Ofwat
Centre City Tower
7 Hill Street
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Wednesday 7th September 2022

Dear Sir/Madam

GIIA is the membership body for the world's leading institutional investors in infrastructure, with our members being collectively responsible for over £1 trillion of infrastructure assets under management across 70 countries. In the water sector specifically, GIIA members hold stakes in two thirds of the 15 privately held regional water companies in England and Wales – supplying over 37 million citizens of the UK.

We are writing to offer a high-level perspective that captures views from within our membership (a full list of members is appended to this letter), in joint response to Ofwat's recent consultations on both its '*PR24 Draft Methodology'* and '*Modifications to Strengthen ring-fencing licence conditions'.* Now, more than ever, companies (and their investors), government and regulators, must work together to deliver the long-term investment required, to help keep bills affordable.

Introduction

While the investor community has welcomed further engagement with Ofwat a number of key concerns remain in respect of proposals outlined in the PR24 draft methodology.

- The approach taken towards the Weighted Average Cost of Capital is indicative of a clear shift away from the CMA's determination on PR19 appeals. Justification must be offered for Ofwat's decision to align itself with the approach taken by a different sector.
- Considerable uncertainty remains around Ofwat's Net Zero-based targets for water companies – including an expectation that objectives are to be funded from base.
- Although there has been a welcome shift from Ofwat towards a 'long term' view, further action is needed. Greater clarity is required for investors to help determine the way in which costs are likely to be treated in the future – for example, in the case of enhancement expenditure.
- Striking the right balance between risk and return remains critical to help deliver the levels of investment required. Existing proposals appear to create more risk for less return while continuing to be grounded in retrospective data.
- Despite growing awareness of the need for greater sector resilience, investors feel Ofwat's existing approach obstructs further investment in upgrades, including via the approach taken toward cost benchmarking.
- A step-change in strategy from Ofwat is needed for PR24 – the decisions taken at this critical juncture will ultimately determine whether the sector is able to help deliver on pressing Net Zero objectives.

Background

Framed by the contextual backdrop of an unprecedented cost of living crisis and rapidly escalating climate threats, we recognise the significant task ahead for Ofwat in creating the right regulatory environment that can deliver the transformational levels of investment needed to meet future challenges in the UK's water infrastructure.

In recent weeks, severe weather conditions (ranging from unprecedented cases of drought, to flash flooding incidents) have brought home the scale of that task which, according to Sir John Armitt, Chair of the National Infrastructure Commission, will require: "more than £20bn of investment in new infrastructure alongside leak reduction… over the next 30 years."[1] This figure, taken together with other estimates including "somewhere in the region of £100bn[2]" required to completely eliminate overflows, paints a startling picture, of the levels of investment needed.

The investor community recognises the scale and significance of the task ahead, including a pressing need to build a more resilient sector with the capacity to meet future demands. That is why our members are already proactively investing in the sector, to help alleviate combined affordability and climate-related pressures.

To resolve this collective and largely unprecedented challenge, greater cooperation between core stakeholder groups (investors, regulators and government) is required – this is the only way to deliver intergenerational fairness and the best outcome for consumers. The investment required today to combat climate-related threats will ultimately drive beneficial outcomes for successive generations. To ensure bills are kept at an affordable rate potential steps could be taken to adjust PAYG/RCV run off rates.

Consumers continue to sit at the heart of investment plans and our members remain driven and prepared to do more, to help achieve the best outcome for them. A key example of the proactive approach being taken by the sector includes, for example, the work of investors to roll out social tariffs, in order to help those most at risk of financial hardship.

Our members welcome the opportunity to contribute to Ofwat's approach in facilitating the right regulatory conditions needed to stimulate the flow of capital. While PR24 must, rightly, address customer needs in order to deliver for them in the long-term, equal recognition must be given to the importance of creating optimal conditions for investment.

GIIA has been encouraged by recent engagement activity that has brought the regulator together with our members to help build a deeper understanding of the shared industry challenges. These open and transparent discussions have helped pave the way for more meaningful cooperation in the future, as we move into PR24.

GIIA welcomes some of the sentiments reflected in Ofwat's *PR24 Draft Methodology* including that "companies are best placed to make decisions over their financing and capital structure arrangements" and that there is not an automatic correlation between capital structure and

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[1] Armitt on drought resilience: fixing leaks, reducing demand, building supply - NIC
[2] Written Evidence submitted by Water UK, to the Environmental Audit Committee: https://committees.parliament.uk/writtenevidence/22552/pdf/

operational performance. These endorsements represent recognition of key concerns raised by GIIA and its members, which we trust Ofwat will continue to adopt moving forwards.

There remain a number of key observations that have been brought to our attention by members and which GIIA feels it would be helpful for Ofwat to reflect on when determining a final approach to any adopted methodology.

