Kip Meek

The Competition and Markets Authority

The Cabot

25 Cabot Square

London E14 4QZ

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Water sector redeterminations – CPP Investments' response to the CMA's WACC Consultation process

Dear Mr Meek,

I write to you on behalf of the Canada Pension Plan Investment Board ("**CPP Investments**"), in response to the CMA's published consultation on the Weighted Average Cost of Capital ("**WACC**") to be used in the Water Sector redeterminations.

This submission is not intended to provide detailed arguments on the technical aspects of the WACC components as we defer to, and fully support, the Anglian Water management team in their articulation of these points. Rather, I am writing to offer you a broader investor perspective and re-iterate our commitment to the original PR19 company business plan, alongside the Anglian Water Board and its customers.

Context - CPP Investments as a global infrastructure investor

CPP Investments is a professional investment management organization that invests the funds transferred to it by the Canada Pension Plan ("**CPP"**) that are not needed by the CPP to pay current benefits on behalf of 20 million contributors and beneficiaries. With net assets of more than £265 billion as at 30 September 2020, CPP Investments is invested globally in public equities, private equities, real estate, infrastructure and credit instruments. CPP Investments is governed and managed independently of the CPP and at arm's length from government. Whilst we are seeking returns for the CPP Fund, CPP Investments' investment philosophy is grounded in the belief that sustainable, maximum returns can only be achieved while balancing the long term needs of all stakeholders; integrating ESG factors into our investment and asset management processes, and aligning with public interests in our infrastructure investment activities, is an integral part of our investment ethos.

CPP Investments has been a significant investor in the UK since 2006 and, as at 30 September 2020, has approximately £10.5 billion invested across a variety of interests, including sizable infrastructure investments in Anglian Water Group, Arqiva and Associated British Ports.

CPP Investments is today the largest direct investor in infrastructure globally, managing almost £23 billion of capital in our infrastructure program with investments spanning the world, across key infrastructure sub-sectors. Our investment program provides us with a unique level of insight into each regional infrastructure market and sector, enabling us to compare and contrast investment opportunities and re-assess the risk/reward profile as markets evolve.

In 2006, CPP Investments joined a consortium of like-minded investors to take Anglian Water private, and we remain the largest shareholder in the company with a 32.9% stake. 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 ability to generate predictable long-term cash flows. During our 14 years of ownership, we have actively supported the 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.

Importance of regulatory framework stability in assessing the relative attractiveness of infrastructure opportunities

The scale and long-term nature of infrastructure businesses should deliver relatively low risk equity exposures which investors are willing to price competitively. However, this requires both political stability and regulatory clarity, giving investors the ability to generate long term returns commensurate with that risk profile. To the extent that we perceive that the political and regulatory risks of a particular market are no longer commensurate with the returns on offer, we will seek investment opportunities elsewhere.

Until recently, the defensive fundamentals and index-linked revenues of the UK water sector, matched with an independent and stable regulatory regime and the UK's status as an attractive and welcoming market for foreign capital, combined to make the UK water sector an attractive market for private investors such as ourselves.

However, over recent years (and particularly in the period following the launch of the PR19 price review) there has been a marked deterioration in the attractiveness of UK water as an investment proposition. This is a view shared by many of our peers in the infrastructure investment community and evidenced by a general lack of interest from new private investors to enter the sector. Indeed, despite the perceptions about a "wall of capital" (committed funds pursuing infrastructure investment opportunities), the UK water sector has not recently attracted investment interest. Investors have instead pursued water investment opportunities in other jurisdictions such as France, Spain, the United States and Latin America.

The well documented uncertainties caused by the Brexit vote (as well as concerns around potential re-nationalisation ahead of the 2019 General Election) has also contributed to the deterioration of investment confidence, but these did not prevent infrastructure investors making significant other UK investments in sectors such as electricity grids, telecoms and renewable energy. Rather, it is our view that the key driver has instead been an increase in regulatory risk and uncertainty in the water sector.

We believe that the role of the regulator when setting prices is to strike a fair balance between supporting necessary investment, allowing a reasonable return for investors, and addressing other critical issues such as climate change and security of supply, while keeping bills affordable for customers.

