30 August 2017

Dear Sirs,

Re: “Delivering Water 2020: Consulting on our methodology for the 2019 price review”

We are writing to you in response to Ofwat’s consultation for PR19 (the “PR19 Consultation”). Allianz Capital Partners (“Allianz”), DIF and InfraRed Capital Partners Limited (“InfraRed”) each manage investments in the Affinity Water group, including Affinity Water Limited. We are responding to the consultation documentation as long-term investors in the UK regulated water sector and have focused our response on some investor-specific matters.

Between them, Allianz, DIF and InfraRed manage over 100 investments in infrastructure assets in the UK and Europe; and in doing so are exposed to a wide range of regulatory regimes. We bring the benefit of this experience to our review of, and response to, Ofwat’s consultation, “Delivering Water 2020”. We believe that other existing and prospective investors share our views.

Our investment philosophy

A long-term investment horizon is core to the investment strategy of the funds that we manage, meaning we seek returns for our investors through cash yield rather than exits. The capital that each of us has invested in Affinity Water focuses on assets that provide stable, preferably inflation-linked, cash flows in perpetuity. We invest in assets that provide essential services to the public seeking regulated or contracted revenues in return. We will also take risk on capital expenditure to improve the services provided to the public, if supported by appropriate contractual or regulatory protection.

The United Kingdom enjoys a long and successful history of attracting private sector investment into infrastructure with a key component to that success having been the stability and predictability of its regulatory regimes. The comfort investors have taken in the country’s regulatory frameworks has fuelled entry into its infrastructure market by the most competitively priced providers of capital from around the world. Many of our investments in the United Kingdom have been made for these same reasons and we urge Ofwat to continue to foster the stable and predictable regulatory regime which it has developed over the past 30 years that provides security of past returns.
PR19 Consultation

We welcome early engagement by Ofwat on important aspects of the forthcoming regulatory settlement for PR19. We have reviewed the PR19 Consultation documentation in detail and commend Ofwat for the clarity and detail of the proposals which have been presented to stakeholders in advance of the price review.

Ofwat has provided greater detail of the assessment tests that it will undertake on the company business plans (compared to PR14) and the core building block metrics are all very well defined. This allows very clear definition of activities and scenarios for PR19 and some certainty over Ofwat’s approach to PR19.

We are supportive of many of the key proposals in the PR19 Consultation. We welcome the focus on:

• Customer engagement;
• Environmental enhancement;
• Operational resilience;
• Affordability;
• Innovation; and
• Stronger incentives for performance (where this is appropriately calibrated).

However, we are also concerned that Ofwat has introduced a range of proposals which, in the round, imply that investors will be assuming more downside risk than upside opportunity during AMP7. This includes proposals around the potential calibration of future performance commitments (PCs) and outcome delivery incentives (ODIs), as well as added uncertainty from the introduction of competition, the move to CPIH, as well as inflation and bad debt risk in retail.

A shift in the underlying risk profile of an investment would normally be compensated by a higher cost of capital. However, Ofwat is also proposing a significant reduction in the headline cost of equity for PR19. The basis for this is a departure from the approach previously employed with respect to estimating a key component of the cost of equity - the total market return (TMR).

The proposed TMR range is based on an extrapolation of the low interest rate environment that prevailed at the time of PwC’s analysis. Recent evidence on interest rate projections show that bank rates over the short to medium term are expected to rise and that any assumption of ‘lower for longer’ is not currently supported by market expectations'. Our position in respect of this issues is set out in more detail in Appendix B.

Conclusions

The PR19 process has been set in motion well in advance of AMP7 and should result in adequate planning for, and transparency over, the regulatory settlement. We are motivated to work with Affinity Water to continue to invest in operational resilience, innovation and technology. From this perspective, we welcome many aspects of Ofwat’s consultation.

Nevertheless, there remains a need for a fair return to support such investment. Our view is that Ofwat’s current proposals, including the proposed increase in the downside risk of an investment in the UK water sector referred to above, do not support a cost of equity in the

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1 See, for example, recent OBR forecasts, consensus forecasts, overnight index swaps/yields and Bank of England interest rate projections.
range proposed in the PR19 Consultation. This also raises the question of the opportunity cost of our involvement in the sector, given the higher returns provided by other UK and EU regulators. We would welcome an opportunity to engage in a further discussion with Ofwat on cost of equity.

