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31 January 2022

Dear Sir / Madam,

1. **Financial resilience in the water sector: a discussion paper**
2. **PR24 and beyond: Discussion paper on risk and return**

InfraRed Capital Partners ("InfraRed"), Allianz Capital Partners ("ACP") on behalf of The Allianz Group ("Allianz"), and DIF Capital Partners ("DIF") collectively manage 100% of the equity in Affinity Water. We are writing to re-iterate our support for continued investment in the water sector. In addition to Affinity's planned £1.4bn investment over AMP7, we anticipate that significant further investment will be required in AMP8 and beyond to support key policy priorities, including supply resilience, climate resilience, net zero, and protecting our chalk streams.

However, we are concerned that some of the proposals in these Ofwat discussion papers could hinder rather than help these objectives. They could disincentivise investors from entering the sector and companies from higher levels of investment. Further, the basis of Ofwat's focus on this area is not clear in the context of the CMA's finding that there was insufficient evidence to support regulatory intervention in its PR19 decision, following an extremely detailed year-long process.

In our view:

- Ofwat has not demonstrated that financial resilience in water companies poses any tangible risk to customers or taxpayers
- Regulatory intervention in capital structure does material and observable harm to the sector as a reliable destination for investment, and also cuts across company directors' responsibilities
- Such intervention may represent disproportionate regulation that leads ultimately to customer harm if it reduces investor confidence in the sector
- Such intervention risks weakening the investment case for all UK regulated sectors

Background on InfraRed, ACP and DIF

InfraRed Capital Partners is an international infrastructure investment manager, investing in real assets which contribute positively to society and support the transition to a net zero future. It operates worldwide from offices in London, New York, Sydney and Seoul. With around 165 professionals, it manages US$10bn+ of equity capital in multiple private and listed funds, primarily for institutional investors across the globe. InfraRed is the Investment Manager of HICL Infrastructure PLC ("HICL") (www.hicl.com), a London-listed, UK investment company that has over 100 core infrastructure investments, including High Speed 1, Affinity Water and 25 hospitals in the UK, as well as projects in Canada, France, the Netherlands, the Republic of Ireland and the

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United States of America. HICL's market capitalisation exceeds £3.3bn. InfraRed is also the Investment Manager of The Renewables Infrastructure Group ("TRIG") (www.trig-ltd.com), a UK-listed renewables infrastructure investment company, with market capitalisation in excess of £3.0bn.

DIF Capital Partners is a leading global independent investment manager, with more than €9 billion in assets under management across nine closed-end infrastructure funds and several co-investment vehicles. DIF invests in infrastructure companies and assets located primarily in Europe, the Americas, and Australasia.

The Allianz Group is a global financial services provider with more than 100 million retail and corporate customers in more than 70 countries. Allianz is one of the world's largest investors, managing around €800 billion on behalf of its insurance customers. As one of Allianz Group's asset managers for alternative equity investments, ACP is a major international financial investor with more than €22 billion assets under management in infrastructure equity that have been invested during the last decade, including Affinity Water, Thames Tideway, Cadent Gas and Porterbrook. ACP manages over €44 billion of alternative equity assets in private equity, infrastructure and renewable energy.

1. Financial resilience in the water sector: a discussion paper

We do not agree that financial resilience (or lack thereof suggested but not substantiated by Ofwat) poses a risk to customers or taxpayers. In the unlikely event of a company insolvency, the customer/taxpayer risks that may apply in other industries do not apply to water.

- **No systemic risk:** There is no equivalent risk as there is in in the banking industry, e.g. water companies do not lend to each other
- **No credit risk:** Customers are not creditors water companies: bills are typically paid in arrears
- **No replacement risk:** As with other infrastructure companies, water companies have very significant asset bases that ensure that there will always be positive enterprise value such that, unlike Carillion or smaller energy retailers, insolvency would be highly unlikely to lead to liquidation and cessation of operations - and hence not lead to potential for customer/taxpayer impact if the replacement is more expensive

There are real world examples of major infrastructure companies becoming insolvent without noticeable customer impact, including Welsh Water and Eurotunnel. In both cases, financial investors took losses, but both businesses continued to operate normally. The asset-heavy business models ensured they were still comfortably profitable at the operating level, and hence could finance working capital as well as a sufficient level of investment. For Eurotunnel, the tunnel stayed open, trains continued to run and there was no impact on customer pricing. For Welsh Water, customers still got clean water supply and wastewater removal, again with no impact on customer pricing. The recent recapitalisation of Southern Water has been characterised by Ofwat as a kind of soft special administration, i.e. analogous to the restructuring that would follow insolvency - and in that case there was also no impact on customer pricing. Indeed, the Southern Water case study reinforces the historical evidence that suggests the market can and will solve the issue without any impact on customers or taxpayers.

