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Benefits Sharing Consultation
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17th May 2018

Dear Sirs,

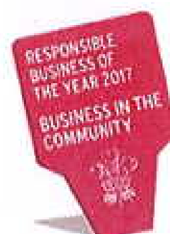
Putting the Sector Back in Balance

I am pleased to attach Anglian Water's response to the above consultation.

We would be happy to discuss with you any of the elements in our response.

Yours sincerely

Alex Plant
Regulation Director



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an AWG Company

Anglian Water's response to Ofwat's April 2018 consultation: "Putting the Sector Back in Balance"

Executive Summary

We welcome the opportunity to respond to this consultation. We support the aims of building trust and confidence and ensuring customers are at the heart of our business. To this end, we announced significant changes in March to make Independent Non-Executive Directors the majority group on our Board, reduce shareholder dividends, reinvest £65m to enhance resilience (adding to £100m already committed), and remove the dormant Cayman Island Company.

However, we do not believe that Ofwat's proposals on sharing financing outperformance would be in the long-term interest of customers, the environment or help to deliver sustainable growth in our region. We do not agree with the stated rationale for, or economic assumptions underpinning, Ofwat's proposals on sharing financing outperformance, and we can find no regulatory precedent for the proposal.

The main driver for Ofwat's proposed changes appears to be its assertion that *"the legitimacy of the regime has been challenged by companies that have paid high dividends, particularly on the basis of returns from high levels of gearing, without demonstrating any corresponding benefits to customers".*

We understand the concerns about the legitimacy of the sector, which was the backdrop for the changes we announced in March. However, we are concerned that, rather than proposing a targeted and proportionate solution to this perceived issue, Ofwat is proposing measures that would impose a significant regulatory burden on all companies in the sector.

More specifically:

- Ofwat has not provided adequate reasoning or evidence to explain why major changes of this nature are needed at this time, i.e. what has changed since Ofwat published its detailed Final Methodology in December 2017;
- Ofwat has not produced a formal Regulatory Impact Assessment. Nor has it provided any assessment of the impact of its proposals on customers and investors;
- The proposals would remove well-established fundamental elements of the regulatory framework. The principle that the WACC should be set regardless of the actual financial structure of the regulated company would be lost;
- The principle that Boards should determine their capital structure based on their own assessment of the most efficient approach would be significantly

undermined. Our securitised structure brings benefits to customers in the short and long-term that are not assessed by Ofwat in its consultation;

- The consultation lacks a balanced discussion of the pros and cons that different capital structures afford to customers or the accompanying actions and safeguards companies and their investors take in ensuring financial resilience of the capital structures they choose; and
- The consultation suggests that securitisation and higher gearing act against the interests of customers or undermine financial resilience. Yet established evidence suggests the reverse.

Regulatory frameworks should seek to provide a stable framework for investment, particularly given the scale of investment needed to address the UK's resilience challenges. Investors in regulated sectors should be confident they are able to earn fair returns that are commensurate with the level of risk that they take. We believe Ofwat's proposals would substantially undermine that principle.

The proposals would also have a very material effect on the construction of Business Plans at a very late stage in the Price Review process, and in the longer term, on the capital structure of highly geared companies, with significant time and cost implications for companies. In light of these significant impacts, we have serious concerns that only 3 weeks have been given for a consultation on such a major policy change, and that the proposals come too late in the Price Review process. We are also concerned that Ofwat should use this consultation to explore the full range of possible means of addressing any perceived problems, not just the narrow range presented here.

We do not consider there to be any fundamental shortcoming in our company structure or approach that warrants the changes proposed in the consultation, in particular that relating to sharing financing outperformance.

However, we are willing to work up alternate proposals on sharing outturn financing performance on debt, if this were on a symmetrical basis, but would need more time to do this justice. Therefore, we submit that any further consideration of these matters should be decoupled from the Price Review process, to allow adequate time for further consultation.

Main Response

We welcome the opportunity to provide our views on this Consultation. Our response is structured as follows:

- First, we set out general observations on the substance of Ofwat's proposals;
- Second, we explain why the economic rationale underpinning Ofwat's proposals does not withstand scrutiny;
- Third, we raise specific concerns in relation to Ofwat's proposal for sharing financial outperformance resulting from high gearing; and
- Fourth, we outline our concerns on the timing of this Consultation and other procedural implications, potential alternatives and suggest some next steps for the Consultation.

Finally, we provide answers to the specific questions raised in the Consultation.

1. General Observations on substance of the Consultation

The Consultation's starting point is the importance of building trust and confidence in the sector and ensuring that customers are at the heart of water companies' businesses. The thrust of the Consultation is that *'trust and confidence in the water sector has been eroded through concerns around corporate behaviour of some companies …'*.[1] The Consultation observes, in particular, that the *'legitimacy'* of the water regulatory regime *'has been challenged by companies that have paid high dividends, particularly on the basis of returns from high levels of gearing, without demonstrating any corresponding benefits to customers'*.[2] The proposals put forward in the Consultation purport to address such concerns as appropriate within the framework of PR19.

We offer the following general comments on the underlying purpose of the Consultation and whether the proposals put forward are suited to addressing the concerns highlighted by Ofwat:

1.1 Ensuring balance: trust and confidence

We are fully supportive of the importance of maintaining public trust and confidence in the water sector. Customers are at the heart of our business. Putting in place plans to meet the needs of customers today and in the future has driven the recent refresh of our Strategic Direction Statement and is central to the development of our PR19 Business Plan.

We believe that we have already undertaken significant measures to address the perceived lack of trust and confidence in the wider sector. We have, in particular, been very active in seeking to address the perceived shortcomings of more highly leveraged water companies. The decisions we announced on 9 March this year included:

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[1] Ofwat Consultation dated 26 April 2018, p.3
[2] Ofwat Consultation dated 26 April 2018, p.3

a) Increasing transparency and clarity by removing our dormant Cayman Islands subsidiary (expected to be finalised later this month) and repaying an inter-company loan (which was concluded in March this year).

b) Changing the composition of our Board so that Independent Non-Executive Directors are in the majority.

c) Making a commitment to work with Ofwat on proposals to ensure companies can be held to account for working in the public interest.

d) Making an additional investment commitment to 2020 whereby we will invest an extra £65m in resilience schemes to enhance our region's ability to deal with drought and flooding, paid for through a reduction in dividends to shareholders. This is in addition to a further £100m of reinvestment we announced last year.

e) Making a commitment to reduce dividends and borrowings through to 2025, resulting in a significant reduction in the company's level of debt and gearing.

