Ofwat's PR19 methodology: Response from shareholders in Anglian Water ("the Company")

OVERVIEW

The Anglian Water investor group of CPPIB, FSI, IFM and 3i have been the owners of the Company since 2006. As investors, we have supported the sustainable development of the Company for over ten years, as well as many other companies operating in key UK infrastructure sectors including airports, ports and electricity networks. Our investment in Anglian Water is largely managed on behalf of pensioners who are seeking long-term investments in stable and well-run businesses that generate a fair return on investment. We maintain very high ethical standards and are committed to transparency, both within our own institutions and at a portfolio company level.

England's system of regulated, privately-financed water and sewerage systems has been a success - it has brought greater investment, cleaner supplies and a greener environment. The sector has supported UK employment, business and housing growth.

At the point of privatisation, the UK's water system was seen as one of the poorest-performing in Europe. Now, it is considered one of the best. Weaknesses in some areas of UK infrastructure are of national concern and require direct funding from HM Treasury, but this does not include water. As the consultation recognises, 'water services are often taken for granted' - an 'indication of the success of the sector'.

Anglian Water operates in one of the fastest-growing regions of the UK and in the driest, averaging only 600mm of rain a year – this is less than Barcelona[1] and half that of Sydney[2]. It supplies over 1 billion litres of water every day to 2 million households and has cut leakage and managed demand so dramatically that less water is used today than in 1989 despite a 27% increase in the number of properties served.

To achieve these results, Anglian has invested heavily – some £15 billion since privatisation. This investment is made in the context of keeping customer bills low (including a reduction of 7% in 2015), meaning that today they remain lower than they were four years ago. It is also in the context of an unparalleled commitment to sustainability - Anglian regularly wins national multi-sector awards for its innovative and sustainable approach to infrastructure investment[3]. The commitment to sustainability recently enabled Anglian to become the first UK water company to issue a Green Bond.

The Company's success can largely be attributed to good governance. Anglian Water has benefited from a strong management team backed by an experienced and stable investor base which is able to take a long-term view, operating under a fair and transparent regulatory regime. Winning the Responsible Business of the Year award from BITC in 2017 represents further external recognition of the significant achievements of the Company over many years.

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[1] http://www.aemet.es/en/serviciosclimaticos/datosclimatologicos/valoresclimatologicos?l=0076&k=cat
[2] http://www.bom.gov.au/climate/averages/tables/cw_066062.shtml
[3] For example, winning the Queen's Award for Enterprise: Sustainable Development in 2015

We believe it is of utmost importance that Price Review 2019 (PR19) continues to support the success of UK water. To that end, Anglian Water has worked closely with Ofwat in the development of its Water 2020 programme and we support the broad ambitions in the draft methodology for resilient, sustainable and affordable supplies. However, there are certain elements of the draft methodology which are a cause for significant concern for long term infrastructure investors such as ourselves. These concerns are detailed below.

INTERPRETATION OF THE 2014 WATER ACT (the "**Act**")

The 2014 Water Act challenged the industry to increase resilience in the face of increased demand and environmental change. In March 2017, the Department for Environment, Food and Rural Affairs underlined the importance of this goal in its clear description of strategic priorities for Ofwat.

Making markets work and securing resilience 'as regards environmental pressures, population growth and changes in consumer behaviour' over the long term were determined as the focus of regulation, before anything else.

Therefore, we are concerned to see that the consultation shifts the focus of the regulator's approach to aspects of resilience that are outwith the definition intended by the 2014 Act, stating that 'resilience in PR19 means long-term financial, corporate and operational resilience'.