Weighted Average Cost of Capital & CMA Findings

Firstly, the approach taken in the methodology towards the Weighted Average Cost of Capital (WACC) marks a clear departure from the guidance issued by the CMA's determination on the PR19 appeals. In this regard, had Ofwat broadly adopted the conclusions reached by the CMA, this would have gone some way to offsetting investor concerns and building greater consensus within the sector. Ofwat's decision to unequivocally position itself in contravention of these findings, GIIA would caution, is likely to result in a material increase in the likelihood of future appeals.

Ofwat's strategy to align itself with the approach taken by the energy sector rather than the most recent detailed review of the water sector requires a clear explanation and justification that has not yet materialised. Investors would argue that the CMA's findings should remain the basis for Ofwat's forward-thinking and future methodology development, given their clear sector-specific focus. The basis for CMA appeal in energy is also fundamentally different to that in water. The threshold for the CMA to change a decision made by Ofgem requires evidence of error and affords Ofgem a significant margin of appreciation, whereas in water, the CMA makes a full substitution of judgement. By definition, a CMA decision in water therefore offers a truer reflection of its view, than a CMA decision in energy.

Net Zero

Turning now to Net Zero and the water industry's joint public interest commitment, we are concerned at the lack of clarity and potential misalignment of expectations between Ofwat and investors. Ofwat has outlined that it anticipates the Net Zero target will be funded from base, in addition to competition for enhancement funding. Fundamentally, this highlights an urgent need for reconciliation between the industry's public interest commitment and Ofwat's proposed approach to funding in PR24.

While broad definitions of Net Zero can be seen to offer an overarching steer, this issue highlights a degree of incompatibility in the granular way in which Ofwat and investors define Net Zero. A specific example is the investor view that moves to utilise 'green electricity' options contribute to Net Zero targets (broadly standard in many industries), while Ofwat does not. Net Zero remains a key objective that investors stand ready and willing to support. Ofwat's approach to funding must be developed to help facilitate success or risk further damage to the reputation of the sector. Perversely, any delay on implementing Net Zero strategies could, over the mid to long term, contribute to further negative impacts on the sector due to climate change.

The 'Long Term' View

As expressed previously, GIIA welcomes Ofwat's move towards a longer term focus -– an outlook that is emphasised clearly within the draft methodology. The need for longer term considerations to form the bedrock of the future regulatory landscape is a policy objective GIIA has consistently called for, most recently in our *'Regulating for Investment'*[3] report. While this step-change has been welcomed, there are a number of mechanisms that investors feel remain geared towards incentivising short-term behaviour and limiting long-term investment.

Intergenerational fairness forms a key part of the 'long term' view. Adopting a shared vision that acknowledges the need for consumer bills to remain affordable while also delivering the levels of investment required to bolster the sector in the longer-term, will ultimately ensure that the best outcomes are delivered for the consumer.

From an investor perspective, longer term certainty remains crucial to help determine the way in which costs are likely to be treated in the future. To illustrate the existing mismatch- PR24 is focused on enhancement expenditure and yet remains largely unsupported by long-term metrics. The proposed framework for performance commitments and ODIs are also set on an annual basis, despite the fact that longer term targets and incentives should be prioritised to ensure that companies are increasing their expenditure over a longer duration.

On a broader point, the principle of yearly targets and/or penalties for failing to meet short-term targets, remains a key issue for investors. The omission of allowances for extreme weather events or cost shocks from energy prices (for example, those brought on by the war in Ukraine) into these targets, ultimately fails to reflect the inherent year-on-year volatility of the sector, as well as elements outside the remit of company control. As such, there is a risk that the existing approach will exacerbate inefficient approaches to investment. A greater degree of clarity, and a focus on intergenerational equity[4], is urgently required to provide investors with the certainty they need when planning long-term investments to benefit customers.

Dividends & Risk/Return Balance

Concerns have also been raised by investors in respect of any proposed moves to link dividends to annual performance levels. Using the example above, increasingly severe and unpredictable weather incidents remain beyond the control of companies and yet significantly impact their ability to perform against environmental criteria. It therefore remains important to strike the right balance between holding companies to account for poor environmental performance while also recognising the boundaries of company control.

The prevailing view amongst investors is that the collective package of reforms proposed by Ofwat would have the effect of creating more risk for less return. In the absence of the right conditions to facilitate investment, long-term negative implications for customers could arise, owing to a shortfall in funding. Risk analysis undertaken by Ofwat also remains largely grounded in the findings of retrospective data and does not account for a shifting set of circumstances. In the case of weather specifically, a notable imbalance towards downside risk exists given there are no benign extreme weather events that will benefit companies and their investors. Ofwat must

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[3] GIIA-Regulating-for-Investment-Report.pdf

[4] GIIA-Regulating-for-Investment-Report.pdf

therefore take a proportionate approach to restore greater equilibrium between risk and return - particularly given that investors overwhelmingly bear the risk.