This contrasts with energy retailers, where the lack of any appreciable asset base, coupled with exposure to volatile commodity wholesale markets for gas and electricity, means that liquidation is inevitable if the enterprise becomes loss-making, potentially leading to socialised costs as customers need to find a new retailer. That scenario does not apply to the water network companies, which are vertically integrated and asset heavy.

In the absence of socialised cost risk, Ofwat's argument appears to rest on an alleged link between operational failures (which do affect customers) and financial stress (which otherwise does not affect customers). Ofwat cites Southern Water as a case study, which appears to represent its principal real world evidence. However, it cannot be inferred that Southern Water's operational issues were caused by its financial issues. Ofwat has not established any causal link to suggest financial issues lead to operational issues. It may well be that operational issues that led to fines and penalties contributed to financial issues but that does not imply that the reverse is true.

Looking across the wider industry there is no evidence of correlation between operational performance and financial performance. A review of Ofwat's own service delivery performance tables over recent years does not show such a pattern. For example, Anglian Water has been a consistently strong operational performer which also had relatively high gearing at the regulated level (until very recently).

To the extent Ofwat has any concern around potential underinvestment, then allowing flexibility in capital structure is actually a positive factor as it helps companies finance investment efficiently. We also note that the Outcome Delivery Incentives create material and immediate disincentives to companies reducing service quality or not improving it as quickly as Ofwat's price determinations require. These incentives appear to be effective, given the increased totex spending observed towards the end of AMP6 in anticipation of more demanding performance commitments in AMP7. This mechanism could potentially be expanded to define performance commitments over a longer period, which may help the business case for longer payback investments in service improvement.

We disagree with the premise that further steps to increase financial resilience are warranted to protect customers, particularly in light of the substantial measures that already exist, including the regulatory ringfence and the requirement to maintain investment grade credit ratings. Under the existing regime, the water network companies have remained resilient throughout the COVID pandemic. They have not made use of any government support, including the furlough scheme. Water network companies have even provided financial assistance to support business retailers that were at risk of financial distress.

Furthermore, we believe that many of the measures proposed by Ofwat fundamentally change the risk profile of the sector for investors. Such measures would both be disproportionate to any theoretical (and probably non-existent) customer benefit and likely also be detrimental to customers because it would make the sector less attractive to future investment. We note that Ofgem has not pursued an equivalent approach for the energy network companies, even though it is consulting on proposals for financial resilience of energy retailers. In the case of energy retailers, Ofgem explicitly cites as its rationale the risk of socialised cost in that more asset-light segment.

We have already seen that regulatory intervention in capital structure has a material and observable negative impact on investor sentiment. On 26 April 2018, Ofwat announced its 'Back in Balance' paper proposing penalties for higher gearing. On 17 March 2021, the CMA issued its final decision on the four PR19 appellants, including a decision to reject the concept of Ofwat's penalties for gearing. During the intervening three years there were no transactions in the unlisted water equity market. The market was effectively frozen during this period. And yet there were transactions shortly before and after this window[1].

We do not agree there is a problem to be solved, and we believe any interventions in this area need to be weighed against significant negative impact on the investability of the sector.

Responses to specific questions in the discussion paper are set out in Appendix 1.

[1] On 13 April 2018, Arjun Infrastructure announced it would acquire a controlling interest in South Staffordshire Water. A short time after 'Back in Balance' was announced, a process to sell a stake in Yorkshire Water was unsuccessful. In fact, there were no further transactions until 3 June 2021, when Pennon announced it would acquire 100% of Bristol Water.

