17 May 2018

Rachel Fletcher
Chief Executive Officer
Benefits sharing consultation
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Dear Rachel

"Putting the sector back in balance: Consultation on proposals for PR19 business plans"

Thank you for the opportunity to comment on the proposals set out in this consultation document. I have discussed the proposals set out in the consultation with my colleagues and this response reflects the combined view of the Board.

Affinity Water is supportive of the general direction of the work on financial legitimacy and the increased transparency this brings. In his letter of 9 March 2018 to Jonson Cox, our Chairman, Tony Cocker, stated we would welcome the opportunity to continue to work with Ofwat constructively and positively as we develop our approach to leverage and securitisation.

Affinity Water operates a whole business securitisation financing structure and we believe that among its benefits to the company and our customers are the comprehensive controls and governance that it enforces around cashflows, dividends, business undertaking and stress testing. These protect the company and therefore customers to an enhanced level above the requirements of our licence. The securitisation structure enables the company to achieve a credit rating of Baa1, the same as National Grid and BT and better than or equal to most of our peers. This credit rating is two grades above the investment grade credit rating required in our licence. Subject to maintaining an investment grade credit rating, we believe that, as stated in the consultation, companies are best placed to make decisions about how to finance their activities.

Our response to the consultation is in two parts. I have set out below in this letter our thoughts on Ofwat's approach to this consultation and our views on each of the matters consulted upon. Our responses to the specific questions raised in the consultation are set out in the Appendix to this letter.

Approach to consultation

We very much welcomed the approach taken by Ofwat to the development of its framework for Water 2020, culminating in the publication in December 2017 of: "*Delivering Water 2020 our final methodology for the 2019 price review*" ("PR19 Final Methodology"). The PR19 Final Methodology was developed over a period of more than two years, during which Ofwat consulted extensively with companies and stakeholders about priorities for AMP7. Companies were encouraged to participate in a "market place for ideas" and Ofwat formulated the PR19 Final Methodology on the basis of evidence and views submitted as part of an extensive and wide-ranging process of research and consultation. We were pleased to support Ofwat in the development of its proposals during this period.

We are disappointed that some five months after publication and four months before companies must submit their business plans, Ofwat should be proposing to re-open the PR19 Final Methodology based on a three-week consultation. The principle of regulatory certainty lies at the heart of the regulatory framework and seeking to re-open the PR19 Final Methodology runs counter to this principle. Accordingly, our responses to the questions raised in the consultation are subject to our overall objection to there being any changes to the PR19 Final Methodology at this late stage of the business planning process and too late to incorporate in our customer consultation work.

Company performance, dividends and the performance related element of executive pay

We agree that companies should be transparent about the performance element of executive pay and should maintain a balanced dividend policy. Executive pay and dividend policies need to reflect and balance all the priorities that are in companies' business plans, including delivering for both the customers of today and tomorrow's customers. We are already taking action in these areas under the ownership of our new long-term investors. We have designed a new long-term incentive scheme for executives that improves the balance of performance related pay and we are also reviewing our dividend policy.

Financial Resilience

We welcome the proposals for companies to build on analysis performed for their long term viability statement in assessing the financial resilience of their business plans. As with long term viability statements, we think it is important for companies to justify and clearly explain the approach that they have taken to reflect their specific circumstances and the risks they face. However, we think that some of the suggested scenarios for stress testing are set at levels that are not appropriate and meaningful for Affinity Water. The ranges suggested do not match the risk of the company or historic trends. In particular, the inflation sensitivities against HM Treasury's forecasts are high and the increase in bad debt suggested at 20% is significantly higher than the effect seen in the last recession which was 4%.

Sharing "financing outperformance"

We believe that introduction of a mechanism to share theoretical outperformance relating to "financing outperformance" is a significant change in the regulation of the industry. Our view is that a detailed regulatory impact assessment should be completed before such a fundamental change in regulation is contemplated or implemented. The impact assessment should include customer research to understand the potential implications both in the near term and long term of this proposed change. While we recognise the perceived public concern this proposal is intended to address, we are not clear this is a material issue for customers or that it serves customers' interests. During our ongoing consultation, including on our draft business plan engagement, customers have not raised this as an area of concern.

We note that Ofwat specifically considered this matter in: *Water 2020: consultation on the approach to the cost of debt for PR19 (September 2016)* and concluded at page 20 that:

> *"We do not propose to introduce a separate approach or specific benefits sharing arrangement for securitised structures. It could confuse the responsibility for bearing the costs associated with the securitised arrangements, which we consider are to be borne by the equity holders of these structures. It would also mean that customer benefits would be dependent on company specific financing arrangements. It would also introduce additional complexity into setting the cost of capital. We consider that customers are protected from the risks of these arrangements by our notional financing approach and our financial monitoring framework."*

This conclusion was confirmed in *Delivering Water 2020: consultation on PR19 methodology Appendix 13: Aligning risk and return* (July 2017) at page 50:

> *"We propose that neither the notional financial structure, nor, risk sharing arrangements, should be different for securitised companies. This is consistent with our overall approach to capital structure, described above."*

We disagree with the proposal for benefit sharing by companies with gearing above a notional gearing as it will likely result in a number of adverse effects which we have detailed in our response to question 1 of the consultation and which potentially could include unintended adverse consequences for customers.

