27 January 2021

Dear Sir/Madam

USS Response to Competition and Markets Authority ('CMA') consultation – Water Redeterminations 2020

USS Investment Management Ltd ("USSIM") welcomes the opportunity to respond to the CMA's most recent publication and provides below our views on the proposals raised in the consultation.

USS is one of the largest private sector pension schemes in the UK with more than GBP 68 billion of assets under management as of 31 March 2020. USS was established in 1974 to administer the Universities Superannuation Scheme, the principal pension scheme for academic and senior staff in UK universities and other higher education and research institutions. USS has appointed its wholly owned subsidiary, USSIM, as the scheme's principal investment manager and advisor. USSIM has over 150 employees based in London. As a UK pension scheme, Sterling denominated investments are a core part of USS's asset base.

USSIM established its Private Markets Group in 2007 and now has over GBP 16bn invested in Infrastructure, Private Equity, Private Credit, Property and other private investments. USS is a responsible and engaged steward of the companies and assets in which we invest. A primary focus of USS is to deploy capital in UK infrastructure assets given they can be a source of long-term inflation-linked cash flows which match the liability profile of our members' pensions.

Owing to the characteristics of the UK water sector and its synergies with USS's investment objectives, USSIM has maintained a longstanding interest in the UK water sector. USS is a 10.9% shareholder in Thames Water and has made over GBP 600m in long dated loans to other UK water companies.

Choosing a point estimate for the Cost of Capital

The current consultation suggests a downwards revision to the allowed cost of equity that was published in your Provisional Findings in September 2020 last year. Among other reasons, the consultation states that *"….the risk of an exit of capital in AMP7 is relatively low, given current market conditions, and that this reduces the size of the risks from setting the cost of capital too low. We consider that the risk of setting the cost of equity too low is not as high as we had implied in our Provisional Findings, since there is a greater probability that the right estimate is towards the middle of the range." (Exec summary para 27)*

In our opinion, the CMA's Provisional Findings regarding the cost of equity were a very welcome development given the support it gave to the general principle of "aiming up". This seemed to us to reduce the risk that returns would be too low. We were encouraged by the approach adopted by the CMA which we felt provided a stable framework which could be used by all stakeholders going forward when thinking about the investment needs of the sector. However, the proposed downwards revision

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of cost of equity to around 0.25% above the middle of the range has cast some doubt on this view. While we appreciate the analytical care that the CMA has taken, this revised approach inevitably places more emphasis on the accuracy of the point estimate and the underlying analysis from which it is derived. This, in turn, introduces a greater risk that returns will be set at too low a level and therefore acts as a strong disincentive to invest.

As a significant investor in the United Kingdom generally and in regulated businesses specifically, as evidenced by our investments in Heathrow Airport, NATS, Moto motorway services, Westerleigh crematoria and a number of offshore wind farms, we believe that our long-term investment horizon coupled with our responsible investment focus makes USS an ideal steward for businesses which operate in the UK water sector. Investment in this sector represents an important part of our investment strategy given the benefits that it can deliver to our members making it one which could potentially account for an even larger allocation of our capital. For that to be the case, however, there are a number of things that we require, including:

- The ability to receive a fair return for the risks to which we are exposed; and
- Regulatory stability and predictability

We would highlight that USS has a duty to its members to ensure that its investments are likely to generate returns commensurate with the risks it is taking on. We therefore have to keep our asset portfolio - both current and future - under continuous review. The level of estimated WACC is the key driver of returns for the sector and as such, the attractiveness of the sector for providers of long-term capital such as USS.

In this context, USS has a global mandate which allows it to invest in markets outside of the UK. In recent years, we have made significant direct investments in Continental Europe, the US and Australia. This is relevant given that when assessing the suitability of any future investment in the UK, we will consider the prospects of that investment relative to similar investment opportunities in other jurisdictions.

Further, the capital we could allocate to the UK water sector will also be assessed against a range of other UK investment opportunities in other asset classes. If the return level for the UK water sector is set below a fair level, it raises the prospect that capital which would otherwise be available for investment in the sector will be allocated elsewhere. We believe that this outcome would be undesirable given the need for significant future investment to deliver the network resilience and net zero carbon outcomes that customers rightly expect.

We would note that USS has not made an equity investment in the water sector since 2017 due to the perceived misalignment of risk and regulatory return. However, USS is fully prepared to play a meaningful part in delivering the future outcomes the sector needs but only if the returns available are fair and, importantly, can be expected to remain in line with the risks to which we are exposed.

Yours faithfully

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