2. PR24 and beyond: Discussion paper on risk and return

We agree that the structure of WACC allowance for PR24 should be as at PR19: fixed (non-indexed) cost of equity, fixed (non-indexed) embedded cost of debt, and an indexed allowance for cost of new debt.

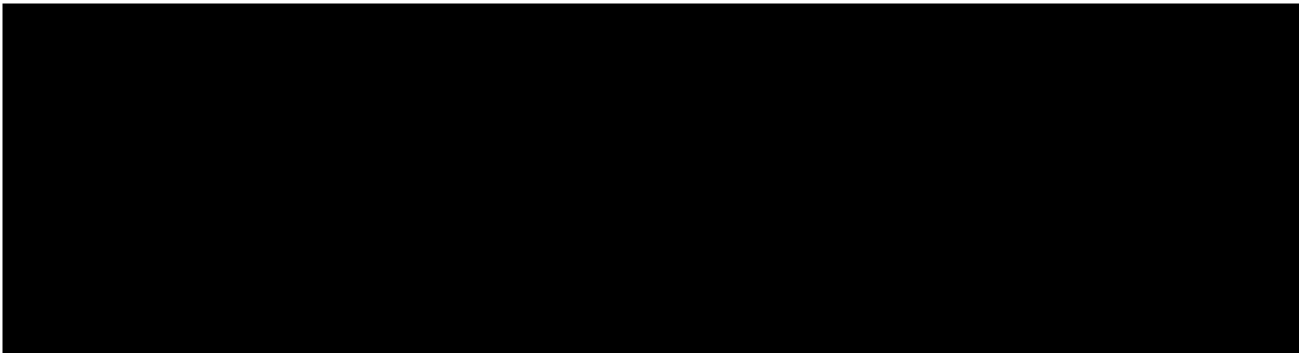
In terms of the calibration of WACC, we expect Ofwat to follow the decisions made by the CMA at PR19. We note that CMA decisions regarding energy companies are not relevant, given the different appeal regime and different criteria for amending a regulatory decision in those sectors. E.g. in regards to 'aiming up', the CMA decision on PR19 remains the starting point. We further note the CMA's emphasis on consistency of approach, e.g. reinstating the small company premium for Bristol Water, rejecting Ofwat's 'gearing outperformance sharing mechanism' and rejecting Ofgem's 'outperformance deduction'.

We believe that the reflection of increased risk in the sector, such as Ofwat notes in relation to climate change and operation penalties, should be reflected in upward movement in WACC. Ofwat raises this matter in the context of the notional gearing assumption, which is largely academic.

We expect Ofwat to regulate the WACC on a consistent basis. We expect companies and boards to give due consideration to the final PR24 determination before accepting it, giving consideration to any deviation from accepted regulatory practice, with particular focus on previous CMA decisions.

We would welcome the opportunity to discuss the concerns set out here in more detail.

Yours faithfully,



Chief Executive Officer	Partner	Managing Director
InfraRed Capital Partners	DIF Capital Partners	Allianz Capital Partners GmbH

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Appendix: Answers to specific discussion questions on financial resilience

