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Rachel Fletcher
Chief Executive Officer
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17 May 2018

Dear Rachel,

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

Wren House Infrastructure Management Limited ("WHIM") invests in infrastructure assets for and on behalf of the Kuwait Investment Authority ("KIA") the world's oldest and one of the largest sovereign wealth funds in the world. WHIM's mandate from the KIA is as a long-term investor with no requirement for exit. It seeks to generate value, not through capital gains on exit but through the increased income returns that result from sustainable growth and investment.

Acting through WHIM, the KIA has committed significant capital to the UK by way of its investment into Thames Water as well as Associated British Ports and London City Airport. WHIM continues to actively pursue opportunities across Infrastructure sectors in the UK. With $4bn invested to date, our fund continues to grow and we seek opportunities to invest in stable asset backed opportunities that are underpinned by strong and stable regulation.

While we have been, and remain a strong supporter of the UK market as an investment destination, we are deeply concerned by the recent consultation and the implications for UK water regulation. We believe that the water industry, and Thames Water itself, has responded positively in recent months to Ofwat's stated objectives to improve public trust and transparency in the sector (e.g. commitment to principles around de-leveraging, improved governance, increased transparency through reduction in Cayman structures, etc.), and has been working hard to restore this trust through improved service and performance. Despite the positive momentum in the sector, our concern with this consultation is that it is a fundamental shift away from the regulatory foundation of capital structure neutrality, risking a crisis of confidence in the stability of the sector and in the UK more broadly, as an investment destination. In fact, our Investment Committee is asking us, what has changed to drive this shift in what has historically been perceived as the 'gold standard' in regulated markets, what the urgency is that is driving a compressed consultation period and whether this signals a broader change across the UK regulated sector. We invested in Thames Water because we were attracted by the fundamental need for sustainable long term investment in the sector and invested with the expectation of increasing our commitment to the sector, with the aim of being a long term participant. However, recent negative sentiment towards Thames, despite the extensive efforts being put into improving customer service and overall performance by the management team and investors collectively, combined with the uncertainty over the future regulatory approach that this consultation has highlighted, has raised significant concerns over the future of the sector as an investment for us.

There are a number of elements of the proposed consultation that concern us;

- **The capital structure is a matter for companies to determine.** This has been a principle in the water sector (and indeed other UK regulated sectors) for 30 years since privatisation, as the long held belief is that companies are better placed to understand what the optimal capital structure is for the company and to manage the financial risk associated with it**.** The approach from UK regulators on financial structure neutrality follows from the corporate finance principle that in an efficient market equity investors do not benefit from increased leverage. Aspects of this consultation change that fundamental principle, which is a big shift in the regulatory framework, and is a divergence from regulatory approaches in other sectors in the UK and internationally. The levels of leverage in the sector are consistent with the nature of the assets being financed – e.g. long-term capital intensive assets with relatively stable and predictable cash flows underpinned by clear and stable regulation. Indeed, these levels of leverage are observed in competitive/contestable adjacent infrastructure sectors, for example, OFTOs, Toll Roads and ROSCOs, to name a few. Furthermore, the market for financing in utilities is highly competitive and efficient, resulting in continually changing options and a low cost of debt.

- **Minor short term financial gains for customers are likely to lead to adverse bill impacts in the long term.** We are concerned by unintended consequences that the proposed approach of sharing alleged gearing outperformance with customers may have. Current market conditions have led to an efficient market with abundance of financing supply for UK regulated assets. Such abundance drives financing costs and cost of capital down, and is a major feature for containing water bills within an affordable level whilst proceeding with ambitious investment plans. Abundance of equity and debt supply is also driven by the fact that there is a wide choice of financing structures and that investors with very diverse risk/return appetites can participate the in UK water financing market. The proposed approach of sharing alleged benefits from higher gearing would incentivize water companies to move towards the notional gearing structure. In the medium to long term it would mean that only investors with a risk/return appetite prescribed by the regulator would take part in the UK Water financing market with a significant reduction in supply of financing for the UK water sector and efficiency of financing market. Such reduction in supply of capital is likely to drive cost of capital up with adverse financial consequence for customers and for affordability of water bills.