We believe that these changes, when combined with existing regulatory protections, create a framework which fully meets the challenges set out by Ofwat and the Government and provide a solid backdrop to our Business Plan.

Ensuring trust and confidence in the sector is also fundamentally related to the operational performance that companies deliver, in particular in relation to the supply of safe, clean drinking water and how they demonstrate that they are playing an effective role as stewards of the environment.

We are proud of our track record on these issues, and our PR19 Business Plan will set out proposals that aim to stretch us even further. On the matters that our customers tell us they value most, such as leakage performance and customer service, we are delighted that we are now industry-leading on both and want to build on that success in the future. Similarly, our customer-centred approach allows us to respond well to incidents such as the recent freeze-thaw event, where we were able to minimise the impacts on our customers despite the severity of the weather conditions. The reinvestment decisions that our Board has made recently, and in the past, show a commitment to addressing the long-term needs of our region, its residents and the environment.

We have also taken a thought leadership role within the sector on issues such as long-term water resource planning through chairing the Water UK Long Term Water Resource Planning Framework and developing multi-sector partnerships through Water Resources East. We have reduced our carbon footprint massively, to levels never seen before in the sector, and are working innovatively with customers to encourage behaviours to reduce costs and carbon through

initiatives such as "Keep it Clear" and "Slug it Out", together with our wider catchment management initiatives.

As a result of these and other initiatives, we were delighted to be named as Business in the Community's 'Responsible Business of the Year' for 2017. We hold a Queen's Award for Enterprise: Sustainable Development and recently became the first English utility to be inaugurated as a 'Leading Utility of the World'. We do not see any fundamental shortcomings in our company structure or approach that warrant changes of the type proposed in the Consultation.

1.2 Ensuring balance: a stable framework for investment

We also note that the proposals set out in the Consultation may undermine the stable investment climate for the UK water and sewerage industry.

The need for investment is underscored by the fact that, on the same day that Ofwat published the Consultation, the National Infrastructure Commission (NIC) published a key report entitled "Preparing for a Drier Future". This highlights the acute need for significant additional investment in demand management and supply enhancements to avert the risk of severe drought, particularly in water-scarce areas of the country such as the south and east of England. The findings of the NIC report accord with our own analysis, and with evidence submitted through Ofwat's "Marketplace for Ideas". Our proposals to address these challenges for our region are contained in our draft Water Resource Management Plan, reflected in the wider cross-sectoral work we have championed through Water Resources East and will be a central plank of our PR19 Business Plan.

The investment that will be needed over the coming decades to address the challenges that the NIC sets out is expected to come from private investors, who are free to choose where they invest. There are similar needs for significant increased investment in infrastructure for other regulated utilities too, also highlighted by the NIC and echoed in the Government's Industrial Strategy.

At a time when broader macroeconomic and political uncertainties may reduce the attractiveness of the UK as a destination for footloose global capital, we believe that regulatory frameworks should provide stability for investment in UK infrastructure. Investors should be confident that regulatory frameworks across all sectors offer the ability to earn fair returns commensurate with the level of risk that they take. This is a point that Ofgem has stressed in its recent RIIO2 consultation when it observed that, *'we have sought to maintain an attractive environment for investors, but investors should prepare for returns that properly reflect the low level of risk that they face because of our stable, predictable regulatory framework.'*

We have sought to take these broad considerations into account, and to judge how Ofwat's proposals would affect them, in framing our response.

2. The economic rationale for the proposed changes

Turning to whether the Proposals set out in the Consultation address Ofwat's concerns, we agree that there are legitimate public policy concerns around:

a) Ensuring that the returns shareholders can make are seen as fair and commensurate with the level of risk that they are taking;

b) Financial resilience, so that companies should be structured so as to be able to withstand shocks;

c) Appropriate dividend policies that relate to effective performance; and

d) Transparency about performance-related executive pay.

We have, however, concerns that the proposals put forward in the Consultation, in particular the proposal for sharing out-performance from high gearing, do not properly address these concerns. Ofwat has not established a theory of harm that would warrant the very significant changes of the type proposed to address points a) and b) above.

We note that the Consultation also fails to set out why the changes that have occurred would now justify this very significant shift in regulatory approach, one that would effectively move the sector towards rate of return regulation. Nor has Ofwat shown that the measures proposed would deliver benefits for customers or avoid damage to investment. As noted above, it is important to consider that if implemented, these proposals could have effects that would last well beyond the current price control and could create impacts that go beyond the water sector, as they could alter the perception of the stability of UK regulatory structures among investors and potential investors in other utilities.

Instead, the proposals on sharing financial outperformance and introducing additional financial resilience tests do not appear to be well designed, or well evidenced. In assessing these proposals against the principles of best regulatory practice, we do not perceive them to be proportionate or targeted responses to perceived (but not clearly evidenced) problems. In particular, we struggle to identify the link between the proposals and Ofwat's concerns in relation to resilience: the proposals neither address the lower resilience that Ofwat contends is attributable to securitised or highly geared structures (and provides no evidence of such), nor do the proposals increase resilience by proposing active measures that would increase resilience.

We also note that the very detailed PR19 methodology as confirmed in December, has already taken steps to address previous concerns about:

a) companies gaining from interest rate movements being different to those predicted, through the policy change that has introduced indexation; and

b) companies with poorer operational performance still gaining through financial performance, through the policy changes that will make the Return on Regulated Equity more dependent on operational performance.

