

Competition & Markets Authority

25 Cabot Square
London, E14 4QZ

27 January 2021

Consultation on CMA Water Re-Determinations

Dear Sir / Madam,

DWS Infrastructure is part of DWS, the independently listed asset manager, investing third party capital on a fiduciary basis in private infrastructure assets and businesses. We are one of the largest and most successful infrastructure investors with a +25 year investment track record, over 100 assets acquired and a global team of 41 investment professionals. DWS Infrastructure has a unique perspective on investor return requirements from managing c.€20bn in assets invested in private infrastructure, listed infrastructure securities and infrastructure debt.

We are a long-standing investor in Kelda, the owner of Yorkshire Water (“the Company”), having made our initial investment into Kelda in February 2008. Today, we manage 23.37% of the equity of Kelda on behalf of our investors – comprised of like-minded and long-term UK and international investors such as (public sector) pension funds, insurers and sovereign wealth funds. Together, over the years, we have maintained the view that Kelda is a top tier, well-managed and continually growing company at the core of both UK infrastructure and of millions of households and businesses in the North of England.

With this in mind, we have witnessed a concerning shift in the direction of regulation in the UK water sector in recent years. In September 2018, Yorkshire Water submitted its business plan to Ofwat for the period 2020-25 (AMP7). This business plan was one of the most ambitious in the sector and met Ofwat’s objective of driving improvements in service to customers alongside a step change in efficiency – both of which have always formed the bedrock of Yorkshire Water’s business model. We were therefore disappointed following Ofwat’s Final Determination. It was clear to us that Yorkshire Water’s high quality and evidence based approach to its AMP7 business plan had been overturned and replaced by a Final Determination that was not only flawed in methodology, but ultimately harmful to Yorkshire Water’s customers and damaging to the Company’s resilience. To that end, the Yorkshire Water Board concluded that this Final Determination was not in the long-term interest of its customers, Yorkshire or of the Company – and as such, has sought this re-determination by the CMA. As a cornerstone investor in Yorkshire Water, we reiterate our full support for Yorkshire Water’s pursuit of this re-determination from the CMA and rejection of the Ofwat Final Determination.

DWS Infrastructure welcomes the critical importance of the CMA in its role of protecting and promoting competition, ultimately for the benefit of consumers within the UK. We echo the CMA’s mission statement in highlighting the utmost importance of competition – not solely for commanding lower prices, but also for delivering innovative, sustainable and fundamentally better products and services. The necessity of this recourse to appeal is perhaps no more critical than it is within a regulatory framework such as the UK water sector, where the lack of natural competition demands a meticulous and well-developed approach by Ofwat.

With this in mind, we were encouraged by the CMA's initial approach to Yorkshire Water's Statement of Case in its Provisional Findings, where there was a thoroughness in the work completed by the CMA in forming its views. With recognition of the wide range of stakeholders with which Yorkshire Water is concerned, we welcomed the evidence-led approach to the CMA's analysis in its duty to command an independent position whilst recognising Ofwat's core regulatory duties, the Government's statement of strategic priorities and the long-term interests of Yorkshire Water's customers. In its Provisional Findings the CMA's understanding of the critical importance of financeability, recognition of an appropriate risk-return package to deliver long-term investment and the rejection of tenuous concepts such as Ofwat's so-called 'gearing outperformance sharing mechanism' – which is inconsistent with all regulatory precedent and principle – marked a positive first step in the right direction towards achieving a more balanced and sustainable redetermination for Yorkshire Water, its customers and the environment and community in Yorkshire.

This said, in absolute terms there remained a number of concerns which, in full support of Yorkshire Water, we agreed required further attention by the CMA. Full details of the aforementioned concerns were shared by Yorkshire Water in its response to the CMA's Provisional Findings and, in summary, identified the overarching notion that the package proposed in the Provisional Findings remained closer to Ofwat's Final Determination than Yorkshire Water's position and as such remained extremely challenging from a delivery and risk perspective. Take for example cost allowances: we welcomed the additional enhancement totex allowance allocated to leakages in the Provisional Findings, for we hoped it marked a shift toward a more balanced and achievable target – a target which is ultimately based on delivering a high quality of service to Yorkshire Water's customers into the long-term. However, in both absolute and relative terms the additional cost allowances remained inadequate, where just 10% of the gap between Yorkshire Water's position and that of Ofwat's was met in the Provisional Findings. Under this assessment, Yorkshire Water continues to find itself in an unworkable position with regards to the Company's ability to deliver on its outcomes and finance itself.