If you have any further questions regarding our response, please do not hesitate to contact us.

Yours sincerely,

[Signatures]

Jaroslava Korpanec  
Allianz Capital Partners

Angela Roshier  
DIF

Tony Roper  
Director, 
InfraRed Capital Partners Limited

Appendix A: About the investors
Appendix B: Ofwat’s proposed approach to the cost of equity

Ends.
Appendix A: About the investors

August 2017
**Allianz Capital Partners:**

ACP, founded in 1998, is a wholly-owned subsidiary of Allianz SE and advises Allianz SE and its insurance subsidiaries on investments in alternative assets. Under its three business lines (Infrastructure Investments, Renewable Energy Investments and Fund Investments) ACP has more than EUR 19 bn of alternative assets under management with investment professionals based in Munich, London, New York and Singapore. The asset classes covered by ACP match the requirements and long-term liabilities of the Allianz SE insurance companies. ACP’s investment strategy is targeted to generate attractive, long-term and stable returns while diversifying the overall investment portfolio for the Allianz Group insurance companies.

ACP combines comprehensive industry expertise and knowledge with financial strength and structuring flexibility. In addition to Affinity Water ACP has considerable experience in the UK regulated space from its investment in Thames Tideway Tunnel and Cadent (formerly National Grid’s Gas Distribution business).

Allianz SE is a leading global financial services provider headquartered in Munich, Germany, which offers insurance and asset management products to more than 83 million customers in over 70 countries. It is a member of the DAX index of Deutsche Börse and has assets under management exceeding EUR 1.8 trillion of which over EUR 683 billion are Allianz’s own funds.

**DIF:**

DIF is a leading independent fund management company with ca. EUR 3.9 billion of funds raised since its inception in 2005. Through seven investment funds, DIF invests in high-quality infrastructure assets that generate long-term, stable cash-flows, including Public Private Partnership projects (PPP/PFI/P3), renewable energy projects, regulated assets and other contracted core infrastructure projects in Europe, North America and Australia.

Over the years, DIF has invested and committed over EUR 3 billion to over 180 infrastructure projects, with a total project value exceeding EUR 25 billion.

**InfraRed Capital Partners:**

InfraRed Capital Partners Limited (InfraRed) has successfully invested in over 200 infrastructure projects since 1997. InfraRed is a leading international investment manager focused on infrastructure and real estate. It operates worldwide from offices in London, Hong Kong, New York, Seoul and Sydney. With over 120 professionals it manages in excess of US$9bn of equity capital in multiple private and listed funds, primarily for institutional investors across the globe.

InfraRed manages a number of funds investing in the real estate and infrastructure sectors, including HICL Infrastructure Company Limited, the largest infrastructure investment company listed on the London Stock Exchange and a member of the FTSE250 index. InfraRed has been ranked in the top 10 infrastructure investors by Infrastructure Investor (as part of the Infrastructure Investor 30 – a ranking of the 30 largest infrastructure fund managers globally by size). InfraRed is authorised and regulated by the Financial Conduct Authority.
Appendix B: Ofwat’s proposed approach to the cost of equity

August 2017
1. Certain of Ofwat’s proposals have the potential to increase equity risk

We believe that Ofwat’s proposal to reduce the cost of equity given recent the market environment is less attractive in the context of several proposed changes in the PR19 consultation which could significantly increase the risk to regulated firms.

1.1. Competition

Ofwat’s proposals to introduce competition in upstream resources for water and bio-resources will place Regulatory Capital Value at risk beginning in 2020\(^1\). Full exposure to competition will occur once the markets are formally opened, possibly during the 2020-25 period.

Given the higher risk, investors such as ourselves assign a much higher cost of capital to assets in competitive markets compared to regulated monopoly utilities.

In the Water 2020 statement, Ofwat acknowledged that an evolution to market pricing could introduce asymmetric risk with an impact on the cost of capital\(^2\). Increasing our risk exposure whilst reducing the regulated return could significantly reduce the attractiveness of our investment.

While a clear timeline has been set for the introduction of competition into the sector, we urge Ofwat to reconsider the impact it will have on the cost of equity now.

