VANTAGE INFRASTRUCTURE

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Attention: Ofwat
From: Vantage Infrastructure

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Submitted by email to Water2020@ofwat.gsi.gov.uk

Response to Ofwat's consultation "Putting the sector back in balance: Consultation on proposals for PR19 business plans"

Dear Sir/Madam

Vantage Infrastructure appreciates the opportunity to comment on Ofwat's consultation "Putting the sector back in balance: Consultation on proposals for PR19 business plans" published on 26th April 2018.

By way of background, Vantage Infrastructure is an independent infrastructure-focused investment firm comprising an experienced team, long-standing institutional relationships and a diverse equity and debt infrastructure investment portfolio formed from the international business of Hastings Funds Management. Vantage Infrastructure currently manages in excess of US$3billion in funds on behalf of a range of directly managed client relationships. With specific regards to regulated infrastructure assets, Vantage Infrastructure is an experienced manager of utilities networks, including South East Water and Phoenix Natural Gas in the UK. Vantage Infrastructure manages 50% of the equity in South East Water on behalf of RBS Group Pension Fund in the UK and Desjardins Group in Canada as well as a 50% for stake for Hastings Funds Management (the manager of UTA from Australia). We have been an active investor and participant in the UK water sector since 2005.

In writing this letter, Vantage Infrastructure would like to fully support the points raised in South East Water's response to Ofwat's consultation. We would also like to add our point of view on Ofwat's consultation questions on behalf of our managed clients.

As we have already indicated at the investor roundtable discussion with Ofwat on 14th May 2018, we have been very surprised by the extent of the potential changes to the regulatory framework Ofwat consults on, which in our view represent potentially fundamental and unprecedented shift in a regulatory framework we have been involved with since 2005. We welcomed Ofwat's open and transparent consultative approach to the PR19 methodology definition and the well-run process, multiple workshops and meetings to engage with and gather views from the various stakeholders on the proposed PR19 concepts. In stark contrast, this consultation has a response time of only three weeks, yet contains potentially fundamental changes vis-a-vis the regulatory principles applied across all UK regulated sectors. In our opinion, these changes are contrary to the foundations of regulatory best practice, lack evidence-based justification of any merits for customers as well as a thorough impact assessment and are, therefore, detrimental to the reputation of the UK regulated water sector.

We support the general themes and objectives that Ofwat is trying to achieve in terms of improving trust and confidence in the sector. However, and in particular, the sharing financing gains and the potential capping of dividends proposals are major concerns. In particular the proposals around sharing outperformance associated with higher gearing and potentially introducing an absolute dividend payout ratio represent retrospective and fundamental changes to incentive-based regulation in the UK, as the framework within which companies in the water sector, as well as their debt and equity investors, have invested for years.

We feel it is important to clarify some facts about South East Water:

- In our role as active shareholders, we have achieved significant improvements in South East Water's performance, in terms of leakage, water quality, customer service, protection of the environment and protection of vulnerable customers, as evidenced by data Ofwat has access to, whilst maintaining a solid level of financial resilience.
- We have started to de-gear the company over AMP6 and will continue to support the company in reducing the company's gearing to the mid-70% area by the end of the next AMP.
- The company has achieved self-assured status for two consecutive years.
- Shareholders have received £91m dividends over the last five years compared to notional allowed dividends of £206m and investments of £413m in the company's assets. It is also highly likely that the dividends paid over the next AMP will be significantly lower based on the methodology published by Ofwat.

Within this context, our answers to the consultation questions are as follows:

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?

We disagree with Ofwat's unprecedented proposal to require companies to propose mechanisms for sharing financing "outperformance" in their business plan and that such mechanisms should be assessed in the IAP.

Proposals around sharing outperformance associated with higher gearing represent a retrospective and fundamental change to the foundations of incentive-based regulation in the UK, which set out the basis for companies', as well as debt and equity financiers' investments for years. They also fundamentally undermine established finance theory adopted by all the UK regulators. A core founding principles of UK economic regulation is, that companies and their directors, not the regulator to choose their actual financing structure. Financing structures in water companies in the UK have been established based on these regulatory principles with long durations and prohibitive breakage costs to unwind such structures.

Mainstream finance theory explains that companies' cost of capital is broadly insensitive to the level of gearing, as higher share of relatively cheaper debt is offset by the increase in cost of equity due to its higher risk. The CMA and other GB regulators have also drawn the same conclusions at recent price control reviews. Hence, evidence indicates that companies do not accrue any "benefits" associated with higher gearing to the detriment of customers.

