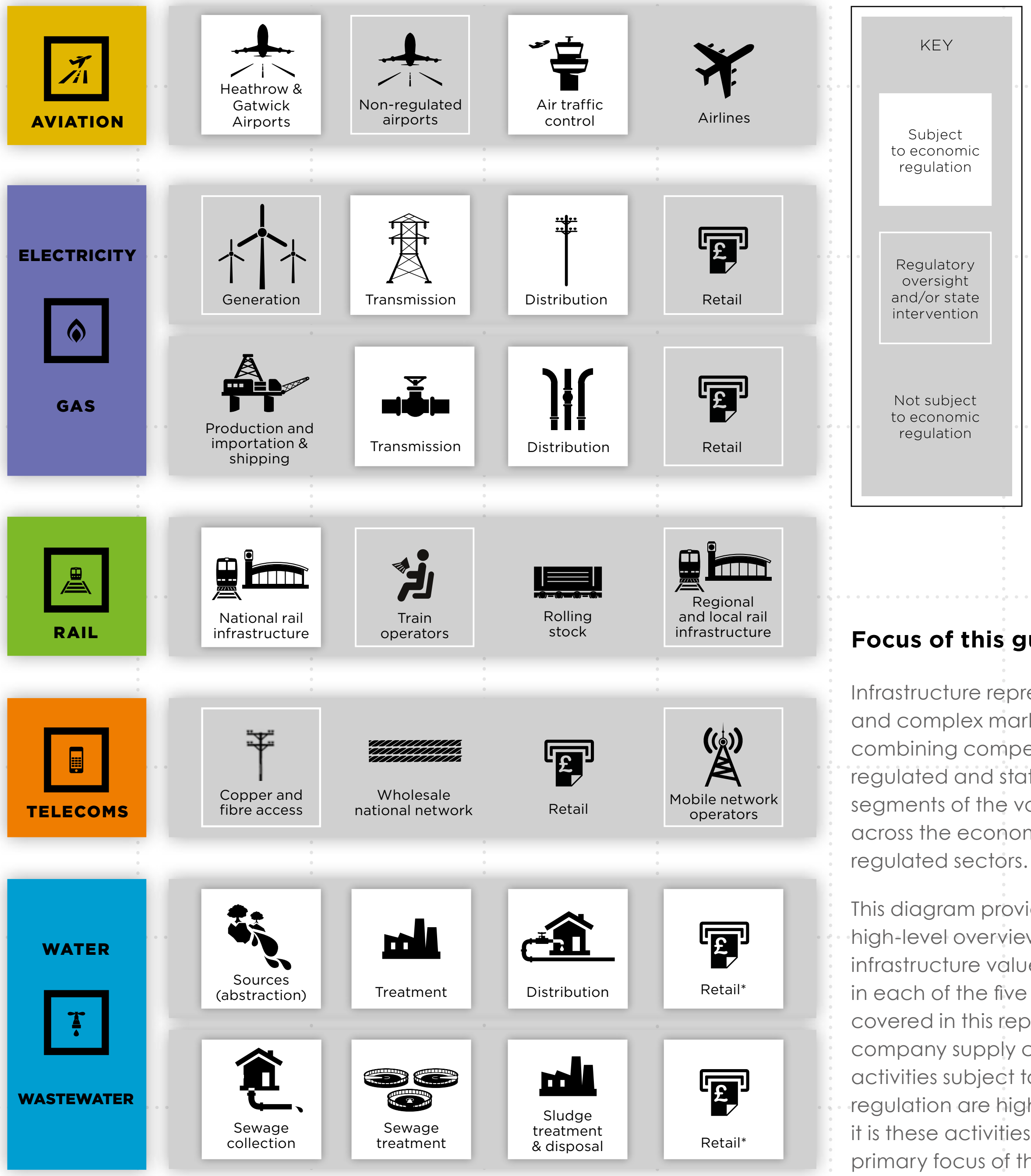
WHICH SECTORS ARE SUBJECT TO ECONOMIC REGULATION?



Source: KPMG analysis

** Retail competition is being introduced for water and wastewater*

Focus of this guide

Infrastructure represents a rich and complex marketplace combining competitive, regulated and state-owned segments of the value chain across the economically regulated sectors.

This diagram provides a high-level overview of the infrastructure value chain in each of the five sectors covered in this report (excluding company supply chains). The activities subject to economic regulation are highlighted, and it is these activities that form the primary focus of this guide.

