Attention: Special Reference Group
Water Redeterminations 2020
Competition & Markets Authority

15th January 2021

Response to Water Determinations Consultation Announced 8th January 2021

GLIL Infrastructure LP ("GLIL") is an alternative investment fund with more than £2.3 billion in committed capital. GLIL is supported by a number of UK local government pension funds, including Greater Manchester, Merseyside and West Yorkshire Pension Funds, which are known collectively as Northern LGPS, and Lancashire County Pension Fund, Royal County of Berkshire Pension Fund and London Pensions Fund Authority, which form Local Pensions Partnership Investments.

In February 2018 GLIL became an investor in Anglian Water Group, through its joint investment vehicle Camulodunum Investments Limited. At the time this was a significant transaction for the fund marking its first investment in a regulated business. GLIL has made no further investments in UK regulated assets; although it has reviewed opportunities to invest none have proven to be sufficiently attractive compared to other opportunities.

Aside from Anglian Water, GLIL's investments include equity stakes in Clyde Windfarm, Forth Ports, two fleets of trains with Rock Rail, a portfolio of PPP assets and investments in biomass and anaerobic digestion energy generation. GLIL continues to be actively investing in infrastructure assets in the UK. In November 2020 GLIL acquired a 30 per cent equity stake in Agility Trains East ('ATE'), a rolling stock fleet of 65 new intercity trains on the East Coast Mainline.

GLIL announced recently that it had received backing from its existing pension fund investors providing a further £500 million in commitments for the open-ended fund established in 2015. In the associated press release GLIL's COO noted "the Chancellor has expressed how critical infrastructure investment is to the immediate economic recovery and our future. Central to that message was the Government's support for the role that private capital can play in funding projects. Our latest fundraising demonstrates the incredible opportunity there is for pension funds to answer that call and to help transform our nation's infrastructure."

It is important context for our response to this consultation that the Competition and Markets Authority ("CMA") appreciates that GLIL considers itself to be an investor that is well aligned with the aspirations of Anglian Water over a long horizon, including the needs of the customer base and the local environment. We have an investment approach that is consistent with the aspirations of the Chancellor seeking private capital to play a role in UK infrastructure development. We are not 'faceless' institutional capital. We represent over one million UK pensioners, and we are accountable to them to act as responsible stewards for our investments over the long-term while generating a fair return on capital to pay the pensions.

Approach by the CMA to the Water Redeterminations

GLIL welcomes the approach taken by the CMA during the water redeterminations process, especially considering the challenges imposed by Covid-19 restrictions. We believe that the CMA has run a robust process and we support many aspects of the approach the CMA sets out in its cost of capital consultation documents:

- Recognising the risk of setting the cost of equity too low and the principle of aiming up;
- Identifying the asymmetry of risk and return within the overall PR19 settlement, and the need for the setting of the WACC to be considered 'in the round';
- Acknowledging the importance of the financeability duty.

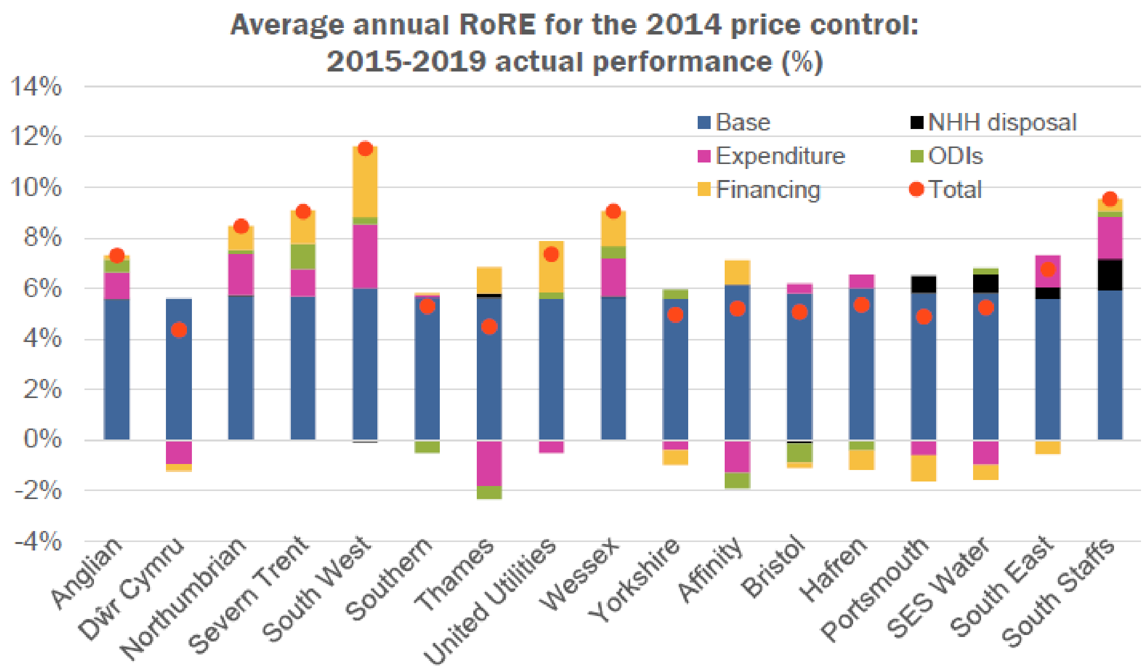
Overall GLIL welcomes the opportunity to provide feedback to the consultation, although it is hard to assess the cost of capital in the absence of some insight into the position the CMA has reached on the wider total expenditure allowance.

