Global Infrastructure Investor Association

Response to Ofwat PR24 and beyond: creating tomorrow together

Thursday 22nd July 2021

Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading investors in infrastructure, and advisors to the sector, who collectively represent nearly US$1 trillion of infrastructure assets under management across 66 countries. Our members are investing today to provide the smart, sustainable and innovative infrastructure needed for our communities and economies to thrive. The investor member base of GIIA is diverse and ranges from fund managers, pension funds, insurers, corporate investors and sovereign wealth funds (a list of GIIA members can be found at http://giia.net/membership).

In relation to the Ofwat consultation paper 'PR24 and beyond: creating tomorrow together' published 27th May 2021, we are keen to provide the perspective of institutional investors in infrastructure. This letter therefore acts as a high-level position statement on behalf of the institutional investor community on the issues raised in the paper and associated 'questions for stakeholders'. Appendix one of this submission, from pages 3 to 8, includes evidence complied by Freshfields Bruckhaus Deringer on behalf of GIIA on PR24 financing structure regulation.

By way of background, many of GIIA's members are exposed in various markets across many sectors and are not exclusively exposed to the water sector in the UK.

GIIA investors' key points to make

- GIIA investors welcome Ofwat's increased focus on long-termism, delivering greater environmental and social value and a focus on incentivising companies to maintain asset performance over the long term, as outlined within the paper 'PR24 and Beyond Creating Tomorrow Together'[1]. To meet the ambition to focus on the long-term, GIIA investors would suggest that the price control framework and associated check points formally include the integration of long-term plans into the process and Ofwat should set a clear path with simple targets to 2050 (leakage, pollutions, per capita consumption etc.)

- The PR24 process should also focus on intergenerational fairness in the context of the costs to achieve net zero and the proportion of those costs that will be borne by current versus future customers.

- The focus on nature-based solutions (NBS) is also a welcome approach – infrastructure investors are supportive of NBS on the basis they can provide a more climate friendly solution than 'grey' infrastructure[2], with wider benefits, often with lower whole-of-life cost, which builds legitimacy and also helps to achieve investors' core ESG agendas.

- However, to date, regulators have been uncertain about the benefits of nature-based solutions which has so far limited the ability for the sector to adopt them at scale, meaning that each NBS project needs active promotion by companies and regulatory sign-off on a case-by-case basis, adding to costs and complexity.

- For NBS to be adopted, regulators should deliver mechanisms to safeguard investment in future price reviews made on terms set in a previous price review. For example,

[1] Ofwat, PR24 and Beyond (2021), URL
[2] Grey infrastructure refers to human-engineered infrastructure for water resources such as water and wastewater treatment plants, pipelines, and reservoirs

solutions with higher operational expenditure to deliver wider environmental benefits should not be welcomed in one price review and then penalised in the next by a narrower approach to benchmarking.

- GIIA investors also hope that Ofwat takes the decision of the CMA final determination on PR19 price controls fully in to account when setting out the parameters for PR24. Investors would like to see Ofwat incorporate the CMA's recommendation that the weighted average cost of capital (WACC) should be set at a level that enables the investment needed for the water sector to meet net zero carbon emissions by 2030[3].

- The CMA also provided increased cost allowances to water companies to pay for improvements in priority areas such as security of supply and leakage. Investors hope that Ofwat will reflect that decision in the PR24 methodology and acknowledge the link between higher costs and improved service levels, especially where there is a step-change in regulatory targets to meet decarbonisation objectives.

- The CMA found no evidence of a link between company financeability and customer risk and removed the Gearing Outperformance Sharing Mechanism (GOSM) from the determination, finding that it was ineffective as a tool for benefit sharing or as a tool to improve financial resilience. There has also not been any evidence to support the case that high gearing levels impact on company decision making.