CONTACT INFORMATION

Will Hayter
Director UK Regulators Network
E william.hayter@ofcom.org.uk

Steve Beel
Project Director, Cross-sector Infrastructure
E stephen.beel@ofgem.gov.uk

Dr Matt Firla-Cuchra
Partner, Power & Utilities and Project Lead
T +44 (0) 20 7694 5308
E matt.cuchra@kpmg.co.uk

Tony Rocker
Partner and Global Head of Infrastructure Investment
T +44 (0) 20 7311 6369
E antony.rocker@kpmg.co.uk

UK Regulators Network

Prepared by:

KPMG
cutting through complexity

UK Regulated Infrastructure

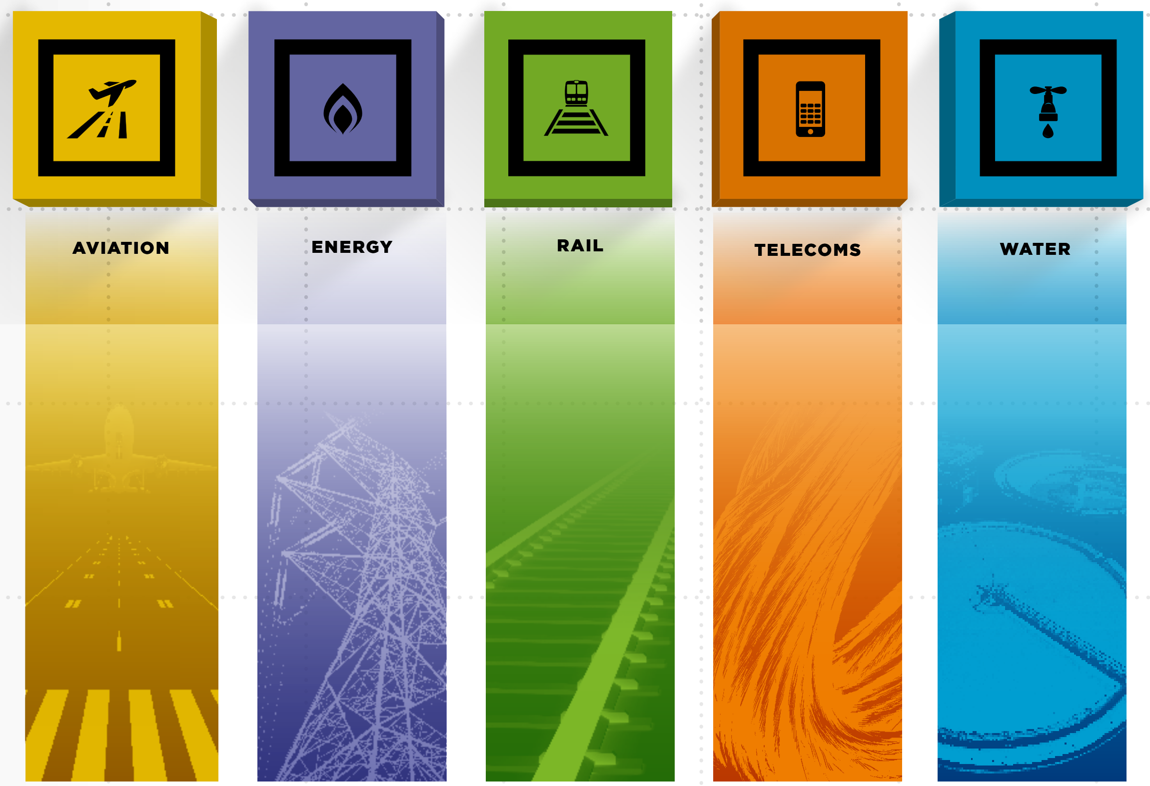
An Investor Guide

OVERVIEW

December 2014

GUIDE PURPOSE

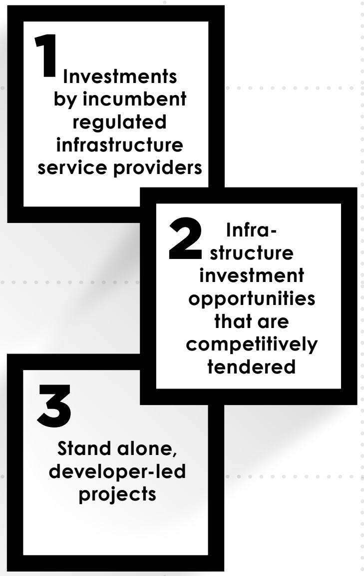
This concise Investor Guide to UK Regulated Infrastructure aims to help potential and existing investors understand, at a high level, the nature of the assets and activities involved, how the market and regulatory regimes are set up and how they function in practice, based on underlying economic principles, market observations and their track record to date.



OVER £100BN INVESTMENT IS EXPECTED

There has been a very significant inflow of private capital into the UK regulated infrastructure sectors since privatisation of almost half a trillion pounds. There is, however, a need for significant further investment. The National Infrastructure Plan estimates that more than £100bn of investment is required in the next five years alone across five infrastructure sectors subject to economic regulation.