We think Ofwat has worked hard to secure the resilience of the sector, and are therefore not clear why further measures, beyond those already incorporated in PR19 to address financial resilience and public trust and confidence, are required. Nor does the Consultation fully explain why the Proposals are needed on top of the existing measures set out in the Final Methodology.

Indeed, little evidence in general is presented as to why a proposed change is required. Where arguments are advanced in favour of the most significant proposed changes, they are not compelling, and in some cases, conflict with generally accepted economic logic or are internally inconsistent within the Consultation document. We discuss some of these points further below. Our existing transparent reporting policies, supported by the emphasis Ofwat has placed on good Board governance in recent years, already address points c) and d) above and, our proposals for the future will be set out clearly in our PR19 Business Plan.

3. The sharing of financing outperformance proposal is flawed

More specifically, we are not persuaded by the need for an intervention such as the sharing of financial outperformance proposal. We have attached as an annex to this reponse a note from Oxera's Partner, Dr Luis Correia da Silva, providing his opinion on Ofwat's proposal on sharing financing outperformance. We agree with the views provided in that note. Our own reflections on the proposal are as follows.

Ofwat's rationale for the proposal seems to be based on the following points:

a) Highly geared companies are *'potentially less flexible and more vulnerable to cost shocks'* and thus less resilient than companies with capital structures closer to Ofwat's notional structure;

b) High gearing and, in particular, securitised structures, enable *'companies to achieve a lower cost of debt (and a lower cost of equity) than would otherwise be the case'* so that equity investors earn "excess" returns (i.e. they enable a lower WACC; and

c) Public trust is undermined by high levels of gearing (see **Section 1.1** above).

We address each of these points in turn:

3.1 Securitisation and higher gearing: a beneficial structure for customers

First, the Consultation suggests that securitisation and higher gearing may act against the interests of customers and financial resilience. The Consultation suggests, that *'highly geared structures are potentially less flexible and more vulnerable to cost shocks'*[3], although provides no evidence to support this suggestion. The evidence in fact shows not only that this position is untenable but also that there are significant customer benefits stemming from securitised structures.

3.1.1 **Resilience*: flexibility and response to shocks***

As a starting point, the evidence does not support Ofwat's suggestion that highly geared structures may give rise, in and of themselves, to concerns around financial resilience.

Ofwat puts forward no meaningful evidence to support its suggestions concerning the weaknesses of securitised structures. Whilst there is a legitimate public policy question relating to the ability of companies to withstand shocks (e.g. if their equity buffer were insufficiently large), this question is not properly

[3] Ofwat Consultation dated 26 April 2018, p.14

explored in the Consultation. Instead, there are more general assertions that more highly geared companies are *per se* not in customers' best interests. The closest Ofwat comes to coherently articulating a theory of harm is when it asserts that '*highly geared structures are potentially less flexible and more vulnerable to cost shocks than companies whose gearing levels are closer to our notional assumption'*. Ofwat therefore simply suggests both that highly geared companies are less resilient than others, and that higher gearing will lead to a systematic outperformance on financing in the future. However, neither contention is backed up by evidence.

In fact, the securitised structure that we and some other companies have adopted is an innovative approach that has allowed water companies to increase gearing to higher but sustainable levels in a way that retains financial resilience and delivers benefits to customers. In a securitised structure, the risk of gearing is taken away from customers and instead passed on to providers of debt, through the introduction of stringent covenants. Proportionately higher risk is borne by equity investors, and the structure still allows for innovation and flexibility, as is shown in our track record and strong operational performance.

For example, AWS adopted a securitised structure in 2002. In this structure equity holders agree to abide by a set of stringent covenants that provide additional assurance to debt providers. A distinctive feature of a securitised business is that there is a focus on ensuring an effective treasury function with a sharp focus on cash management, efficiency and performance, which brings associated benefits to customers and shareholders. Credit rating agencies usually reward this financing discipline and protection with a one notch rating benefit when compared to a traditional structure.

In the interests of giving Ofwat additional information to inform its decision-making, we note that the view of the acknowledged experts in assessing risk - the credit rating agencies – seems to suggest that our existing structure is not lacking in flexibility or resilience for the following reasons:

*i. **<u>Evidence of resilience: the global financial crisis</u>***

Our credit rating has remained well within the investment grade since we adopted the securitised structure in 2002. We have remained a respected issuer in the market and continue to attract a diverse set of debt providers. A critical test of the resilience of our structure was the global financial crisis in 2008. This was a once in a generation credit shock when large corporates struggled to refinance debt. However, we continued to raise debt at attractive terms throughout this time, and these relatively low rates kept being passed on to customers. The structure survived the worst credit crisis in recent memory and retained credit quality well above the investment grade throughout.

In recent years, our gearing has come down as shareholders have taken fewer dividends than they could have and reinvested in the business. As mentioned above, the Board made clear commitments this March to continue to de-gear during AMP7. This means our 'equity buffer' is significantly higher than it was during 2008 and it continues to grow. This is reflected in the market's assessment of our risk, as our credit rating remained stable even though Moody's announced a negative outlook for a number of WASCs.

ii. ***Evidence of resilience: the UK Corporate Governance Code***

In addition, our Board complies with the UK Corporate Governance Code which prescribes a set of rules and principles around corporate governance. Every five years, we sign a five-year corporate viability statement and in doing so, we undertake financial resilience scenarios that go over and above the typical requirements.

iii. ***Evidence of resilience: assessment of the rating agencies***

We have an open dialogue with the rating agencies which includes an annual review meeting. As experts of risk, rating agencies scrutinise our financial strength and require us to run diverse scenarios that include significant divergence in inflation or cost shocks.

Moody's reaction to Ofwat's publication of its indicative WACC in December 2017 illustrates this point:

- Moody's changed its credit outlook for the water sector to negative.
- In addition, Moody's specifically downgraded their outlook for two large water companies - Severn Trent and Yorkshire Water.
- Severn Trent's gearing (60.7%) is in line with Ofwat's notional company target of 60%, and Yorkshire Water (75.4%) had already given undertakings to reduce its leverage.
- However, the credit rating for securitised companies, that are typically more highly geared, such as ourselves (79.1%), remained 'stable'.

