

2 February 2022

CPP Investments' response to Ofwat PR-24 discussion papers: Financial Resilience and Risk & Return

Dear Sir/Madam

I write to you on behalf of Canada Pension Plan Investment Board (“**CPP Investments**”), in response to Ofwat’s recently published consultations on Risk & Return and Financial Resilience in the Water Sector (the “**Consultations**”), both of which represent important milestones in informing Ofwat’s strategy for the PR-24 price review process (“**PR-24**”).

By way of background, CPP Investments is both the largest direct investor in infrastructure globally and (at 32.9%) the largest shareholder in Anglian Water (“**Anglian**”, the “**Company**”), the 4th largest Water company in the UK. CPP Investments has been an investor in Anglian for more than 15 years, having participated in the take private of the Company with other like-minded investors in 2006. As with other large-scale high-quality infrastructure businesses, we were attracted by the opportunity to invest in a company that (at the time) benefitted from a stable regulatory framework, long-term investment requirements and the potential to generate predictable long-term cash flows. During our 15 years of ownership, we have actively supported the Company’s management team’s strategic vision for the business (as supported by customers), including making significant additional investment beyond our regulatory commitments and reinvesting returns from operational outperformance back into the business to drive further environmental improvements and improve outcomes for customers.

We welcome the invitation to contribute to the debate on PR-24 at this early stage in the process. For the avoidance of doubt, this submission is not intended as a detailed response to each of the specific questions being asked in the respective consultations. Rather, it is intended to offer a broader perspective from a leading global investor and to re-affirm the importance of fair and reasonable comparative returns to investors such as ourselves as we undertake investments on behalf of our beneficiaries.

To that end, we support the direction of Ofwat’s recent discussion paper which sought to place greater emphasis on the longer-term. The requirement for companies to set out long-term investment delivery strategies to address the many priorities facing the water sector, including net-zero, water resilience and river water quality provides strong alignment with our own investment horizons.

We understand the competing pressures on Ofwat as water regulator as it sets tariffs for each five-year business plan cycle in order to ensure that:

- bills are affordable (particularly for less well-off members of society who benefit from social tariffs);
- the long-term investment needs of the sector are funded; and

- companies are financeable, allowing investors to achieve fair returns in exchange for strong operating performance.

For PR-24, we also recognize that those competing pressures will be compounded by the investment required to meet the broader net-zero challenge and the need to address stakeholder concerns on the impact of water companies on the environment, in the context of rising prices elsewhere and the continued pressure on household finances. However, in seeking to address these challenges, we firmly believe that it would be inconsistent with Ofwat's stated emphasis on the long-term and the conclusions set out in the CMA's recent redeterminations, were Ofwat to respond by further reducing investor returns from the historic lows where they are at today.

Reflections on PR-19

In 2020, we were strongly aligned with Anglian in its decision to ask Ofwat to refer the final PR-19 price determination to the CMA. While this decision was not one that the Anglian Board took lightly, it was made on the premise that the original Ofwat final determination would not only be detrimental to Anglian, its customers, and the environment, it would also be inconsistent with the company's stated purpose to deliver social and environmental benefits for the region it serves. In addition, we concluded that the PR-19 final determination would imperil long-term investment in UK water and serve to diminish the attractiveness of the UK as a destination for broader infrastructure investment in the eyes of global investors such as ourselves.

You must concur that the CMA's 2021 redetermination resulted in an extremely challenging five-year business plan for Anglian, including unprecedented levels of investment in the network juxtaposed with customer bill reductions. However, despite the level of challenge, we supported many of the conclusions of the CMA's assessment, in particular that:

- Ofwat had a duty to ensure financeability of Companies through the price determination process;
- There was a need for water investment in the region beyond Ofwat's assessment (reflected in the increase in allowed totex);
- Sector returns needed to be sufficiently attractive to ensure future investment and be commensurate with the risks companies' face (reflected in the increase in allowed WACC); and
- Company boards should decide the appropriate capital structures for their businesses (reflected in the removal of the Gearing Outperformance Sharing Mechanism).

It is our firm belief that these conclusions remain valid and indeed more salient than ever as we approach PR-24.

