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Benefits sharing consultation
Ofwat
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By email: water2020@ofwat.gsi.gov.uk

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Dear Rachel

Response to Benefits Sharing Consultation (the "Consultation")

iCON Infrastructure wholeheartedly agrees that the management, the boards and the ultimate owners of UK water companies should ensure that the trust of customers and wider society is central to their stewardship of these essential, community facing businesses. Evidencing this, we have fully supported measures taken by the Board of Bristol Water to address proactively, and well in advance of this Consultation, the issues that have been raised:

- Numerous measures have been implemented to increase Board effectiveness, including strengthening the role of independent Chairman and the board, reducing the size of the board (and reducing the number of shareholder representatives) as well as the addition of new highly qualified and engaged independent non-executive directors alongside new experienced and senior shareholder representatives;

- Alongside a comprehensive refresh of management (including a new CEO and new senior management team), management performance measures have been implemented and a balanced scorecard approach to performance pay developed for executive directors. The policy and measures adopted are set out in detail in the Remuneration Report contained in Bristol Water's annual report; and

- Bristol Water has reduced financial leverage over AMP6 to increase financial resilience, achieved through suspension of dividends from the group to ultimate shareholders (and limitation of those dividends paid to its group by Bristol Water to the level necessary meet intragroup loan obligations as well as "start-up" working capital funding requirements of Water2Business, our non-household retail joint venture).

Notwithstanding, we at iCON Infrastructure believe that the Consultation raises many important issues of principle and practice and thus welcome the opportunity to respond. We note that this response represents the preliminary views of iCON Infrastructure only and thus does not reflect the views of Bristol Water's management or Board.

General

This Consultation is taking place in the context of Boards and management of the water companies being challenged to come up with ambitious business plans which deliver excellent customer outcomes. We have a deep concern in the context of this ambition that multiple new measures being contemplated, the way they interact with both each other and other aspects of the PR19 review and the combination of downside "financial resilience" scenarios proposed could give rise to unintended consequences, including raising issues as to both financial viability and resilience, two of Ofwat's core duties.

We have a general issue with the Consultation that it contains proposals that apply universally and those proposals are potentially both intrusive and prescriptive in relation to matters that we expect would be covered by general board discretion, such as dividend policy, leverage and executive compensation. Elements of the Consultation seem to group all water companies together as a single class, rather than explicitly targeting relevant companies by reference to behaviour or position. In this regard, the Bristol Water example evidences that responsible Boards acting with foresight are thinking about these issues and addressing them without the need for the action proposed. Given their limited applicability, we would question whether the matters covered are better achieved within the existing features and tools of the regulatory framework (and have highlighted in our responses below where this could be the case).

Given the short time frame of the Consultation, we are unfortunately not in a position yet to understand fully the implications and interactions of the proposals. In addition, for example, the highly leveraged companies (being those most affected) may be challenged on their ability to consult with customers as contemplated given how far progressed customer consultation programmes for PR19 should be at this stage in the regulatory planning cycle. Finally, we note that there is some ambiguity in the Consultation and, for example, the specific questions asked do not in all cases marry up well with the commentary in the broader consultation document.

In this light, we have sought to respond to the specific questions raised and, where appropriate, constructively propose potential alternative approaches but our comments should be read acknowledging their preliminary nature.

Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?

Our response to the question focuses on the concept of sharing financing outperformance in relation to highly levered equity. We note that the PR19 methodology seeks already to address cost of debt outperformance via a new debt cost adjustment mechanism (and leaves open for companies to voluntarily supplement this with supplementary proposals).

On the specific question of equity outperformance, we do not believe that all companies should be required to propose mechanisms for sharing "financing outperformance" relating to leveraged equity returns in their business plans. If such a mechanism is deemed desirable, only those specific companies where an issue is perceived to exist should be the focus, mechanisms should be voluntary (as they are for debt) and we would expect the need to be considered in the round as part of business plan assessments (eg. should a highly leveraged company with a highly ambitious business plan potentially also be required to share returns?).