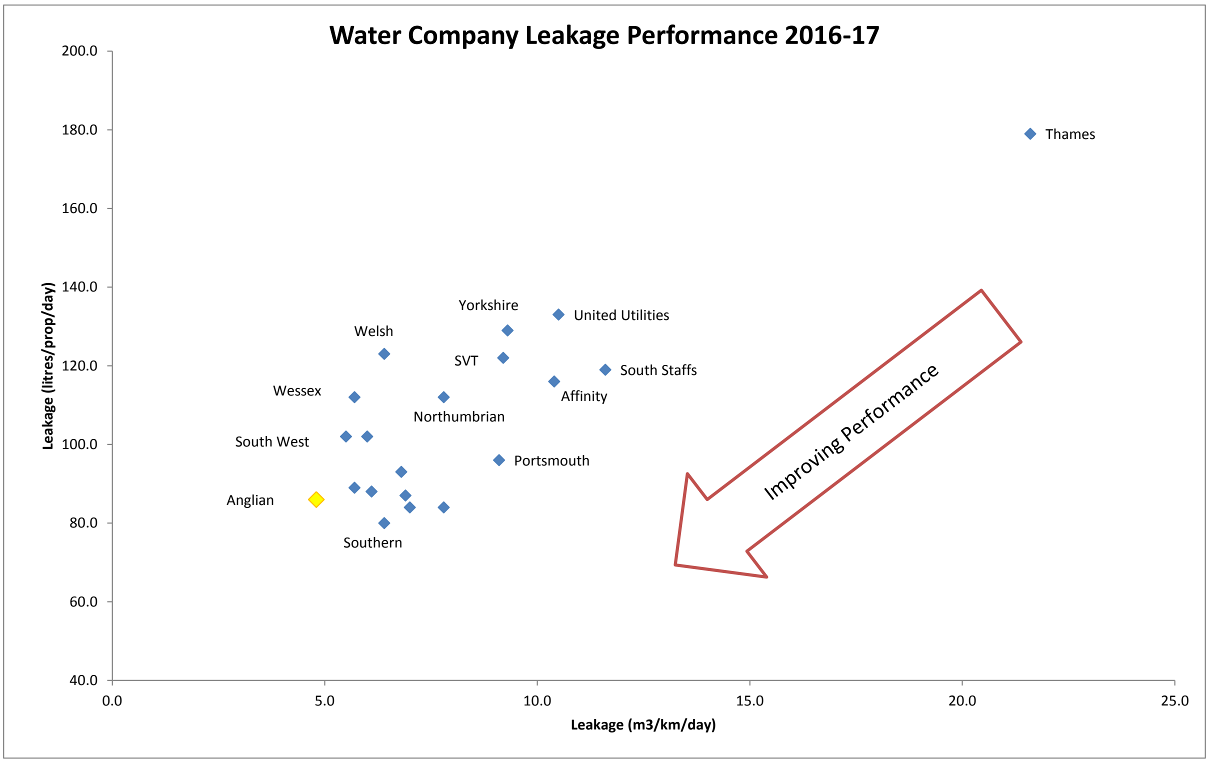
Whilst the contribution of these other factors to resilience are important, the consequence in this context is to extend the definition for regulatory purposes beyond the original scope of the Act - the need to provide secure supplies in the face of environmental pressures and population growth. In particular, we are concerned that Ofwat's reinterpretation of "resilience" takes a prescriptive approach regarding capital structures which was not the intention of the Act (see Capital Structures below).

OPERATIONAL PERFORMANCE

As currently envisaged, it is not clear that the PR19 methodology takes sufficient account of the long-term past and future performance of businesses in meeting resilience as defined by the Act.

Clearly, not all businesses start from the same position or face the same situation 'as regards environmental pressures, population growth and changes in consumer behaviour'.

An example is leakage. As investors, we have historically supported significant investment by Anglian Water to reduce leakage rates to the best in the industry (see chart below).



However, Ofwat's proposed target of a 15% or greater reduction in leakage by 2025, irrespective of the starting point for a company, seemingly takes no account of past performance. Clearly, a business that has taken limited measures to reduce leakage is likely to find this target easier to meet than one which has eliminated many causes of the problem already. There is a risk that PR19 provides an unbalanced set of incentives and penalties in such circumstances.

We are also concerned by the overall approach to incentives (i.e. ODIs). As proposed, these will create a level of asymmetry between penalty and reward resulting in an unbalanced and punitive regime. The Consultation states that 'an average company with average performance would expect to incur penalties on its ODI package'. This creates the position where a company could improve against a strong starting point and exceed the performance of others in the sector but still be penalised financially. A tough but fair regime would, in our view, see such companies at least in a neutral position.

