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Attention: Ofwat

From: Hastings Funds Management

Date: 30 August 2017

Submitted by email to water2020@ofwat.gsi.gov.uk

Response to Ofwat's PR19 draft methodology consultation

Dear Sir/Madam

Hastings appreciates the opportunity to comment on Ofwat's draft methodology for the upcoming 2019 price review ('PR19').

By way of background, Hastings is a specialist infrastructure debt and equity manager with a focus on long-term sustainable investing. Hastings currently manages in excess of £8.5 billion[1] in funds on behalf of a range of open-ended pooled investment funds and direct client relationships. In total, Hastings manages 18 investments globally across the electricity, water, airports, ports and roads sectors. With specific regards to regulated infrastructure assets, Hastings is an experienced manager of utilities networks, including South East Water and Phoenix Natural Gas in the UK as well as Sydney Desalination Plant, ElectraNet and Transgrid in Australia.

For over 22 years, Hastings has been an active investor, effectively and responsibly managing a number of critical infrastructure assets which provide essential services and play a key role in their local communities. Hastings understands its responsibilities in relation to ensuring the resilience of critical infrastructure and is committed to managing its investments on the basis of sound environmental, social and governance values, acting ethically and transparently. Hastings also recognises the importance of promoting health and safety, innovation and technology.

In writing this letter, Hastings would like to fully support the points raised in South East Water's response to Ofwat's PR19 draft methodology consultation. We would also like to add our point of view on Ofwat's proposals on behalf of our managed financial investors.

We welcome Ofwat's open and transparent consulting approach and appreciate the well-run process, multiple workshops and meetings to engage with and gather views from the various stakeholders on the proposed PR19 concepts. We endorse new approaches which improve water quality, deliver affordable customer services and protect vulnerable customers, promote innovation, preserve asset resilience and enhance the environment, to the extent those continue to provide an attractive risk adjusted return on investment.

In that sense, we support Ofwat's overall objectives but have specific areas of concern which we would like Ofwat to consider carefully:

[1] *As of 30 Jun 2017, conversion rate of 1 GBP = 1.6924 AUD*

- **Insufficient overall risk/reward balance** – Financial investors, both debt and equity, will look at the outcome of the proposals as a whole. While most elements taken individually seem challenging but potentially achievable, we believe their combination does not currently provide a reasonable risk adjusted return on investment.

  Effective incentive mechanisms can drive better outcomes and we support the incorporation of stronger efficiency and performance incentives as long as they provide a fair pain/gain balance. However, Ofwat's new proposals are both more challenging and skewed towards penalties. Those include more stringent efficiency targets based on forward looking estimates, no glide path to upper quartile positions and no deadbands. Ofwat's proposed incentive methodology would mean that not only on any given measure, 75% of water companies will be in penalty, but cumulatively across all measures an even higher percentage will likely be in net penalty. Such distribution of outcomes, and therefore the balance of risks and probabilities, is more punitive than observed in other regulatory regimes across the world.

  To compensate for the greater skew to downside risks, a premium to the allowed return would be expected from investors. Instead, Ofwat proposes to lower the cost of capital. Using a short term Total Market Return approach constitutes a major departure from regulatory precedent and introduces significant regulatory uncertainty. This is likely to further increase the risk perceived by investors and would translate in a higher cost of capital in the long term to the detriment of customers.

  While we are supportive of the cost of new debt indexation to the extent it continues to provide incentive to optimize the capital structure whilst maintaining notional financeability, we do not believe it is appropriate to allow for an ex ante downward adjustment. There is no precedent in other regulatory regimes and defeats the purpose of using an index. Applying a downward adjustment would lead to an over reliance on short-term debt and/or an over exposure to a subset of lenders which would make companies, in the round, less financially resilient.

- **Due consideration for individual circumstances** – While we generally support Ofwat's notional approach, the proposed methodology appears to unfairly ignore fundamental company differences. With regards to ODI benchmarking, the focus on upper quartile performance, and the elimination of glide paths and deadbands may penalize companies even though they put forward performance stretching commitments once taking into account their specific circumstances. It may also reward other companies who are naturally in an upper quartile position due to their specific circumstances and do nothing different or special. Another example is Ofwat's proposed treatment of the cost of embedded debt which penalises companies with a higher actual embedded debt cost solely as a result of the timing of issuance despite the efficient raising of finance; this is also inconsistent with the recent CMA decisions. We suggest that legitimate cost adjustment factors are duly considered in Ofwat's methodology.

- **Insufficient status incentives** – The incentive to submit a high quality and ambitious business plan should be stronger to truly encourage company boards to adopt a riskier approach that fosters innovation and puts customers at the heart of the plan. The financial reward proposed in the draft methodology for receiving 'Exceptional' status is very small and there appears to be only a reputational benefit for achieving 'Fast Track' status. The financial and reputational benefits need to be compared to the cost and associated risk of delivering better customer service (through potentially untested methods), greater performance commitments which are, to some extent, not fully in the company's control, and operating cost reductions through innovative technologies with limited or no track record of success.

- **Direct procurement for customers** – We are concerned about the exclusion of the incumbent company from the bidding process of large capex projects. We believe incumbent companies may be best placed to deliver the most compelling and competitive proposition for such projects and, hence, offer real value for money. We concur with South East Water and believe that a well-run, independent process will deliver the maximum benefit to customers. We also believe that certain projects may create operational issues stemming from a lack of direct control by the incumbent's management and that it may be more difficult to set and measure certain performance standards.

  In addition, Hastings would like to be able to participate in the competitive tender either as a sole investor or in a consortium with other like-minded partners if, for whatever reason, South East Water declined to participate in the procurement directly. In this scenario, Hastings would likely have a strategic or financial benefit (associated with its investment in South East Water) in participating in the large capital project and would, therefore, put forward a competitive bid which may deliver additional value for customers.

To conclude, we support Ofwat's key themes and process and are keen to continue a transparent and constructive dialogue. We agree with Ofwat that pushing efficiency frontiers and investing further in resilience and innovation are necessary and will benefit customers in the long term. We believe an effective regulatory regime can help contribute to a better alignment of shareholders and customers' interests and would like to stress that the stability of such a framework and a fair risk/return balance are critical to maintain the attractiveness of the UK water sector, preserve investors' trust and confidence and encourage investment.

As a long-term and active owner, Hastings looks forward to working collaboratively with Ofwat, South East Water and its customers to develop a customer focused Business Plan for PR19. If you would like to discuss any aspect of this submission, please do not hesitate to contact Marissa Szczepaniak.

Yours sincerely,

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