INVESTMENT WILL COME TO MARKET IN THREE FORMS



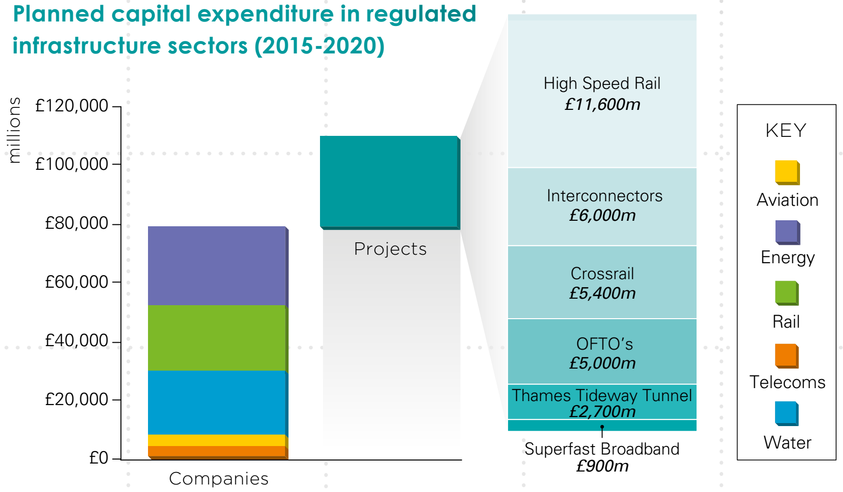
Significant opportunities for investment

There is a significant pipeline for future investment in UK infrastructure creating major opportunities for private debt and equity capital and private sector delivery. Across regulated infrastructure sectors, there is a recognised investment requirement not only to maintain and replace existing infrastructure, but also to upgrade and build new facilities.

Projects are also put out to tender periodically either by the relevant regulator or through another mechanism. The standalone projects tend to be either significant one-off developments, such as Thames Tideway Tunnel, or in market segments where there is a regular pipeline of new projects, such as in the offshore transmission or capacity auctions.

30% of the projected investment is in 'projects', some of which may be competitively tendered

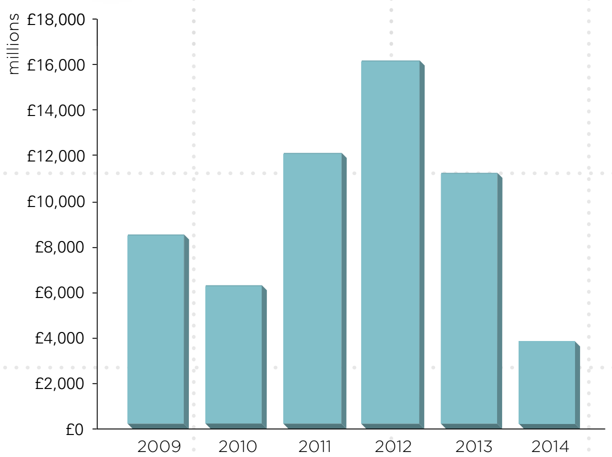
Planned capital expenditure in regulated infrastructure sectors (2015-2020)



Source: National Infrastructure Pipeline, Ofgem, KPMG analysis. Note: 2012/13 prices

There are multiple investment routes to enter into the UK regulated infrastructure sectors

Fixed income securities issued by economically-regulated infrastructure companies



Source: Capital IQ, KPMG analysis. Note: excludes Artesian debt

On the equity side there are a number of investment channels. In the secondary markets, shares in publically listed companies are freely traded. Additionally, a large number of companies operating in these sectors are privately owned. Stakes in these businesses can be negotiated as can full acquisitions. In both listed and private companies the level of control purchased can be flexible from small minority to full control.

There has been a growing share of debt participation in the overall financing mix of regulated infrastructure as the actual financial structures have caught up with the higher debt capacities available given the nature of regulated assets. Public debt capital markets are heavily used to regularly access investment grade bond financing in a relatively liquid market.