1. **Do you agree that it is not appropriate for providers of essential infrastructure to operate at, or be at risk of falling to, the lowest investment grade credit rating?** We do not agree that the current requirement for companies to maintain an investment grade credit rating is insufficient. The existing licence regime includes extensive measures to prevent companies falling below this level and ensure that they recover to this level if they do fall below. We do not believe that any different rating level, such as one notch higher, holds any significance and has not been evidenced as providing benefit to customers.
2. **Do you agree with the notion that a company should be taking actions to improve its credit rating well before it is downgraded to the lowest investment grade credit rating?** We believe that existing measures within the licence are sufficient and that any further strictures are unnecessary and disproportionate given there is no actual or potential customer harm. Under the current regime, companies are already unable to pay dividends if they fall below investment grade, which represents a major incentive to restore the rating.
3. **On the option not to define limits on capital or financing structures at this time and necessity to define limits for companies where financial resilience does not improve.** We strongly agree that Ofwat should not define limits on capital or financing structures; this is the responsibility of company boards.
4. **On amending the existing trigger level for the cash lock-up conditions to a higher credit rating and the potential for the trigger to be linked to measures of service performance.** As per question 1, we do not believe that any amendment to the cash lock-up conditions is warranted, given the strength of the existing regime, the absence of customer harm, and the lack of evidence supporting the significance of any particular rating within the investment grade band. In addition, a change in the required credit rating is an indirect limit on financing structures that differs from the existing regime. The transition to a different gearing level would involve significant friction costs. Of the possible routes: prepayment of existing debt incurs material make-whole penalties to lenders, carrying cash on the balance sheet causes significant drag on returns (especially at current interest rates), and suspension of dividends significantly reduces the attractiveness of a company to equity investors. Moreover, such intervention represents a significant restriction on the board's discretion to run the business, which is inconsistent with the emphasis Ofwat places on board leadership in its principles for board leadership, governance and transparency.
5. **On a requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.** We believe that the existing licence requirements on credit ratings are sufficient and that no additional measures are warranted.
6. **On a requirement for additional board assurance statements when dividends or other distributions are declared or made, and credit ratings are below the targets stated for the notional capital structure at a price review.** We believe that the existing licence requirements on credit ratings are sufficient and that no additional measures are warranted.
7. **On a requirement for companies to maintain two investment grade issuer credit ratings.** We believe that the existing licence requirements on credit ratings are sufficient and that no additional measures are warranted.
8. **On a requirement for companies to formally notify Ofwat of any changes to credit ratings (including changes to rating and/or outlook, new ratings or planned rating withdrawals).** We note that information on company credit ratings is publicly available already and that Ofwat does not require additional obligations on companies to obtain this information. However, we have no objection to direct disclosure to Ofwat if this is helpful to Ofwat.
9. **On removing dispensations from the requirement to maintain an investment grade credit rating.** As investors in a credit-rated company, we have no direct interest in whether unrated companies must obtain ratings. However, we note that maintaining a rating may be unduly onerous for smaller companies and may actually hinder their ability to raise finance on efficient terms, e.g.

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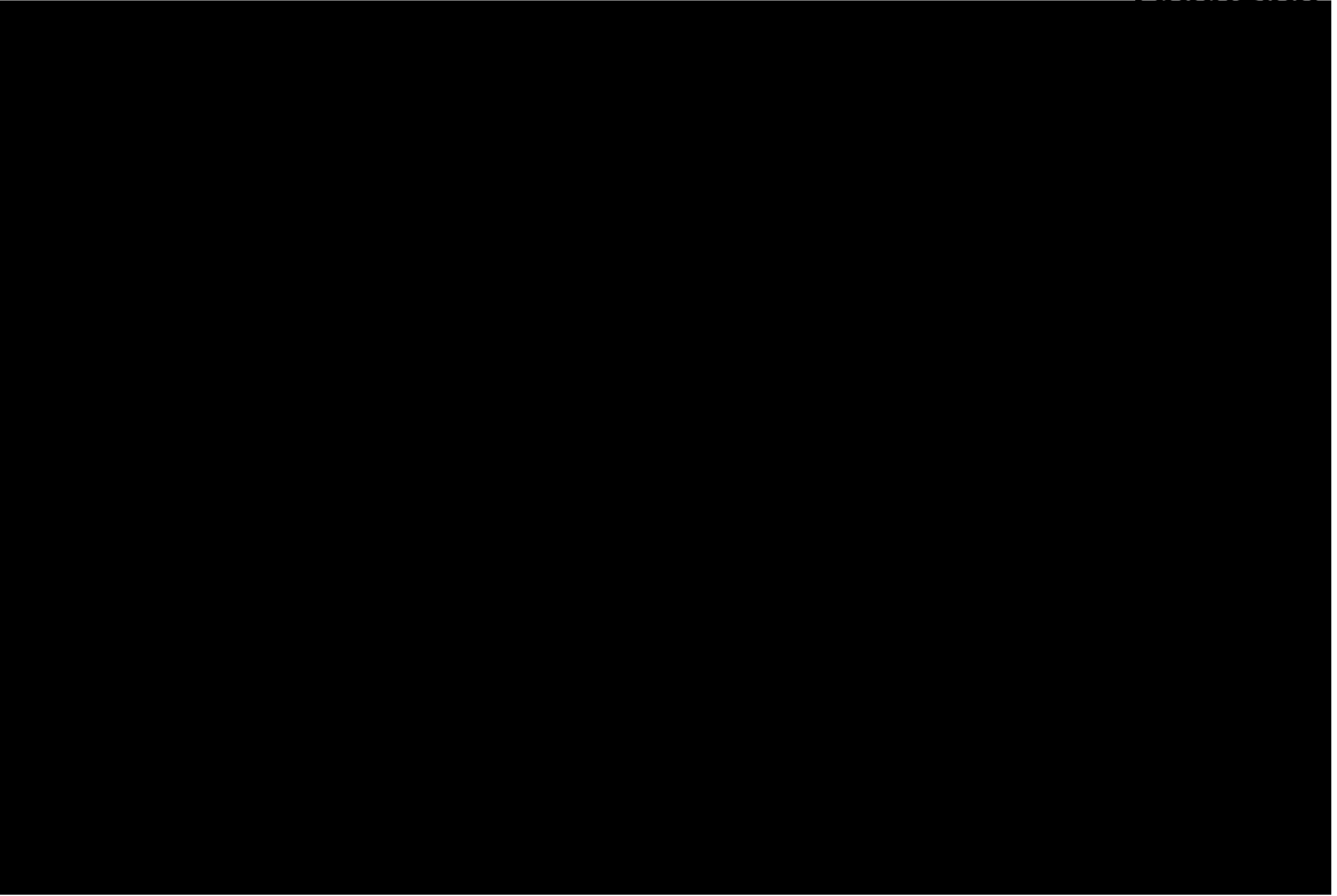
where lenders rely on their own credit assessment but must take account of a public credit rating if there is one.

