

Jonson Cox / Rachel Fletcher
Benefits sharing consultation
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4 UA

Via email: Water2020@ofwat.gsi.gov.uk
17 May 2018

Dear Jonson and Rachel,

We are making this submission in response to the Ofwat publication: "Putting the sector back in balance: Consultation on proposals for PR19 business plans" in our capacity as longstanding and long-term equity investors in the UK Water and Sewerage sector on behalf of a range of institutional investors that includes 11 UK pension schemes with 755,000 underlying members.

Summary

We and our investee companies are realistic about the legitimacy challenge the sector currently faces in the court of public opinion. We are actively supporting company management teams and Boards as they diligently work to achieve the long term and sustainable improvements to operational performance that are important to regaining the public's confidence and trust. This is a long term project with multiple work-streams.

It is therefore unfortunate that we do not believe that wholesale implementation of the proposals contained in the consultation would contribute positively to this journey. In fact, there is a real risk of seriously undermining investor confidence in the sector by implementing the proposals contained in the consultation. Furthermore we believe that the proposals will do little to address the underlying issues that the sector faces.

The asymmetric and retrospective changes proposed risk fundamentally undermining UK water regulation's reputation for genuine independence, stability, predictability, transparency and proportionality.

Consultation period

The perfunctory three week consultation period is manifestly inadequate and fails to appreciate the magnitude and potentially long term consequences of the proposals. Such a limited consultation period for such critical matters is unprecedented and we believe inconsistent with best regulatory practice.

Sharing financing "out" performance

The proposals in relation to sharing financing performance may undermine debt and equity investor confidence and have adverse unintended consequences for the sector's future viability whilst risking contagion to other regulated industries.

To date, Ofwat has successfully used regulatory and financial mechanisms to ensure companies continually improve the delivery of a public service to customers and has clearly outlined its commitment to delivering "more for less" for customers in PR19. As long term investors, we welcome that challenge and recognise the Regulator's duty to seek continuous improvement in performance in the interests of customers. However, the introduction of a financing performance mechanism that requires companies to de-lever over an extremely short period or effectively receive a lower WACC represents a level of regulatory intervention in the capital structures of water companies that is unprecedented. There is no evidenced

based justification for this additional intervention which would set an unhelpful precedent, not only for the water sector, but also for other regulated industries.

The current capital structures for companies have been established over-time in a manner that complied with licence conditions and other regulatory and legal requirements. The regulatory principle that, subject to such compliance, the risk and reward inherent in capital structures was a matter for the companies, their investors and boards, represented a key component of the regulatory landscape and contributed to the success of the sector in attracting investment.

We believe that the proposals in the consultation are inconsistent with best regulatory practice and flawed as:

- (a) being retrospective in effect as requiring the immediate deleveraging of existing capital structures lawfully established in accordance with applicable licence conditions and regulatory and legal requirements;
- (b) effectively imposing a solution on companies that fundamentally undermines the principle that responsibility for capital structures lies with boards;
- (c) creating an asymmetrical outcome where customers share in the benefit but do not take the risk of more highly geared capital structures noting that customers do benefit from the related tax deductions;
- (d) imposing a penalty on more highly geared companies effectively institutionalising a discriminatory distinction without appropriate consideration of the long term consequences for the sector i.e. that lower geared companies are always in the customer's best interests; and
- (e) ignoring the undertakings already made by many companies to de-lever overtime and which no doubt Ofwat would expect to be reflected in PR19 business plans.

Dividend policy:

As you are aware we are proponents of high standards of corporate governance and have publicly advocated for the adoption of enhanced governance broadly consistent with the listed company model for privately owned infrastructure businesses where the interests of all stakeholders, most especially end-users, should properly be a key component of board decision making.

We strongly believe that as stewards of essential services the responsibilities of boards of privately owned infrastructure businesses should practically extend beyond those enshrined in UK company law in a manner that is consistent with the privilege of being responsible for delivering monopoly services. This is part of the social as well as economic contract.

Our experience is that high quality boards populated by experienced directors with requisite skills represent the essential foundation for delivering high quality services sustainably in the interests of all stakeholders. We support Ofwat's modernising proposals in this area as the long term solution to many of the current challenges faced by the sector. It is therefore unfortunate that the proposals in respect of capital structure and dividend policy fundamentally undermine the role of boards.

Whilst we agree that dividend policy for regulated water companies should properly take account of operational performance and customer outcomes, we view that setting a specific nominal dividend yield cap is an unnecessary interference in the integrity of boards and contrary to the concept of incentive based regulation.

Prescribing a dividend cap imports the Regulator into key corporate decision making which is inconsistent with board independence and the involvement of private investment in the sector intended to align private capital with performance. Dividends, within the constraints of an appropriately prudent policy, should be the by-product of performance. The risk inherent in setting a cap is that its presence inadvertently distorts decision making. It becomes a factor in investment decisions, rather than a product of them, and therefore potentially undermines an incentive mechanism that should support future investment and stakeholder alignment.

Whilst, for the reasons outlined, we object to the principle of a cap we are also conscious of the complexity of setting a fixed cap that is unable to adapt to shifting markets and economic circumstances.

Company responses

While this letter focuses on the appropriateness of the consultation period, sharing financing performance and dividend policy, we support our investee companies' detailed responses to the consultation and the consultation questions, which we have had sight of.

Yours sincerely

A handwritten signature in black ink, appearing to read "R. Howe". The signature is written in a cursive style with a long, sweeping tail.