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Consultation on proposals for PR19 business plans

Dear Sir / Madam,

We recognise the challenge to the industry made at the Water UK City Conference by Jonson Cox and Michael Gove. We agree it is more important than ever that the industry demonstrates that the privatised model is working in the interests of customers and of society more broadly. Jonson Cox set out a number of principles in his speech, which the Yorkshire Water chairman has since broadly endorsed with the support of investors.

Yorkshire Water is delivering for its customers and we have urged the company to further improve transparency, including publishing and explaining corporate structures. We also note that Yorkshire Water was the first to undertake to remove Cayman entities and to publicly commit to re-invest in achieving upper quartile performance in line with Ofwat's service challenge.

The regulator's role in capital structure

Several aspects of this consultation relate to financing and capital structure. We believe that both Ofwat and companies must reassure customers that the suppliers of this essential service are financially robust. Additionally, there is no parallel to banks because customers are not creditors of water companies, and there is no parallel to Carillion because water companies would never get to negative enterprise value and need to be liquidated.

However, it is crucial that regulatory policy should not lead to a determination of capital structure by the regulator. For nearly 30 years since privatisation, Ofwat has maintained the position that the determination of capital structure should lie with companies. There are already substantial 'ringfencing' obligations in the licence, including a requirement for companies to maintain an investment grade credit rating. This seems an appropriate level for regulatory policy in this area, and consistent with Ofwat's focus on outcomes in other areas of regulation. As we explain below, we believe some of the proposals set out in the

consultation would have a negative impact on the industry, the climate for investment and, most importantly, customers.

These late stage consultation proposals represent a significant departure from a core and well established regulatory principle that has underpinned the investment case for UK regulated assets since privatisation, including water, gas, electricity, aviation and telecommunication networks. Imposing such a radical change in this way at this stage would reflect negatively on the overall investability of UK plc from a global investor perspective.

Ofwat has not offered evidence that more highly geared companies deliver worse outcomes for customers, but rather only vague reference to unspecified behaviours of a subset of companies with higher gearing. Ofwat has also not substantiated any link between company behaviour and gearing. In reality:

- There is no correlation with bills: Yorkshire Water customers enjoy the second lowest bills in the country
- There is no correlation with delivering strong business plans: Affinity Water's business plan was one of two companies to be rated 'enhanced' by Ofwat at PR14
- There is no correlation with outperformance on costs and customer outcomes: Yorkshire Water is meeting 23 of its 26 performance commitments, and exceeding them in several cases

Ofwat has also not demonstrated there has been any market failure resulting in current gearing levels. Gearing levels in competitive or contestable infrastructure market segments are often as high or higher than in water, including for example in OFTOs, ROSCOs, the M25 expansion, and waste management projects.

The proposed consultation approach appears punitive, unjustified and retrospective. Coming at such a late stage in the process, on the back of an unprecedented proposed reduction in the allowable returns it risks undermining trust in the regulatory regime and disincentivising desirable proactive behaviour and investment, to the detriment of customers. Yorkshire Water has been taking proactive steps to increase financial resilience for a number of years. Dividends are suspended by its parent company to the ultimate owners. Sales proceeds from other businesses in the Kelda group have been invested as fresh equity in Yorkshire Water. Yorkshire Water has chosen to re-invest over £200 million of cost efficiencies it expects to achieve over AMP6 into areas that directly benefit customers, albeit with a marginal increase in near term gearing since those efficiencies cannot instead be applied to de-gearing. Part of that re-investment will go to exceeding targets set by Ofwat for key customer outcomes, including leakage and pollution. The remainder will accelerate the transition from incineration to anaerobic digestion of waste, making Yorkshire Water greener and more efficient.

We continue to agree with the position set out by Ofwat both in its cost of debt consultation in 2016 and in the final methodology for PR19 in December 2017 that additional pain/gain mechanisms should not be mandated. The same applies to an automatic link between acceptance of specified mechanisms and the rating of a company's business plan.

On specific areas of the consultation

Sharing of financial outperformance

Ofwat should not be determining company gearing through proposing or imposing 'sharing' mechanisms that do not relate to true outperformance.

The mechanism proposed by Ofwat confuses two distinct concepts: cost of capital and gearing. It is possible to achieve financial outperformance by raising debt at a lower cost than assumed by Ofwat in setting the allowed return. However, it is fundamentally not possible to achieve 'outperformance' of regulatory assumptions simply by virtue of higher gearing alone. We will not support a sharing mechanism that does not relate to true outperformance and so will not support such a sharing mechanism in relation to pure gearing.

Widely accepted and applied economic theory establishes that a company's value and risk are independent of its financial structure. As a consequence the total required return on investment is also independent of the financial structure. If gearing is higher, the variability (i.e. risk) of returns is concentrated on a smaller equity proportion of the investment, and hence that equity requires a higher return. This can be positive for company behaviour; for example higher gearing will therefore amplify the effect of financial regulatory incentives on the equity and hence the management of the company.

There is just one way in which returns may be enhanced by higher gearing, which is related to tax. In the UK, as in many jurisdictions, interest on debt is tax deductible but dividends to equity are not, such that higher gearing results in lower taxes. That is the only true outperformance derived from higher gearing. However the existing regulatory framework already ensures that 100% of that benefit goes to customers, based on actual gearing.

