCF and £103m DSRLF for a period of 5 years (with two optional 12-month extensions at our request). These facilities form the cornerstone of our financial resilience in downside scenarios and allow us to mitigate and manage liquidity whilst we respond to challenges.

We continue to disagree with Ofwat's proposed gearing outperformance mechanism. It is at odds with corporate finance theory, and does not contribute towards financial resilience.

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4. Action SRN.LR.A3

Statement of support from Greensands Holdings to Southern Water

Board of Directors
Southern Water Services Limited
Southern House
Yeoman Road
Worthing BN13 3NX

Dear Directors,

Support for Southern Water's 2020 – 2025 Business Plan

We are delighted to support Southern Water's SWS) ambitious business plan that we believe will deliver a resilient water and wastewater future for customers in the South East.

As part of our support for SWS' plan, and in order for the company to maintain financial resilience now and in the long term, with your agreement and support we have recently facilitated a new equity contribution of £700m to SWS as part of a series of risk mitigating measures undertaken as part of SWS' own strategic review of its capital structure, as detailed in their September 2018 business plan.

The new equity investment into SWS will reduce SWS' AMP 7 opening gearing to around 70%, constituting a significant reduction in external debt, thereby reducing financial risk and representing a clear risk transfer from SWS to companies outside the SWS 'ring-fence'. We are also currently engaging with SWS in relation to the mitigation measures it is developing to maintain sufficient financial headroom in support of its Baa2 target credit rating.

We see these measures as part of SWS's comprehensive plan to ensure resilience in the round in delivering to customers' essential water and wastewater services. They also result in a robust and transparent capital structure in line with Ofwat's requirements.

The recent equity investment is consistent with our support for SWS since acquisition in 2007, and indicative of our continued commitment to SWS. Over the period since 2007, we have supported the adoption by the SWS directors of a dividend policy that underpins SWS' target credit ratings.

Our support for this strategy has resulted in prolonged periods of low equity returns to shareholders relative to those of comparable companies. However, our collective actions have enabled SWS to invest in the business when required to ensure resilience of water and wastewater services for customers.

In the last year, we have also supported the company and its Board as it seeks to resolve legacy wastewater issues and in the further modification of the dividend policy to ensure that it remained compliant with Ofwat's and SWS' customers' requirements.

Our support for this approach, now and in the future, is consistent with our mandate as long-term infrastructure investors, and is supportive of SWS's ambition to continue to undertake a significant transformation that will enable a step change in performance into the future for the benefit of its customers. To ensure the company is sufficiently resourced for this step change, we have supported the SWS board in its appointment of a new Chairperson (Keith Lough) and two new independent non-executives (Kevin

McCullough and Gillian Guy) with specific experience and skill-sets intended to improve the capability of the Board to successfully navigate SWS though the ambitious transformation.

We take pride in our stewardship of our investment in SWS, a company that provides an essential public service. We are committed to continue our responsible approach to ownership and to supporting SWS's delivery of its ambitious vision for the 2020-2025 period and beyond.

Yours sincerely,

Chairman, Greensands Holdings Limited on behalf of the Greensands Holdings Limited board of directors

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