I would reiterate the statements in our letter of 9 March 2018 that we will consider our long-term gearing as part of our business plan submission and that we remain willing to work with Ofwat to develop an appropriate future approach to leverage and securitisation, taking an evidence-based approach.

Your sincerely

Pauline Walsh
Chief Executive Officer

Affinity Water

APPENDIX

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 mechanism in the IAP?

We do not agree that Ofwat's PR19 Final Methodology should be re-opened and amended for the reasons stated in this letter.

In any event, we do not agree that companies should be required to propose mechanisms for sharing "financing outperformance" in their business plans. Accordingly, we do not agree that these mechanisms should form part of the IAP. Further, we believe that such a fundamental change in regulation should be supported by a full regulatory impact assessment as was the case with all other proposals in the PR19 Final Methodology.

Our own engagement with customers on our draft business plan has not shown that "financing outperformance" is an issue that customers are concerned about. They are however, concerned with the environment, meeting their expectations for service, ensuring future supplies, and assisting customers in vulnerable circumstances.

We believe the proposed changes, coupled with a tough PR19, would likely see a credit rating downgrade for the industry. Companies impacted would see increased pressure on cash cover ratios including interest cover ratios and dividend cover ratios. This would be viewed negatively by investors in the industry and could have far reaching consequences for investment for the water industry and beyond.

Many investors in the industry have changed in recent years. Investors such as ours are investing for the long-term and our concern is that the proposed change, if implemented, might make long-term investors less interested in investing further in the industry at a time when more investment is required, particularly in the South East to tackle the water and waste water demands of the future. Tackling this challenge was specifically highlighted by the National Infrastructure Commission in their recent report "*Preparing for a drier future: England's water infrastructure needs*" and will be subject to consideration at the forthcoming EFRA select committee inquiry.

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

We do not agree that Ofwat's PR19 Final Methodology should be re-opened and amended for the reasons stated in this letter.

Accordingly, we do not agree that Ofwat should intervene to impose mechanisms "to ensure customers will receive an appropriate level of benefit from companies with high geared structures" for all the reasons detailed in the response to question 1 above. Ofwat has published its Final Methodology for PR19 and should not seek to re-open it.

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 the notional cost of debt?

We do not agree that Ofwat's PR19 Final Methodology should be re-opened and amended for the reasons stated in this letter.

In any event, we do not agree that a mechanism as described in the consultation should be implemented for the reasons set out in our response to question 1 above.

We note that the mechanism proposed implies that savings would be shared with customers through a reduction in their water bills. Through our ongoing consultation with customers as part of the preparation of our PR19 business plan, it is evident that bill reduction is not a concern for the majority of our customers. However, they do value investment in the environment, meeting their rising expectations, ensuring future supplies, and assisting vulnerable customers.

The proposed mechanism compares actual gearing to a notional gearing. However, justification for the notional gearing has not been provided. Equally, references to "high gearing" are not objectively based and, in particular, do not reflect the benefits of securitisation structures, some of which are acknowledged in *Water 2020: consultation on the approach to the cost of debt for PR19 (September 2016)*. We also note that the notional gearing level has changed in the last two price reviews and therefore pegging "outperformance" against this provides regulatory uncertainty for companies moving forward. The mechanism as described does not set out how the level of actual gearing would be calculated.

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 do not agree that Ofwat's PR19 Final Methodology should be re-opened and amended for the reasons stated in this letter. Accordingly, Ofwat's IAP assessment should not be amended in this way.

We do agree that companies should be transparent about their dividend policies and we intend to set out within our dividend policy to be included in our business plan the link to all aspects of our plan including delivery for today's and future customers, achievement of performance commitments, compliance, financial resilience, employee interests and providing an adequate return to shareholders on their capital investment.

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 do not agree that Ofwat's PR19 Final Methodology should be re-opened and amended for the reasons stated in this letter. Accordingly, we do not agree there should be any change to the IAP assessment.

We agree that companies should fully explain their approach to performance-related pay for executives and should continue to do so in their annual reports. We intend to set out our approach to the performance related element of executive pay in our PR19 business plan in any event, explaining how performance-related remuneration is linked to delivery of all aspects of our plan.

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

We do not agree that Ofwat's PR19 Final Methodology should be re-opened and amended for the reasons stated in this letter. We therefore do not agree with the proposed revisions to amend the test question in the IAP.

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

We do not agree that Ofwat's PR19 Final Methodology should be re-opened and amended for the reasons stated in this letter

We consider this is a change to rather than clarification of Ofwat's approach to financial resilience in the IAP and accordingly should not be implemented.