1.2. Increased downside risk

Ofwat has introduced a range of proposals which do not in themselves increase systematic risk but which have more downside than upside, or are downside only.

Equity investors expect to participate in and receive remuneration for undiversifiable risks - exposure to downside risk should be matched by comparable exposure to upside risk. The CAPM methodology used to determine the cost of equity depends on the normal distribution of returns, with no ex-ante expectation that upside or downside will dominate\(^3\).

Examples where returns are skewed to the downside include:

- ODIs where Ofwat expects that average performing companies will receive penalties. It is possible that even those performing well above average will receive penalties if the thresholds are set using upper quartile efficiency.

- The introduction of frontier efficiency for Totex benchmarks, with no allowance for a glide path. This will cause all but the frontier company to incur an initial loss, with no corresponding upside.

- The cost sharing percentages for Totex will be asymmetric, with less of an over-run being shared, while more of outperformance will be retained.

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\(^1\) Ofwat consultation July 2017 p118-119, p125-128

\(^2\) Water 2020: our regulatory approach for water and wastewater services in England and Wales, Ofwat, May 2016, p121

\(^3\) See, for example: Investment Valuation, Damodaran, 2002
• The bio-resources revenue forecasting incentive, which is penalty only.

• Inflation risk in retail along with increased bad debt risk in the absence of legal rights to deny service.

Empirical studies demonstrate that skewed return expectations affect the cost of equity, thereby rendering the unadjusted CAPM misleading. In the presence of asymmetrical returns with greater exposure to downside risk, the cost of equity should be increased to provide a fair expectation at the outset.

1.3. Added uncertainty from the move to CPIH

Ofwat has indicated the change from RPI to CPIH indexation will be implemented such that it is NPV neutral to investors. While we welcome this proposal, we highlight certain downside risks which may be outside of Ofwat’s control, particularly in the longer term, including:

• Low liquidity in the CPI-linked debt market driving higher premia for future financing.

• Higher cashflow volatility until such time as the company can replace all of its RPI-linked debt given the lower volatility of CPI compared to RPI. Revenues will be more stable but interest costs could still shift dramatically.

• Over the long term, Ofwat being unable to or choosing not to implement the mitigants which will make the transition from RPI to CPI NPV neutral. Examples are applying two real WACCs, one derived using RPI and one using CPI and the true-up for the difference between the outturn and forecast value for RPI less CPI.

All the above present potential sources of increased risk to shareholders.

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4 See e.g. Investment Valuation, Damodaran, 2002
2. The proposed approach to cost of equity is at odds with UK and European precedents

2.1. UK precedents

Ofwat proposes a real total market return (“TMR”) of between 5.1% and 5.5%, based on current forecasts of TMR.

In setting the market-wide parameters for the cost of equity, regulators have ordinarily placed weight on long-run methods i.e. a “through the cycle” view. Past decisions therefore generally adopted a long-run, ex-post returns figure to set TMR, which resulted in TMR estimates of approximately 7.0% real. This followed the 2003 and 2006 Smithers reports which concluded that long-run ex post returns were the appropriate bases on which to set TMR for charge control purposes.

In the NIE 2014 appeal, the CMA moved away from the 7.0% real TMR to a range of 6.0% to 6.5%, with weight being placed on the upper end of this range. The Smithers reports and the CMA’s 2014 NIE case have been an ongoing source of reference by UK regulators and recent regulatory decisions have all set a TMR of approximately 6.5% in real terms. No final determination has resulted in a TMR lower than 6.10% real.

Table 1: Recent UK European benchmarks for the RFR, ERP and TMR (real)

