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VANTAGE INFRASTRUCTURE

Attention: Ofwat
From: Morrison & Co Utilities Management ('Morrison & Co')
Vantage Infrastructure ('Vantage')

Date: 31 January 2022

Submitted by email to [redacted]

Response to Ofwat's PR24 financial resilience and risk and return discussion papers

Dear Sir, Madam,

Morrison & Co and Vantage appreciate the opportunity to comment on Ofwat's *financial resilience* and *risk and return* discussion papers for the upcoming 2024 price review ('PR24') and beyond.

By way of background, both Morrison & Co and Vantage have wide-ranging expertise in managing essential infrastructure assets. In aggregate, we manage over USD33bn infrastructure investments globally. With specific regards to regulated infrastructure assets, we are an experienced manager of UK utilities networks, including South East Water ('SEW') and Phoenix Natural Gas.

As long-term investors, we understand our responsibilities in relation to ensuring the resilience of critical infrastructure and are committed to managing our investments on the basis of sound environmental, social and governance values, acting ethically and transparently. We are committed to continuing to support SEW so that it can continue to provide essential services to a large and growing customer base and play a key role in its local communities. Our fiduciary duty to our ultimate beneficiaries (who are largely pensioners and retirees) is to earn an appropriate risk-adjusted return on investment and we recognise that long-term returns are reliant on a constructive relationship with the regulator and maintaining a social licence to operate. In this context we have carefully reviewed Ofwat's recent financial resilience and risk and return discussion papers.

In writing this letter, Morrison & Co and Vantage would like to fully support the points raised in SEW's and Global Infrastructure Investor Association's responses to Ofwat's discussion papers. We would also like to add our perspective on Ofwat's proposals as managers of our clients' investments in and as responsible stewards of SEW.

We welcome Ofwat's engagement on these issues at an early stage of the PR24 process and believe that it is important that Ofwat, water companies and investors work closely on these areas during the price review process. However, we are concerned that there are clear inconsistencies between Ofwat's papers, with proposals which emphasise the importance of financial resilience on one hand and proposals which imply material reduction in returns and equity buffer available for management of risk on the other hand. We also do not agree with Ofwat that there is a financial resilience issue in the sector that needs resolving and believe it is in the long-term interest of customers for Ofwat and water companies to instead focus on the challenges facing the sector including climate change risks, population growth and increased base costs. We are concerned that Ofwat's unprecedented proposals could hinder the investability of the water sector when significant investments are required to resolve those issues.

Identification and specification of the financial resilience problem

Ofwat is seeking to introduce new regulation on financial resilience. In practice the proposals set out in the discussion paper impose limits on financial structures in the sector, but do not clearly identify a problem. Ofwat provides neither evidence nor impact analysis to support its proposed measures and we are concerned that those could have unintended results which are not in the long-term interest of customers.

Ofwat's proposals for new regulation and changes to company licences in relation to financial resilience seek to address an alleged systemic problem that has not been defined or evidenced – and could result in sub optimal capital structures across the sector, perverse incentives and additional costs for companies and customers. Critically a number of these proposals could result in the sector becoming *less* attractive to investors. We consider that this would not be in the interest of customers or in accordance with Ofwat's statutory duties, particularly given the significant need for the sector to invest in operational resilience and enhance the network to mitigate exposure to external pressures such as climate change, population growth and additional environmental factors.

While Ofwat is right to highlight that maintaining good customer service levels and prudent financial resilience are important as we approach PR24, it does not provide evidence to support its assumption that weak financial resilience leads to a deterioration in customer service levels. The single example of Southern Water that Ofwat cites does not demonstrate correlation, causality, nor that there is an industry-wide issue that would justify regulatory intervention.

Existing regulatory and corporate protections

Ofwat does not evidence that existing regulatory mechanisms, capital structure protections and corporate governance arrangements are ineffective to resolve insufficient customer service levels or weak financial resilience and therefore need adjustment.

There are regulatory protections in place, including regulatory ringfence provisions such as cash lock up conditions in the licence or the special administration regime, which ensure water companies maintain prudent financial resilience and insulate customers from companies' financing choices. These mechanisms have proven to be effective during the financial crisis and the Covid-19 pandemic – companies have been operationally and financially resilient to these shocks and continued to invest in customer services. They also seem to have been effective in the case of Southern Water which ultimately received an important equity injection to address both its financial resilience and customer service issues.

In addition to regulatory protections, we note that companies like SEW have robust governance processes in place as well as a securitised structure that provides additional protections to customers.

Given the above, we consider that Group activities and holding company debt sitting outside of the regulatory ringfence are not relevant to Ofwat's assessment of financial resilience of the regulated business.

Moreover, the inclusion of additional reporting of holding company financing and how equity investment in the sector is financed represents an unprecedented extension of regulation beyond the ringfence. It is not clear on what legal basis Ofwat believes it is entitled to create new regulatory obligations that extend regulation beyond the activities of the regulated company.

Overlaying additional regulation on existing requirements is not proven to be necessary and may result in detrimental outcomes for customers.

In addition, undue focus on maintaining a certain credit rating within the ringfence could have unintended side effects, including deferral of investment or use of complex financial instruments to support short term cash flows as demonstrated in SEW's response. It is clear that this would not be in customers' interest. It is also a significant departure from regulatory precedent.

Importance of predictability and stability for investors in the water sector

Infrastructure investors, such as Morrison & Co and Vantage, take a long-term view when making investment decisions. In this context the predictability and stability of a fair regulatory regime underpins the investment attractiveness of a sector. It can also support low customer bills, as it has historically been the case in the water sector.