10. **On whether there is a need to align the licence to our broader expectations for dividend policy.** We believe payment of dividends is fundamentally a matter for boards and that licence restrictions in this area represent an undue dilution of the board's role, which is inconsistent with the emphasis put on board leadership by Ofwat. We further note that the chief attraction of equity in utilities is the dividend profile, especially given the relative lack of upside potential. Consequently, additional restrictions on dividends that reduce or destabilise the expected dividend yield would be expected to reduce the appeal to investors and increase the overall cost of capital, and/or increase reliance on debt funding. In particular, we believe that any specific condition on dividend payment based on operational performance would be unwarranted, given that totex and outcome performance already has a direct financial impact on companies that flows directly to the cash available for dividends. We do agree that companies could do more to explain to customers how dividends align to customer outcomes, although discretion on dividends should remain with the board and not be a matter for the licence.
11. **On enhancing the transparent reporting of the use of swaps and how this could best be achieved.** We believe that the disclosure of swaps is most appropriately reflected in the statutory accounts, where current GAAP already captures extensive information including the 'fair market value'.
12. **On whether disclosure requirements should be set for companies to increase the reporting of holding company debt levels (for example to state holding company gearing levels) in their Annual Performance Reports.** We do not believe that Ofwat should have any jurisdiction beyond the regulatory ringfence, e.g. into the financing of corporate structures above the regulated entity. However, we have no objection to disclosure, noting that in general holding companies tend to be UK entities and hence the accounts are already available in the public domain.
13. **On the option to improve the transparency of pension deficit reporting.** We have no objection to the reporting of pension deficits, noting these are already reported in the statutory accounts, which are publicly available.
14. **On whether there should be an expectation that PR24 business plans should include a board assured assessment of financial resilience.** We believe that the board's assessment of financial resilience is an important component of any business plan, regulatory or otherwise, although ultimately the chief determinants of financeability lie with the regulator's decisions to provide (or not) adequate cost of capital and totex allowances.
15. **On how the incentives framework around capital structure should evolve at PR24 taking account of the other views set out in the paper and the scope to which companies should provide voluntary sharing arrangements at PR24.** We believe the incentives framework around capital structure should be evolved to remove the gearing outperformance sharing mechanism introduced in PR19, in line with the findings of the CMA. Beyond that, we believe no additional interventions are warranted. We note that regulatory intervention in this area has historically been detrimental to investment, e.g. given the total suspension of all unlisted equity transactions in the sector during the 3 year period between the PR19 'Back in Balance' decision and the CMA's final decision that included the rejection of Ofwat's 'gearing outperformance sharing mechanism'.



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