<table>
<thead>
<tr>
<th>Date</th>
<th>Jun-14</th>
<th>Jun-14</th>
<th>Dec-14</th>
<th>Dec-14</th>
<th>Feb-15</th>
<th>Oct-15</th>
<th>Apr-16</th>
<th>Nov-16</th>
<th>Sep-16</th>
<th>Mar-17</th>
<th>Jun-17</th>
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</thead>
<tbody>
<tr>
<td>Regulator</td>
<td>Ofcom</td>
<td>Ofcom</td>
<td>Ofwat</td>
<td>Water &amp; sewerage</td>
<td>Teleco</td>
<td>Water &amp; sewerage</td>
<td>Teleco</td>
<td>Water &amp; sewerage</td>
<td>Teleco</td>
<td>Telecoms</td>
<td>Ofcom</td>
</tr>
<tr>
<td>Sector</td>
<td>Telecoms</td>
<td>Telecoms</td>
<td>WBA</td>
<td>MCT</td>
<td>Telecoms</td>
<td>Telecoms</td>
<td>Telecoms</td>
<td>Electricity</td>
<td>Telecoms</td>
<td>Gas</td>
<td>Telecoms</td>
</tr>
<tr>
<td>Price control</td>
<td>LLU WLA</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
<td>PC15</td>
</tr>
<tr>
<td>Risk free rate</td>
<td>1.30%</td>
<td>1.30%</td>
<td>1.25%</td>
<td>1.30%</td>
<td>1.30%</td>
<td>1.30%</td>
<td>1.30%</td>
<td>1.30%</td>
<td>1.30%</td>
<td>1.30%</td>
<td>1.30%</td>
</tr>
<tr>
<td>Equity risk premium</td>
<td>4.80%</td>
<td>4.80%</td>
<td>5.50%</td>
<td>5.50%</td>
<td>5.10%</td>
<td>5.10%</td>
<td>5.30%</td>
<td>5.30%</td>
<td>5.10%</td>
<td>5.30%</td>
<td>5.30%</td>
</tr>
<tr>
<td>Total market return</td>
<td>6.10%</td>
<td>6.10%</td>
<td>6.75%</td>
<td>6.50%</td>
<td>6.10%</td>
<td>6.10%</td>
<td>6.60%</td>
<td>6.10%</td>
<td>7.3%</td>
<td>6.25%</td>
<td>6.50%</td>
</tr>
</tbody>
</table>

2.2. European precedents

Figure 1 below shows the risk-free rate and equity risk premia set by various continental European regulators in recent years, as reported by the Council of European Regulators. It is interesting to compare decisions on risk free rate and equity risk premium in European jurisdictions, particularly those made a number of years after the 2008 financial crisis.

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5 See for example the Competition Commission’s final decision on Bristol Water 2010 where 7.0% TMR was used.
6 Smithers 2003 and 2006.
7 Cost of Capital – Annual Update Report, 31 May 2017, UKRN, plus additions of UR recent decision
Figure 1: Recent European benchmarks for the RFR and ERP\textsuperscript{9} (real)

![European Benchmarks on risk free rate & equity premium](image)

Table 2: Averages for the sample shown.

<table>
<thead>
<tr>
<th></th>
<th>Risk free rate</th>
<th>Equity premium</th>
<th>Total market return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average – total sample</td>
<td>2.28%</td>
<td>4.61%</td>
<td>6.88%</td>
</tr>
<tr>
<td>Average – since 2015</td>
<td>2.32%</td>
<td>4.70%</td>
<td>7.02%</td>
</tr>
</tbody>
</table>

The averages presented above in Table 2 do not vary dramatically if calculated between 2008 and 2016, or between 2015 and 2016. We note also that the averages are all considerably higher than Ofwat’s range of 5.1-5.5%.

The evidence presented above in Figure 1 and Table 2 suggest that Ofwat’s current proposal for the cost of equity would present a notable opportunity cost for investors in UK water companies.

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\textsuperscript{9} The sponsor, the Council of European Regulators, acknowledges that national investment conditions can only be compared with each other to a certain extent. WACC and its components are part of an overall regulatory framework that will differ from country to country and there will be a package of different decisions which need to form a coherent whole. Investor views on the attractiveness of a regulatory framework comprises many more factors than WACC.
3. The evidence for reducing cost of equity is not sufficiently strong

3.1. Ofwat’s approach is unprecedented in UK regulated utilities

It has been common practice in all UK regulators to use long-run averages when estimating total market returns and equity risk premia. This has been endorsed by the CMA in numerous appeals of regulatory decisions. Analysis using historical returns, such as Dimson Marsh and Staunton (DMS) evidence of TMR over the long run going back to 1900, shows that there is no statistical evidence to prove short term returns are different from long term historical estimates.