- Investors highlight that there are already many regulatory controls in place to provide protection to consumers from high gearing including: licence conditions, ringfencing and, in worst case scenarios, special administration measures. The risk of financial distress is borne exclusively by shareholders and debtholders and there is no evidence of overspill to consumers. **[See separate note below prepared by Freshfields on behalf of GIIA, regarding Ofwat's approach to financial structures].**

- We would also emphasise the importance of having a very clear thread between the next water sector Strategic Policy Statement and Ofwat's strategic objectives in order to increase the alignment between government, regulator and companies in taking on the challenge of achieving net zero during a period when many of the difficult decisions will need to have been taken or begun to be implemented.

- Investors would also be keen to learn more about Ofwat's intentions and rationale in terms of the stated objective to develop 'a targeted and more effective approach to capturing customers' views'. We certainly feel that alignment between regulator, companies and customers is important in terms of helping companies to fully represent customer views in the price determination. However, we would also emphasize that it is important to ensure that regional variation in customer priorities is not diluted through any such standardization, and that the views of elected representatives (such as directly elected regional Mayors) are also adequately reflected within the process. In any potential changes in this regard, it will be important that operating companies are able to maintain strong relationships with their customer bases to continue to build confidence and trust between them.

- Finally, we note Ofwat's recognition of one of its duties to 'align the interests of companies and investors with those of customers, so that the sector is attractive to investors'. GIIA supports this approach and we would emphasize the importance of ensuring that rates of return for investors are internationally competitive and sufficient to attract the long-term investment required in the sector.

[3] Water UK, 2030 Net Zero Routemap (2020), URL

APPENDIX ONE

Freshfields Bruckhaus Deringer Comments on Ofwat's Proposed Approach to Financing Structure Regulation in PR24

1. Introduction

1.1 The Global Infrastructure Investor Association (***GIIA***) has asked Freshfields to provide you with a legal perspective on Ofwat's proposals to regulate companies' financial structures in PR24.[4] Freshfields has extensive experience in regulated industry price control reviews, including advising one of the disputing water companies before the CMA in the PR19 redeterminations. Given this expertise, Freshfields hopes to provide legal insights in order to assist in HM Treasury's consideration of the issues arising from Ofwat's concurrent development of policy for the next water price control, PR24.

1.2 GIIA's members share common ground with the Government and the Competition and Markets Authority (***CMA***) in their belief that price controls should deliver the highest-priority objectives facing the water sector, including tackling population growth pressures and climate change,[5] recovering from the COVID-19 pandemic,[6] and designing a stable regulatory framework to attract the level of investment required to build a resilient and affordable network for UK customers in the long term.[7]

1.3 So, going forward, it is crucial that, given the size and speed of investment necessary to tackle these issues, regulators consider the long-term impacts of regulatory decisions on consumers and not just the impact on bills in the short-term.[8] Indeed, Ofwat also recognises the importance of these long-term objectives: Ofwat's interim CEO, at a recent conference, said, *"[Ofwat] need to see the next five price reviews as incremental steps to deliver a 30 year plan*".[9]

1.4 However, these high-level sentiments from Ofwat's senior leadership do not appear to have translated into the detail of the recent PR24 consultation, particularly the re-emergence of Ofwat's consideration of unevidenced proposals to control companies' gearing levels which do nothing to further any of these key policy objectives.

1.5 Ofwat's latest proposals for its forthcoming PR24 price review – in particular, proposals to regulate companies' financing structures in the water sector – are unduly focused on historical issues that have been thoroughly reviewed, and dismissed, by the CMA in its PR19 redetermination. Ofwat appears to be unnecessarily channelling energy into areas where the CMA has recently confirmed that compelling evidence supports the view that regulatory intervention into financing structures is not necessary. Such misdirected effort by Ofwat is particularly problematic at a time when other well-evidenced and urgent challenges face the sector. It also fosters investor concern in

