Global Infrastructure Investor Association

Response to Ofwat PR24 discussion papers:

Financial Resilience and Risk and Return

January 2022

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 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 discussion papers 'financial resilience in the water sector' and 'risk and return' published December 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.

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.

1. Economic regulation in the water sector

For the last 30 years, economic regulation has supported high levels of investment in the UK's regulated sectors and should be celebrated as a successful model that has been reproduced around the world. Broadly speaking, it has been accepted by the regulators and the regulated sectors that the model has delivered good outcomes for consumers whilst at the same time unlocking investment that the public sector would have otherwise been unlikely to deliver alone.

Private investment in the UK water sector has delivered the following outcomes for consumers and society:

- Since privatisation, £150bn has been invested in the water sector in England and Wales.
- Annual average water bills are £110 lower than they would have been if companies had remained in the public sector[1].
- International comparisons of prices for water utility services in 2015 show that the UK has lower water charges than Belgium, Switzerland, Finland, Australia and the Netherlands and similar costs to France[2].
- Annual productivity growth for the water and sewerage sector has averaged 2.1% since privatisation, with a total improvement of 64% since privatisation[3].
- Reductions in supply interruptions and sewer flooding.

[1] Ofwat, Affordable for All (2011), URL
[2] IWA Statistics and Economics, URL
[3] Frontier Economics, Productivity Improvement in the Water and Sewerage Industry Since Privatisation (2017), URL

2. Looking ahead

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. 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, much of which will be required in the water sector.[4]

The water sector is already facing multiple challenges relating to the impact of climate change with risks from both flood and drought increasing. In its 2018 report 'Preparing for a drier future'[5] the National Infrastructure Commission found that England faces serious risks of water shortages particularly in the South and East and called for £21bn of investment over the next 30 years to reduce drought risks. The NIC stated that without this investment the costs in the long-term are likely to rise to around £40bn over the same time.

In its Baseline Report for the second National Infrastructure Assessment 2022, the NIC also found that extreme weather events are heightening the risk of flooding, with surface water flooding a key risk to over 3 million properties in the UK[6]. Analysis by the UK Met Office showed that from 2010-19, UK summers were 13% wetter, and the winters were 12% wetter, with 7 of 11 wettest years on record since 1862 having occurred after 1998.[7] Climate projections indicate that winters continue to become wetter and warmer, and that summer and autumn rainfall is expected to become much heavier during extreme weather events which occur in between long periods of drought, further compounding the infrastructure and resilience challenges faced by the sector.

Given the above, it is imperative that water companies, investors and Ofwat work together to create the right enabling environment to deliver the transformational levels of investment that are required, including the strategic agenda for Net Zero, climate resilience, adaptation, and nature-based solutions[8] in line with the Prime Minister's 10 Point Plan for a Green Industrial Revolution. In parallel with the need for this long-term investment is a growing concern around the cost of living for consumers, and the need for future bills to remain affordable. It is essential that the regulatory model can adapt to these unprecedented challenges.

3. Water company financial structures

One of the fundamental underlying principles of UK water sector regulation since privatisation, and a reason behind the success of the model, has been that it has been accepted 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 companies with independence to design their financing structures, thereby ensuring that the risks sit with the shareholders rather than

[4] GIIA and PwC, Unlocking Capital for Net Zero Infrastructure, November 2020, p.3.
[5] NIC, Preparing for a drier future, 2018 (URL)
[6] NIC National Infrastructure Assessment, Baseline Report (2022), URL
[7] Met Office, State of the UK climate 2019, 2018 (URL)
[8] Infrastructure investors are supportive of natural capital solutions which can provide a more climate friendly approach than 'grey' infrastructure, 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.

being passed on to customers. The Competition Commission (and more recently, the CMA)[9], as well as other UK economic regulators, have consistently endorsed the efficacy of this approach in price control (re-)determinations.

Indeed, Ofwat has itself acknowledged consistently throughout previous price controls[10] that water companies should independently determine their financing structures and has explicitly recognised the benefits to consumers of higher levels of gearing in capital structures.