- **Companies already take financial resilience very seriously.** We don't believe that higher gearing implies lower resilience or potential risk to customers. Existing financial structures have features that increase resilience and embedded protection for customers (e.g. covenants, lock up provisions, cash management mechanisms), while the existing regulatory mechanisms exist to strengthen financial resilience (e.g. maintenance of investment grade ratings, regulatory ring-fencing, financeability and stress testing). At Thames, we have and continue to test the financial resilience of the company under a number of scenarios on a regular basis, given the focus we have on covenants and lock-up provisions as part of the securitisation structures. With regards to the resilience scenarios proposed through the consultation, we believe that they are very extreme and unlikely to all occur at once – and are not sure that many companies would be resilient under these proposed scenarios. We certainly intend to test some extreme situations that are appropriate for TW based on the risks we see facing the business and ensure that measures are in place to address these risks. On the premise that the existing financial structures are resilient under their securitisation structures, and as we don't believe that there is any direct evidence that highly geared companies systematically underinvest, or behave in a risk adverse manner, we don't believe that increased leverage puts customers at greater risk.

- **While we support increased transparency on dividend policies and performance related pay, determination of the dividends should be left up to Board discretion.** While we agree with the principle of increasing transparency around the dividend policy, and that this policy should include careful consideration of factors including customer outcomes, performance of the business, operational and financial resilience (including employee protections) and future investment requirements, we believe that it should be at the discretion of the company to determine an appropriate dividend level that is not based on an arbitrary cap, given the differing requirements of the water companies. On the performance related elements of executive pay, we agree with the principles of aligning this with performance outcomes, which ultimately drives customer service. We support the view that it is in the best interests of customers for the water sector to attract and retain high calibre management. We also support the view that it is important for its stakeholders that we are transparent about how executives are remunerated and how the performance related element of that pay relates to the overall performance of the business, for example; customer service, environmental performance, leakage and asset health, all of which are important to customers.

We do support the view that the sector needs to improve as it matures and there are opportunities to address challenges of the past. The shareholders of Thames Water have embraced this and we believe that we have made significant progress since our investment in June 2017. Alongside reinvesting in the business by not taking dividends in the last year, we have supported the company in a number of areas that we believe will help achieve the aim of restoring trust and legitimacy, including;

1. Implementing a new strategy to put customers at the heart of the business, including a restructuring of the business to improve service performance
2. Improving financial transparency through closure of Cayman subsidiaries and enhanced reporting
3. Improved governance, including reviewing the future role of the INEDs and clarifying shareholder reserved matters
4. Increased clarity and greater transparency on dividend policy
5. Alignment of senior management performance incentives, particularly the CEO, with delivery of performance commitments
6. Commitment to improved resilience through reduction of gearing towards the mid-70s over the medium to long term - the speed of achieving this will be impacted by the proposal of sharing any benefits of leverage over the proposed 65% level
7. Ensuring that management is focused on delivering a high quality business plan for PR19 that has the support of its customers

We are supportive of the principle of increasing transparency in the sector, and support the goal of ensuring we have a thriving water sector that holds the trust and confidence of customers and the wider society. However, we are not supportive of some of the specific proposals in this consultation, including the sharing of outperformance related to gearing or cost of debt, the setting of a dividend cap and the stipulation of resilience tests, as we believe that these proposals are a significant departure from the current regulatory construct. Furthermore, we feel that given the degree of change this is proposing, not only is it very late in the PR19 process (creating a high degree of management distraction), but the consultation period at 3 weeks has been much too short. As an investor, we are already doing a lot to support Thames Water as it seeks to address a number of the principles that have been raised in discussions over the past few months, and with the benefit of further time, we would welcome an opportunity for further continued dialogue around the intent behind these proposals and the benefit they would have for the customers. The water sector in the UK is being asked to invest more to meet the demands of population growth, improve the standards of service delivery and increase the level of operational resilience whilst also keeping bills affordable. Thames Water is working hard to complete a high quality plan for PR19 that will deliver these outcomes, supported by its investors. We believe that regulating the future capital structure not only is a significant change in the core foundation of UK regulation, and will have an impact on confidence in the market as a whole, but it will also result in a sub-optimal outcome for the water sector customers.

Regards,

Hakim Drissi
Managing Director

cc: Jonson Cox