This suggests that markets and risk experts value the covenant protection (and other constraints) that securitisation offers, that gearing on its own is not a determinant of financial resilience within the water sector, and that securitised and non-securitised structures are very different and not directly comparable solely in terms of gearing.

iv. ***Evidence of resilience: equity holders respond when needed***

Another key feature of our securitised structure is the flexibility that equity holders have demonstrated. Our shareholders have shown that they are ready to support the business as and when needed.

In 2009, when the UK economy experienced its first deflation for over 50 years, our shareholders injected equity of c. £100m as a precautionary measure at short notice. This flexibility is a key feature of securitised companies and has also been evidenced by shareholders of other securitised water companies. It also clearly demonstrates that greater risk is genuinely borne by those equity holders.

v. <u>Evidence of resilience: our resilience framework</u>

In January 2018, building on Ofwat's approach to "Resilience in the Round", we published our Resilience Framework. This drew on work we undertook with Arup (a model now being adopted by many other companies) to think about how we manage risks in the short-term, alongside longer-term trends and lower likelihood risks. It combines an analysis of our financial, operational and corporate resilience and also builds on Cabinet Office guidance on resilience.

vi. <u>Evidence of resilience: the Special Administration Regime</u>

The regulatory regime in water already provides a backstop protection, should companies overreach, and serves to incentivise companies to ensure that their structures are resilient. As Ofwat stated in its 2015 publication on financial distress: *'The special administration regime, and other protections within water company licences, help to protect customers from the risk of company failure by ensuring the continued delivery of services'*.

vii. <u>Evidence of resilience: Conclusions</u>

All of these checks and balances ensure our financial resilience is tested regularly and by different means. With all these processes in place and significant evidence of our current and past ability to see through shocks, we find it hard to understand Ofwat's suggestion that our structures are weaker or less flexible than they need to be. Furthermore, given our analysis above, we do not believe that the additional resilience requirements that are proposed in the Consultation are necessary, targeted or proportionate. They would create a very significant additional set of tests that seem to us, to go beyond what is needed to ensure long term financial resilience, something we and other companies already report on to Ofwat and which our Board is required to give specific assurance on.

3.1.2 **Significant** *customer benefits from our securitisation structure*

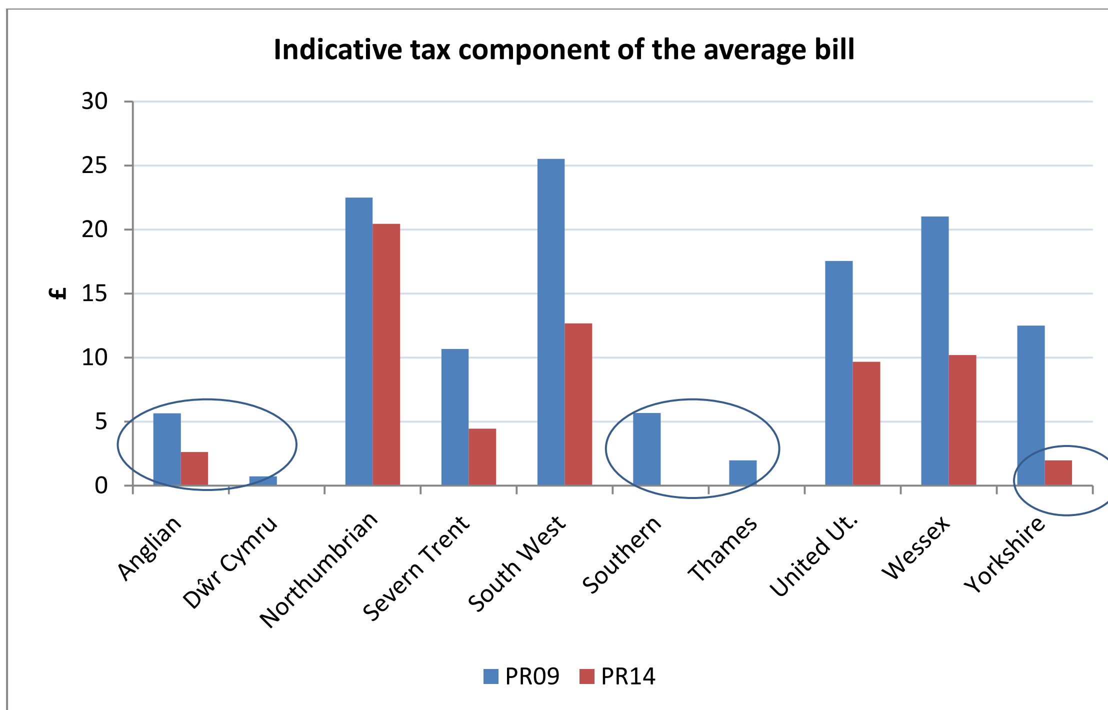
There are, in fact, significant benefits from securitised structures that would be lost were water companies to deleverage in response to the proposal.

In particular, higher gearing results in tax efficiencies that are passed on to our customers in their entirety in accordance with Ofwat's own methodology. Our

customers therefore receive a direct and significant material benefit from securitisation through a reduction on their bills, as the below charts evidence.

There are different factors that affect the cash tax component of the average bill, but the most significant factor is the interest charge of the business that can be deducted from profits to reduce the tax exposure. This benefit to customers would disappear if the effect of Ofwat's financial outperformance sharing proposal were to, as is likely over time (and predicted by the Ofwat Chairman in his exchange of letters with the Secretary of State), drive gearing down to the notional company level of 60% (or 65% allowing for the deadband proposed).

We have drawn from data captured from the PR09 and PR14 final determination to show the very material reduction to water customers' bills that flows directly from securitisation and higher (but resilient) levels of gearing.



It is clear from the table above that where customers are served by a highly geared company, their average bills show much lower payments towards the 'tax' component.

During the PR14 price control, where customers served by a securitised company paid between £0-£3 towards tax, customers served by lower geared companies paid up to £20 on their bills. These are significant figures which, over time have a compound effect. Customers in our region have benefitted significantly over the last 15 years, and this is part of the reason why customer bills in our region have risen by the lowest amount (about 10%) since privatisation, whereas the average for the industry is around 40%.