In light of the aforementioned progress made in the Provisional Findings, Yorkshire Water made its response to the CMA. The Company and its stakeholders hoped for a meaningful dialogue to be opened with regards to addressing some of the outstanding concerns (in particular on Yorkshire Water specific performance and cost allowance measures). We were therefore disappointed to learn that, as signalled through the recently published working papers published, the CMA are engaged in an ongoing consideration around the reversal of some of the positive steps made in its Provisional Findings and leaning back toward the position of Ofwat's Final Determination – with particular focus on both the WACC and totex allowances.

With reference to the Provisional Findings, the CMA and Yorkshire Water had reached an alignment in understanding that financeability should be considered in the context of the full package of Yorkshire Water's business plan – where an increase in the WACC could act as a remedy, being both central to financeability and a material determinant of allowed revenues. That is, we had previously welcomed the CMA's recognition that the WACC is the primary factor in ensuring that an efficient firm can finance its functions. As stated in the CMA's Provisional Findings: "the WACC is the main driver of expected financial ratios"; and that "if the WACC is set too low, notionally geared companies would not be able to retain strong investment-grade credit ratings". As such, in light of the deeply concerning working papers published recently by the CMA on the WACC and risk asymmetry – which to our assessment contain manifest errors or indeed serious gaps in methodology – we fully endorse Yorkshire Water's current and planned responses to the CMA's working papers. The similar U-turn in potential leakage enhancement allowances, as seen in the CMA's recent working paper on leakages, is equally

disappointing. To that end, we defer to the details of the specific considerations in Yorkshire Water's submission.

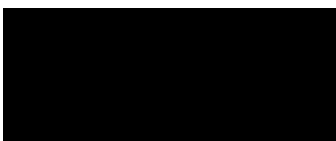
To add to our above concerns surrounding the WACC and cost allowances, we would also like to emphasise that there remain a number of other outstanding issues – stemming both from the initial shortcomings in the Provisional Findings as well as in the additional working papers by the CMA. Those of particular mention include of the Outcome Delivery Incentives downside skew, deadbands on penalties, lookback methodology surrounding the cost of debt, and the highly disappointing indication that the CMA will not factor the actual 2019/20 data into its final decision. Where – in our mind – the high levels of spending, not only at Yorkshire Water but across the industry, over the year paints a clear picture in support of the argument that the cost allowances considered in the Provisional Findings are insufficient.

We were initially encouraged by efforts made toward constructive cooperation in the recent roundtable discussion chaired by Kip Meek on the 20th January 2021. With the CMA, Ofwat and Yorkshire Water appropriately represented, we hoped the roundtable would facilitate meaningful discussion on the matters outlined above and in Yorkshire Water's formal dialogue with the CMA. While we appreciate the formalities demanded by such a roundtable, we were disappointed to hear references were made stating the Ofwat Final Determination has no impact on investor interest in supporting the UK water sector. To put it plainly, we are at somewhat of an inflection point – where investor appetite in the UK water sector is now being held in the balance. As mentioned before, the CMA's Provisional Findings were a step in the right direction, albeit fundamentally insufficient by itself in restoring interest amongst investors into the sector. With that in mind, if actioned, the CMA's latest consultation findings will set an irreversibly unattractive precedent which will extend far beyond AMP7. If the UK's water sector is unable to attract future investment and finance itself appropriately, the consequences will be considerable. Without investment and appropriate financeability, both short-term (retaining and attracting high performing management teams and investing to improve efficiency, performance and resilience) and long-term challenges (e.g. green recovery ambitions, the levelling up agenda and net zero) will become unattainable targets which will have a long-term damaging impact on Yorkshire Water's customers, its environment and communities as well as its resilience.

With Brexit now behind us, many countries and investors will be looking to the UK as it redefines itself as a global investment hub – still at the heart of Europe. We cannot stress enough that policy makers, regulators and independent bodies such as the CMA have a critical role with regards this redefinition of the UK, and to that extent the trajectory and quality of the UK's development over the coming decade.

We look forward to our continued collaboration with the UK Government and regulators, as well as our full support for Yorkshire Water.

Yours faithfully,



Hamish Mackenzie
Global Head of Infrastructure
DWS Infrastructure