Furthermore, we believe the specific mechanism proposed by Ofwat would be directly harmful to customers. The mechanism creates a strong incentive to reduce gearing quickly, since it creates incremental costs for companies geared above the notional level, which do not relate to outperformance. Rapid de-gearing is unlikely to be undertaken by prepaying debt, as many debt facilities have very costly penalties for prepayment. The most cost effective means of de-gearing quickly will be to reduce discretionary investment, such as the re-investment of cost outperformance into customer outcomes undertaken by Yorkshire Water. The proposed mechanism for sharing financial outperformance is also likely to reduce the financial resilience of companies levered above the deadband as the cost it imposes will put pressure on interest coverage ratios.

KPMG has prepared a helpful report which examines the economic arguments and evidence in more detail. KPMG's work is supported by Professor Alan Gregory of Exeter University, a recognised expert in the field and a former member of the Competition and Markets Authority. Both reach similar conclusions. We attach KPMG's report and a note from Professor Gregory for your information.

Dividend policy

We agree that it is appropriate and desirable for both customers and investors that companies set out a clear and transparent dividend policy. This should include an explicit link to the allowed returns and an explanation of where variations may arise. In particular, dividends may be adjusted by outperformance and underperformance in the current AMP, and carried over where there are financial effects from previous AMPs.

However, we believe this is an area where Ofwat should not propose or impose a specific approach. Setting dividend policy is an essential function of company boards, which are best placed to balance customer legitimacy, other stakeholder interests and investors' return expectations. Furthermore, it is ultimately the legal responsibility of the board under the Companies Act to ensure that dividends are financeable. Boards also need to ensure that dividends are sufficient to attract investors to fund the significant investments needs of the sector at a low overall cost of capital.

Financial resilience

We agree that companies should be financially resilient and Ofwat is right to expect companies to demonstrate that its plans are financeable and resilient as part of discharging its financeability duty. Some of Ofwat's innovations in this area have been welcome improvements to the transparency and legitimacy of the industry, notably the Financial Monitoring Framework.

We agree that stress testing is an appropriate tool for Ofwat to assess financial resilience. We agree with Ofwat's requirement for companies to model scenarios that are severe, reasonable and plausible. However, we do not believe that Ofwat should be specifying any of the scenarios. Companies, boards and credit rating agencies are better placed to calibrate the exercise. While some of the scenarios Ofwat has suggested as a 'minimum' are reasonable and plausible, others are extremely unlikely and materially more

severe than credit ratings agencies apply for robust investment grade ratings. We would expect any company to struggle in some of Ofwat's scenarios.

We would also ask that Ofwat clarify the reference to the 'nature of investors' under the financial resilience factors relating to equity, including what is considered stronger/weaker and why. As a practical matter, it is difficult for companies to predict the hold periods of its investors. Investors in listed companies may hold for two years or two seconds. Unlisted managed funds may hold for a few years or for over a decade (as several have). Unlisted direct investors such as pension funds or sovereign funds have potentially very long or indefinite hold periods, but have been seen to sell investments where they believe that investment fundamentals had deteriorated or where levels of uncertainty materially increased such that the investment stability sought was no longer present. We would also observe that there would likely be wider implications for the investability of UK plc in the event that certain types of investor were favoured over others by an economic regulator.

Executive remuneration

We strongly agree with Ofwat that it is in the best interests of all stakeholders that the industry should be able to pay executives at a sufficient level to attract and retain individuals of suitable calibre and experience. This becomes even more important as Ofwat rightly pushes companies harder to innovate and deliver more for less to customers. The same is true for investors as regulatory incentives are increasingly calibrated to drive greater differentiation in financial outcomes based on company performance.

We also recognise that executive pay is a key sensitivity with customers and in society more broadly. We agree that companies should be transparent on how performance related components are set and how pay relates to services delivered to customers as well as returns delivered to investors. Customers and investors are aligned in wanting to see executives rewarded only if they are truly performing.

We welcome Ofwat's proposals in this area. We have been supportive of Yorkshire Water taking up the challenge set by Ofwat to take a fresh look at executive remuneration structures, and deliver innovation in this area.

We also welcome Ofwat's approach to this area of the consultation, which implicitly recognises that setting executive pay is an essential function of board and simply sets a high level challenge to deliver against an objective. We would encourage Ofwat to take a similar approach in other areas of this consultation.

Risk of challenge

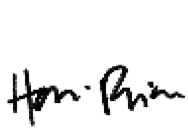
The materiality and timing of this consultation, coming when companies and their boards are finalising AMP7 plans for submission in September, elevates the risk of companies challenging their determinations with the Competition and Markets Authority, to the extent that significant unjustified costs are imposed and/or incentives are created that are not aligned with customer interests.

Challenge processes are high profile and harmful to the sector's investability. They also represent a significant distraction for management and the regulator from delivering for customers. Moreover the prospect of a potential challenge at this stage of the PR19 cycle risks undermining the process incentives that Ofwat has set out to encourage companies to submit ambitious business plans for customers.

We believe this risk can be mitigated if Ofwat simply challenges companies to address the principles but leaves the specific solutions to companies and their boards.

We look forward to continuing collaboration with Ofwat and continuing to support Yorkshire Water.

Yours faithfully,



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