The use of a common approach and long-term averages has resulted in low TMR variances over time, contributing to overall regulatory stability. The long-term stability and predictability of the UK framework for utility regulation has contributed to the success of the sectors in attracting large amounts of capital at relatively low costs, benefitting the sectors’ customers.

Ofwat is proposing to move to a new and untested method which lacks track record and evidence supporting the application of the necessary judgements. The use of forward looking methods inevitably introduces more uncertainty than using observable historical returns.

Ofwat’s reliance on shorter-term, forward-looking measures risks reducing the predictability and stability of the regulatory framework which have attracted investors to the UK water sector since privatisation.

3.2. Ofwat’s approach disregards the negative correlation between RFR and ERP

PwC and Ofwat justify a reduction in the cost of equity on the basis that there has been a reduction in interest rates and therefore the risk-free rate (“RFR”) and that this reduction has reduced returns on all asset classes.

However, in practice when there is a reduction in the RFR there is a counter-increase in the equity risk premium (“ERP”), which serves to mitigate the impact of RFR on TMR. It follows that the premise of Ofwat’s reduction in TMR i.e. the low interest rate environment is flawed.

Appendix 13 of Ofwat’s consultation document shows a five-year time series of weighted average discount rates derived from HICL’s portfolio valuation methodology. The PwC report commissioned by Ofwat to inform its PR19 proposals also refers to this metric. We would

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10 In the 2014 NIE appeal, the CC / CMA considered historical ex-post, historical ex-ante and forward-looking measures, both based on long-run returns. The first two measures were used to estimate a range of 6-6.5% for the TMR, with 6.5% being used in the decision. Forward looking measures were used as a cross check. In the 2015 Bristol Water appeal, the CMA used the NIE precedent, as it was then recently published.

11 See for example, the Smithers report from 2003. This report, regularly quoted in regulatory assessments, says that TMR is less volatile than its component parts (Wright, Mason and Miles: A study into certain aspects of the cost of capital for regulated utilities, 2003). Wright and Smithers conclude in a report to Ofgem in 2014 that there is no case for reducing equity risk premium further on the basis of recent movements in risk free rates, as the equity premium is counter-cyclical. (Wright and Smithers, The cost of equity capital for regulated companies: a study for Ofgem, 2014).


13 PricewaterhouseCoopers LLP, “Refining the balance of incentives for PR19”, June 2017, p82.
therefore like to use this opportunity to provide our response on the interpretation by Ofwat and PwC of this data.

Firstly, the data illustrates a wider theme of the evolution of infrastructure asset pricing (referenced in section 3.1 above). During the analysis period extracted in the PR19 consultation document, the weighted average discount rate used to value HICL’s portfolio decreased by 120 bps from 8.6% in March 2012 to 7.4% in March 2017. However, over the 11-year period since HICL’s IPO in March 2006 the discount rate showed a decrease of only 50 bps (see Figure 1); and over the 10-year period from March 2007 to March 2017, the discount rate has in fact increased by 40 bps.

![Figure 1: HICL weighted average discount rate since IPO (2006)](image)

The weighted average discount rate used to value HICL’s portfolio is determined by market movements and the composition of the underlying portfolio. In relation to the latter, different asset classes attract different risk premia; and asset-specific risk premia reflect asset level performance. However, it is notable that for the entirety of the period in question, 80-95% of HICL’s portfolio was invested in UK-based assets, the overwhelming majority of which were operational. In practice, the movement in the weighted average discount rate has provided an indication of market pricing for assets; and movements in market pricing have been muted.

Secondly, reviewing the evolution of discount rate (or TMR) for HICL’s portfolio over the period since 2008 (see Figure 2), it is not correct to conclude in all periods that “changes in the risk-free rate are, to a limited extent, offset by changes in the equity risk premium, but not fully”15:

- in 2008-9 increases in the ERP more than offset reductions in the RFR; and
- over the period 2010-12 TMR remained broadly constant despite material reductions in RFR (labelled as “R_f” in Figure 2);

Overall, the evolution in HICL’s weighted average discount rate supports the view that ERP tends to increase when RFR reduces, leading to muted changes in TMR. This is consistent with the wider approach taken by ACP, DIF and HICL which is not to make sharp adjustments in our long-run expectations of TMR based on the current prevailing low interest rate environment.