If gearing were reduced to Ofwat's proposed notional levels, customers would pay more due to higher tax, but with no measurable benefit for customers associated with de-gearing. In light of these concerns and the potential magnitude of the (negative) impact, we would expect Ofwat to conduct a Regulatory Impact Assessment to consider the tax efficiency and other existing customer benefits and how they would be affected by the implementation of the proposed changes.

3.2 No justification that higher gearing generates a meaningful "efficiency" that can be shared

Second, Ofwat equally fails to demonstrate that there is a financial efficiency (i.e. a decrease the cost of debt without a corresponding increase in the cost of equity) from securitisation structures that justifies "sharing" of financial outperformance and, in any case, fails to demonstrate the magnitude of such an efficiency necessary to properly calibrate any sharing mechanism.

3.2.1 No evidence for **Ofwat's** *Proposal*

Ofwat's reasoning appears to be that, while economic theory implies that equity returns increase in a linear fashion with gearing, such theories do *'not reflect the benefits of* securitisation *arrangements'* because the covenants in such arrangements *'allow companies to achieve a lower cost of debt (and a lower cost of equity)'* than would otherwise be the case. Ofwat's justification is not, however, consistent with established economic and financial theory (including Modigliani and Miller) which shows that the cost of capital is not affected by the level of gearing. Yet, notwithstanding the fact that Ofwat's justification runs contrary to established economics, Ofwat offers no evidence to support its contention that, in practice, such arrangements result in a lower cost of equity than would be assumed under economic theory.

Ofwat suggests that securitisation enables lower cost of debt and lower cost of equity. However, this misses the point that the covenants on which securitisation relies (e.g. dividend lock-ups) will naturally embed greater risks with equity holders. So, whilst debt costs can be reduced through efficient financial structures and treasury functions, equity costs will go up as gearing increases. Whilst it is true that, as gearing increases, companies can benefit from greater tax efficiency, all the tax benefits of higher gearing are passed on to customers. This benefit to customers would be unwound if gearing levels reduced. With such a tax sharing benefit to customers in place, the cost of capital will be unchanged at any level of gearing.

Perhaps even more problematically, the Consultation contends that *'investors in companies with higher gearing levels can take the benefit of the difference between the cost of equity and the cost of debt for the actual proportion of*

gearing that is above our notional assumption'.[4] In economic terms, the Consultation appears to assume that gearing higher than the notional assumption does not have any effect on the required return on equity and that there is a risk-free arbitrage between the return on equity allowed in the price control and the cost of debt. In more practical terms, Ofwat seems to be assuming that securitisation represents a silver bullet, eliminating any the increased risk to equity holders resulting from an increase in gearing. If this were the case, Ofwat should logically insist on a securitised structure for all companies as delivering a better outcome for customers.

3.2.2 Does not address underlying purpose of Consultation

Furthermore, we do not consider that the proposal addresses Ofwat's specific concerns outlined in the Consultation. The underlying purpose of the Consultation is to put forward proposals tackling the payment of high dividends ostensibly stemming from highly geared financial structures.

However, the "sharing financial outperformance" proposal targets water companies with highly geared structures (often as a result of securitisation) *regardless* of whether such structures have been previously implicated in the payment of unduly high dividends or whether they may be used to do so in the future. Conversely, the proposal equally does not ensure that such structures may not be used to pay high dividends in the future. Instead – as Ofwat itself has stated – the main likelihood of the proposals set out in the Consultation is *'a progressive reduction of the highly leveraged balance sheets'* irrespective of whether such structures may be beneficial to the overall functioning of the water and sewerage industry in the UK.[5]

As such, the proposal amounts to a blanketed targeting of water and sewerage companies with high gearing and / or securitised financial structures and we are concerned that such an approach, which is neither targeted nor proportionate to Ofwat's concern underlying the Consultation, is likely to do more harm than good.

3.2.3 Proposal contains logical inconsistency

There also appears to be an inconsistency in Ofwat's argument in the Consultation. Ofwat seems to argue simultaneously that (a) higher gearing is riskier when considering financial resilience *but* (b) securitised structures offer an efficiency by enabling water companies to achieve a higher gearing without a commensurate increase in risk to equity holders (and thus higher returns to equity holders).

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[4] Consultation, p.15

[5] Letter from Ofwat's Chairman to the Secretary of State for Environment, Food and Rural Affairs, dated 9 April 2018

If highly geared structures are more vulnerable, one would expect the cost of equity to be greater, as equity investors would require a greater premium given the greater risks associated with such investments. If, however, securitised structures are more efficient, one would expect them to be less vulnerable to cost shocks (as they enable firms to run a higher level of gearing without a corresponding increase in risk).

So, while both statements can, in principle, be correct, they cannot both be correct simultaneously.

3.3 No evidence that high leverage has contributed to reduced public trust in water companies

Third, as set out in more detail in **Section 1.1** above, we do not consider that there is any meaningful evidence – and certainly none provided in the Consultation – which supports Ofwat's contention that public trust in water companies has been undermined by high leverage. Indeed, recent analysis from Britain Thinks suggests that water companies enjoy a relatively high level of trust, with 74% of those surveyed saying that they trust their water company. Whilst we understand that there has been concern raised about the sector more widely in the media, and that there has been political discussion of these issues, it is not coming over as a major issue for customers in the huge engagement exercise we've been carrying out in advance of our Business Plan submission.

3.4 No regulatory precedent to support the proposed approach

Fourthly, we observe that the Proposal severely undermines Ofwat's long-stated policy that it is for companies to determine their own financial structures and appears to be at odds with regulatory practice.