By seeking to apply such a mechanism to the sector as a whole (or even a narrower sub-class of companies being those which have "securitisations"), this creates a risk of perpetuating views of illegitimacy across the entire sector. The sector is diverse and there is a need to distinguish between those companies where there may be an issue (that can address the issue in their business plans) and those where there is not an issue. Where an issue is evidenced, measures should be specifically addressed in relation to the relevant company. Should circumstances change for any company within a regulatory period such that it should become subject to any concerns as to leverage, Ofwat could consider using the licence mechanisms such as IDOKs for these circumstances, as it has in the past.

At a general level, we would have liked to see a comprehensive impact assessment for the change, given the proposal amounts to a significant change of principle for the sector which rests on arguable theoretical underpinnings. It involves potentially large sums:- we estimate that it would require c.£8 billion of new equity to return all highly levered companies to the notional gearing level immediately (and up to c.£10 billion of additional equity in total between now and the end of AMP7). This compares with the estimated "give back" by subject companies totalling c.£100 million per annum (with the four WaSCs most affected comprising the vast majority of this sum).

Some questions and risks that could be considered in the context of an impact assessment include:

- Does it risk less ambition being included in business plans of the affected highly leveraged companies? By clawing back compensation for risk, capital can be expected to compensate for that reduction elsewhere (in order for it to recover its cost of capital) or, potentially, flee. This incentive may be exaggerated by the need to demonstrate adequate financial resilience.

- Does it risk making the sector less appealing to fundamental classes of capital providers to the sector, such as dividend investors and those with absolute return requirement (and implicitly seeks substantial amount capital from them just at the time when the measures could be making the sector less attractive to different types of investors in the water sector)? This is a real risk:– for example, iCON Infrastructure's predecessor as owner of Bristol Water, Capstone Infrastructure which was a listed dividend stock, was compelled to exit because of limited dividend outlook given steps proactively taken by the Board. Further, how does it affect and is it addressed in practice by companies with diverse ownership (such as the large private companies owned by consortia)?

- Does it risk increasing cost of capital across the sector as a whole? The ability of highly leveraged companies to finance themselves at a lower overall cost of capital has helped support the downward cost of capital trend for the sector as a whole, for the benefit of customers generally.

- Does it risk customers of lower levered companies asking the legitimate question as to why they pay a higher price for their water, all other things being equal? Further it could be argued that having lower debt levels has enabled such companies to run more interest rate risk - a fortuitous strategy over a period of decreasing interest rates but one which nevertheless involves risks to customers over the life cycle of these assets. There is not a mandatory mechanism for customers to benefit from this incremental risk in respect of these companies.

- What are the outcomes sought over the long term for companies (and their customers) targeted by such measures, and what is the demonstrable benefit achieved? For example, are lower water prices for highly leveraged companies over the long term targeted or is it envisaged that all companies would adopt, over a suitable transition period, the notional balance sheet? We are not aware whether the aim is either operationally or resilience linked as, notwithstanding the "possibility" suggested in the Consultation, we are not aware of robust analysis establishing a causal link between high leverage and operational underperformance or, in the case of the UK water industry, financial risk crystallising to the detriment of customers.

By way of precedent, a significant change to the approach to allowed returns occurred in PR99 which precipitated the development of whole of company securitisation structures to bring new capital to the sector when it would have otherwise faced a deficit. This was welcomed by all at the time but is now being brought into question by this Consultation, as well as more broadly. In this light, what are both the desired and potential unintended consequences of proposed measures in the short and long term, with respect to pools of capital supporting the industry now and in the future?

Q2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?

As stated in Q1 above, the contemplation of any measures should be confined to a sub-set of companies where there are demonstrable issues specifically arising from, and attributable to, their highly levered structures. Any intervention could then be based on an overall assessment of their business plans (including customer support on the specific issue at hand) rather than solely the fact that they are highly levered and then on a tailored basis recognising that all companies are in different positions. At first instance, we would expect Boards of these companies to seek to address concerns without need for intervention. We note in this context that the measure of an “appropriate level of benefit” cited in the question is extremely difficult to define and quantify.