Competition for capital – regulated assets need to compete with other infrastructure opportunities

This section is most relevant to the CMA's consultation on the cost of equity, as set out in "Choosing a point estimate for the Cost of Capital – Working Paper". References to paragraph numbers in this section will refer to that document.

As evidenced by GLIL's recent investments there are many potential investments in the UK representing a compelling risk versus reward for investors when compared to an investment in regulated UK water assets. While we recognise the point regarding international comparisons made in paragraph 30, the local competition for capital is of greater importance, and quite relevant to the newer capital which has entered the sector which is expected to support future investment in AMP7 and beyond. We agree with the CMA that international comparisons provide little help in setting the cost of capital in this instance.

Some parties argue that regulators have been too lenient on investors in the past. From the list of companies measured by Ofwat on their actual performance in AMP6 in the chart below, over half measured were earning below their base allowed cost of capital (red dot below top of blue bar). This would suggest that Ofwat, and the CMA, are not in the position of needing to deal with a substantial lack of challenge for companies and their investors based upon most recent performance metrics. Indeed, the CMA has recognised the asymmetry in performance incentives, and the need to consider cost of capital 'in the round', which we welcomed from the Preliminary Findings ("PF"). In contrast, the proposed reduction in cost of capital from the PF approach introduces substantial risk to future investment in our view, both in AMP7 and beyond.



Source: Ofwat, Monitoring financial resilience, January 2020

We would argue that we are perilously close to the edge, which itself is hard to define, leading to a negative cycle of low investment, poor returns, inability to attract and motivate strong management teams, and greatly reduced incentives for institutional investors to invest time and capital to pursue upsides, an outcome which would play out through AMP7 and over future regulatory periods. This would be a poor result for a regulatory framework which has, for the most part, delivered good results for customers and investors alike when measured over multiple regulatory periods since privatisation. We believe that the CMA has identified this risk, which is enshrined in the principle of 'aiming up' on the cost of equity. We are concerned at the arguments being put forward by Ofwat and their advisers in paragraph 37 (d) which imply a low likelihood for reduced investment with too low a WACC. This may not lead to a collapse in investment since regulatory obligations need to be fulfilled in AMP7, but it could be the start of a negative cycle which is hard to reconcile with the upcoming risks from climate change and, in the case of Anglian Water, population growth and reductions in the amount of water permitted for abstraction from rivers.

In paragraph 44 you note that Ofwat and its advisers "stress the difference between the risks associated with lack of investment in the water sector and other sectors like the energy sector, pointing to a lack of similar societal risks arising from extreme adverse events". GLIL believes this misses the point that investing for continued quality of service, climate change adaptation and mitigation initiatives, and ensuring resilient water supplies should be no less important than avoiding blackouts in the energy sector; therefore, we agree with the CMA interpretation that "water is an essential service". In our view that means the risks of setting the cost of capital too low should not be underestimated.

However, the CMA goes on to observe that if WACC is set too low "this may only have a limited effect on investment in the short term." While this may be true in the context of the total size of allowed expenditure, it removes the incentive to re-invest during a regulatory period. In the case of Anglian Water there is recent evidence of such re-investment occurring in AMP6; we would argue that this decision may have been different when faced with returns which are weaker compared to the possibilities offered through alternative infrastructure commitments.

