Minutes of the 4th joint seminar of UKRN &
Long-Term Infrastructure Investors Association *(LTIIA)*
London, 10 September 2019

1. The seminar convened around 50 persons hailing from different backgrounds (Public sector, civil society-NGOs, and Private sector/investors & utility managers, as well as lawyers and rating agencies representatives - see list attached) around the following discussion theme:

How can investors (domestic and foreign) navigate challenges linked with current and evolving regulatory environment in the UK infrastructure market (and more specifically the Regulatory-asset based model covering the big utilities' sectors of Water, energy & telecoms) aimed at supporting investment & innovation while at the same time keeping costs down for consumers?

2. Backdrop: Against a backdrop of Brexit, the prospect of renationalization of network infrastructures and global trade disputes, this seminar was part of a "call for evidence" organized by and with the UK authorities to sound out and obtain feedback from the private sector/investors community regarding possible new Infra market rules & regulations. As such, LTIIA secretariat and interested members participated in another similar-themed event on June 12th, at a roundtable on Regulation at the National Infrastructure Commission (NIC)

3. The Commission's National Infrastructure Assessment, published in July 2018, identified the major strategic challenges in these sectors: energy, transport, telecoms & water infrastructure. The UK government is now developing a National Infrastructure Strategy in response to the Assessment.
Simultaneously, in October 2018, the UK government asked the National Infrastructure Commission to conduct a new study into regulation of the UK's energy, telecoms and water industries, to ensure the necessary levels of investment and innovation whilst these critical services are kept affordable for everyone. This final report of the study – *Strategic investment and public confidence* – was published on 11 October 2019 and is accessible here.
(See also LTIIA email and consultation of its members on this report dated 31 October 2019)

It is to be noted that the UK is one of the few jurisdictions where this type of strategic exercise is periodically conducted, allowing private sector players to voice their issues or concerns in the process.

4. **Summary of discussions:**

Panel 1 - Balancing Trade Offs: How do the perspectives of investors, regulators, consumers and other stakeholders differ and how can they be balanced?

Discussion in this panel focused on:

- **How has the current model of independent economic regulation delivered so far for investors (in terms of return, competition, efficiency, innovation…)?**
  Overall, shared feeling it has worked pretty well for investors & lenders: double-digit IRR for equity investors, no default ever observed for A-rated UK infrastructure bonds, stable cash flows patterns. At the same time, has delivered much needed infra for the country.

- **What is the perception from investors in terms of transparency, consistency, predictability?**
  Historically good, but degrading lately, with talks of return caps reviews by Ofwat & Ofgem (new methodology would result in an allowed return of 4.3%, as per new regulatory price regime RIIO 2 set to come into effect in 2021) + Labour platform calling for renationalization of network utilities + Brexit looming but still, most investors realize that there is no equivalent in Europe to the UK market in terms of openness and depth of market.

- **Renationalisation risk/Labour program:**
  According to latest surveys, up to 80% of Brits favour it; but such a move is widely deemed as unrealistic as it would entail huge costs: according to Centre for Policy studies, a think tank, it would cost approximately 50bn£ for Energy, double that amount for Water, 30bn£ for PFI social infra projects, depending on equity valuation method retained (RAV, Enterprise value,…). Debt value is set contractually so, theoretically, protected but real risk is for lenders to get repaid by anticipation (so as to take advantage of lower rates on public side).

- **Brexit:** *whether UK part of the EU or not, it shouldn't affect final demand for water, energy. Main impact would be currency risk (1£ already went down from 1.36€ in Jan 2016 to 1.1 today (-18%) for international investors who cover a large part of infra investment in UK. On debt, less debt provided by EIB (historically up to 50% of Infra debt in UK) would mean increasing the debt market & returns for commercial providers.*

- **What is the perception from the regulators side in terms of return/risk balance, funding gearing/refinancing and tax optimization issues?**
  Perception that while Regulation should be about protecting both consumers and Investors, there have been loopholes allowing investors to get big profits while delivering a subpar service. Also, "borderline" techniques of tax optimization in the UK, by deducting interest payments to offshore based lending facilities. Hence, gearing tax option envisioned: Project or Utility Companies with over 70% debt gearing would have to share corresponding extra financial upside with customers. But that would be contrary to long-

established policy that it's for companies to determine their financial structure & live with the consequences.

Also idea (pushed by "Citizens advice" the CSO behind the "Monopoly money" report in 2019) but endorsed by some regulators - that regulators have been too generous when setting the funding costs: historically, these funding costs have been less than budgeted allowing for higher IRR ex-post (regulators may have overshot in erring on the high side of capital costs, plus there has been a systemic bias linked to the use of past indicators of risk-free rates & equity returns), to the point many consider relationship hasn't been balanced enough and has favoured private investors. Rather than trying to forecast costs by reference to past levels of interest rates, regulators should just index them on a sliding, readjustable scale.

- **Does the current model of independent regulation offer fair value? How can it meet the needs of current and future consumers, including vulnerable consumers? How can these be reconciled with the interests of investors?**
  Delicate balance and moving target; existing different assessments need to be better supported.

