

Dear OfWat Team,

On behalf of Long Term Infrastructure Investors Association I am pleased to submit our responses to the consultation above. The responses are based on a feedback from our members. In total, seven members provided their input, including five fund managers, one institutional investor and one law firm. As a general policy matter, we do not disclose individual responses but share consolidated position, which you find below.

Q1: Do you agree that the cost of debt allowance should be set on the basis of a notional capital structure and notional cost of debt for all companies as opposed to being based on the actual capital structure and debt costs of each company?

The notional structure is a long standing methodology. Any change would be seen as a reduction in regulatory certainty which is only acceptable if justifiable through added benefits. A notional debt allowance is also sensible, provided it reflects efficient cost of debt incurred. All Companies have been incentivised in the past to only take on debt at efficient cost, and this efficient cost should be recoverable as part of allowed income.

Q2: We do not propose to introduce a specific benefit sharing arrangement for companies with securitised capital structures. Do you agree with this approach?

Yes, for the reasons Ofwat described. Also, doing it differently would be inconsistent with maintaining the approach of notional capital structure and notional cost of debt.

Q3: Do you agree to the introduction of indexation for the allowance for the cost of new debt?

Generally not, unless the right index can be found that compensates real costs. The risk of working with an index is that it encourages a Company to take on new debt with a profile that reflects the index (so as to avoid risk of underperformance), which may not be desirable. Currently many water companies have a debt profile longer than 10 years, which was deemed efficient. Also, it is unclear how well an index can capture expected cost of debt volatility around 2019 in connection with Brexit. Finally, in the past, appropriate debt structure and debt profile has been a decision of management.

A positive of the indexation may be better risk sharing with customers.

Q4: Do you agree that indexation of the new debt allowance should have an end of period adjustment?

There are pros and cons of either. On balance we favour end of period adjustments.

Q5: Do you agree to an adjustment to the inflation estimate to reflect out-turn inflation and so mitigate inflation forecast error for new debt only?

Generally, yes (assuming the indexation is introduced). A negative is that this triggers another perverse incentive that might arise to favour index linked or nominal debt.

Q6: Do you agree that we should leave companies to develop their own risk company specific risk mechanisms on a voluntary basis for the 2019 price review and we should not mandate a company specific risk sharing mechanism?

Yes.

Q7: What are the potential advantages and disadvantages of a menu based approach to the cost of equity, compared with the approach adopted by Ofwat at PR14?

A menu being judged by the Regulator is subjective – which potentially increases uncertainty for investors which is not desirable, but a mechanism to reward “ambition” within a sensible risk framework could be positive. We note that the current regime encourages company management to focus on providing benefit to consumers through the incentive arrangements.

In addition, let me re-confirm that LTIIA stands ready to enable sharing of the data and research findings from the EDHECinfra [benchmarking platform](#) to the extent you might find that useful for calibrating allowed return and other regulatory parameters.

Happy to discuss our feedback further at your convenience.

Best regards,
Eugene

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