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29 September 2022

Dear Sir / Madam,

Response to Ofwat consultation to modify licences in relation to financial resilience issued July 2022

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.

We refer to our previous letter of 31 January 2022 in response to Ofwat's discussion paper on financial resilience from December 2021. In that letter we indicated our view that:

- 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

We acknowledge that Ofwat has engaged constructively with investors since then and has set out more targeted proposals in this latest consultation compared to the suite of actions contemplated in the December 2021 discussion paper.

However, we remain of the view that the proposals are neither justified nor desirable. They risk affecting investors' perception of the stability of the regulatory regime following an already challenging PR19 price review when many investors (including Affinity Water shareholders) committed to reinvesting dividends and/or putting new equity at risk.

Furthermore, we believe the proposals have the unwelcome effect of undermining Board ownership on fundamental matters such as capital structure and we remain unconvinced that the tools Ofwat proposes to use would deliver tangible improvements for customers or enhance financial resilience.

We support Ofwat's decision not to link the lock-up condition to operational performance, which we believe could create excessive volatility in dividends, which could in turn make equity in water companies less attractive and hence increase the cost of capital.

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We also believe it is reasonable that Board should be required to explain how operational performance and other factors have been considered when paying a dividend, as it is already the case in practice. However, we believe this should be a matter of disclosure by the Board rather than a retrospective test.

We support Ofwat's desire for more transparency on pension liabilities and swaps. However, we also support Ofwat's decision to handle that outside the licence, especially as we do not envisage that companies would resist such transparency.

In relation to the credit rating threshold for dividend lock-up, we maintain there is no need to raise the threshold above the minimum investment grade rating. The existing licence condition has proven fit for purpose, noting the relative significance of the investment grade boundary relative to other points on the rating scale in terms of liquidity and cost of debt.

In relation to the requirement to maintain two issuer ratings, we maintain that this is not necessary. However, we acknowledge that several companies in the industry, including Affinity Water, are already subject to this requirement under their financing arrangements. However, for avoidance of doubt, we believe that any 'Class B' ratings in relation to securitised companies should not be considered appropriate measures in relation to the lock-up test. Class B debt is contractually subordinated to Class A and therefore does not represent the overall creditworthiness of the company as a whole. In addition, Class B debt typically represents only a small proportion of the company's overall debt, with the majority being Class A. Ofwat has previously indicated its agreement to this point in past correspondence with companies, but it would be helpful to investors for Ofwat to re-iterate this position.

We believe consistency in approach across the sector is to be welcomed and therefore we support Ofwat's proposal to bring Wessex Water's licence into line with the rest of the sector.

We hope that the licence modifications can be agreed in line with the above, such that we may move forward together and refocus on delivering the crucial investment needs of Affinity Water and the sector as a whole. We thank Ofwat for its engagement on this topic.

Yours faithfully,

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Werner von Guionneau	Angela Roshier	Andrew Cox
Chief Executive Officer	Partner	Managing Director
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