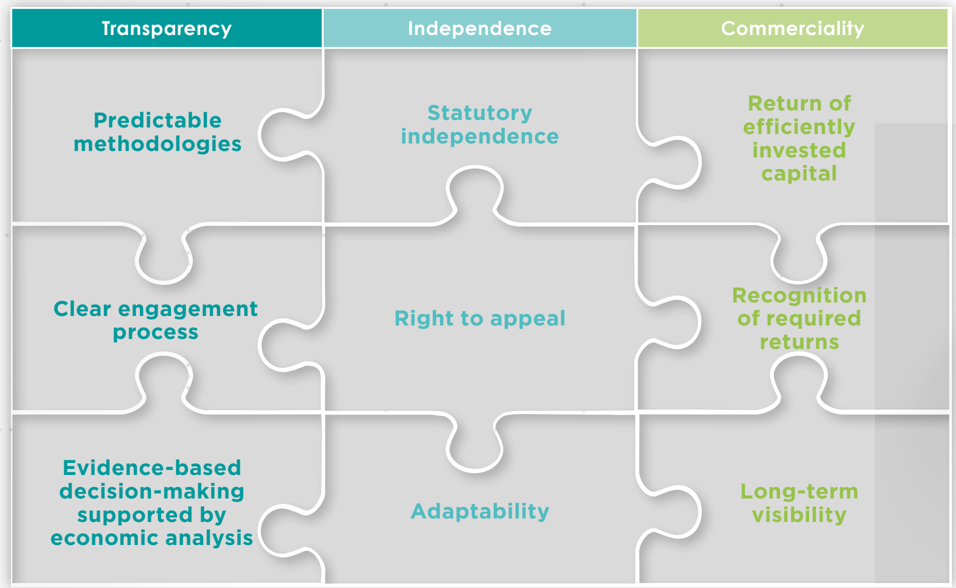
UK REGULATION DRIVEN BY CORE PRINCIPLES

Developments in technology, society and business requirements have driven a continuous evolution in regulated infrastructure, but the core principles of successful regulation in the sectors have remained the same.

Central to these principles and the successes of UK regulated infrastructure to date is fulfilling the objective of protecting customers through the application of regulation based on underlying values of transparency, independence and commerciality, which are designed to ensure efficient and targeted regulation.

There is recognition that companies and investors should be able to recover their efficient costs and earn a reasonable return on the capital employed, commensurate with the risks faced when operating an efficient, well run company.

Selected principles of regulatory practice



Returns

There is a recognition that companies and investors need to earn a reasonable return on their capital for operating a well run company

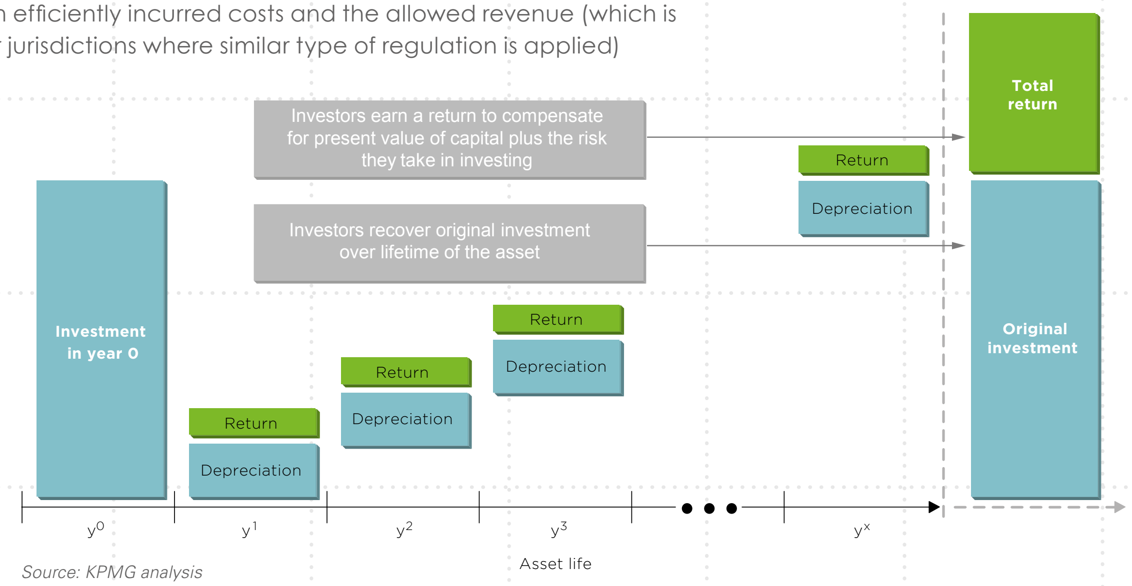
Principles of returns of and on invested capital

Most regulators have a duty to ensure efficient companies can finance their licensed activities.

This duty tends to be discharged through the allowance for a return of and a return on efficiently invested capital alongside the recovery of efficiently incurred costs from end users (as opposed to taxpayers). This approach implies there should be no 'revenue gap' between efficiently incurred costs and the allowed revenue (which is not the case in all other jurisdictions where similar type of regulation is applied)

Number of regulated infrastructure M&A transactions since 2010

34



Source: KPMG analysis