RISK

All investments carry risk and their scale should determine the likely level of return. As both the 2014 Act and Defra statement of strategic priorities make clear, UK water supplies face pressure from a growing population and a changing climate. In 2014 the Act allowed business customers a choice of suppliers, now in place, and the Government has since suggested that this may be extended to retail customers.

As highlighted under operational performance, the draft methodology proposes to impose performance targets on companies which would not take due account of past investment and proposes a punitive approach to incentives.

Furthermore, the proposed move to CPIH (a new additional measure of consumer price inflation that takes account of housing costs) introduces a new risk to a sector that has relied heavily on inflation-linked debt. There is no established market for CPIH-linked debt or derivative financial instruments.

The overall balance of the UK water sector is clearly shifting to one of greater risk for long term investors. This change in the risk profile is concurrent with external political factors such as Brexit which are adding general instability to decisions about investment in the UK.

Given the premise that UK water as a whole is not a sector requiring remedy, it could be questioned whether now is the appropriate time to introduce multiple additional complications which add to existing risks to investment. Where additional risks are being introduced, it stands to reason that these should be fairly remunerated.

CAPITAL STRUCTURE

Ofwat has historically presided over a regime that has enabled water companies to choose their own capital structures, requiring companies to be financeable at their selected gearing level, rather than applying a “one-size fits all” approach to leverage. Extending the interpretation of resilience under the 2014 Water Act marks a clear change of direction, resulting in a far more prescriptive approach.

During PR04, Ofwat said: ‘Each company’s management is free to choose its own capital structure. We must be satisfied that customers are protected from any undue additional risk arising from a particular structure and that companies remain able to access the capital markets readily and at reasonable cost to finance present and prospective capital programmes.’

As investors, we have followed those principles. As a result, Anglian Water has been able to raise debt at advantageous rates when compared to its listed peers, with a credit rating from both S&P and Moody’s one notch stronger than our peers that follow a notional capital structure with lower debt levels.

The proposed methodology appears to be based upon an assertion that structures such as that of Anglian Water, with a higher level of debt than a “notional company” are not efficient, add risk and are not in customers’ best interests. We challenge this assertion.

Our experience over the last 15 years of being one of the biggest issuers in the capital markets suggests that Anglian Water’s capital structure has been more efficient than that of a conventional notional capital structure. In particular, the Company’s financing structure and associated covenant package explicitly introduced measures that support long term governance and financial stability and have therefore been in customers’ best interests.

RETURNS

In the context of an operating model where equity risk is clearly increasing (as detailed above) we were very surprised to see the extent of the decrease in the cost of equity range quoted in the methodology statement (3.8% to 4.5% on a real RPI basis, compared to 5.65% at PR14). Indeed, despite the increased risk profile, the proposed cost of equity range serves to make UK water one of the lowest (if not the lowest) returning investments amongst peers in UK and European regulated industries.

When calculating the returns to shareholders to meet the increased risk profile, it is clear that Ofwat has insufficiently recognised the interplay between the various elements in its proposed methodology. This is compounded by basing the long term position on cost of equity and total market returns wholly on the recent atypical period for low interest rates. A number of companies within the sector have recently commissioned an independent work to challenge this approach to calculating cost of equity.

CONCLUSION

In conclusion, the extended interpretation of the Water Act by Ofwat, the overall volume of regulatory change, the increase in the risk profile of the sector and the lowering of returns are all a cause for significant concern. Continuing private sector investment in water infrastructure is essential to meet the aims of the Government's industrial strategy and realise the significant housing growth ambitions for the East of England.

More widely, the PR19 methodology consultation and the resulting regulatory regime which we believe would be unnecessarily punitive if changes are not made, is likely to send a negative message to the international investor community at a time when the UK needs to position itself as an attractive jurisdiction for infrastructure investment.

We would invite Ofwat to reconsider the aspects of its approach we detail above. We would, of course, be delighted to discuss any aspect of this letter in more detail.

On behalf of the shareholders:

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