CORSAIR CAPITAL

HARI R. RAJAN
Partner and Head of Corsair Infrastructure Partners

January 26, 2021

Competition & Markets Authority
25 Cabot Square
London E14 4QZ

Consultation on Water Re-Determinations

Dear Sir / Madam,

Corsair Infrastructure Partners is the global infrastructure equity sponsorship and investment management business of Corsair Capital. We manage 30.31% of the equity of Kelda, the owner of Yorkshire Water, on behalf of an international group of long term investors including public sector pension funds, insurers and sovereign funds, which has been invested in Kelda since 2007.

We have been concerned about the direction of regulation in the water sector for some time. Following Ofwat's final determination for PR19, we concluded that the determination was not in the best interests of investors, customers or the environment, and we fully supported the Yorkshire Water board's decision to reject Ofwat's determination and seek a redetermination from the CMA.

Corsair and other investors place a great deal of significance on the regulatory appeals regime under the CMA, as it represents a key check and balance in the system. We have been heartened by the CMA's approach to date, which we see as rigorously independent and supported by evidence-based analysis. The CMA has taken a balanced approach, recognising both Ofwat's core regulatory duties and the government's statement of strategic priorities. We note that the CMA's provisional findings thoughtfully reflected evidence submitted by different parties. We were particularly encouraged that the CMA has upheld key principles such as a rigorous approach to financeability, and rejected dubious concepts such as Ofwat's so-called 'gearing outperformance sharing mechanism', which was inconsistent with all regulatory precedent and principle.

Although we welcomed the CMA's provisional findings, we remained concerned that the overall package, taken in the round, still appeared closer to Ofwat's position than Yorkshire Water's, particularly on costs, where the CMA closed only 10% of the gap between Yorkshire Water and Ofwat. The overall package following the provisional findings still leaves very significant challenges for Yorkshire Water's ability to deliver its obligations and finance itself. The various working papers

717 Fifth Avenue, New York, NY 10022
Tel [redacted] | Fax [redacted]
www.corsair-capital.com
www.corsair-infrastructure.com

published over the last few days suggest the CMA is considering material movement from the provisional findings, and may be veering still further towards Ofwat's position.

We fully endorse Yorkshire Water's responses to the working papers, and we defer to those in relation to the detailed aspects. We would, however, draw the CMA's attention to some observations on the wider questions raised in relation to choosing a point estimate for different aspects of the cost of capital, such as the CMA's comments that it now believes that "the risk of setting the cost of equity too low is not as high as we had implied in our Provisional Findings" (executive summary, paragraph 29).

Firstly, we agree with the CMA's assessment that the Outcome Delivery Incentives skew to the downside, implying that there is a less than 50% probability that the headline return on equity will be achieved. The industry is also required to take more risk than in previous determinations; for example extreme weather events lead to increased costs and challenges to meeting performance commitments. Ofwat has acknowledged this effect as well as the likelihood that climate change will lead to more extreme weather events, and yet it makes no allowance in its assessment of allowances. In fact Ofwat has reduced tolerances in the system such as deadbands on penalties. The industry also expects to face increased levels of customer bad debt in the wake of the economic consequences of the COVID crisis. If this is to be the balance of risk, then a material degree of aiming up is warranted.

This point is reinforced by the working papers on other areas of the provisional findings: to the extent that any resultant changes lead to a further deterioration of the risk balance, that would further increase the need to aim up on returns. The further paper indicating that the CMA does not intend to reflect 2019/20 data at all in its final decision seems a clear example, given this was a high spending year across the industry and suggests that cost allowances in the provisional findings are too low. The proposals in the working paper on leakage allowances add to our concern.

More broadly, we believe the risks for the sector in attracting capital are currently high. The UK's reputation as a stable investment environment has been eroded in recent years. At the 2019 general election, the Opposition's manifesto included the expropriation of water company shares at below market value. In 2020, an unprecedented four companies have found it necessary to reject the regulator's determinations. Meanwhile, having now left the European Union, the UK is being watched closely by the global investment community as it redefines its investment proposition to the world. Foreign direct investment has been volatile in recent years and has declined for the last three years. The last equity transaction we are aware of in the unlisted water sector was nearly three years ago in early 2018 and more recent experience suggests that UK water assets are currently perceived as relatively unattractive compared to international peers.

The provisional findings went some way to addressing these risks and would have created a more positive environment for incremental investment in the sector. However, we do not believe the revised point estimate for WACC implied by the consultation would have the same effect. For example, a number of companies have been working on a programme of investment opportunities above and beyond PR19, which policymakers may wish to accelerate as part of a green recovery effort in the wake of COVID. Investor support in many cases was predicated on a materially higher WACC than Ofwat allowed in PR19. We believe the implied revised WACC within the CMA consultation will not be sufficient to gain investor support for these projects.

Finally, we would also make a single observation in relation to the cost of debt. The length of the lookback period is clearly a major driver of the embedded cost of debt because debt has been significantly cheaper since the financial crisis and the ultra-loose monetary policy that has prevailed during that period. Before the crisis, water companies could not reasonably have foreseen this would occur. At the time, regulators and policymakers agreed that it was responsible of companies to raise long term debt to match the long term nature of their asset base. We believe the lookback period should reflect this and not implicitly assume a level of hindsight.

We look forward to continuing collaboration with UK Government and regulators, and continuing to support Yorkshire Water.

Yours faithfully,

[redacted]