We consider it would be a better position to signal that business plans for the relevant highly levered companies should consider the issue without Ofwat being prescriptive as to backstop mechanism. There are a number of different ways of achieving the objective and some could be more in tune with the overall objectives of the PR19 methodology. For example, an alternative mechanism may contemplate upside from outperformance or incentive sharing being weighted by reference to actual equity (versus notional equity) so the absolute % RORE (based on actual leverage) is the same for a company regardless of its leverage. At present for highly levered structures, outperformance may result in increased actual RORE outperformance.

Q3. Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?

We have a number of areas of disagreement with the proposals for the design of the outperformance mechanism, including:

- Companies that are highly levered cannot “turn on a tuppence”, assuming one aim of the proposed mechanism is to encourage leverage reduction. Many have long term debt, which is often inflation linked and has significant break clauses. Similarly, all owners may not be able to subscribe the substantial capital required (especially in cases of consortium ownership). Accordingly, there would at a minimum need to be a transition period, which may encompass deferral or glide paths. For example, Bristol Water’s proactive efforts to reduce leverage have necessitated an effective dividend freeze for a five year period (and itself has been assisted by a growing RCV over the period).

- The proposed 5% buffer over notional leverage for sharing provides too narrow a buffer, especially for smaller water companies. For example, notional leverage at PR14 was set at 60-65% and Ofwat’s PR14 determination for Bristol Water assumed that notional leverage would increase over the period to greater than 70%. Our preliminary review would suggest that a buffer of at least 10-15% of RCV over notional leverage is a more realistic basis (and more in line with what has been publicly classed as “highly levered” as well as the views of ratings agencies). On a transitional basis, we would suggest that the starting point for the assessment of highly levered companies should consider Ofwat’s PR14 assumptions for specific companies, could include a buffer towards the higher end of the 10-15% range indicated above for AMP7 and that credit is somehow given to companies that work to reduce leverage (for example by using formulations such as the lower of average or ending AMP7 leverage).

- We consider that the mechanism should be by reference to the <u>higher of</u> (1) actual debt cost and (2) notional debt cost. The equity mechanism in its current form may encompass obligatory sharing even where a company is underperforming the allowed cost of debt (thus sharing could be required even where there is no financing outperformance in total to share). Actual debt financing outperformance (over and above the debt adjustment mechanism specified in the PR19 methodology) is a voluntary mechanism. Finally, by virtue of their long term debt structures, it is expected that the highly levered companies actual cost of debt will be higher than the notional cost in the short to medium term.

- We have not concluded our analysis but would be inclined to expect that actual inflation was used for any debt and equity adjustment (on an ex post basis). Using forecast inflation results in material basis risk, especially in period of volatile inflationary environment. Part of the excess debt (over the notional assumption) of highly levered companies may be attributed to inflation-linked debt. There is no way for highly levered companies to manage this risk.

- We would expect that the sharing mechanism and percentage could be company specific having regard for a range of issues including financeability and overall business plan assessment.

These issues (along with others touched on in this response) allude to the difficulties in being prescriptive, especially with a "one size fits all" default mechanism.

Q4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests?

We agree that it is for companies to consult and settle an appropriate level for the purposes of business planning, albeit we consider 5% to be a mere reference figure and subject to numerous provisos given the factors including those mentioned below, all of which may influence dividends in any particular year, within any AMP and from one AMP to the next.

Rather than being an input, dividend levels are an outcome as evidenced by the manner in which they are determined by all companies' boards (ie. ex-post). They are determined by numerous legitimate factors both including (and in addition to those listed above), such as: allowed cost of capital, PAYG ratios, capex programmes (including lumpiness of spend), depreciation profile, corporate actions (eg. carve out of non-household businesses and associated working capital), operational performance (including ODI outcomes), future RCV movements, financing structure (eg. leverage levels and cost), financing covenants, financing instruments (eg. servicing of upstream loans), historical dividends, ability to pay from year to year (and AMP to AMP), pension position, ability to cope with operational and financial shocks, working capital position, retained earnings position, non-appointed business contribution, etc.

