Attention: Ofwat Date: 7 September 2022
From: Morrison & Co Utilities Management ('Morrison & Co')
Vantage Infrastructure ('Vantage')

Submitted by email to [redacted]

**Response to Ofwat's PR24 draft methodology and financial resilience consultations**

Dear Sir, Madam,

***Context and summary of key points.***

Morrison & Co and Vantage Infrastructure appreciate the opportunity to comment on Ofwat's PR24 draft methodology and financial resilience consultations.

Both Morrison & Co and Vantage Infrastructure have wide-ranging expertise in managing essential infrastructure assets. In aggregate, we manage over US$20bn infrastructure investments globally. With specific regards to regulated infrastructure assets, we are experienced managers of regulated 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 financial 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 and with a focus on customer service levels.

We are committed to continuing to invest in SEW so that it can continue to provide high quality essential services to a large and growing customer base and play a key role in its local communities and the environment. 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. In this context we have carefully reviewed Ofwat's recent publications, specifically the finance issues within the PR24 draft methodology and Ofwat's financial resilience consultations.

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

We provided a response to Ofwat's financial resilience and risk and return discussion papers earlier this year and we are disappointed that Ofwat has not taken our response and the broader investor community's comments into account when setting the draft methodology.

As long-term investors in the water sector, we rely on the predictability and stability of regulatory policy across price controls and the certainty this provides. In that regard, we are concerned about Ofwat's proposal to shift away from the CMA's PR19 methodology when setting the cost of capital for PR24. The CMA is the ultimate decision body in the water sector and Ofwat's approach to ignore this recent decision – where the CMA estimated the cost of capital using a detailed 'bottom up' and sector-specific approach over the course of a 12 month process – with no clear justification undermines the predictability and stability of the regulatory regime. This stability is crucial to support a continued low cost of capital in the sector and in turn to ensure the continued affordability of high-quality water services to the population at a time of rising energy bills and energy poverty.

By contrast the proposed methodological changes to the cost of capital set out in the draft methodology for PR24 ignore relevant evidence, are arbitrarily selectively downward biased and will all else equal result in a material reduction in the allowed return. This reduction is fundamentally at odds with the need to secure additional capital over the long term to support the future scale of investment required to improve resilience and meet environmental commitments. Operationally the sector is currently also seeing unprecedented increases in costs driven by energy and material prices, as well as increases in refinancing costs. Ofwat's draft methodology implies that the increases in these costs will not be met with a corresponding increase in allowances.

It is also critical that Ofwat sets a return commensurate with the characteristics of and risk faced by *individual water companies* including:

- An uplift on the WACC to establish a WoC-specific WACC that captures the relatively small size of water-only companies, based on clear and transparent measures of the notional WoC. This characteristic has a material impact on the frequency of debt issuance for a small notional company, and hence risk exposure and efficient costs.
- Adjustments to reflect operational risk differentials for the water business, particularly in relation to design and calibration of ODIs for the water services (which currently imply *higher* downside asymmetric exposure).
- Consideration of regional risk, driven by factors such as population growth and increased exposure to climate change. The costs to mitigate these risks should be reflected in totex allowance and ODI targets or remunerated in the allowed return.

An approach which reflects company specific risks and characteristics will establish an appropriate balance between risk exposure and allowed returns which will in turn support the investment required to deliver key policy objectives and service levels. The appropriate allocation of risk and calibration of returns will also support financial resilience. In that respect, we are concerned that Ofwat's proposals start with very limited risk analysis and a material reduction in returns, which could lead to financial resilience erosion in the sector.

We consider that Ofwat's financial resilience proposals are unwarranted and contravene long standing regulatory policy that decisions and risks relating to capital structures are the responsibility of companies and shareholders. Ofwat has not clearly articulated the financial resilience problem it is seeking to address. In particular the significant proposals set out in the licence consultation are not supported by (1) a broad definition of financial resilience which considers both equity and debt capital, (2) analysis of whether there is a market failure which could justify new regulation or (3) an impact assessment setting out the associated benefits and costs of the proposals in Ofwat's consultation.

Different companies across the sector have different investment profiles, capital structures, governance arrangements and financing strategies. It is not appropriate to introduce the one-size-fits-all approach to regulation of capital structures, credit ratings and corporate governance arrangements that these proposals imply. The proposals would unjustifiably increase Ofwat's intervention. This will affect equity control rights and may deter the required investment and/or increase costs for customers.