4. Absence of evidence for intervention

It is for this reason that investors find it deeply frustrating that Ofwat now persists with a narrow focus on applying pressure to water companies over their capital structures, particularly given that the CMA found that there was insufficient evidence to support regulatory intervention in these areas at its final determination ruling at PR19 in March 2021. The CMA also found no evidence of a link between company financial structures and increased customer risk which was the reason for the removal of the Gearing Outperformance Sharing Mechanism (GOSM) from the determination which the CMA found could actually risk harming financial resilience rather than improving it.

In order for Ofwat to consider implementing the measures along the lines that they have consulted on, which would be an unprecedented step, not only in the water sector but across all regulated sectors, there would need to be an overriding and compelling case underpinned by the strongest possible evidence. However, Ofwat's present argument in support of intervention, as outlined in the discussion paper, appears to rest on an assumed correlation between specific individual (and unrelated) cases of operational failures to financial stress. Ofwat cites Southern Water as a case study of this supposed correlation but offers little else as evidence that this signals customer harm more broadly across the sector. In fact, even in the case of Southern Water, Ofwat has not established that financial issues caused or exacerbated the operational issues.

5. Existing protections for consumers

In addition, there are already multiple license conditions in place, including the regulatory ringfence and special administration scheme, together with a water company's large and

[9] 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.

[10] 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."

stable asset base, that provide protection to consumers from any risks posed by the financial structure of a water company. During the two major economic crises of recent history (the financial crisis of 2008-09 and the Covid-19 pandemic, the latter of which has posed unprecedented challenges to company operations) it has been the case that no risks related to the financial resilience of these companies were passed on to consumers, which goes against Ofwat's argument for further license changes for consumers.

On the contrary, water companies have proved to be financially resilient in the face of such challenges, particularly in comparison with private companies in other regulated sectors of the economy. Therefore, fundamentally, we reject the premise that further steps by the regulator to increase financial resilience are necessary to protect consumers, particularly in light of the substantial aforementioned measures that already exist. In addition, network companies did not make use of government support schemes that were available including furlough and they also stepped up to support business retailers that became distressed during the COVID crisis.

We also believe that many of the measures proposed by Ofwat materially alter the risk profile of the sector for investors. Such measures are disproportionate and could actually be detrimental to customers because they would make the sector less attractive to investors and thus reduce investment. The proposed approach also fosters concern in the investor community regarding the stability of the regulatory framework, as investors have historically placed a reliance on the fact that the regulator has not seen fit to interfere with company financial structures in the past. This forces investors to factor in additional risks when deciding whether to invest in UK infrastructure, at a time when transformational levels of investment are critically needed to meet future challenges, which will only increase in coming years due to a combination of growth pressures and changes to drought and flood risk associated with climate change[11].

6. Risks to infrastructure investment

More broadly, GIIA investors believe it is the case that Ofwat's focus on financial structures acts as a distraction from the more substantive issues facing the sector, such as the need for transformational levels of investment to deliver Net Zero, address climate resilience and adaptation challenges, and in enabling the delivery of nature-based solutions. Government, regulators, and industry should be focused on these issues as a matter of acute urgency, as opposed to expending additional time, resource and cost revisiting arguments from previous price determinations[12].

Investors particularly emphasise the importance of a proper merits-based appeals system as a cornerstone of the gold-standard for UK economic regulation in the water sector. The very fact that Ofwat is seeking to revisit the findings of a year-long exploration of these issues at the CMA which concluded less than 12 months ago, where there have been no changes in the market evidence and which were themselves arrived at following a lengthy and costly appeals process, diminishes confidence in the appeals process in the eyes of investors. This confidence is fundamental to the delivery of investment in UK infrastructure, as investors need to be certain that, in the unlikely instance of a dispute with the regulator, their concerns will be handled fairly, and crucially, these issues should not then be revisited in future price control periods without significant new evidence and justification.