3.4.1 Significant change to existing guidance

Since privatisation, Ofwat's own guidance has been clear and supportive for companies to choose their own capital structures:

> *'It is for the companies, their shareholders and management to determine the most efficient financing structure to meet their circumstances within the price setting package.'*[6]
>
> *'We have been clear that we model assuming a capital structure based on our gearing assumption; accordingly, it is inappropriate that we should make specific adjustments associated with companies' actual financial structures.'*[7]

[6] Ofwat PR09 Final Determination, p. 141
[7] Ofwat PR09 Final Determination, p. 138

'The actual capital structure that companies choose is a matter for their management and the markets.'[8]

If implemented, these proposals would de facto, if not de jure, restrict the choice of capital structure which companies have and instead substitute Ofwat's preferred structures (within a narrow band of choice) as the incentives on investors which would serve to drive gearing levels down to a maximum of 65%.

The current levels of gearing and securitised structures are, moreover, the result of firms responding to regulatory incentives put in place by Ofwat and, furthermore, the impact of the proposals would be borne by current and future owners of companies across the industry, rather than those who may have been perceived to have benefited unduly in the past. It should also be noted that changes already announced for PR19, including the move to indexation of debt, have removed one way in which companies may previously have benefited when interest rates moved in their favour.

3.4.2 Inconsistent with other regulated industries

We also note that the CMA's determination in last year's Firmus Energy appeal[9] confirms our analysis above, and that this is also supported by previous publications on gearing from Europe Economics and PwC.[10] We also note that a key recommendation of the Gray review was for Ofwat to achieve a balance between rewards and penalties to encourage positive behaviour. A key feature of the proposed sharing mechanism would be to create an asymmetric mechanism, which seems at odds with that recommendation and regulatory precedent.

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[8] Ofwat PR04 Final Determination, p.230

[9] https://assets.publishing.service.gov.uk/media/5953bfd8e5274a0a69000079/firmus-final-determination.pdf (see para 7.108 onwards)

[10] http://publicapps.caa.co.uk/docs/33/PwC_H7InitialWACCrange.pdf; http://www.europe-economics.com/publications/20100204eecostcapital.pdf

4. Materiality of the proposed changes and the links to PR19

Finally, we observe that the Consultation sets out Proposals that would have a significant impact on our business plan if implemented, and in the longer term, on how we and other water and sewerage companies manage their capital structure.

While the Consultation contends that its proposals *'make targeted amendments to, and clarifications of, the methodology for the PR19 price setting process'* and *have 'minimal' regulatory impact for companies*, the Proposals amount to significant amendments to Ofwat's PR19 Financial Methodology, more than four months after Ofwat issued the Final Methodology. If implemented, the proposals could have very wide-ranging effects, including beyond the water sector, affecting how investors perceive stability or regulatory regimes in the UK for many years to come.

While Ofwat has always maintained that companies are free to determine their own capital structures, Ofwat itself acknowledges that its measures may have a significant effect on the capital structures of water companies. Ofwat stated in an exchange with the Secretary of State for the Environment that it *'[expects] the measures we're taking on financial resilience to lead to a progressive reduction of the highly leveraged balance sheets. As a result, securitisation may well become redundant.'*[11] We agree that if Ofwat were to implement the proposals set out in the Consultation, this is precisely the outcome that would eventuate, as water companies would be [forced / strongly incentivised] to reduce their gearing and thereby shift towards more inefficient capital structures (see further below). This, in turn, would ultimately remove around £15m annually of tax benefit shared with our customers alone.

Bearing this in mind, and leaving aside our views on the substantive merits of Ofwat's proposals which are addressed separately above, we have serious concerns over the way in which the Consultation has been conducted for the following reasons:

4.1 Ofwat has allowed inadequate time for companies to consider and respond to the *Consultation*

Ofwat's allocation of only three weeks for responding to the Consultation notwithstanding that it marks a step change in Ofwat's approach to capital structures, the significant financial consequences on ourselves and the other water companies and the potentially significant implications for their draft business plans, provides an inadequate period of time to meaningfully consider the proposals. There are detailed analytical issues at stake in the reasoning which underpins Ofwat's proposals. We have set out our concerns with Ofwat's

[11] Letter from Ofwat's Chairman to the Secretary of State for Environment, Food and Rural Affairs, dated 9 April 2018

reasoning below as far as possible in the time available, however further time is required to fully consider and respond on those issues.

As part of the original consultation process for adoption of the Final Methodology, respondents were typically allowed much longer periods to respond to Ofwat's consultations on various parts of the Final Methodology and the draft Methodology. Against this backdrop, three weeks to respond to these significant proposed amendments to the Final Methodology is insufficient. Furthermore, the Consultation has been issued at a time when water companies are in the latter stages of developing their business plans and are thus capacity-constrained in their ability to respond.

4.2 The Consultation proposals are too significant to introduce at this stage of the PR19 process

Ofwat's proposals set out in the Methodology introduce significant amendments to its Final Methodology too late into the PR19 process, jeopardising our ability and the ability of other water companies to put forward the most effective business plans.

We have, like the other water companies, been working on our Business Plan since the Final Methodology was published in December. Given the impact of the proposed changes, we do not believe that there is time within the PR19 process to address them properly, not least when the detailed requirements of the various assurance processes we need to complete are taken into account. We have already spent significant time and effort seeking to understand how Ofwat's indicative WACC would affect the assessment of financeability for the notional company as well as our actual structure and how this affects our Business Plan.

To conduct the necessary assurance processes on our business plan, we will need to sign off on the plan within the next 3 months before submission by 3 September. With a Consultation decision unlikely until June at the earliest, and with the significant impacts that the changes, if implemented would create, we believe that implementation of the Proposals would undermine the integrity of the PR19 Business Plan process. Contrary to Ofwat's assertions that its proposals constitute *'targeted amendments'* to the Final Methodology, we consider that the proposals mark a step change in Ofwat's regulatory policy, necessitating a fundamental re-evaluation of our business plan and capital structure and, as such, are not justified at this stage in the PR19 process.

As such, we have serious concerns that Ofwat has not properly calibrated the proposals set out in the Consultation bearing in mind the late stage of PR19.

We also have serious concerns that Ofwat has prejudged the outcome of the Consultation, rather than consulting when the proposals are in a formative stage, in particular when the proposals set out in the Consultation are read in conjunction with the exchange of letters between the Chairman of Ofwat, and

the Secretary of State for Environment, Food and Rural Affairs dated 9 April 2018.