[4] GIIA is the membership body for the world's leading institutional investors in infrastructure. GIIA members operate in 66 countries across 6 continents and are responsible for over US$940bn of assets under management globally, with over a third of that value invested in the UK. GIIA members have stakes in 10 of the privately held regional water companies in England and Wales, which supply over 50% of the UK population's water. GIIA members are also active across numerous other regulated industries in the UK.
[5] GIIA, Future of Regulation, November 2020, p.11.
[6] GIIA, Future of Regulation, November 2020, p.12.
[7] GIIA, Future of Regulation, November 2020, p.12.
[8] See, for example, Meg Hillier MP, Letter from Committee of Public Accounts to Department for Environment, Food & Rural Affairs, 29 July 2020, p.2.
[9] David Black speech, Water Security Conference 2021, 29 June 2021, p.3; Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021, p.14.

the investor community regarding the stability of the regulatory framework that forces investors to factor in additional risks when deciding whether to invest in UK infrastructure, at a time when their investment is critically needed.

1.6 The remainder of this note addresses the following:

- Section 2: regulatory treatment of financing structures in the UK;
- Section 3: Ofwat's proposals on financing structure regulation in PR24;
- Section 4: concerns of the investor community regarding these proposals; and
- Section 5: concluding remarks.

2. Regulatory treatment of financing structures in the UK

2.1 One of the fundamental underlying principles of UK water sector regulation since privatisation has been that companies, their shareholders and their management are best placed to make decisions about raising finance and designing efficient capital structures. This principle underpins the approach taken by Ofwat to setting financial parameters of its price controls for the *notional* company i.e. it leaves actual companies with independence to design their financing structures, thereby ensuring that the risks sit with the shareholders rather than being passed on to customers. The Competition Commission (and more recently, the CMA)[10], as well as other UK economic regulators such as Ofgem[11], have consistently endorsed the efficacy of this approach in price control (re-)determinations.

2.2 Indeed, Ofwat has itself acknowledged consistently throughout previous price controls[12] that water companies should independently determine their financing structures. Further, Ofwat has explicitly recognised the benefits to consumers of higher levels of gearing in capital structures, which include that:[13]

(a) interest payments on debt are tax-deductible and the resulting upside is shared with customers under the tax allowances that are set with respect to a company's actual level of gearing; and

[10] The CMA/CC have echoed this position in various precedents. CMA, SONI Limited v Northern Ireland Authority for Utility Regulation Final Determination, November 2017, para. 7.306: "*[The CMA agrees] with the UR that it is well established regulatory precedent that there are many financing structures that can be used, and that it is not for the regulator to impose any particular financing structure, other than to the extent of requiring minimum financial strength*". CMA, Bristol Water plc Final Determination, October 2015, paras. 10.93, 10.27, 10.132: the CMA noted that it was for the shareholders and the management of the company to determine the most efficient financial structure (including its levels of gearing) and that "*the amount of new debt taken in any particular period remains a decision for management, and hence not for the regulator to second-guess*". Also see CMA, Bristol Water plc Final Determination, August 2010, paras. 10.10, 10.21.

[11] Ofgem, Finance Annex to Ofgem's RIIO-2 Final Determinations, February 2021 para 2.43: "*We do not consider it our role to influence treasury strategy…and it is up to networks to determine their own capital structure and treasury strategy*".

[12] Ofwat, PR04 Final Determinations, p.230: "*the actual capital structure that companies choose is a matter for their own management and the markets*"; Ofwat, PR09 Final Determinations, p.141: "*it is for companies, their shareholders and management to determine the most efficient financing structure to meet their circumstances within the price setting package*"; Ofwat, PR14 Final Determinations policy chapter A8 – financeability and affordability, p.10: "*Our focus is on the financeability of the company with a notional capital structure as this ensures that **risks around** financing decisions, such as **the level of gearing** and structure of debt, **remain with shareholders** in the company **rather than being passed on to customers***" (emphasis added). Indeed, even in its Consultation on the approach to the cost of debt for PR19, p.19, Ofwat held when discussing securitised structures that "*we have been clear that the risk and consequences of adopting these structures remains with the companies and their investors.*"

[13] Ofwat, Water 2020: consultation on the approach to the cost of debt for PR19, September 2016, p.19.

