British Columbia Investment Management Corporation
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Infrastructure & Renewable Resources Dept. InfrastructureExternal@bci.ca

VIA EMAIL:

May 17, 2018

ATTN: Benefits Sharing Consultation

Ofwat
Centre City Tower
7 Hill Street
Birmingham, UK
B5 4UA

To Whom It May Concern:

RE: PUTTING THE SECTOR BACK IN BALANCE: CONSULTATION ON PROPOSALS FOR PR19 BUSINESS PLANS

We appreciate the opportunity to respond to this consultation. BCI's investment activities help finance the retirement benefits of more than 569,000 people in the province of British Columbia, Canada – as well as insurance and benefit funds that cover 2.3 million workers. BCI manages C$135.5 billion of assets on behalf of British Columbia's public sector as of March, 31, 2017. This makes us one of the largest asset managers in Canada and the largest in Western Canada.

Our C$11.0 billion global infrastructure program started in 2002 and includes a portfolio of regulated utilities in the water, electricity, and wastewater sectors, energy transmission, as well as roads and high-speed rail. BCI has been a long-standing investor in the UK water sector since our initial acquisition in 2006 of a minority interest Kemble Water Holdings Limited ("Kemble"), which owns Thames Water Utilities Limited ("Thames"). We further increased this interest in 2010 and 2011. Today we own an 8.7% interest in Kemble.

BCI is an active responsible investor. After Thames' pollution fines in 2017, we engaged continually with Thames to share our responsible investing policy and belief that addressing environmental, social and governance ("ESG") issues protects and improves sustainable, long term investment returns. We feel BCI is fundamentally aligned with the customers' goal of achieving long term resilience in the UK water sector. Due to changes at the management team and board level, we believe improvement at Thames in regards to its operations, transparency and governance are well under way.

During the time of our ownership, the Company invested an average of £1.1 billion a year which is triple the amount invested in the five years before privatization. However, we recognize the need to continually invest and support significant capital expenditure to Thames' aging infrastructure, strong operational capability, and continual innovation. These are now becoming the minimum requirements to deliver to customers in a challenging economic environment. We therefore support any changes to improve the level of trust between customers, society and water companies, which is important during this period of investment and transformation.

We hope that Ofwat acknowledges our support of the changes to improve transparency in the sector and welcome further improvements to governance at the board and Company. We are also supportive of Ofwat's initiatives to deleverage companies over time and are open to alternative approaches through dividend policy or degearing.

From BCI's perspective, we require reciprocal levels of trust between water companies, their investors and Ofwat. However, the recent consultation introduces the mechanism of sharing of financing outperformance. This is unprecedented and contradicts the long-standing principles of capital structure neutrality in regulatory jurisdictions across the UK and globally. This mechanism is not the most effective method of ensuring delivery to customers and not in the customers' long term best interest. For further details, please see below, our responses to the consultation.

While BCI has been a long term investor and advocate for the UK water sector for almost 12 years, the sharing of financing outperformance could undermine our ability to continue with our investment in the UK water sector. This would be unfortunate during a time when the UK's critical water and sewerage infrastructure will benefit from continued access to patient long term capital.

Sincerely,

Lincoln Webb
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cc Gordon Fyfe, Chief Executive Officer, BCI
Enc

BCI Answers to the Consultation Questions

1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans?

We do not believe sharing of financing outperformance adds value to customers.

The debt tax shield pass through mechanism already in place has not allowed shareholders the tax shield benefit associated with incremental leverage. The proposed sharing of financing outperformance therefore removes the incentive for companies to keep additional leverage and would result in an immediate loss of the debt tax shield pass through to customers.

Further, the sharing mechanism does not address the fundamental need to re-invest into the Company to serve customers.

2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?

We do not agree with this type of intervention and retroactive sharing. This would materially impact the ability of investors to continue to invest in the sector at a time when there is a critical need for capital spending. This is not in the long term interests of customers.

3: Do you have views on our proposals for the design of the sharing mechanic? Should the calculation be on a nominal basis and take account of the actual, rather than notional cost of debt.

No, as we do not agree with the sharing mechanic in principle.

4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and takes account of factors which include obligations and promises to customers etc?

This could be a more constructive approach to ensuring delivery of service to customers.

We do not agree with dividend policies that are too prescriptive or restrictive in nature, but are open to testing our dividends / dividend policy in consultation with customers at each price review in a way that is unique to Thames.

The water sector requires extensive long term capital and operational and innovation planning so we do require a degree of flexibility in our dividend policy to address these investment needs.

We support increased transparency of our dividend policies in the interests of gaining further trust with our customers.

5: Do you agree that companies should explain their approach to any performance related element of executive pay.

We welcome increased transparency on executive pay in order to gain further trust with our customers.

However, we require the ability to communicate to our stakeholders the importance of retaining talented management teams that can capably manage a top performing utility system while innovating.

We do not believe in compensation policies that are too restrictive in nature and result in retention risk and misalignment with shareholders and broader stakeholders.

6: Do you agree that our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?

We do not agree with the wording that the Company needs to gain trust through "*appropriate measures to provide a fair balance between customers and investors*..". Such wording can potentially lead to very prescriptive and restrictive measures. As mentioned above, in questions 4 and 5, we do require a degree of flexibility in our dividend and executive pay policies.

7. Do you have any comments on the additional clarification of our approach to financial resilience?

We agree with the concept of increased stress testing to ensure financial resilience across the sector. However, the scenarios outlined in the consultation may or may not apply specifically to Thames based on its gearing, operational and relative performance.

We would welcome an approach that is Company specific subject to further challenge from stakeholders.

In support of our responses to the consultation, please find attached:

- *KPMG commentary on the Ofwat Consultation on Sharing Gearing Outperformance*
- *Professor Alan Gregory of the University of Exeter's review of the Ofwat Proposals for Sharing Financial Outperformance*