We note, in particular, that Ofwat is *'taking action to reduce what companies can reap from high gearing and to require them to share benefits with their customers in the form of lower bills'* and that the new outperformance sharing mechanism *'will sit alongside mechanisms already in place…'.*[12] We invite Ofwat to confirm the steps that it intends to take to address this issue and ensure that any decision to implement the proposed changes to the Methodology conscientiously takes into account the responses to the Consultation.

4.3 Alternative approaches and suggested next steps

Finally, we have considered alternative mechanisms to address Ofwat's concerns as well as set out proposed next steps for the Consultation.

With regard to alternative mechanisms, we have given consideration to potential alternatives which could take account of key principles such as a symmetric approach and ex-post implementation. However, in the time available, we have not had the time to fully develop these alternatives. In terms of preliminary proposals, we suggest that a possible alternative could be sharing outperformance of the outturn cost of debt. This would be unrelated to gearing levels but could perhaps work in a similar way to the current totex sharing mechanism. This would be a symmetric approach, so that if the cost of debt proved too generous or too tough, a "pain/gain" sharing mechanism would apply at the end of the AMP. We would be happy to work with Ofwat to develop this alternative.

With regards to next steps, we note that the short duration of the Consultation means that additional time would be needed to consider appropriate mechanisms so that the industry has adequate time for assessment and analysis. Accordingly, we would suggest that, at the very least, the consultation on these proposals should be decoupled from the PR19 process. Decoupling the consideration of the substantive matters in this Consultation from the wider PR19 process would enable the attention we believe they merit to be afforded to them. It would also provide Ofwat, companies and others the time to explore fully the significant concerns and disagreements that we have with the underlying rationale for the proposals and the mechanisms proposed.

[12] Letter from Ofwat to the Secretary of State for Environment, Food and Rural Affairs dated 9 April 2018, pages 1 and 3.

RESPONSE TO THE SPECIFIC CONSULTATION QUESTIONS

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?

No. The materiality and complexity of the proposed changes are such that it is too late to embed them within the PR19 process and the IAP.

We would also need to see further evidence of the need for such a change, as we do not believe financing outperformance exists in the way it has been described in the Consultation, and because we consider that the changes we have already announced to our structure and governance, combined with the existing regulatory mechanisms, are already sufficient to safeguard customer interests.

Changes of the sort proposed would, in fact, serve to harm future customer and environmental interests and threaten the ability to raise finance for necessary investment in the future.

It is not clear that a theory of harm has been established by Ofwat that would warrant the very significant changes proposed.

Ofwat has not explained what (if anything) has changed to justify this very significant change in regulatory approach which would effectively move the sector towards rate of return regulation. Nor has Ofwat shown that the measures proposed would deliver benefits for customers.

If implemented, these proposals could have effects that would last well beyond the current price control, and could create impacts that go beyond the water sector, as they could alter the perception of the stability of UK regulatory structures among investors and potential investors in other utilities.

The proposals on sharing financial outperformance do not appear to be well designed, or well evidenced. In assessing these proposals against the principles of best regulatory practice, we do not perceive them to be proportionate or targeted responses to perceived (but not clearly evidenced) problems.

Ofwat’s stated rationale for the changes is not consistent with established economic and financial theory (including Modigliani and Miller) and as confirmed in the recent CMA decision on Firmus Energy, which shows that the cost of capital is not affected by the level of gearing.

Ofwat’s contention that ‘*investors in companies with higher gearing levels can take the benefit of the difference between the cost of equity and the cost of debt for the actual proportion of gearing that is above our notional assumption*’ is at odds with the basic principle that the cost of capital is not affected by the level of gearing and we cannot find any economic or financial analysis that aligns with this statement.

Higher geared companies reflect a capital structure where the balance of risk and reward is different to the notional company level. That is, the securitisation rules in place, ensure additional protection for debt investors, but at a cost to equity investors. In other words, risk is transferred between debt and equity in more highly geared structures, but overall risk (and WACC) remains same.

Indeed, on p.15 of the Consultation document, this point seems to be acknowledged by Ofwat. However, Ofwat contradicts the suggested logic underpinning the sharing proposal and the mechanism proposed.

We further consider that the current levels of gearing and securitised structures are the result of firms responding to the regulatory framework put in place by Ofwat.

The proposals as envisaged would arguably be retroactive in their effect, and the impacts would be borne by current and future owners, rather than those who may have been perceived to have benefited in the past. It should also be noted that the move to indexation of debt has already removed one way in which companies could have previously benefited if interest rates moved in their favour.

Ofwat suggests that securitisation enables lower cost of debt **and** lower cost of equity. However, this misses the point that the covenants on which securitisation relies (e.g. dividend lock-ups) will naturally embed greater risks with equity holders. So, whilst debt costs can be reduced through effective financial structures and efficient treasury functions, equity costs will increase as gearing increases.

It is true that, as gearing increases, companies can benefit from greater tax efficiency. However, in the case of water regulation, all the tax benefits of higher gearing are passed on to customers (which is therefore an existing benefit to customers of such structures which would be unwound if gearing levels reduced). With such a tax sharing benefit to customers in place, the cost of capital will be unchanged at any level of gearing.

We are willing to work with Ofwat to develop a more appropriate alternative. However, this should accord with two key principles:

- **Symmetry of risk.** As with other cost types, deviations from efficient financing costs should be treated on a symmetric basis. The rationale for this, is that sharing only outperformance would mean that the overall risk distribution of a company would be skewed to the downside and, therefore, all else being equal, investors would require a higher expected return to balance the risks and rewards;
- **Real benefits to consumers.** It will be important to introduce sharing only where real benefits exist. Introducing a mechanism that does not demonstrably bring benefits for consumers (e.g. because there is not much scope for sharing) would only introduce extra complexity to the regime as well as potentially distort incentives.

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?

No. We do not believe that the case has been made for this proposal. Customers receive the benefit of highly geared structures through a reduction in bills as the benefits of tax efficiencies are passed on to customers in full.