(b) management of highly geared companies are subject to increased scrutiny to ensure efficient delivery of services at lower cost, the benefits of which can be passed on to consumers.

2.3 Ofwat has also recently noted that *"a securitised structure can support a higher level of gearing with limited impact on interest costs than a non-securitised company while maintaining a similar investment grade credit rating"*.[14] This is because securitised structures involve protective covenants and a security package which provide restrictions on the companies, and additional creditor rights, thereby enhancing protection against insolvency and disruption to services.[15]

2.4 It is additionally worth noting that none of the measures introduced in PR19 – reduced bills, reduced allowed returns, increased Outcome Delivery Incentives (***ODI***s)[16] targets and associated penalties - which made it Ofwat's toughest price control yet, were constrained by gearing levels.

CMA's recent decision in the water sector

2.5 Ofwat's approach to financing structures U-turned in the run up to its PR19 final determinations when it proposed interventions seeking to penalise more highly geared companies,[17] culminating in the introduction of a gearing outperformance sharing mechanism (***GOSM***). The GOSM involved companies with gearing higher than specified trigger points having to 'share' with customers on a 50:50 basis the deemed benefit apparently accruing to shareholders of gearing over 65%.[18] However, when four water companies requested redetermination of their PR19 price control, the CMA concluded that this mechanism should not form part its final determination on the following basis:

(a) the mechanism was not well-designed to increase the financial resilience of water companies and might even reduce it;

(b) Ofwat had not adequately evidenced the existence of financial resilience risks requiring regulatory intervention.[19] As such, the CMA was rightly concerned that the GOSM would represent a significant break from a well-established regulatory approach without offering sufficient evidence to justify doing so;[20]

(c) even if high gearing did reduce financial resilience, for which there was no evidence, the GOSM only *encouraged* reduction in gearing rather than *requiring* it[21]; and

[14] Ofwat, Monitoring financial resilience, November 2016, p.28.
[15] Securitisation enables a company to raise debt by granting a mortgage (charge) over an identifiable stream of future cashflows generated by the business, rather than through a mortgage on the asset. In order to protect the quality of future cashflows, a securitised borrower agrees or 'covenants' with its lenders, under a common set of terms and conditions, to maintain the assets to a certain standard and not to sell the assets without consent – see Ofwat, Monitoring financial resilience, November 2016, p.28.
[16] ODIs are a measure used by Ofwat to monitor performance of water companies.
[17] Ofwat introduced the concept of a GOSM into the water regime for the first time during the course of the PR19 price control consultation process – see Ofwat, Putting the sector in balance: position statement on PR19 business plans, July 2018, section 6.
[18] CMA, PR19 Final Determination, March 2021, para. 9.1152.
[19] CMA, PR19 Final Determination, March 2021, para. 9.1223.
[20] CMA, PR19 Final Determination, March 2021, para 9.1223.
[21] CMA, PR19 Final Determination, March 2021, para. 15.55.

(d) there are already multiple licence conditions[22] (for instance, the regulatory ring-fence and special administration scheme), together with a water company's large and stable asset base,[23] which provide protection to consumers. In particular, the ring-fence licence conditions place specific obligations on a company to ensure that it has sufficient financial and managerial resources to carry out its regulated activities.[24] On 13 July 2020, Ofwat introduced new licence conditions to water company appointments to further tighten the regulatory ringfence.[25]

2.6 Notably, the CMA also observed in its redetermination decisions that:

(a) even highly geared water companies were able to navigate the global financial crisis of 2008/09, arguably the most difficult financing environment in modern history, without evidence of financial distress or impact on either customers or the taxpayer; and

(b) the COVID-19 pandemic has also not caused the highly geared water companies to experience financial distress.[26]