We strongly agree with the CMA position set out in paragraph 53, that "given the expected scale of investment needed to address climate change, there can be expected to be a long-term benefit where the expected returns are sufficient to provide incentives" to invest. We would note that customers of Anglian Water have identified this potential benefit as well through the PR19 consultation process, and so the obsession with reducing bills above all other criteria, including deferring making beneficial investments during AMP7, seems imbalanced and misplaced. This may not be directly part of the consultation on cost of capital, but it does appear odd that at a period when cost of capital is going to be the lowest in the history of the water sector, and when the UK government is talking about investing in the future to take advantage of growth, the focus for Ofwat has been to reduce the scope of investment as far as possible. So far we have seen the CMA endorse this approach to spending allowances. We strongly argue for the need to allow investment, and to promote and incentivise investment in the current environment. The cost for future consumers, whom surely should form part of the relevant considerations for the CMA when setting the WACC as noted in paragraph 15 (b), should be considered if dis-incentives are imported into AMP7 through too low a cost of capital. We do not believe it is simply the bills in AMP7 which should be paramount in setting the WACC, but that the CMA should include a broader interpretation of "the protection of consumers" in the future. This is a position which is endorsed by today's consumers from the work completed by Anglian Water through the customer interactions during PR19, where over 500,000 customer contacts were recorded in soliciting views from customers. These customers were strongly in favour of investing now to enhance resilience to the increasing risks of drought and flood, and to avoid leaving the bill to be picked up by future generations.

GLIL agrees with the CMA in Paragraph 103 (a) that "regulation should create a supportive long-term investment environment." However, in that context we do not accept the shift in stance for the cost of equity as presented in Paragraph 105, stating "There is also evidence that there continues to be significant availability of new capital for further investment in infrastructure, should it become necessary. We therefore consider that the risk of an exit of capital is relatively low over AMP7." This is contrary to our view as a UK-based institutional investor. We see significant competition for our capital with a pipeline of potential investments which are offering compelling returns versus the risks and rewards presented by a regulated UK water business at the revised cost of capital. Admittedly this revised level is considerably better than that offered by Ofwat in the Final Determination, so we recognise the progress relative to that benchmark.

Cost of Debt Assessment

We note that the CMA has proposed to shorten the period for the trailing average of embedded debt to be used to set the cost of debt for the notional company from a 20-year look back period to a 15-year period. We note that the CMA propose to retain the iBoxx A/BBB 10+ index for setting the benchmark. In the PF the CMA acknowledged that the average maturity of the respective indices is in the range 17-22 years. Subsequently Ofwat has made the point that companies issuing debt longer than 10 years ago were more likely to be weak single A rated. Therefore, it follows that, as issuers at that point in time, the maturity profile of the debt is likely to be more in line with the 20+ years average for the A index. In this regard it is inconsistent to apply a shorter reference look back period than 20 years. We support a return to the longer period as proposed by the CMA in the PF announcement.

Separately, the use of a shorter period would appear to incentivise companies to issue debt which has a shorter maturity than the index, in anticipation that regulators are going to assume a shorter look back period for reference in the future. Despite being in a period of extremely low interest rates, this will mean that companies issue shorter-dated debt in this period than may have been available, ultimately resulting in higher costs for customers in future regulatory periods, assuming that risk free rates increase from current levels in the future.

Finally, this new approach leaves companies that efficiently incurred debt in the past facing a shortfall in return to cover those costs. This creates a drag on business performance, and on returns to investors who have no choice but to bear this cost, with consequent implications for future investment as highlighted in the section above on competition for capital.

Conclusion

As noted in our introduction to this response, we consider that GLIL is precisely the type of investor that UK regulators should be seeking to encourage to act as a long-term shareholder in the UK water sector. However, the actions of Ofwat through PR19 have created significant uncertainty over the near-term and long-term returns available to investors in the sector, and for Anglian Water in particular, especially when considering the balance of risks on performance commitments and the delivery of the AMP7 business plans. In this regard we have welcomed the approach of the CMA as laid out in the PF.

Notwithstanding these early indications from the PF, we now see a new set of uncertainties introduced into the water redeterminations process. The CMA is proposing to reduce the cost of capital available to investors at a point in time when the risks to investors' returns are heightened through regulatory challenge, and while the competition for capital from other infrastructure sectors makes for a compelling pipeline of investments away from UK water assets.

We strongly recommend for the CMA to reconsider its approach to the balance of risks set out for revised the cost of capital published in the 8th January 2021 consultation.

Your sincerely,

[redacted]

Chris Rule
Chief Executive
Local Pensions Partnership

GLIL Executive Committee Member