Corsair Capital LLC
7th Floor, 12 Charles II Street
London, SW1Y 4QU

GIC (London) Private Ltd
York House
45 Seymour Street
London W1H 7LX

Deutsche Alternative Asset Management (Global) Limited
Winchester House
1 Great Winchester Street
London EC2N 2DB

State Infrastructure Holdings 1 Pty Limited
Level 22 Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Australia

Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

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Consultation on the Methodology for the 2019 Price Review

Dear Sir / Madam

As long term supporters of the UK water sector, we are grateful for the improved regulatory process in preparation for PR19. The core concepts such as new price controls have been well signalled and investors have been consulted at various stages. We believe the draft detailed methodology contains a number of positive innovations that will deliver more benefits for customers in AMP7 and beyond. We do however have some views and potential concerns on the draft methodology. We look forward to engaging with Ofwat on these areas.

<u>Approach to assessing risk and reward</u>

Investors will consider the risk and reward package as a whole and will do so in the context of the uncertainty around the CPI-H transition. In this consultation, Ofwat lays out a number of positions which could, in combination, make it extremely challenging for companies to cover their cost of capital with the majority of companies unable to do so. Investors will not only look at how Ofwat determines the theoretical "reasonable return" in the headline WACC assessment but also how this translates to the actual returns which can be achieved under the proposed operational performance and efficiency incentive regime.

For example:

- A significant reduction in the cost of equity, driven by a shift in approach to assessment
- Benchmarking cost of debt to an index of comparable credit quality but then potentially applying a discount to that index

- A statement that the average company would be expected to be in net penalty for ODIs, i.e. all else being equal the average company will not earn the allowed return
- Suggesting that companies will be expected to make simultaneous and immediate step changes in both cost efficiency and customer outcomes, with no glide path or deadbands to facilitate transition from the levels funded for AMP6

While we support stronger incentives to deliver more benefits for customers and the logic of variability in returns between stronger and weaker performers, we believe that the use of 'stick' and 'carrot' incentives should remain in appropriate balance.

With respect to the cost of equity, the assessment is different to past price reviews, with more weight put on a forward looking approach. In the past, regulators have been cautious of such an approach due to a lack of data and in recognition of the significant investment in the current RCV. Any Ofwat changes in methodology will be viewed with interest across the UK regulatory sector. We note that an independent report commissioned by the Regulator's Network will be published later this year and will be a useful reference for Ofwat's consideration for its final methodology.

Ofwat notes that it has not yet concluded its work on the beta component of the cost of equity. We note that asset betas have been increasing. Hence, for consistency with any forward looking approach to cost of equity, we would expect the asset beta component to also be assessed on a forward basis, with the likely corresponding increase vs. PR14. We believe this is also appropriate to reflect the greater variability in future equity returns implied by the overall methodology, e.g. the wider RORE range for ODIs. Whilst this will put a modest degree of upward pressure on the cost of capital, we agree with Ofwat that this greater variability will be an overall positive change for customers as it puts more pressure on companies to perform.

<u>Stronger process incentives</u>

We are supportive of Ofwat's drive towards customer focused business plans that are high quality, ambitious and innovative. We believe the approach to assessment of business plans can potentially be a powerful means of getting companies to focus further on delivering more benefits to customers.

However, we are not convinced that the proposed process incentives are strong enough to elicit 'exceptional' or 'fast track' plans. Without strong incentives for those categories, investors would need to consider whether the companies have forgone allowances for legitimate costs and/or increased the risk of underperforming its plan. This may still be desirable if the company's net financial outlook is improved by process rewards, but this is unlikely to be the case when rewards are limited to 0.2% on RORE (i.e. less than 0.1% WACC) for at most two 'exceptional' companies and nothing at all for 'fast track' companies. The overall implication could be more conservatism in positioning companies' plans.

To balance the risk and return, we believe greater financial reward for 'exceptional' and some financial reward for 'fast track' would deliver more aligned incentives with the objective. At the other end of the scale, the ramifications of the 'significant scrutiny' category should be an effective deterrent from submitting a poor quality plan or one that does not provide value for money for customers.

<u>Due consideration for differences in circumstances</u>

We recognise that standardisation of measures and targets is an important tool for assessing and driving industry performance. However, we believe a balanced approach would be optimal, potentially retaining a degree of specific adjustments where clearly justified.

We support the introduction of standard ODIs, where possible. However we note that company territories have significant variations in population density, topology, type of water resources and other features, which affect deliverability of various outcomes. Consideration should be given to well evidenced circumstances beyond management control to allow for legitimate differences in the cost to serve on some performance commitments.

Similarly, legitimate cost adjustment factors should be given due consideration where sufficiently evidenced, without an arbitrary penalty being applied elsewhere.

Otherwise, without some degree of recognition for such differences, there is a risk that a company's success is primarily defined by its lack of unique features.

<u>Appropriate allowances for household retail costs</u>

The draft methodology appears to assume that all companies are currently inefficient in the household retail segment. Unlike other costs, Ofwat is proposing not to index retail costs to inflation, notwithstanding that the largest element of cost in this segment is labour.

Benchmarking against other sectors may be appropriate. However, it will be important that such benchmarks are applied carefully. Firstly, consistent customer feedback indicates that the use of a local retail billing and contact centre is strongly welcomed and that the requirement for social tariff is expected. In the case of Yorkshire Water the social tariff is also partly company funded. The cost of providing these important services compared to other industries needs to be balanced so that companies can be efficient whilst providing the support their customers want and need. Punitive cost measures could compel a review of service and support levels.

Secondly, the water industry is unique in not being able to withdraw service for non-payment. We note that the impact of that difference cannot be assessed by simply looking at incidence of service withdrawal for non-payment in other industries: the absence of a deterrent being used does not imply that the deterrent is not effective (often it means the opposite).

If Ofwat is too rigid in its assessment, we see a risk that companies with efficient retail operations may be perversely penalised by being unable to access the 'exceptional' or 'fast track' categories.

We look forward to continuing collaboration with Ofwat and continuing to support Yorkshire Water.

Yours faithfully,

Corsair Capital LLC	GIC (London) Private Ltd	Deutsche Alternative Asset Management (Global) Limited in its capacity as Manager for the RREEF Pan-European Infrastructure Fund, L.P.	State Infrastructure Holdings 1 Pty Limited