Therefore, not only there is no "benefit" from higher gearing that the company accrue and could share, but for this reason Ofwat's gearing outperformance measure would undermine financial resilience by delivering (by definition, through the sharing of a non-existent benefit) an allowed and actual equity return below the efficient financing cost that Ofwat itself has set.

In addition, a clear customer benefit associated with higher gearing is the reduction in companies' tax liabilities, which has already been fully passed through to customers under the existing regulatory rules for a number of current and past price controls. Conversely, Ofwat's proposals are likely to incentivise higher geared companies to de-gear even further with a consequent increase in tax liabilities, leading to higher customers' bills.

We therefore believe incentivising companies to adopt the notional gearing structure through such mechanisms undermines trust and confidence in the sector, as it would lead to an increase in customer bills and seeks to address an issue for which we see no evidence of customers' concerns.

We also disagree with the proposals that companies should share outperformance associated with the cost of debt. By setting the allowance based on an industry average for embedded debt and an efficient industry benchmark, Ofwat's approach ensures that companies recover only efficient debt costs. Similar types of approach have been adopted in other UK incentive-based regulatory regimes for years. In addition, an asymmetric mechanism where companies that outperform the cost of debt share the upside with customers whilst companies that underperform do not share the downside with customers is inconsistent with other areas of regulation. For example both totex outperformance and totex underperformance are shared with customers.

We refer to the more detailed technical explanations contained in South East Water's response to the consultation on both points.

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?

As explained above we disagree with the statement that there is a "benefit" to companies from higher gearing that can be shared with customers.

Common financial theory as well as regulatory practice by all other regulators and the CMA indicate that that companies' cost of capital is broadly insensitive to the level of gearing.

Ofwat has not provided any evidence supporting the need of an intervention under best regulatory practice, ensuring that regulatory activities are targeted only at cases in which action is needed:

- Ofwat has not demonstrated that customers are concerned about gearing levels
- Ofwat has not demonstrated that there is any benefit to companies from higher gearing
- Ofwat has also not presented an impact assessment demonstrating direct and indirect effects of any of the mechanisms mentioned in the consultation paper.

Therefore, Ofwat should not impose any sharing mechanism on financing "outperformance" and we disagree that Ofwat should intervene with such an imposition.

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?

As explained above we disagree with the statement that there is a "benefit" to companies from higher gearing, that can be shared with customers. We therefore reject the design propositions and calculations as presented by Ofwat.

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?

Companies should explain their approach to actual dividend policy in their business plans, where this is relevant for the purpose of demonstrating that the company is financeable based on the actual financial structure. Ofwat's IAP assessment of companies' dividend policy should focus on the impact of the company's dividend policy on companies' financeability on an actual basis, as well as financial resilience to downside scenarios.

We disagree with any proposition that Ofwat should assess or regulate companies' dividend policies or that dividends should be capped or tiered, whether in absolute terms or by reference to any thresholds. It is the responsibility of the company's directors and them alone to set the dividend policy and level of pay-out based on a number of factors, taking into account annual results but also forward-looking liquidity requirements of the company, financial resilience, interests of all stakeholders including customers and employees. Ofwat is not in a position to assess these factors for the companies. Dividends represent an output integrating company performance, investments, outperformance compared to targets (as set by the regulator and shared with customers) and capital structure effects.

If Ofwat were to regulate companies' dividend policies, this would inevitably imply a regulation of companies' actual financing structure, contrary to Ofwat's stated policy of regulating companies on a notional basis. This would again represent a fundamental departure from long established regulatory principles in the UK and would significantly erode debt and equity investors' confidence in the sector.

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 Ofwat's proposal around performance related executive pay. South East Water's performance related element of executive pay already demonstrates a substantial link to exceptional delivery for customers in the current regulatory period, reflecting a linkage to cost saving, the Service Incentive Mechanism and Outcome Delivery Incentives. The performance related element of executive pay is set out transparently in the company's annual report, which is available from the company's website.

Determination of executive pay is a matter for companies' boards, not the regulator, and it should remain the boards' responsibility to be able to attract the best talent in the interest of the company and all its stakeholders, in a competitive recruitment market.

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 agree with the proposed revision to provide a test around appropriate measures to provide a fair balance between customers and investors. For the reasons set out above, we do not believe it is appropriate to share outperformance on gearing or cost of debt.

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

We have no comments on the assessment of financial resilience in the IAP.

As a long-term and active owner, Vantage Infrastructure looks forward to continuing to work collaboratively with Ofwat, South East Water and its customers to develop a customer-focused Business Plan for PR19.

Yours sincerely,

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