3. Ofwat's proposals on financing structure regulation in PR24

3.1 In light of the regulatory background outlined above, it is, therefore, surprising and concerning to see the latest commentary in a recent Ofwat May 2021 consultation on its plans for financial resilience in the upcoming price review ("*PR24 and beyond: Creating tomorrow, together*").[27]

3.2 Although Ofwat acknowledges that previous price controls have focused on a notional capital structure to set the base allowed return which "*benefits from simplicity and provides some protection to customers from bearing the risks of company choices around their capital and financing structure*",[28] it nevertheless states in its latest consultation document that this regulatory approach may not do enough to discourage some companies from adopting *"risky"* financing strategies. Ofwat states that: "*[w]e acknowledge that the CMA's March 2021 redeterminations disallowed the gearing outperformance sharing mechanism which we introduced to address distorted incentives around highly-geared structures. We will consider whether further work targeting risky structures is required to address distorted incentives alongside our work on strengthening financial resilience discussed below*".[29]

3.3 Despite the CMA's dismissal of these measures in its PR19 redeterminations, Ofwat continues to be considering amending both the notional approach and whether

[22] CMA, PR19 Final Determination, March 2021, paras. 9.1224 and 15.55. The CMA concluded that the managed financial distress of Wessex and Dŵr Cymru were examples indicating that these tools – specifically ring fence measures – have be successfully deployed without obvious harm to either customers or taxpayers.
[23] CMA, PR19 Final Determination, March 2021, paras. 15.55 and 9.1202.
[24] CMA, PR19 Final Determination, March 2021, footnote 3058.
[25] Ofwat, Conclusions on section 13 of the WIA91 on proposed modification to ringfencing provisions, 14 July 2020.
[26] CMA, PR19 Final Determination, March 2021, para 9.1203. Also footnote 3110 states that: "*nearly a year into the COVID-19 crisis we have not seen any evidence of widespread financial distress in highly leveraged regulated utilities in general, or more specifically in the highly leveraged Disputing Companies involved in this procedure*".
[27] Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021.
[28] Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021, p.116.
[29] Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021, p.116.

additional customer protections are required.[30] Indeed, a more recent report prepared for Ofwat by CEPA suggests that "*[d]iscussion of the [GOSM] by the CMA has highlighted that further thinking would be useful here, in particular whether the mechanism suitably deals with harm faced by society in the long-term from more highly geared structures and financial resilience risk*".[31]

3.4 However, critically, no new evidence has been put forward by Ofwat or CEPA (than that which was available to the CMA) that there is an actual legitimate concern that needs to be addressed, or that investors are benefiting from "risky" structures at the expense of customers. Indeed, it is difficult to discern what more evidence Ofwat might draw on, given the detailed consideration of the issue by the CMA following the extensive submissions by Ofwat on the matter during the redetermination process, including around two thousand pages of documents (in which gearing was addressed), spanning numerous rounds of written submissions, hearing transcripts and post-hearing submissions, responses to the CMA's provisional findings and working papers, and replies to companies' responses to the CMA's provisional findings.

3.5 Ofwat will be publishing a discussion paper on customer protections on financial structures in Autumn 2021.[32]

4. Concerns of the investor community

4.1 We understand that regulating financing structures in such an interventionist and arbitrary manner would be highly unattractive to many investors, who recognise the benefits and efficiencies arising from companies being granted the independence to design their financing structures in a way which best suits their company as part of a long-term financing strategy.

4.2 In contrast, were Ofwat to impose a mechanism that controlled financial structures at the company level, companies could be required to make changes to their financing structures in order to meet Ofwat's unevidenced concerns, even if they were not the most efficient or sensible decisions for the company.