[11] Environment Agency, Water Supply and Resilience and Infrastructure (2015), URL
[12] According to the CMA, the recent regulatory appeals process in the water sector on PR19 price determinations cost the four appellant water companies around £140m and took three years to complete, adding at least £15 to customer bills even ahead of the CMA process

7. UK Government investment policy

Ofwat's position also risks setting a dangerous precedent for investment in the UK more generally, right at the point in time when the Government (including BEIS, DIT, and the Office for Investment) is working hard to create an attractive inward investment environment to deliver the transformational investment that is required to meet future challenges including Net Zero. It is particularly problematic for investors in infrastructure who warmly welcomed the statement of intent from the National Infrastructure Strategy 2020, which clearly stated:

"Private investment has delivered major benefits for UK infrastructure and will be critical over the coming decades as the UK moves towards meeting net zero in 2050. The government is committed to supporting private investment...[and] the model of independent economic regulation, but will refine it [the model] to ensure it provides a clear and enduring framework for investors and delivers the major investment needed in decades to come, while continuing to deliver fair outcomes for consumers"

Unfortunately, the experience on the ground in the delivery of economic regulation in the water sector since the release of the National Infrastructure Strategy is perceived by investors to be acting against the Government's intent to crowd-in additional private investment in UK infrastructure as outlined in the NIS.

If we are to address the long-term challenges in the sector, then trust must be rebuilt between regulator and investors following the bruising experience of PR19. An early step towards that is for the focus of engagement to shift towards addressing the overarching challenge, which is how to address the complex balance between short-term pressure on prices for consumers vs the need for transformational investment to meet future challenges, and away from the narrow focus of downward pressure on customer bills at the expense of the investment required.

This view is not just held by investors, but has been accepted by two separate Parliamentary Select Committees:

In 2020, the House of Commons Public Accounts Committee notably wrote to Defra 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"*.[13] This was in line with the findings from that Committee's report on Water Supply and Demand Management[14].

On 13th January 2022, the House of Commons Environment and Audit Committee report 'Water quality in rivers'[15] also found that recent regulation in the water sector has not incentivised the levels of investment required in the UK wastewater system: *"Ofwat's regulatory approach to date appears to have placed insufficient emphasis on facilitating the investment necessary to ensure that the sewerage system in England is fit for the challenges of the 21st century… We recommend that Ofwat prioritise the long-term investment in wastewater assets as an essential outcome of its price review process. We further recommend that Ofwat incentivise the use of nature-based solutions in wastewater management, including ongoing funding for maintenance and operation"*[16].

[13] Meg Hillier MP, Letter from Committee of Public Accounts to Department for Environment, Food & Rural Affairs, 29 July 2020, p.1.
[14] House of Commons, Public Accounts Committee, Water Supply and Demand Management (2020), URL
[15] House of Commons Environmental Audit Committee, Water Quality in Rivers (2022), URL
[16] Ibid.

8. Specific points on the risk and return paper

In the same way as investors might reasonably expect that decisions of the CMA at PR19 on company financing structures intervention are carried over to PR24, investors would also expect decisions on the weighted average cost of capital (WACC) and risk and return to be reflective of the methodology and findings of the CMA, in line with accepted good regulatory practice.

Instead of taking CMA's extensive review of water as the basis for its future thinking, Ofwat has instead chosen to select CMA decisions regarding energy companies as part of the final determination for the RIIO-2 process as its preferred basis for comparison. Given the differences with the water sector in terms of the appeal regime and criteria for amending a regulatory decision in those sectors, such a comparison is fundamentally flawed and is likely to increase disbenefits for consumers by reducing investment.

Ultimately, investors expect Ofwat to regulate the WACC on a consistent basis as part of providing transparent, stable regulation across regulated sectors and thereby creating the conditions for investment to flow, given that infrastructure investors largely invest across a range of sectors at any given time.

The need for transformational investment to meet future challenges is clear. It is time for Ofwat to focus on enabling this investment by working with water companies, their management teams, and boards to move away from a focus on capital structures, which have featured prominently within previous price controls, and towards incentivising the transformational levels of investment needed in the sector to meet the challenges ahead.

Contact details

For more information about GIIA and the contents of this submission please contact

[redacted]