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17 May 2018

Benefit sharing consultation
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Dear Ms Fletcher,

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

We are writing regarding your consultation entitled **"Putting the sector back into balance: Consultation for proposals for PR19 business plans"**.

Allianz Capital Partners ("Allianz"), DIF and InfraRed Capital Partners Limited ("InfraRed") each manage investments in Affinity Water ("Affinity"). Between ourselves, we manage over EUR 16bn investments in infrastructure assets across the UK, Europe and Asia primarily on behalf of pension funds, local authorities, and insurance companies. We are long-term investors who are deeply committed to the jurisdictions in which we operate as well as delivering stable and sustainable returns. We seek to actively contribute to the communities we serve and are fully aligned with customers in delivering long term value.

We welcome the opportunity to engage in this consultation and to work with Ofwat to deliver improved outcomes for customers and to ensure the long-term physical and financial resilience of the UK water sector. In this letter we would like to specifically address the proposal of introducing a gain-sharing principle relating to perceived financing outperformance. We believe that fundamentally the capital structure as previously stated by Ofwat is a matter to be determined by the board whilst performing its fiduciary duties. We believe that financial outperformance is already being shared with customers through well-established principles of the economic regulation in place and introduction of additional measures would not be appropriate for a number of reasons including:

- The proposed approach fundamentally changes the risk-reward balance of higher gearing departing from Ofwat's long established principles that financial arrangements are the preserve of boards and investors. This sets a worrying precedent at a time when significant investment is required in order to ensure future security of supply and meet rising service expectations. As new investors into the sector with a buy-and-hold investment mandate, confidence in the predictability and transparency of the regulatory framework is paramount. Undermining central pillars of the investment framework risks jeopardizing long-term investment that is required to deliver better outcomes for customers.

- The case for this radical intervention is made without supporting evidence that gearing above the notional level is harmful to consumers or implies lower financial resilience. Indeed, companies are already required to demonstrate their financial resilience through existing regulation. The haste with which the proposals are being introduced leaves insufficient time for thoughtful consideration as to how to incorporate the potential new requirements into PR19 business plans. It has also meant there has been insufficient analysis of the long-term consequences for the sector, making an unwelcome departure from the evolutionary regulatory environment into which we have committed as long-term investors.

- While there has been debate in the industry over levels of gearing since the start of 2018, there is as far as we are aware, no evidence that Affinity's gearing levels are hampering its ability to service its customers. Affinity's management team tell us that capital structure has not been raised as a concern by their Affinity customers, who are instead focussed on network resilience (security of supply), the environment and receiving a value-for-money service. Views expressed by customers are in keeping with DEFRA and Ofwat's long term objectives. We invest in a range of different infrastructure asset types and readily acknowledge that different assets can support different levels of debt. When we acquired the investment in Affinity we carefully reviewed the capital structure to make sure it was robust, as equity suffers if there is a downside in an over-levered asset (e.g. such as the M6 toll road when traffic revenue was insufficient to service the levels of debt).

- The premise that gearing in excess of what Ofwat perceives as being notionally efficient implies lower resilience and worse outcomes for customers is not supported by empirical evidence. Alongside internal stress tests performed as part of the long-term viability statement, credit rating agencies provide an additional layer of assurance and third party assessment of companies' financial resilience. Affinity has for a number of years had a securitised debt structure with robust stress tests and a stable, above investment grade rating by Moody's consistently in line or better than other UK and European utilities (e.g. National Grid). Similarly, the concept of so-called 'gearing outperformance' is misleading. With more debt, the underlying equity is taking more risk whilst passing tax benefits directly on to customers. Cost of debt outperformance is furthermore shared with customers through the periodic reset of WACC and will be further strengthened in PR19 through the new debt indexation mechanism.

- Like other water companies, Affinity has long-term financing arrangements which aim to minimise refinancing risk and optimise the cost of debt. This ensures that customers benefit from the lowest cost of capital available. The proposed mechanism will effectively lead to investors being retrospectively penalised for historic decisions made under a well-established regulatory framework prior to these proposals. This would set a concerning precedent across the investor community and weaken overall confidence in both the UK water sector and wider UK infrastructure.

- The principle of capital structure neutrality is widely acknowledged in economic theory and has formed the basis of UK water economic regulation for decades. The proposal of sharing perceived gains not only increases risk to investors as they are not able to earn required returns to fully compensate for the potential cash flow volatility, but this is exacerbated further through sharing in an asymmetrical structure.

- If a sharing mechanism existed it would make it harder for companies to reduce their levels of gearing as free cash which could do this would not be available.

The proposal of sharing perceived financing outperformance set out in this consultation has not been raised previously and comes at a late stage in the PR 19 business planning process, whereas most other topics have been well-trailed and debated following a rigorous process and evidence-based approach. A rushed consultation proposing to shift fundamental regulatory goal posts risks having negative, long-lasting effects on both the regulated water sector as well as wider infrastructure sectors in the UK.

Yours faithfully,

Jaroslava Korpanec	DocuSigned by: Angela Roshier 20EF2AFA9C734F8...	A. C. Roper
Jaroslava Korpanec	**Angela Roshier**	**Tony Roper**
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