We note the proposed licence modification relating to dividends contained in the current change of control consultation for Thames Water and are concerned about the narrowness of considerations cited, in light of the sample of factors outlined above.

Q5: Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related element of executive pay demonstrate a link to exceptional delivery for customers?

We agree that companies should be transparent about pay policies, schemes and outcomes as they apply to executive directors and other employees as appropriate. However, facility for such disclosure (and its policing) already exists, for example via companies' annual remuneration reports. At iCON Infrastructure, we seek for our investee companies to adopt maximum transparency and strive for industry best practice in relation to such schemes and disclosures.

We would query the need to enforce the general requirement contained in Q5, for reasons including the following:

- The case for establishing an incremental, parallel regime alongside what exists already today has not been established (which is particularly the case for the sector as a whole);

- Performance and base pay are subject to change over time to address, inter alia, emerging issues, market conditions, recruitment, etc. raising the question whether the business plan the correct place to deal with these issues?;

- We would question whether Ofwat (or the public generally) is best placed to assess the reasonableness or otherwise of compensation levels for the relevant roles. As acknowledged in the Consultation, water companies compete in the market for talent. They seek to attract, incentivise and retain the best people for complex, multi-facetted roles having regard for need, merit and affordability. It is the board's role to secure executives on appropriate arrangements and explain them to all stakeholders; and

- The test of "<u>exceptional</u> [*emphasis added*] delivery for customers" for performance pay appears flawed, both in terms of scope and the threshold cited. Business plans are required to be ambitious. We would expect boards to take a "balanced scorecard" approach to the delivery of outcomes by executive management against that ambition. As part of that, delivery for customers is a key parameter upon which executive directors should be assessed, but it is not the only one. We would expect it to be considered and measured alongside factors such as financial performance, health and safety, environment, delivery of key initiatives important to the company, personnel development and succession, etc. The balance should be for the board to determine in the interests of the company having regard for all of its stakeholders (and weighted by their relative importance).

We note the considerable investigation into compensation issues by other interested parties, including financial regulators following the banking crisis. Consideration of these initiatives could help inform this consultation as well as assist in anticipating consequences.

Should anything over and above existing mechanisms be considered necessary, we would expect that a targeted approach would be adopted which focuses on specific companies and behaviour requiring explanation. For example, explanation by the board could be required when compensation packages are large (with independent expert support if helpful): - say, over £1 million per annum in aggregate (inclusive of potential performance pay). Further, thresholds for performance pay as a proportion of overall compensation could be considered (analogous to the financial sector where triggers for enhanced shareholder approvals, absolute maxima and deferral requirements have been implemented).

Finally, should transparency on executive director compensation be inadequate in specific cases, we expect that this could be dealt with under Ofwat's existing company monitoring framework.

Q6: Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?

Our view of the proposed revised test question is conditioned by our comments on the above questions. We would have thought that the issues now separately identified under the "fair balance" heading would be identified as issues that matter to customers (to the extent that they were relevant for the specific company) and thus would have already been encompassed in the original test question. Our suggestion would therefore be to leave the question unchanged but, if desired, make clear, for example, that Ofwat's default position is that high leverage (however that is ultimately defined) is assumed to be an issue that matters to customers.

Q7: Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?

Prima facie, the proposed test levels appear severe and especially so in the combination cases. These tests are also being applied contemporaneous with a significant proposed reduction in allowed return (which reduces financial flexibility) as well as the drive for increased ambition in business plans (and therefore risk). We would caution as to how the parameters specified (and the expectation of outcomes that need to be delivered from such testing) will be interpreted by stakeholders including board members, customers, ratings agencies and debt capital providers. For example, we can foresee (on a highly preliminary basis) how some companies may need materially lower than notional leverage to satisfy the proposed stress testing, especially having regard to historical rating agency benchmarks.

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We would be happy to discuss any aspect of your Consultation and our response contained in this letter at your convenience.

Yours sincerely

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