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 do not believe that the proposed mechanism would serve to benefit customers' long term interests and we do not believe it is required. The economic rationale for the design of the mechanism is flawed.

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 companies should explain their dividend policies, and that this should be part of Ofwat's IAP assessment. This should then be judged in the round, and against Ofwat's broader duties.

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 with the first part of this question, i.e. that our approach to any performance-related element of executive pay should be set out in our business plan, and that the IAP assessment should assess that transparency. In relation to the second part of this question, we would suggest that policies for performance-related elements of executive pay should be more nuanced than only linking to "exceptional delivery for customers". If a company is delivering on its promises to customers, getting to top quartile performance and performing well on CMEX, then this could justify some rewards. A sliding scale is perhaps more appropriate, as is the case for most performance-related pay systems.

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?

We would accept the majority of the suggested revised wording, but not the reference to outperformance sharing, for the reasons we have set out above.

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

We agree with Ofwat that the sector should be financially resilient. However, the proposals would create a very significant additional set of tests that seem to us to go beyond what is needed to ensure long term financial resilience, something that we, and other companies, already report on to Ofwat and which our Board is required to give specific assurance on.

Companies' applications of these stress tests should also be informed by the mitigations they already have in place to prevent such impacts materialising.

Ofwat proposals in relation to gearing outperformance

Prepared for Anglian Water Services Ltd

17 May 2018

Final

I, Dr Luis Correia da Silva, Partner at Oxera Consulting LLP, have been asked by Anglian Water Services Ltd to provide my opinion on the proposals for sharing financing outperformance in the recent consultation published by Ofwat.[1] I have organised my comments under the following headings:

- there is a lack of evidence in support of Ofwat's assumption that 60% gearing represents the only efficient capital structure for the whole industry;
- there is a lack of evidence in support of Ofwat's presumption that high gearing *per se* leads to harm;
- there is a lack of evidence in support of Ofwat's claim that highly leveraged companies over compensate equity holders for the risks they bear in these structures;
- in any case, the proposed remedy is not well targeted, is disproportionate and has potential negative unintended consequences;
- to develop robust evidence in these areas to enable policy intervention in line with best regulatory practice requires a significantly longer timeframe than the one allowed in the consultation.

There is a lack of evidence in support of Ofwat's assumption that 60% gearing represents the only efficient capital structure for the whole industry

[1] Ofwat (2017), 'Putting the sector back in balance: Consultation on proposals for PR19 business plans', April.

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One of the most well-established principles of corporate finance is that the cost of capital of a project or a company is determined by the risk of expected cash flows generated by the assets of the project or company. The expected return on assets is not affected by how the return is divided between different financial claimants, under a number of assumptions.[2] In other words, the weighted average cost of capital is invariant to gearing. The features of securitised financing structures formalise the risk transfer between debt and equity. Therefore, there is no sound basis for Ofwat to assume that the notional capital structure of 60% represents the most efficient capital structure for the industry or for individual water companies.

There is a lack of evidence in support of Ofwat's presumption that high gearing *per se* leads to harm

In the consultation, Ofwat states that:

> …companies with high levels of gearing have potentially lower levels of financial resilience, as the impact of cost shocks or poor performance is magnified to a smaller equity base. As it is companies and investors rather than customers that make the choices about financial structure, despite the safeguards that we put in place, it is possible that service to customers is put at risk in the event of failures that relate to a company's choice of capital structure.[3]

The consultation does not advance any evidence to support a link between high gearing and actual or potential harm to customers. The consultation does not therefore justify a departure from the long-established principle of Ofwat and other regulators, including the CMA, of neither encouraging nor discouraging particular forms of capital structure. There are many factors that affect service levels, and the extent to which capital structure plays a role—positive or negative—is not well understood.

There is a lack of evidence in support of Ofwat's claim that highly leveraged companies over compensate equity holders for the risks they bear in these structures

In the consultation, Ofwat states that:

> investors in such companies take the benefit of the difference between the cost of equity and the cost of debt for the actual proportion of gearing that is above our notional assumption, with no equivalent benefit to customers. Consistent with our approach to benefit sharing on costs and service, we consider it is reasonable for customers to benefit from financing performance associated with high levels of gearing.[4]

The consultation appears to assume that gearing higher than the notional assumption does not have any effect on the required return on equity and that there is a risk-free arbitrage between the return on equity allowed in the price control and the cost of debt. The consultation advances no theory to support such assumption nor evidence to contradict the positive relationship between risk and expected return predicted by standard finance theory.

In any case, the proposed remedy is not well targeted, is disproportionate and has potential negative unintended consequences

Even if there are benefits from high gearing, because these have not been identified by Ofwat, the proposed remedy cannot be well targeted. The remedy

[2] This concept is formalised in Modigliani, F. and Miller, M. (1958), 'The Cost of Capital, Corporation Finance and the Theory of Investment', *The American Economic Review*, **48:** 3, June.
[3] Ofwat, op. cit., p. 14.
[4] Ibid., p. 15.

is based on the assumption that the cost of equity is independent of gearing and is likely to generate transfers from companies to customers that are far in excess of any benefits from gearing. The proposed mechanism incentivises companies to reduce gearing without any evidence that this is efficient. It would also reduce cash flow and financial resilience. The arbitrary cut-off level of 65% means that a large number of companies in the industry are likely to be affected as their gearing fluctuates over time depending on their financing needs.

To develop robust evidence in these areas to enable policy intervention in line with best regulatory practice requires a significantly longer timeframe than the one allowed in the consultation

Interventions of the nature proposed by Ofwat are significant and will have a material financial impact on several companies. They depart from established regulatory practice of leaving capital structure decisions to be made by companies and their investors. The evidential threshold for introducing such measures should therefore be higher than that used for making more routine updates to price control methodologies. The three weeks that companies have been given to submit evidence to the consultation is insufficient time and too late in the PR19 process to conduct a thorough analysis of the evidence and enable a robust assessment of whether to intervene, and if so, what form this intervention should take.