

Jonson Cox / Rachel Fletcher  
Benefits sharing consultation  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4 UA

Via email: Water2020@ofwat.gsi.gov.uk

17 May 2018

Dear Jonson and Rachel,

We write to you as representatives of pension funds and other long-term investors in the UK Water and Sewerage sector to raise concerns about aspects of "Putting the sector back in balance: Consultation on proposals for PR19 business plans". In particular, we are concerned that the millions of families' pensions that we represent will be significantly disadvantaged by Ofwat's proposals for sharing of financing performance, which represent a significant change in UK regulation.

As investors in Southern Water and in UK water, we are committed to maintaining customer trust and confidence in Southern Water and in the sector. As our Chief Executive Officer, Ian McAulay, recently communicated to Rt Hon Michael Gove MP, Southern Water's customers rightly expect the company to care for our environment and provide resilient water and wastewater services at a price that is affordable.

As stewards of our community, customers and investors' pensions, we are committed to the highest standards of transparency, corporate governance and operational and financial resilience;

- Southern Water is working towards closing its Cayman Islands finance subsidiary by year-end and has communicated this clearly to both Ofwat and its customers (although we note that this entity was set up to issue debt in the UK rather than to avoid any taxes or levies)
- The company is refreshing its dividends policy, which is robust and protects the interests of customers and the ring-fenced regulated entity, and is always examining ways to improve the linkage between executive remuneration and public service values
- We and the company maintain the highest standards of governance and have formally ensured the separation of the regulated entity board from that of our investor holding company, Greensands Holding Limited. Only two of the directors (out of eight) at Southern Water are investor representatives. We, collectively, are aiming for the independent non-executive contingent to represent the majority of the SWS board by the end of the year through the appointment of additional INEDs
- Southern Water is undertaking a capital structure review which will significantly reduce gearing in the regulated company and has demonstrated to Ofwat that the company is financially resilient in a range of major downside scenarios. This assessment has also been tested independently with three rating agencies
- Importantly, the team at Southern Water is also working hard to build innovative and highly ambitious approaches to secure a resilient water future for the South East in the PR19 business plan submission.

As investors in Southern Water we have been and continue to be highly supportive of the initiatives laid out above. The consideration of all stakeholders and the long-term sustainability of water in the UK is particularly important to the 41 UK pension schemes that are investors in our funds or in direct water investments that we manage.

### Sharing financing performance

We are concerned about the proposals in relation to sharing financing performance, which we believe could have adverse and unintended consequences. There has been a longstanding principle in UK regulation that the risks and rewards of capital structures sit with shareholders. This has worked well since 1989 and provided a long track record of financial stability, strong credit ratings and significant investment. There is no evidence of any customer harm resulting from this principle. It follows that the proposals are effectively retrospective in nature and represent a significant change in UK regulation.

Based on Ofwat's consistent view that capital structures are a matter for companies and their investors, we have a legitimate expectation that Ofwat would maintain this position, absent any clear evidence that it is no longer appropriate.

We are concerned that a retrospective change such as the one proposed could be the tipping point for other changes in core principles of UK economic regulation and would undermine water regulation, which to date has been perceived as stable, transparent and generally symmetrical.

To date, Ofwat has successfully used regulatory and financial mechanisms to ensure that companies continually improve the delivery of an essential service to customers, while challenging the industry to demonstrate public service values in delivering this service. A financing performance mechanism that requires companies to de-lever or receive a lower WACC represents a level of regulatory intervention in water companies over and above that seen to date. In our view there is no justification for this additional intervention and it sets an unhelpful precedent for further intervention.

While this letter focuses on sharing financing performance, we support Southern Water Board's own response to the consultation and the consultation questions.

Yours sincerely



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Head of Infrastructure  
Equity Europe  
UBS Asset Management



Mike Nagle  
Director  
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