A further area of concern in the methodology relates to the scope of Ofwat's discretion. Investors have remarked on a notable increase in the level/references to capacity for discretion in the methodology when compared with previous Price Reviews. While, in some areas, further discretion may be advisable, this shift perpetuates investor impressions of a complex and overall higher risk investment environment. Not only does this pose the risk of depriving investors of much-needed visibility of the long-term investment horizon to support investment decisions, it also directly contradicts the demands made of investors for a fresh flow of equity and greater investment in the sector. Ofwat must seek to redress this approach and strike the right balance between proportionate discretion and providing clarity of the investment horizon for investors.

It remains crucial to strike a balance that appropriately reflects the level of risk incurred by the investor. Equally, consideration must be given to reaching an appropriate compromise between the rate of investment required in the sector and ensuring that consumer bills continue to be affordable.

Resilience

As noted above, the need for adaptability and instilling greater resilience in the sector continues to loom large in the face of recent climatic events. However, Ofwat's approach towards resilience (which continues to be funded only at a base level) is, in some areas, regarded by many investors as a hindrance to positive development.

For example, investors have argued that the cost benchmark adopted by Ofwat is inherently skewed toward companies with the lowest expenditure on long term resilient upgrades and does not account for costly repairs to critical infrastructure, including mains. It is vital that Ofwat revisits and reflects on its approach to this key issue and seeks to build-in greater allowances or risk constraining investment significantly.

Need for Action

In conclusion, the period set to be governed by PR24 will not only determine the direction of travel for the water sector but also, more broadly, whether we succeed in meeting our binding Net Zero commitments and deliver for consumers.

The combination of severe weather conditions in recent years, taken together with increasing societal demands to address environmental concerns, is creating significant additional pressure on the water industry, including the regulatory framework. This has brought into sharp focus the clear requirement for Ofwat's regulatory approach to stimulate the flow of private capital. Tendencies to base forward-looking reforms on retrospective data mean that a "business as usual" approach simply will not suffice.

Ofwat must take the opportunity at PR24 to use the regulatory system to unlock the transformational levels of investment needed. Investors stand ready and committed to upgrading our water infrastructure- the regulator must ensure the right conditions are in place, to allow them to do so.

As Ofwat finalises its roadmap for PR24, it must carefully consider the signals it wishes to send to companies and their investors as well as customers and wider stakeholders. Creating the right investment conditions now to pave the way for sector improvements spanning the months, years and decades ahead must be the key priority for the regulator.

The degree of alignment and cooperation fostered between government, companies (and their investors) and Ofwat, is fundamental to address persistent sector challenges deliver optimal outcomes for consumers and rebuild confidence in the sector. Building on positive recent engagements, GIIA and its members look forward to continuing constructive dialogue with Ofwat, to ensure that much needed investment in infrastructure continues to be delivered at the scale and pace required to meet UK consumer needs.

Yours sincerely

[redacted]

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APPENDIX ONE – GIIA MEMBER COMPANIES

3i, abertis, AIMCo, ALINDA, Allianz, AMP CAPITAL, ANCALA, ANTIN Infrastructure Partners

apg, AQUILA CAPITAL, arcus Infrastructure Partners, ARDIAN, ARGO Infrastructure Partners, ARJUN Infrastructure, ATTEXO CAPITAL, AVIVA INVESTORS

Blackstone, BCI, Brookfield, CDPQ, CalPERS, CALSTRS, CPP Investments

CBRE CALEDON, CORSAIR, DALMORE CAPITAL, DIF CAPITAL PARTNERS, DIGITALBRIDGE, DWS, EDF Invest

equitix, ferrovial airports, GIC, GLOBAL INFRASTRUCTURE PARTNERS, GMR, Goldman Sachs, GPIF, Federated Hermes

FIERA INFRASTRUCTURE, HOOPP Healthcare of Ontario Pension Plan, IFC Asset Management Company, ifm investors, igneo Infrastructure Partners, Infracapital, InfraRed Capital Partners

IMCO Investment Management Corporation of Ontario, I SQUARED CAPITAL, John laing making infrastructure happen, J.P.Morgan, KKR, MACQUARIE, Marguerite, Morgan Stanley

NIIF National Investment & Infrastructure Fund, OAKTREE, OMERS, ONTARIO TEACHERS' PENSION PLAN, OPTrust, PEMBANI • REMGRO, PGGM

Plenary, PSP Investments, QIC, SLATE, SEARCHLIGHT, STEPSTONE inside private markets, STONEPEAK, SwissLife Asset Managers

UBS, VANTAGE INFRASTRUCTURE, WHI WREN HOUSE INFRASTRUCTURE