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15 Ofwat consultation, July 2017, Appendix 13 p16
3.3. Setting the cost of equity based on short term market data exposes us to significant financeability risk due to volatility in TMR

Short term market data shows a high degree of volatility and the confidence intervals necessary to get statistically reliable results are large.

It is common practice for regulators to set WACC parameters either above the centre of the estimated range, or to set ranges sufficiently high that choosing the mid-point of the range is less likely to under-estimate WACC.

Regulators and the CMA have adopted what seems at first sight like a conservative approach because it is understood that the risks to the wider economy from setting WACC too low are higher than setting it too high. A WACC that is lower than the underlying (but unobservable) requirement that investors set could lead to underinvestment across the sector.

Moreover, while the observable TMR is a volatile parameter, investors’ expectations are long term and less volatile (see section 3.2 above). It follows that whilst inferences can be made about possible changes in TMR, such an inference is not supported by the data, to any degree of statistical reliability. In particular, it is not possible to extrapolate forward the ‘low interest rate environment that prevailed at the time of PwC’s analysis.

3.4. Ofwat’s range for the cost of equity implies negative real risk free rates

The consultation states that PwC estimates TMR at between 5.1% and 5.5% in real (RPI adjusted) terms. Using the PR14 gearing and asset beta assumptions, this is equivalent to a cost of equity of 3.80% to 4.50%.

The table re-creates the equity range and demonstrates that at the low end of the range it is necessary to assume a risk-free rate of -1.4%, consistent with PwC’s analysis.

The introduction of negative real risk-free rates that need to endure from now to at least 2025 is another unprecedented step. The negative risk-free rate is generally considered to be a by-product of the Bank of England’s policy of quantitative easing and is reflective of a period of dis-equilibrium for the UK economy. In relying on a negative risk-free rate, Ofwat is assuming that this disequilibrium will continue through to 2025. We do not agree with this assumption and we question the support which Ofwat has in relation to the same.

Table 2: Re-creation of Ofwat’s real cost of equity ranges

<table>
<thead>
<tr>
<th></th>
<th>PR14</th>
<th>Ofwat Low</th>
<th>Ofwat High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total market return</td>
<td>6.75%</td>
<td>5.10%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Risk free rate</td>
<td>1.25%</td>
<td>-1.4%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Asset beta</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Equity beta</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Equity risk premium</td>
<td>5.50%</td>
<td>6.5%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Cost of equity</td>
<td>5.65%</td>
<td>3.80%</td>
<td>4.50%</td>
</tr>
</tbody>
</table>

16 Consultation, p208
4. The impact of Ofwat’s approach on capital structure

Ofwat has recently been paying close attention to issues around financial resilience of the sector and the capital structure used by UK utilities, pointing in particular to questions around appropriate levels of gearing, the quantum of dividends paid to investors and the ability of businesses to absorb unforeseen cost shocks.

The use of lower cost debt in an RCV-based regulatory framework is a key component that contributes to the low cost of finance that the sector has been able to attract. This low-cost finance has supported substantial levels of ongoing investment to maintain and improve the delivery of services to customers while minimising the impact on customers’ bills.

The balance of equity and debt in the financial structure is rightly left to companies to determine, as they are best positioned to do so. As a result, companies have been able to use the low risk and relatively predictable nature of future cash flows to support gearing that is higher than in some other sectors.

Ofwat suggests that companies should consider increasing equity to address financeability concerns, either via dividend restrictions, or equity injections or both.

Ultimately what matters is that an appropriate mix of equity and debt, and level of gearing, enables the most efficient capital structure. This structure is then able to support the most efficient delivery of services to customers by accessing low cost finance that helps to keep customers’ bills lower than they otherwise would be.

We remain committed to the long-term success of the sector, with customers receiving essential services at prices that are fair. We fully support the need for Affinity and other water companies to continue to invest in improving performance for their customers. The long-term remuneration of investment in the sector needs to continue to support that aim.

Higher gearing has also contributed (via interest deductibility) to the lower levels of tax paid in comparison to other sectors. Ofwat has passed the benefits directly to customers by reflecting the actual levels of tax paid, not those that would result from the notional gearing structure. As a result, customers have directly benefitted where actual gearing is above notional gearing.