- **How do we ensure that balance of risk and return is perceived by both investment professionals and the general public as legitimate and fair? What is the role of regulators and investors in this?**
  This is a key dimension, as it conditions the legitimacy of Private sector Participation in Infra in UK & elsewhere: Not just about convincing political decision-makers, but the broader community (CSO, NGOs, public opinion & media). Both need to do a better job in that respect, by building and conveying a narrative supported by concrete evidence of results and benefits, and highlighting that the money invested through institutional investors is representative of contributions from citizens/savers (future pension benefits,…).

- **How can we foster a more open & continuous dialogue that brings together different perspectives?**
  Investors need to engage more proactively with regulators early on and in a continuous way, not just during new WACC reviews… This is still far from being the case for most investors.

Panel 2 - Investing for the Future: What future challenges do investors, regulators, consumers and regulated firms face and how should regulators, rims and investors alike respond?

Discussion in this panel focused on:

- **Current debate very relevant & timely as needs for further private investment will remain high/ strategic for the UK in coming years*. Cf IPA assessment:*** *£600b pipe of* *infra development in next 10 years, 20% for utilities and mostly provided by Private Sector Participation (also National Infra Assessment at 2050 horizon).*

- **Are infrastructure investors and regulators set-up in a way that is conducive to promoting efficient & sustainable investment?**
  It's a global infra market: Investors and capital have a choice as to which market they want to allocate their funds. And many institutional investors are looking to Infra as a natural complement or alternative to low (or negative) bond return. But Regulators need to engage more and actively market their framework: real change from situation prevailing over past 25 years where few eligible infra markets, hence capital was flowing spontaneously to the likes of UK, Australia & Canad
  Now "Catch 22" "situation for public sector: Regulators have to balance demands linked to technological change, customer expectations, investment needs, fair value for taxpayers and wider policy and social goals.

- **Do Investors need to think and act differently to respond to future challenges? If so, what needs to change?**
  They should hold their project or utility managers more accountable for long-term socio-economic performance beyond financial performance and returns: key to sustainable approach. Current approach not transparent enough.
  Also, need for Investors & Regulators to reconcile demands for affordability by *consumers with LT needs for energy transition. Corresponding framework still missing in some sectors (civil aviation for instance).*
  Attitudes of investors are still very patchy around the globe on this issue: in Nordic/low countries: ESG completely embedded.
  Most US investors somehow lagging behind but evolving rapidly.

- **What regulatory incentives are needed to ensure investment responds to major challenges such as ESG, climate change, automation, ageing infrastructure etc?**
  Sustainability approach still failing to get sufficient buy-in at UK and European levels: European utilities have been degraded by 3 notches on average over last years, for failing to meet ESG criteria: Now most are barely Investment grade!
  Investors to follow in OpCos steps.

- **How do we manage this in the context of increased political uncertainty? What are the concerns or opportunities from an investor perspective (Political risk, regulatory overreach, currency depreciation etc.)?**
  Even for LT investors (like LTIIA members), short term uncertainty is having a negative effect.
  Regulation also has to be explainable to the wider public, not just to political decision-makers: not yet fully the case!
  Regulatory asset-based model (RAB)= Pure regulatory Construction, not embedded in legislation or licence. There should be a clearer delineation between Regulators and Government Policy (executive branch), regulators being fully independent from

politicians, and accountable to the Parliament. Regulators cannot be in any case a substitute for a government policy framework.
As Regulators are not satisfied with what they see as drifts/loopholes in way current approach implemented, there's current talk about DEFRA & Ofwat wanting to rewrite the rules: imposition of a gearing tax, unilateral changes to company licences (only subject to right of appeal to CMA): potential deterrent + risk in investment rating that may ultimately translate in higher cost of financing!

- **No more appetite for PPP/PFI model => need for new tool & ideas to get new project off the ground.** *But needs are different from the past: new infra projects may not have proven funding model, nor generate stable, predictable LT cash flows from the outset (ex: data infra or RNE, unlike low-risk water projects…). RAB model should play a more prominent role by comparison to PPPs/PFI. In particular, for consumer-funded projects (concessions), with broader risk allocation between stakeholders.*

- **Need for new, independent body supporting government policy on Infra, providing early stage capital &Pump Priming to take early stage projects to investment stage? Should there be one super-regulator body replacing existing sectoral regulators?**
  No. Broad consensus among participants that sector-specific issues remain relevant at regulator's level.

- **Need for public financial support/gain sharing?**
  Distinguish between:
  - *Debt investors: need for credit enhancement in some cases,*
  - *Equity investors: gov't needs to be able to capture equity gains (not well done under old PFI model)*

<u>Conclusion:</u>

In face of all uncertainties and challenges, investors have to engage early on and continuously with Regulators, as in this seminar. We at LTIIA, as representative of the LT investors community, will continue working with regulators, Governments and Investors to build a better narrative about private sector participation, hold managers accountable and demonstrate Investors can be responsible corporate citizens.

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