Modifications to company licences to implement proposals on financial resilience represent an extreme approach for the introduction of new regulation and it is inappropriate to make these changes in isolation, without considering the interplay with existing regulation or calibration of PR24 allowances. The proposed licence modifications, implemented outside of the standard regulatory cycle, further undermine the predictability and stability of the regulatory framework.

We are concerned that Ofwat does not appear to have taken into account any of the evidence and analysis from water companies and investors set out in response to the December discussion paper on financial resilience. If no changes are made, we anticipate that companies may be compelled to appeal the implementation of these proposals – which do not address a clear problem and are not in the customer interest – to the CMA.

Overall we remain concerned that there is a fundamental disconnect between Ofwat's approach to setting the allowed return for PR24 and its emphasis on financial resilience in the sector. The proposed licence modifications will not improve customer service levels and will increase uncertainty and costs at a time when extensive investment is required in the sector, exacerbated by a very challenging regulatory settlement at PR19, which has already contributed to an under-funding of enhancement expenditure.

## *The PR24 methodology implies that risk faced by a company like SEW will not be fully priced and is likely to be skewed to the downside.*

**It is critical that Ofwat sets the allowed return that is commensurate with the risk exposure faced by each company in the sector due to its characteristics including size, location, demographic of its customer base and service offering. As a small water-only company in the south east of England, SEW faces different risk exposure to other companies in the sector.**

- First, due to its location SEW is facing increased exposure to climate change and severe weather events. For example this year SEW had to manage (1) the impact of Storm Eunice, the worst storm to hit the region in a generation, and (2) increased pressure on stressed raw water resources, due to the current drought. It has been the driest eight-month spell in the south east since 1976, the driest July for Kent since records began in 1836, and the lowest rainfall in Sussex since 1911, combined with record temperatures leading to record demand levels.
- Second, SEW is seeing continued population growth in the region which is putting additional pressure on the existing network. Additional investment will be required to meet this growth, especially in the context of scarce raw water resources.
- Third, due to SEW's smaller size it accesses debt markets less frequently than other, larger companies in the sector. This infrequent debt issuance results in increased exposure to market risk and a higher cost of debt for SEW compared to other companies in the sector, which needs to be remunerated.
- Fourth, water and wastewater services are facing fundamentally different challenges. It is imperative that the risk differential is either (1) addressed at source through the calibration of ODIs and totex allowances or (2) priced in the cost of capital.

The above illustrates that SEW is exposed to different risks relative to the average company in the sector. It is also expected that some of these risks will be increasing over time. Ofwat's one size fits all approach to setting returns results in a mismatch between risk allocation and pricing which will create additional exposure for some companies. Ofwat should, as a minimum, introduce a differentiated WACC that acknowledges allocation of additional risk to companies facing additional risks, like SEW.

## *The proposed changes in methodology for setting cost of capital are downwards-biased, ignore relevant evidence and will all else equal reduce financial resilience, which could lead to Ofwat-generated rating pressure and less attractive refinancing conditions.*

**The allowed return is a primary driver of financial resilience in the sector, however, there is clear juxtaposition between Ofwat's financial resilience concerns and proposed changes in methodology which are likely to reduce returns at PR24.**

We noted in our response to the December discussion papers that there was a disconnect between the approach to risk and return and the proposed regulatory intervention on financial resilience. These issues have not been addressed.

Ofwat's cost of capital proposals result in significant downwards pressure on returns driven primarily by methodological changes. These changes in methodology are selectively downwards-biased and ignore relevant evidence. The scale of the reduction appears to contrast with Ofwat's focus on financial resilience and all else equal the risk and return proposals will most likely reduce the financial resilience of the sector. We are concerned that Ofwat's financial resilience proposals do not consider these inter-dependencies.

We are also concerned with Ofwat's approach to use Market to Asset ratios (MARs) as the primary cross check on the allowed cost of equity. In our experience, MARs have significant limitations as indirect benchmarks and are generally unreliable as a source of market data to inform estimates of required returns on capital. Alternative approaches such as the financeability cross check, detailed company specific risk analysis and multi factor models should be adopted instead.

