OMERS

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Rachel Fletcher
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Dear Rachel

Re: Putting the sector in balance: Consultation on proposals for PR19 business plans

I am writing on behalf of OMERS in response to the above consultation document issued on April 26th. OMERS is the defined benefit pension plan for almost half a million public sector workers based in Ontario, Canada. OMERS is a leading global investor with net assets of C$95bn, with one of the world's largest infrastructure portfolios of C$17bn. We have a significant presence in the UK, with investments of over £10bn in real estate, private equity and in infrastructure (including The Royal Exchange, Vue Cinemas, SGN, London City Airport, and Associated British Ports), and in May 2017 we also invested in Thames Water; indeed we are now the largest investor in the business.

OMERS is a long-term responsible investor, and invested in Thames Water with the objective of working with the new executive team to transform the business. Since our investment we have supported initiatives to deliver on the "trust in water" programme launched by Ofwat in 2015 that seeks to build trust with customers but also with investors.

We agree with the objectives that Ofwat has previously stated, of delivering a market that works well for customers. We are eager to work with Ofwat, and broader stakeholders, to improve consumer outcomes in the sector. We believe that the approach laid out in the consultation is inconsistent with these objectives since it risks the investability of the sector. In particular the consultation undermines the important principle that the capital structure of a business is a matter for boards and shareholders. This long-held principle of economic regulation has underpinned the attractiveness of the UK to long-term domestic and foreign investors like ourselves.

The sector is being asked to invest more to meet the demands of population growth, improving standards and increasing operational resilience whilst keeping bills affordable, and we believe that Ofwat intervening in capital structures would result in sub-optimal solutions for customers.

We take our responsibility to the sector and our ability to deliver for consumers seriously, and we are working with our fellow investors and the Board of Thames to develop a coherent package of measures that will improve trust. Thames Water has already committed to:

- re-invest in the business (we have not taken a dividend since our investment)
- deliver on a new strategy that puts the customer at the heart of its business
- restructure the business to improve operational performance
- simplify the corporate structure, including removing Cayman Island entities
- reduce gearing to the mid-seventies over the medium- to long-term
- increase the transparency of financial returns
- reform the CEO's remuneration to be more strongly linked to customer outcomes
- improve its governance model
- develop a clear dividend policy
- produce a high quality PR19 business plan that is supported by customers

Rather than the approach suggested in the consultation document, we believe that the above could be a model for the sector – a model that increases customer legitimacy, but also maintains investor confidence. We would welcome the opportunity to discuss this further with you.

We provide answers to your consultation questions in the attached, and we ask that this letter and attachment be kept confidential.

Yours sincerely,

Philippe Busslinger
Senior Managing Director and European Head of Infrastructure, OMERS

cc Jonson Cox, Chair of Ofwat

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Answers to the consultation questions

Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?

No. We believe that this retrospective approach undermines the long-held principle that a company's balance sheet is for its board and shareholders, and risks undermining investor confidence. This long-held principle of economic regulation has underpinned the attractiveness of the UK to long-term domestic and foreign investors like ourselves.

Further, the consultation implies that Ofwat should set the efficient capital structure for the industry and not just set a notional gearing level. We believe that shareholders and boards are best placed to determine the efficient gearing level and manage balance sheet risk. Moving this accountability to the regulator risks having inefficient gearing structures, a higher cost of capital and hence higher prices for customers.

Q2: 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?

No. The concept of outperformance related to gearing is false: there is nothing to share other than the debt tax shield that is already shared. Any imposition of a mechanism would be seen as a significant and retrospective change of regulatory approach for the reasons set out in our answer to question 1.

Q3: Do you have views on our proposals for the design of the outperformance sharing mechanic for highly geared structures? Do you agree that the calculation be on a nominal basis and take account of the actual, rather than notional cost of debt?

The proposals are flawed as they are contrary to the accepted financial theory (according to Modigliani and Miller, there are no benefits), contradict Ofwat's own methodology, and are asymmetric. The only benefit that comes from higher gearing is through the debt tax shield, but this is already allocated to customers.

Q4: 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 take account of factors which include obligations and promises to customers, financial resilience, and employee interests?

We do believe that dividend policies should be transparent, and any dividend paid should made after careful consideration by the board of multiple factors and stakeholders that include customers, employees, financial resilience and the long-term health of the business. However, the payment of dividends is a fundamental part of attracting long-term investors with a low cost of capital into the sector, and hence investors are an equally important stakeholder in the consideration of what dividend to pay, if any.

Q5: Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related element of executive pay demonstrates a link to exceptional delivery for customers?

Yes, we believe that remuneration policies should be transparent. We want to attract top talent into the sector to drive the cultural transformation needed, and we believe that remuneration should have an appropriate element of pay that is performance-related to create good alignment and incentives to perform. This performance spans all stakeholder considerations including delivery of customer service but also financial performance as efficiencies delivered by executives result in lower prices for customers over the longer term and hence should be rewarded. We also caution that an unintended consequence of the proposals might be to force boards to increase base pay and reduce performance related pay, which would be an outcome against customer interests.

Q6: 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 would support an IAP test that addresses board assurance regarding the appropriateness of measures to provide a fair balance between customers and investors, but not if this test implies that business plans should include a retrospective gearing sharing mechanism along the lines proposed in the consultation.

Q7. Do you have any comments on the additional clarification of our approach to financial resilience?

As long-term responsible investors we take the financial resilience of companies we have invested in very seriously. We agree that it is the responsibility of the company to determine the appropriate stress tests to assess financial resilience based on company-specific risks. The proposed Ofwat common scenarios contradict this and hence should not be a requirement of the business plan or IAP.