As a responsible long-term investor, we understand that the best outcomes are achieved when the interests of both investors and customers are aligned. In this vein, we have been openly supportive of many of Ofwat's initiatives to evolve the regulatory regime towards an incentive-based framework built on the foundations of transparency, stability and independence. Indeed, Anglian Water's industry leading track record of performance under this framework is well documented and we and our fellow Anglian Water investors are rightly proud of such performance.

Establishing a regulatory environment in which patient institutional investors can confidently invest their capital over the long term is strongly aligned with the public interest. The objective of good regulation should be achieving a balance between a sustainable robust infrastructure that is run efficiently and affordably for its customers. However, we firmly believe that a fair balance was not struck in Ofwat's proposed 2020-25 price control for Anglian Water. The final determination placed too great an emphasis on short term headline bill reductions to the detriment of securing and incentivising longer term sustainable investment in the network that customers had clearly signaled they wished to see. That sustainable investment aligns with the broader purpose of Anglian Water, as set out in its revised Articles of Association, to meet the needs of communities and the environment over the long term and indeed would secure affordability over the long run for future generations.

We wholeheartedly support the company in its decision to ask Ofwat to refer Anglian Water's price determination to the CMA. While we saw this as a decision of last resort and certainly one that we did not take lightly, the results of the original Ofwat determination would be underinvestment and the redirection of capital flows to jurisdictions with a more balanced approach to regulation.

It is fair to say that the response of infrastructure investors to the unbalanced and negative skew of risk and return reflected in the PR19 final determinations will be to continue to seek (and support) superior water investment opportunities in Europe, North America, and South America; moreover, the overall attractiveness of the UK as a destination for broader infrastructure investment in the eyes of investors such as ourselves has been diminished as a result of the PR19 process.

CMA process and provisional findings

The CMA's provisional findings published in September 2020 would result in an extremely challenging five-year business plan for Anglian Water, including unprecedented levels of both investment in the network and customer bill reductions. Despite this level of challenge, we support many of the conclusions, including the acknowledgment of the financeability duty and the need to attract future investment in the sector, reflected in the provisional WACC.

Furthermore, with the publication of the provisional findings, it was clear to us that a robust process was being run, with the CMA taking an independent view from both the appellant companies and the economic regulator supported by its own analysis. We recognise the CMA appeal mechanism as a key part of the 'checks and balances' inherent in the regulatory process which enable long term investment in the sector. In that context, the tone of the response from Ofwat to the publication of the CMA's provisional findings was concerning.

Comments on the CMA's updated WACC point estimate

As highlighted above, it is not the purpose of this letter to undertake a detailed analysis of each of the WACC parameters.

We do, however, believe that the proposed reduction in the WACC from the provisional findings serves to make the UK water sector a significantly less attractive sector for investment, with the risks assigned to investors (such as ODIs, unfunded debt and unfunded totex) not being commensurate with the afforded equity returns. The lower WACC raises the risk of an exit of capital from the sector and puts at risk future investment. Investors such as ourselves will be far less likely to support ambitious business plans in future price reviews, with negative consequences for all stakeholders. As a long term investor in Anglian Water, this is particularly concerning given the need for a further step change in investment as the company seeks to meet its carbon goals, improve asset resilience, support growth and enable environmental improvements.

We also firmly believe that removing the cost of efficiently incurred historic long-term debt from the overall WACC calculation sets an unwelcome precedent for responsible long term investors in the sector, effectively incentivising companies to take out shorter tenor debt (with associated refinancing risk) rather than match liabilities to assets' long useful economic lives.

Conclusion

We are extremely proud of our investment in Anglian Water and the work undertaken by the company to build an efficient sector-leading business that delivers excellent service to customers.

We are appreciative of the diligence and professionalism shown by the CMA in reappraising the AMP 7 business plans during this challenging year. We trust that as you finalise your findings you reconsider the position as set out in the WACC consultation documents so as to deliver a fair regulatory outcome, balancing the interests of all current and future stakeholders, allowing investors a reasonable return on their investment, and averting the risk of dissuading requisite future investments in the water sector.

Yours sincerely,

[redacted]

R. Scott Lawrence

Managing Director, Head of Infrastructure

CPP Investments