The proposals in both discussion papers undermine the predictability and stability of the framework as (1) they signal an unprecedented step change in regulatory risk where Ofwat does not attach due weight to recent decisions from the CMA as the ultimate decision body, (2) they imply a material reduction in investment returns which is not supported by market evidence, and (3) they introduce new regulation of actual capital structures and dividend profiles which contravenes long standing regulatory policy in this and other sectors.

An important feature of the UK water regulatory system is the possibility to refer a price determination to the CMA, which confers robustness and provides regulatory checks-and-balances, and the acceptance of that as the ultimate decision-making forum. Departure from the methodologies recently adopted by the CMA at the PR19 re-determination introduces a more volatile profile of regulatory judgment and decision making and provides uncertainty for investors looking to commit capital on a long-term basis.

It is important that Ofwat recognises that it has a role in ensuring a stable investment regime, which goes hand in hand with financial resilience in a sector that requires substantial, consistent capital investments. The balance of risk and return set out in regulatory determinations, and the consistency and transparency in these determinations go to the heart of investment decision making and therefore financial resilience. However, the implications of Ofwat's risk and return proposals for the resilience of the sector do not appear to have been explored, nor supported by impact analysis.

Price control calibration and design at PR24 matters. We highlight that Ofwat's focus on lower customer bills and financial resilience in the recent discussion papers follows on from a very challenging regulatory settlement at PR19 which included for companies like SEW (1) under-funding of enhancement expenditure (2) a significant reduction in returns not supported by relevant market evidence (as reflected in the CMA's decision), leading to shareholders having to accept returns far below the notional returns (3) the introduction of the Gearing Outperformance Sharing Mechanism which itself weakened resilience, as demonstrated by its rejection by the CMA (4) the 'fixing' of financeability constraints with cash profiling adjustments which were not taken into account by rating agencies.

We consider that combined these factors have weakened financial positions across the sector and that this reinforces the need to carefully review implications of PR24 decisions on levels of returns and risk exposure, particularly for a small company like SEW which focuses on water services.

We are concerned that the proposed changes to the notional company undermine Ofwat's financeability assessment as a meaningful and binding cross check on price control calibration. This change means that, first, there is no overall cross check and, second, there is increased pressures on financial resilience in the sector.

Risk and return balance

Ofwat's PR24 proposals for cost of capital rely on a selective choice of estimation methodologies which exclude relevant evidence the CMA relied on in its recent re-determination. This will result in downwards-biased estimates of required returns.

Ofwat has not relied on the PR19 CMA process to inform its approach to setting the Cost of Equity at PR24. Instead Ofwat has used the RIIO-2 CMA precedent to arbitrarily reduce each parameter within the cost of equity. This approach ignores the fundamental differences in the appeal regimes and that the CMA is the ultimate decision body in the UK water sector. Importantly, the resulting downward pressure on equity returns and credit ratios does not incentivise investment.

The challenges facing the sector can only be met if the necessary investments attract capital by earning a reasonable risk-adjusted return. Ofwat's use of Market-to-Asset Ratios (MARs) as the primary cross check on the Cost of Equity is flawed and cannot serve as a robust sense check of whether equity returns are sufficient. The MARs have significant limitations as indirect benchmarks and are generally unreliable as the sources of market information to inform estimates of required returns on capital.

Further, we consider that Ofwat should re-assess using sector wide mechanisms, such as a one-size-fits-all cost of capital, for a diverse group of companies – specifically mechanisms which create random "winners and losers" on efficiently-incurred debt financing costs at the time of issuance. These approaches undoubtedly put a number of companies under more financial stress than others based on factors such as size and frequency of issuance which are not within their control. We view this as a very material consideration, which is not covered by Ofwat, when assessing financial resilience and its drivers in the water sector.

Ofwat also fail to consider, or price, the risk differential observed between water service and wastewater service. Given the fundamental characteristics of these activities it is important the risk is either (1) addressed at source through re-calibrating incentives between the water service and wastewater service; or (2) priced in the allowed return.

The water sector will require significant equity investment if it is to meet the challenges of climate change, growth investment, increased base costs and environmental priorities. We encourage Ofwat to focus PR24 on encouraging the investment needed to meet these challenges as opposed to focus on customer bills.

To conclude, we support Ofwat's key strategic themes and are keen to pursue a transparent and constructive dialogue. We agree with Ofwat that investing further in resilience will benefit customers and deliver greater environmental and social value in the long term. We believe an effective and balanced regulatory regime can help contribute to a better alignment of shareholders' and customers' interests and would like to stress that the stability of such a framework and a fair risk/return balance and financial resilience cross-checks are critical to maintaining the attractiveness of the UK water sector, preserving investors' trust and confidence and encouraging investment.

As active managers of long-term investors, Morrison & Co and Vantage look forward to working collaboratively with Ofwat, SEW and its stakeholders to develop a customer focused Business Plan for PR24.

Appendix

Morrison & Co is a leading alternative asset manager with deep experience managing assets in the infrastructure sector. Morrison & Co combines deep sector knowledge, asset management capability, and operational expertise to deliver exceptional risk-adjusted returns for clients. With a team of over 150, including ~65 investment professionals, the Morrison & Co group manages over A$20 billion of investments, on behalf of sovereign wealth funds, institutional and retail investors.

Vantage Infrastructure is an independent infrastructure specialist manager committed to delivering sustainable investment solutions with an equity and debt infrastructure investment portfolio of over US$5.8 billion as at 30 June 2021 across Europe, North America and Australia on behalf of global clients.