We recognize that the need for appellant companies to make a CMA referral was costly, represented a distraction to management during the COVID-19 pandemic and delayed implementation of Anglian's AMP 7 plan. We had hoped, therefore, that the overall conclusions of the CMA referrals would be accepted by all stakeholders (including Ofwat, the Companies and investors), leading to a balanced starting point for

PR-24 discussions, and enabling us to work together to address the very real challenges facing the sector. It is in this context that we have reviewed the content of the Consultations.

Reflections on the PR-24 Consultations

We are pleased to see several themes being promoted in these and other recent Ofwat Consultations that reflect our own high expectations of companies and their boards, and indeed where Anglian is already taking a lead. These include taking a longer-term view to investment planning beyond the traditional 5-year regulatory business planning cycle while ensuring that intergenerational equity is taken into consideration. We also agree with Ofwat that it is not for the regulator to define limits on capital structures and that where companies are experiencing poor operating performance to the detriment of their customers, then it is normal that these companies be subjected to closer scrutiny by regulators.

Unfortunately, there are other themes being developed in the Consultations which make us uncomfortable about how Ofwat is framing the forthcoming PR-24 process:

- Ofwat has signalled that for PR-24, a further reduction in allowed returns from the historically low levels seen today can be expected, while the overall risk profile to equity investors is set to deteriorate. It is our view that the risk-reward balance in UK water is already unattractive in comparison to other globally comparable regulated businesses, and that further deterioration in this balance will disincentivize investment.
- Ofwat appears to be discounting the CMA's PR-19 redeterminations on returns, financeability and financial resilience, despite the recency of the conclusions, the sector specificity and the recognized rigor of the CMA process for UK Water. At the same time, Ofwat is placing undue reliance on the CMA's conclusions on RIIO2 appeals for energy companies so as to justify a reduction in returns. This is despite the material differences between the respective appeal and redetermination processes that detract from any read across.
- Similarly, we take umbrage with Ofwat's long held premise that securitized structures are more likely to lead to poor operational performance. You will be aware that Anglian (a company with a securitized structure) has a history of excellent operating performance, including stand-out operating performance in Year 1 of AMP 7 that Ofwat itself highlighted. There is no evidence to support the read across from the Southern Water case study, where performance was impaired by multiple factors, to companies such as Anglian.
- There is no evidence to support draft proposals by Ofwat to intervene in board-prescribed matters, such as early-stage dividend blocks, which risk further discouragement of investment, and reduce the flexibility of companies to respond to near-term events.

Conclusion

Taken in the round, the Consultations do not imply a fair and reasonable risk-reward balance for investors such as CPP Investments in PR-24, but rather suggest that Ofwat will be primarily focused on solving for

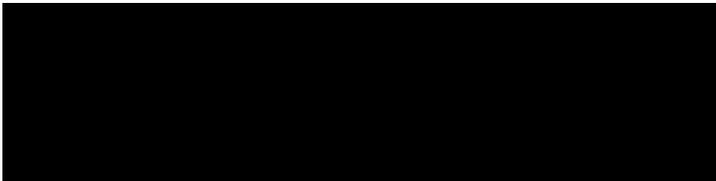
headline bill reductions. As a result, the necessary investment the UK water sector so desperately needs will be at risk, to the detriment of customers and all other stakeholders. With the implied risk-reward balance implied by the Consultations, boards will struggle to assure business plans that underwrite the investment in water infrastructure necessary for carbon and sustainability goals to be met, for asset resilience to be improved and for environmental improvements to be enabled, all while continuing to support those customers who are struggling to pay their bills in a higher inflation environment.

Due to the impressive work of the Company, Anglian Water is an efficient sector-leading business that delivers excellent service to customers and is at the forefront of many innovations in UK water. As long-term investors, we continue to strive to generate a fair return on our investment in Anglian on behalf of our beneficiaries, while working equally hard to deliver on our social license promise and Anglian's commitments to its broader stakeholder community.

The PR-24 process will need to balance the interests of all current and future stakeholders, including allowing for a reasonable risk-reward balance for investors, averting both the risk of Companies scaling back investment in their business plans and future unnecessary CMA referrals.

We ask that, as you continue to refine your thinking ahead of formally launching the next price review, you reconsider the positions set out in the Consultation documents so as to make further investment in UK water infrastructure an attractive proposition for global investors such as CPP Investments.

Yours faithfully,



Managing Director, Head of Infrastructure

CPP Investments