



USS Investment Management
60 Threadneedle Street
London
EC2R 8HP

17th May 2018

Benefits Sharing Consultation
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Thank you for the opportunity to respond to this consultation. Universities Superannuation Scheme ('USS') is one of the largest pension funds in the UK, ranked in the top 10 largest corporate pension funds globally, and is the principal pension scheme for universities and other higher education institutions in the UK. The scheme represents c.390,000 UK based members and had assets under management of c. GBP 61bn as of 31 March 2017.

USS is an active long standing investor in the UK water sector. USS completed its acquisition of a 10.94% interest in Kemble Water Holdings Ltd, the ultimate holding company for Thames Water Utilities Limited, in November 2017. Prior to this investment the scheme also made a number of long term loans to UK water companies. The scheme's combined total exposure to the UK water sector is over GBP 1bn.

USS is an active responsible investor; since our investment in Thames Water last year we have been fully supportive and welcoming of the changes proposed by Ofwat to improve governance arrangements and transparency in the sector. We recognise the importance of restoring confidence to customers in the sector and ensuring that value for money and customer choice are positioned at the centre of decision making. The UK water sector will require both significant capital expenditure and investment in innovation in the long term in order to balance the demands of both a growing customer base with increasingly challenging environmental conditions. Accordingly we remain supportive of changes that work to further reinforce the contract of trust between water companies and their customers, which will be essential over the course of this period of investment and transformation.

However, we also believe it is equally important that the same contract of trust between water companies and Ofwat remains strong and operates on the same principles of transparency. We believe that elements of the benefit sharing consultation, particularly the retroactive nature of some

USS INVESTMENT MANAGEMENT LTD

"USS" and the USS logo are both trade marks of Universities Superannuation Scheme Limited. All rights reserved.

6th Floor, 60 Threadneedle Street, London, EC2R 8HP Tel: +44 (0)20 7972 0300 Fax: +44 (0)202 7628 0662 Website: www.uss.co.uk

Registered in England & Wales No. 3380864 Registered Office: Royal Liver Building, Liverpool L3 1PY Authorised and regulated by the Financial Conduct Authority

of the proposals, contravene what have been long established principles of regulation for the sector and would result in material value loss for shareholders. We consider that the associated loss of confidence in regulation of the sector by equity and debt investors will outweigh any potential financial benefits received by customers. As such we are very concerned by the proposals contained in the benefit sharing consultation, and as our responses indicate we do not believe that they are in the best interests of stakeholders.

We continue to be highly supportive of Ofwat's initiatives to improve governance arrangements and have agreed, as a shareholder in Thames Water, to deleveraging the company over time in response to customer concerns regarding high leverage. We would be willing to engage further with you on these topics and other additional ways in which to improve customer confidence.

Please note that our preference would be for our response to remain unpublished.

Best regards

A handwritten signature in black ink, appearing to read 'Mike Powell', written in a cursive style.

Mike Powell

Head of Private Markets Group
USS Investment Management Ltd

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?

We do not consider this to be an appropriate adjustment to make. A retroactive sharing mechanism would represent, in our view, a material deviation from established regulatory practices. We believe that such a change would materially impact the performance of companies and reduce the investability of the sector to both debt and equity investors. The increased costs in the long run from these higher required returns would not be in the interests of 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?

Again we do not believe this imposition would be beneficial to the industry as a whole. Efforts to increase transparency of ownership across the industry including changes to dividend policy are more likely to be effective in strengthening customer trust, in our view.

Q3: 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.

Please see our responses to questions 1 and 2.

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 takes account of factors which include obligations and promises to customers etc?

We agree with the concept of increased tests in relation to dividend payments and would consider additional requirements in this regard. We appreciate the sensitivity surrounding dividend payments and the need for Ofwat to address this issue in order to further trust in the sector. However, given the very long term nature of planning and management in the water sector, we would advise against requiring dividends or compensation to be paid only in the event of operational outperformance or in relation to backwards looking tests. This could discourage investment in innovation and long term planning in business plans, which typically require significant investment but do not produce any immediate short terms benefits. We would prefer to see company specific dividend tests which are agreed at each price review and are unique to each company's business plans and feedback received from customers.

Q5: Do you agree that companies should explain their approach to any performance related element of executive pay.

We agree with this concept and are supportive of increased transparency in relation to compensation. However we think it is important to underline the role that performance related elements of executive compensation play in building stakeholder alignment and delivering best outcomes for all parties. Restrictions to performance related elements of executive pay would reduce alignment between management and stakeholders, which we do not believe would be in the best interests of the industry.

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 not be supportive of an assessment that includes question 3.

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

We appreciate the need for Ofwat to have standardised stress tests in order to draw comparisons of company resilience across the industry, and further that financial resilience should be an important aspect of future price reviews. This is consistent with our earlier comments in relation to customer trust. However we would encourage Ofwat to engage with water company management teams to develop a more practical set of resilience tests. We view that current set of tests will not provide realistic assessment of company financial strength and would encourage further engagement before these tests are finalised.