Dear Sir,

PR19 Methodology Consultation Response

Introduction

We are grateful for the opportunity to comment on Ofwat’s proposed methodology for the 2019 price review. We are doing so on behalf of OMERS, the defined benefit pension plan for Ontario’s municipal employees with more than C$85 billion in net assets and Wren House Infrastructure Management Limited, the direct infrastructure investment arm of the Kuwait Investment Authority.

OMERS has been investing in a diversified global portfolio of large-scale infrastructure assets for more than eighteen years, and is currently a significant investor in UK infrastructure, with sizeable and long-standing interests in Associated British Ports, Belfast International Airport, London City Airport and SGN (since 2005). Since its establishment in 2013, Wren House has delivered on its strong commitment to UK infrastructure, having invested over £1.3bn in the UK in the last 24 months alone.

In May 2017, OMERS and Wren House invested in the water sector for the first time and will shortly have a 23% and a 9% interest in Thames Water respectively. OMERS and Wren House are attracted to investing in the sector for the long term because of its history of regulatory stability and its track record of delivering privately funded investment into public infrastructure to improve asset resilience and customer service, all while keeping bills affordable for all. We have also observed the consistency and transparency of the regulatory framework, the industry’s growth via investment, and the increasing opportunities to support management teams that are focussed on operating efficiency and service improvement. As a growing defined benefit pension plan, OMERS’ own investment objectives are well aligned with the sector’s need for investment, innovation and efficiency of capital and operating costs. Similarly, Wren House’s mandate for perpetual investment is well aligned with the sustainable investment environment the UK water sector provides.

Both Thames Water’s own response to the PR19 Methodology Consultation, and its ongoing commitment to deliver high quality customer service, value for money and better governance, receive our full support.

Selected Comments on the Draft Methodology

As investors, we are fully cognisant of the responsibilities and obligations placed on all companies in the sector in relation to service provision and asset health. We are supportive of PR19’s key themes of customer service, long term resilience, innovation and affordable bills. We also believe that many of the new features tabled for PR19 are positive, for example the introduction of separate price controls through the value chain, the opportunities to generate efficiency from competition in water resources and sewage sludge treatment, and direct procurement, the reform of the Service Incentive Mechanism and the increasing importance of Outcome Delivery Incentives.

However, we have some specific areas of concern that we would like to highlight at this stage.

1. Lower Returns

The proposed approach to cost of debt indexation is a natural evolution of the regulatory framework and is a new feature that has worked in the Ofgem-regulated networks and with which we broadly agree. However, we disagree with the proposed approach to setting the cost of equity (CH10, Q1). What is currently proposed is an unnecessary departure from the historically acceptable approach of taking a long term view recognising the very long term nature of the asset life cycle in this industry. While there are arguments that can be made in today’s markets (that are impacted by excess liquidity) that equity returns have fallen, it is important to consider that short term market data presents a high degree of volatility and there is a high risk of error associated with using short term forward looking
metrics. We believe that greater weight should be placed on historic trends and prior regulatory determinations, recognising also that there is embedded equity (just as there is embedded debt) in this sector. Overall, we would recommend a rethink in the cost of equity approach.

2. Higher Risk

With the introduction of competition and higher penalties and rewards comes greater cash flow volatility and therefore risk. This is not necessarily a bad thing, but only in conjunction with the potential for higher returns on average. This means that there is a need to: (a) update key data points like the asset beta estimate for the sector; and (b) ensure that the distribution of expected returns is symmetrical for the sector overall, by allowing for glide paths to meet stretching performance targets (i.e. balance the pain of the “stick” with the reward of the “carrot”). The perception by the global investment community that the sector is “very low risk” has been a fundamental underpinning of its historic success in attracting low cost capital to drive performance, investment and affordability. If ever lost it will be difficult to regain at a vitally important time for investment in both the water sector and more broadly in UK infrastructure.

3. Level Playing Field

We welcome the fact that Ofwat intends to set challenging efficiency targets for companies. It will be important that the economic models take account of the extent to which cost differences between companies are due to factors outside the control of management, including any relevant special factors. Ofwat will also take account of the cost impacts of any required changes to standards of service between those implicit in the benchmarking data and the targets set at PR19. In combination, these elements may constrain the maximum rate of efficiency change that a company could reasonably be expected to achieve. This will need to be considered in setting allowable costs.

Ofwat has consistently stated that the actual capital structure adopted by each company is a matter for that company (within its licence obligations). It is also undisputed that the more “highly levered” companies have strengthened the “ring fence” around the operating entity to the benefit of both bondholders and customers, and that customers’ bills would be higher if these companies were to lower their debt levels and therefore require a higher corporate tax allowance. We would therefore be very concerned if PR19 were to be designed in any way to disadvantage companies with more efficient capital structures, and by extension, disadvantage end customers.

In Summary

We share Ofwat’s focus on efficiency as a key enabler of affordable bills in the context of the challenges that the sector faces. However, future efficiency in this sector will be driven by (a) a truly long term approach to asset management; and (b) innovation (i.e. trying new processes and technologies). Neither of these will be supported if most companies are earning less than their cost of capital and management teams are excessively focused in the short term on achieving stretching economic and operational targets that, if not reached on Day 1 of the price control, they will be heavily penalised for. We trust, therefore, that Ofwat will carefully consider the appropriate balance of risk and return in the round before finalising its PR19 Methodology. The current proposals, if unamended, would both increase risk and reduce returns to a degree that will be ultimately detrimental to both current and future customers.

Once again, we appreciate the openness, transparency and the several opportunities we have in which to engage directly with Ofwat. We are ready and willing to help push the frontiers in this industry to the benefit of all stakeholders for a reasonable return on capital. We would be pleased to elaborate further on any of the specific points in this letter at your convenience.

Yours faithfully,

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OMERS

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