We are disappointed Ofwat has not evaluated the financial resilience proposals in parallel with the PR24 draft methodology resulting in a mismatch between the risk exposure for equity investors in the sector and the allowed return. These proposals should be revisited to consider the return and risk components together to ensure the benefits of the financial resilience proposals outweigh the costs.

## ***Ofwat has not clearly specified a financial resilience problem which justifies regulatory intervention.***

**Ofwat has not clearly articulated the market failure it is seeking to address through the introduction of the proposed financial resilience licence modifications. Ofwat provides insufficient evidence of customer harm arising from current financial resilience arrangements in licence conditions.**

We agree with Ofwat's focus on customer service levels and resilience in the sector. However, it is critical that regulation is targeted at a specific problem. If Ofwat is concerned with customer service levels it should review the calibration of totex allowances and the ODI framework, not introduce regulation to restrict dividend payments.

There is a high bar for introduction of new regulation in the water sector. It is therefore critical that Ofwat clearly articulates the problem it is seeking to address including an assessment of the benefits of the proposals and whether these outweigh the public costs of the changes. We would expect to see this articulated in a regulatory impact assessment which could form the basis of a discussion about the actual evidence and impact of the proposed policy.

The discussion of consumer harm in the Ofwat paper is very limited; it is anecdotal and lacks any concrete and objective analysis to evidence consumer harm or a market failure that could support regulatory intervention. By contrast Ofwat's proposals could *inhibit investment* for the sector and *increase* costs for customers.

The existing regulatory and corporate protections have proven to be effective during the financial crisis and the Covid-19 pandemic and SEW has been operationally and financially resilient to these shocks and continued to invest in customer services. We do not see the rationale for introducing new regulation which duplicates existing protections and may result in distortions.

We believe it is in the long-term interests of customers to instead focus on the challenges facing the sector including climate change risks, population growth and increased base costs.

***Ofwat is extending regulation to include matters, previously reserved for company Boards.***

**An underlying principle in the England & Wales water sector and in UK corporate law is that companies and shareholders are responsible for setting the actual capital structure and bear the associated risks with that chosen structure.**

Ofwat has stated this over multiple price controls, including within the recent financial resilience consultation "*Our long standing approach is that companies are best placed to make decisions over their financing and capital structure arrangements"*.[1] It has historically been clear that companies and shareholders are responsible for the risk associated with a capital structure which varies from the notional structure. However, Ofwat's recent proposals contradict this long running policy. The proposed regulation will mean that in some circumstances companies will not be able to choose their optimal capital structure.

Ofwat states that the proposed licence modifications will strengthen the regulated entity by restricting payments made out of the regulatory ringfence. However, Ofwat does not consider the impact of the proposals on payments *into* the ringfence. As the changes would put at risk capital leaving the ringfence, it will also deter new capital coming into the ringfence. This contradicts Ofwat's stated objectives.

***The predictability and stability of the regulatory framework underpins investor confidence and a continued low cost of capital in the sector.***

**Infrastructure investors such as Morrison & Co and Vantage take a long term view when making investment decisions. It is therefore important for us to have certainty and stability in how regulation will be set in the longer term, not just for the upcoming five year period.**

An important feature of the UK water regulatory framework is the redetermination process and the option to refer a price determination at the CMA, ensuring robustness and providing regulatory checks-and-balances, with the acceptance of that as the ultimate decision-making forum. Ofwat's draft methodology represents a number of departures from the CMA's PR19 methodology which undermine predictability in the regime and place material pressure on allowed returns for PR24. The increased uncertainty, coupled with a reduction in returns reduces the attractiveness of the sector for long-term investors.

We are concerned that Ofwat's proposed changes for PR24, including specification of the notional company, will undermine the financeability test at PR24 meaning there is no meaningful cross check on the allowed return which could undermine long term financial resilience in the sector.

To provide the required predictability for the sector and so ensuring the continuation of an environment supportive of investment, Ofwat should base its decisions on the CMA's PR19 determination and only deviate from that where there is clear and unequivocal evidence of change since the CMA's decision. Given the need for certainty and predictability as the sector enters a period of required increased investment, the importance of the role played by the CMA may need to be even greater at PR24 than it was at PR19.

To conclude, we continue to 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.

[1] Ofwat (2022), Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers, page 8

**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, the Morrison & Co group manages c. US$17 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 c. US$4 billion as at 30 June 2022 across Europe, North America and Australia on behalf of global clients.