

June 17th, 2018

## OFWAT Consultation:

### “Notice of OFWAT’s Proposal to Impose a Penalty on Thames Water Utilities Limited”

I wish to comment on the above Consultation.

1. OFWAT’s Report as above (the “Report”) is, indeed, a sorry tale of mismanagement and lost opportunity at Thames Water Utilities (“TW”). However, it raises a number of important issues, not least as they impact on OFWAT’s recent Consultation on “Change of Control – General Policy and its Application to Thames Water”, which closed Jun 15<sup>th</sup>, 2018
2. **Management Structure:** OFWAT clearly identifies management failures to report the extent of water leakage during the period 2016/17, if not before, as well [ref. para 3.12 & 3.22]. However, a review of the TW Board shows that for the last 10 years or more it has been dominated by financial interests: there has only been two executive, i.e. operational, directors, whereas there have been 8 or 9 representing institutional shareholders. It is not surprising, therefore, that operational issues, such as leakage, have not been given the attention they should have at Board level.
3. Notwithstanding the limitations of the Appointee’s Licence, there is an argument to be made that Appointee Boards should be required to be more balanced and reflect the operational importance of the enterprise.
4. **Accountability:** the OFWAT Report identifies that most of the leakage failures arose post-April 2015 through 2016 until April 2017. The Report also identifies that during this period TW’s “main shareholder, Macquarie Infrastructure and Real Assets (“MIRA”) was in the process of selling its stake in the company”, [ref. para 2.26].
  - To my knowledge, MIRA was not, and never has been, a shareholder in TW, or its associated companies.
  - MIRA is an (infrastructure and public utility) asset manager and part of the Macquarie Group. It is understood that MIRA is a UK domiciled company and regulated by the FCA.
  - On the other hand, in the context of Condition P of TW’s Licence up to April 2017, Luxembourg-domiciled, Macquarie European Infrastructure Fund (“MEIF”) II Luxembourg Holdings, provided Ultimate Controller undertakings for TW to OFWAT.
  - The relationship between MIRA and MEIF II, plus any of the other investors comprising the Macquarie consortium which took-over TWUL in

Dec 2006, have never been publicly disclosed, albeit there may be an implicit assumption that MIRA has managed MEIF II.

- Hence, from May 2017, it must be assumed, - albeit it has not been publicly confirmed, - that neither MIRA, nor MEIF II, have any ongoing relationship with TW.
- Nevertheless, the leakage failures, as identified in the Report and for which penalties are to be imposed, arose on MIRA/MEIF II's watch as Ultimate Controller.
- It has also been noted that over the last 12 months, TW has appointed new senior management, a new Ultimate Controller, and taken initiatives to ensure past events do not re-occur. [Full marks for that, so far!].

5. The above scenario will be, to many observers with financial backgrounds, not unexpected. Many Private Equity-type funds have a 10-year life, after which time the Fund is dissolved and investors reap any capital gain and the managers their carried interest, plus fees. However, the example of TW leakage has shown that during the run-up to, and including, the transfer of a controlling shareholding can lead to managerial weaknesses, e.g. costcutting, which should be outlawed, as they negatively impact on surviving shareholders, as well as customers.

[To many it is morally wrong for investors and customers for a privately-owned, public service monopoly to suffer financial distress at the expense of shareholders, who have moved on before their mis-management deeds have been exposed and they have been held to account.]

6. As a remedy to this issue, it is noted that each year under their Licence, Appointees have to submit a "certificate of adequacy" annually to OFWAT (ref, Condition F, Para 6A.2A), which covers financial, managerial and planning resources for the next 12 months. The liability for such a commitment should be extended for a further 12-24 months after submission, to cover events such as have arisen with TW in the event of controlling shareholders selling their stake in the utility in the meantime.
7. In this context, given the financial impact of the proposed penalties on TW, its current shareholders and TW customers, is OFWAT, or alternatively, TW, seeking redress from the shareholders who sold out in 2016/17, or even earlier, to recover some of the additional costs to be incurred to catch up on TW leakage?
8. It has been noted that TW paid its shareholders dividends of £82.4mn for year-ending March 2016 and £157mn for 2017, which is comparable to the proposed fine to be imposed by OFWAT, so current shareholders will suffer

significant loss at the expense of their earlier co-shareholders. Overall, this event has been a fine example of the weakness in the current Condition P provisions for non-UK ownership and control of E&W private water utilities.

9. The rationale for the structure of the proposed penalties to be imposed on Thames Water seems somewhat convoluted and elusive to pin down [ref. para 5.44]. Can TW customers have a clearer explanation of the values and the timetable as how each component might affect them, please?
  
10. **Alliancing:** the Report shows how TW failed to get to grips with the mechanisms underpinning the “alliancing” contractual concept, which was part to blame for the failures to address leakage failures promptly. Indeed, as a concept, “alliancing” provides a platform conducive to non-confrontational management, - viz. a type of partnership, where there can be no losers, only winners, - but its effectiveness in executing civil works to time and cost remains somewhat elusive, lacking clear accountability.
  
11. Worryingly, TW has applied the same technique in its approach to, and structuring of, The Thames Tideway Tunnel.