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Water 2020

Ofwat

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Dear Water 2020,

On 10 December 2015, you published a consultation on your preferred approach to the design of the future regulatory framework for the water industry entitled "Water 2020: Regulatory framework for wholesale markets and the 2019 price review."

The consultation contained a number of important key proposals, including a separate briefing sheet on implications for investors. M&G is one of the largest investors in the water sector, with significant debt and/or equity holdings in most companies in the sector.

A water industry that addresses stretched water resources, customer affordability, water quality and system resilience builds the case for attracting further private sector investment in the future. We therefore support the overall objectives of Ofwat towards any improvements that increase the attractiveness of the sector in this regard, including transparency and stability.

However, we wish to register a number of significant concerns with the substance of the proposals, drawing out some high level implications in the process.

**Indexation**

While we understand why a regulator may be attracted to the lower indexation inherent in moving from RPI to CPI we are concerned that the implications for financial markets have not had adequate weight in the decision. The majority of the underlying capital which we invest in the water sector comes from our pension portfolios which are looking for long term investments to match against their long term liabilities. The majority of these liabilities are explicitly linked to RPI and as a result there has been substantial appetite for long dated investment-grade RPI linked paper, which the water sector has been able to provide.

CPI is relatively new on the liability side and, unsurprisingly, there is only fledgling appetite for CPI linked paper, with much of that short dated (i.e. c. 5 year). To date, the Government has not decided on its preference for either CPI or CPIH; it has not issued any CPI linked gilts, let alone tackled the issue of developing a liquid CPI related government bond curve alongside maintaining a liquid RPI curve. The ability to hedge CPI is still rudimentary and so a liquid and transparently market-priced CPI market for corporate issuance cannot form. The net result is that the market is adding a "wedge" to RPI to represent the spread between RPI and CPI. There is a market up to about ten year maturities but not longer than that. This makes long dated CPI linked debt or swaps expensive and scarce.

In our opinion, the proposed changes in the water sector risk putting the cart before the horse. If the government wishes to introduce CPI indexation more widely it should focus on creating a benchmark CPI linked gilts curve from which a deep and liquid financial market for CPI corporate issuance can form and be priced. Only then should Ofwat be making changes to the way the water industry cashflows are indexed. Without those changes, the water industry is significantly less attractive to us as an investment proposition. Furthermore, the report published by N.E.R.A. Economic Consulting on the use of inflation indices in the water sector has concluded that, relative to an RPI approach, customer bills will increase by 4 - 7% relative over a 15 year period under Ofwat's preferred proposal. Pay-As-You-Go ratios would need to be adjusted down by 6 - 10% to offset the impact of a higher CPI-based W.A.C.C.. We take these consequences as materially reducing the sector attractiveness for investors, all else being considered equal.

**Markets**

In Water 2020, Ofwat also introduces fundamental proposals to develop competition at both ends of the water value chain, for Water Resources provision and for Sludge treatment and handling. This is on top of the previous Price-Control-Review decision to introduce competition for non-household retail customers from 2017. Ofwat is also looking at the possibility of competition for all UK household customers, which if actioned would result in further significant change for the sector from 2020. While we appreciate that climate change, population growth and consumer water bills are issues that need to be considered, such changes are unlikely to come without cost.

We note the potential changes are likely to diminish or indeed break the traditional vertically integrated business model of water companies and WaSCs. At the same time, we believe that the sector faces significant unforeseen or neglected water system costs such as flooding but also potentially managing wider catchment management, which need to be tackled intelligently and on a sustainable footing. While new bodies could be created and resourced to tackle these issues, water companies have a geographic footprint and significant expertise to overlap with intelligent or innovative solutions which might be lost with vertical dis-aggregation.

Undeniably, the changes proposed will also add far greater sector complexity with higher numbers of parties involved in the water value chain, create an increase in the number of regulatory reviews, as well as raise questions as to how the remaining water and wastewater companies will grow, evolve, be credit rated, financed, and how consumers will perceive all of this. In essence, increasing future sector complexity raises many questions and longer term uncertainties that as investors we have to take a view on today.

Ofwat proposes to ascribe both RCV value and competitive viability to separate Water Resources and Sludge businesses going forward. There appears to be some cannibalisation of the legacy RCV in favour of new businesses valued at MEAV (modern equivalent asset value). It is a well-known fact that the MEAV for the UK regulated water and wastewater sector is above the RCV allocated at the time of privatisation, potentially by as much as 160%, which is a detail hardly emphasised given the economic and political questions it triggers. However, allocating more asset value to new business by detracting it from the legacy business risks sending a

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destabilising message to investors. All regulated UK water companies, except for Thames Tideway, have a RCV that was fixed at the time of privatisation. In the absence of an absolute anchor to the actual asset base, regulatory and government behaviour around RCV remain the key tenets of maintaining corporate and financial confidence in this core principle.

In the case of Water 2020, the RCV allocation on a MEAV basis to the new Resources/Sludge businesses equates to circa 10% of the total RCV of UK regulated water (i.e. the combined water and wastewater resources), whereas the £ RCV value of the combined remains as before. At the very least, this raises some fundamental questions from a credit perspective, as to whether the traditional reliance on RCV more widely is fully appropriate, as well as linking into the RPI/CPI discussion above.

We further suggest that the context of Ofwat's proposed changes be considered against a wider backdrop of a government desire to invest significantly more into UK infrastructure while also protecting consumers. This raises the danger of asymmetric risks with regard to cost versus investment building up in the system over time. The regulated UK water sector is certainly not as immune to this risk as it has been historically. We note the apparent progressive shift in political backing, evident with the Water Act 2014 evolution and vs. that of its preceding Water White Paper, then more specifically with the arguably pointed critique reports of the National Audit Office and Public Accounts Committee, and now with an enquiry for full retail competition underway.

For regulated UK water companies, the corporate model is used to manage the interests of customers and all risks with relative stability over the long-term. This enables access to relatively cheap debt finance and for re-financing on a continual basis. Some of these proposed changes are likely to represent a very different risk and investment proposition for end investors.

In conclusion, as lenders and investors, we judge the valuable overall aims of Water 2020 to be adversely impacted by a number of specific proposals which significantly reduce the attractiveness of the sector for both debt and equity. In particular, we return to the original concern of investors that moving indexation of revenues and RCV to CPI is not value-neutral over the long term, and we cannot ignore issues raised from the other proposed changes and rapidly expanding sector complexity. As we have met in the past, we remain happy to meet to clarify and to discuss any of the above in greater detail.

Yours faithfully,

Orlando Finzi

Director of Fixed Income

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