4.3 Moreover, these proposals could dampen investment in the sector and operate contrary to Ofwat's statutory duties set out in the Water Industry Act 1991, including the duties that Ofwat should act to protect current and future customers and further the resilience of water companies.[33] Furthermore, in performing its duties, Ofwat is obliged by the Water Industry Act 1991 to adopt the principles of transparency, accountability, proportionality and consistency, including targeting only circumstances in which action is needed.[34] Pursuing this proposal would operate contrary to these principles, including consistency (since it is out-of-step with regulatory precedent), proportionality and the targeting of additional regulation only where action is needed (in the face of an overwhelming lack of evidence to support pursuing this intervention).

Government priorities in the coming years

---

[30] Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021, p.120.
[31] CEPA, Allocation of Risk (prepared for Ofwat), 18 June 2021, p.56.
[32] Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021, p.121.
[33] Ofwat duties are designed to shape how Ofwat exercises its functions. Ofwat's primary statutory duties include acting to protect the interests of consumers, ensuring the company is able to finance the proper carrying out of its functions and furthering the resilience objective to support long-term planning and investment: Section 2(2A), Water Industry Act, 1991.
[34] Ofwat must have regard to the better regulation principles: Section 2(4), Water Industry Act, 1991.

4.4 Current Government priorities affecting the water sector highlight the importance of environmental goals and encouraging ambitious investment to support these objectives, particularly Net Zero targets.[35] GIIA's recent joint report with PwC on private infrastructure investment for Net Zero has found that around £40bn per annum on average is required to be invested across key infrastructure over the next 10 years.[36]

4.5 In the water sector, the Public Accounts Committee notably wrote to Defra last year stating that "*it is the Committee's view that the regulatory regime [for water] does not adequately recognise the urgent need for long-term infrastructure investment to improve resilience and the emphasis on price is overplayed*".[37] The CMA also specifically recognised the fact that the legal framework requires it to consider the interests of consumers through the lens not only of short-term bills but also of long-term resilience – a perspective that underpinned the outcome of its redeterminations.[38]

4.6 In focusing on the long-term, Ofwat expects water companies "*to adopt more nature-based solutions and to unleash game-changing innovations to drive up their performance*".[39] Infrastructure investors are supportive of natural capital solutions which can provide a more climate friendly approach than 'grey' infrastructure,[40] with wider benefits and lower whole-of-life cost. But the challenge for investors is that nature-based solutions are fundamentally more uncertain in their delivery than hard engineering solutions/grey infrastructure. Therefore, the role of policy and regulatory frameworks in incentivising investment is central.

4.7 As such, ongoing collaboration between Government ministers, regulators and investors, particularly on proposals for additional investment during AMP7, to support the blue/green initiatives to stabilise the industry following the COVID-19 crisis,[41] is crucial to ensure water sector regulation takes place in a way that ensures long-term investment continues.

5. Concluding remarks

5.1 This note sets out why, as a matter of law and evidence, sector regulation experts at Freshfields believe that Ofwat's renewed attempts to micro-manage water companies' financing structures are out-of-step with very recent regulatory precedent.

5.2 Such attempts are a distraction and should be eschewed at the outset of PR24 preparation so that investors, Ofwat, and Government can productively collaborate to tackle core challenges.

---

[35] The Government has made achieving Net Zero by 2050 a matter of law (reinforced further in April 2021 when the Government also enshrined in law an interim milestone of cutting emissions by 78% by 2035 compared to 1990 levels) – see UK Government Press Release, UK enshrines new target in law to slash emissions by 78% by 2035, 20 April 2021.
[36] PwC, Unlocking Capital for Net Zero Infrastructure, November 2020, p.3.
[37] Meg Hillier MP, Letter from Committee of Public Accounts to Department for Environment, Food & Rural Affairs, 29 July 2020, p.1.
[38] CMA, PR19 Final Determination, March 2021, para 3.
[39] Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021, p.2.
[40] Grey infrastructure refers to human-engineered infrastructure for water resources such as water and wastewater treatment plants, pipelines, and reservoirs.
[41] GIIA, Cost of Capital and Cost of Debt Consultation Response, January 2021, p.4.