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CMA Water Redeterminations 2020:

Response to consultation on cost of capital working papers

First Sentier Investors is one of the longest-established managers of infrastructure assets on behalf of institutional investors with ca. €10 billion of equity invested across unlisted infrastructure assets globally. In the UK alone, we manage in excess of £1.2 billion of equity, including our investment in Anglian Water. The majority (>90%) of the equity we manage is from Pension Funds, including several large, high profile UK Pension Funds representing many thousands of members. We are proud of our investment in Anglian Water, and have fully supported enshrining in its Articles of Association its purpose to meet the needs of communities and the environment whilst earning a fair return for shareholders.

We support the robust, evidence based process that the CMA undertook in arriving at a cost of capital (CoC) for the U.K water sector in its Provisional Findings (PFs). This has gone some way to address concerns relating to i) the poor balance of risk and reward resulting from the asymmetry in the design of certain regulatory mechanisms; and ii) financeability. We note, however, that appellant companies are still faced with very high levels of unfunded totex, which in turn impacts negatively upon said concerns and has substantially increased the risk to investors in these businesses.

The PFs presented a welcome and rational improvement to an unprecedentedly unfair Final Determination (FD) by Ofwat, one that shook investor confidence in a regulatory system that was once considered the "gold standard" and has been copied multiple times around the world. We are now disappointed and concerned to see the CMA reversing key aspects of its PFs. The CMA has cited no new evidence to support the decision to do so, notwithstanding the unprecedented level of engagement that took place, with detailed submissions from each of the appellant parties and over forty third-party submissions. It appears, rather, the row-back that the CMA now contemplates is based on revised assessment or judgment rather than new evidence.

The CMA consultation does not fully recognise an equity return (CoE) that reflects the risk of significant unfunded totex (over £600 million at the PFs in the case of Anglian Water) and embedded debt or asymmetric ODIs. Equity returns stipulated in the PFs are eroded and even well-run businesses will face poor financeability. Furthermore, we are very concerned that the gearing outperformance sharing mechanism (GOSM) is still on the agenda. There is no new information on this issue, which was fully considered and the PFs set out a clear position from the CMA. PR19 has raised significant concern from our investor base around the validity of the investment thesis for Anglian Water, one that was predicated on a stable and predictable regulatory framework.

The consultation on the cost of debt (CoD), reverses the position in the PFs on unfunded interest cost for embedded debt. Anglian Water investors are asked to fund £100m of interest in this price review period, yet there is no evidence of debt being raised inefficiently by the company, in fact the opposite is true in many cases. In the past, companies following regulatory signals have raised long term debt to match long asset lives. This debt was raised efficiently at prevailing market conditions, which was recognised in all previous price controls. Ofwat's treatment, with hindsight, of embedded debt is a departure from established and well-regarded regulatory practice evidenced over several price reviews. We are surprised and concerned about the CMA taking this position and believe it is fundamentally unfair to retrospectively take this position. Such a change clearly undermines confidence in the regulatory system which necessarily needs to take a long-term view.

In summary, we are concerned about the revised views of the CMA on cost of capital (CoC) as this results in increased risk being passed to equity against diminished returns. When considered 'in the round' - also accounting for the large totex gap, unfunded embedded debt cost and largely asymmetric ODIs - the resulting regulatory envelope falls short and raises questions around its suitability to attract the necessary long term capital (debt and equity) required for the efficient financing of this essential infrastructures. Moreover, it forces well-run companies that are focused on long term resilience to take short term decisions to the detriment of the stated goals of PR19 in securing long-term resilience, protecting customers and making markets work. Ultimately, this is harmful to customers and undermines trust in the regulatory system.

We trust that the CMA will consider all facts to ensure the financeability of the sector and maintain its attractiveness to the investor community, many of which support millions of pensioners as water assets are well-placed to match long-term liabilities with steady and reliable cash flows. This is all the more important at this juncture, as the sector faces unprecedented challenges in meeting its net-zero carbon ambitions by 2030, playing its full role in the post-Covid green recovery, and delivering against the clear priorities its customers communicated through its extensive engagement process.

As long-term investors in the sector, we have a responsibility to represent our underlying pension funds and their members. We take this responsibility very seriously and must ensure that our risk vs return balance is fair for the members. At present we feel that this balance has been significantly tipped to greater risk and that will impact on our appetite for ongoing investment in the sector.

Yours sincerely,

[redacted]

Niall Mills

Managing Partner, Head of Global Infrastructure Investments
First Sentier Investors