Ofwat
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27th August 2024

Global Infrastructure Investor Association (GIIA) response to:

Ofwat's PR24 Draft Determinations

Dear Sir/ Madam,

The Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading investors in infrastructure and advisors to the sector. Collectively, our members are responsible for $2 trillion (GBP £1.5 trillion) of infrastructure assets under management distributed across 70 countries and six continents. They have substantial and diverse investments in the UK, including water, renewable energy, telecoms, ports, and airports, totalling some £260 billion.

In the water sector specifically, over 25 GIIA members hold stakes in two thirds of the privately held regional water companies in England and Wales – supplying over 37 million UK citizens. These investors are long-term stewards of critical infrastructure assets throughout the country. They are targeting investments that have the capacity to provide steady and predictable returns. These investments are often financed by pension fund capital, which entails a responsibility to deliver returns to millions of people who depend on these funds for their pensions. Our research indicates that approximately 6.8 million UK public and private sector employees have a stake in water companies through their pension fund savings, highlighting the direct public interest in maintaining the sector's viability and profitability.

This response to Ofwat's consultation on the '*PR24 Draft Determinations'* offers a high-level perspective that captures views from within our membership (a full list of members can be found here). Now, more than ever, water companies, their investors, government and regulators must work together to deliver the long-term investment required in the sector.

Introduction

The investor community has a number of critical concerns in respect of the PR24 draft determinations. In this context, we would like to underscore the significant impact that an unsatisfactory outcome of the PR24 process would have on investor sentiment, further diminishing the attractiveness of the sector. Moreover, ensuring a fair outcome for PR24 which is acceptable to all parties will provide the necessary platform to undertake longer term necessary reforms to the water sector. If there is not a satisfactory outcome to PR24 then the opportunity to implement future change will be severely diminished.

- **An inadequate investment plan:** In PR19, insufficient funding was provided to companies to execute their agreed plans. Disappointingly, the PR24 draft determinations propose significant cuts in expenditure from the companies' proposed plans – 16 percent overall and 25 percent in enhancement spending – undermining the sector's ability to meet rising challenges like sewage spill reduction and infrastructure resilience. Coupled with a 7 percent reduction in operational funding and insufficient financial returns (including a lower than required Weighted Average Cost of Capital), these measures compromise the sector's ability to attract necessary investment and maintain service reliability.

- **An unattractive investment proposition:** The proposed Weighted Average Cost of Capital (WACC) is low compared to other sectors, offering returns that are only marginally above risk-free rates. At the same time, increased regulatory constraints, new gearing restrictions, delivery-related penalties, and a perceived unstable regulatory environment have significantly increased investors' assessment of risk in the sector. The relative risk-reward ratio that Ofwat is proposing is out of kilter with investors' needs in today's market conditions, eroding investor confidence and making it incredibly difficult and ever more expensive for the sector to secure essential capital.

- **Strangling constraints on companies:** Ofwat's new constraints, including restrictions on executive compensation and dividend payments, and tougher performance targets, limit companies' financial flexibility and operational effectiveness. These measures, combined with reduced funding, hamper companies' ability to deliver on ambitious investment programmes and improve sector performance.

GIIA analysis

The current situation in the UK water industry is troubling, the public perception of the sector is at an all-time low, investors are increasingly declaring the sector uninvestable, and the regulator continues to publicly criticise companies for poor performance, setting ever more challenging targets whilst failing to equip them with the sufficient funding needed for improvement. Until recently, efforts to secure increased investment to tackle the sector's challenges have been repeatedly blocked by Ofwat, who have continued to prioritise keeping customer bills low over increasing investment. In evidence to this point, during the PR19 price review, Ofwat rejected around £6.7 billion of extra investment, concluding that approximately £35 billion in capital works between 2020 and 2025 could be delivered whilst companies simultaneously reduced customer bills by around 12 percent before inflation[1].

The failure to build alignment and properly equip the sector has created a downward spiral, where companies are penalised for underperformance but lack the resources to invest in enhancing the sector's resilience and reducing environmental impacts such as spills. Even when investment is permitted, the returns are significantly lower than those in comparable sectors, notably the energy sector in the UK, but also across many other sectors in Europe and North America, making it increasingly challenging for investors to justify additional capital deployment. Many of our members with stakes in the water sector have been unable to provide returns to the ultimate beneficiaries of their investment for years, many of which are pension savers.

Additionally, Ofwat has further moved the goalposts in the PR24 draft determinations by introducing new measures, such as arbitrary gearing restrictions, tougher outcome delivery incentive (ODI) targets and the new Price Control Deliverables (PCD) penalties. These changes mean that companies will face higher fines and more risk, further reducing their capacity for investment. In this context, it is crucial for Ofwat to use the PR24 process to reset the sector and lay a strong foundation for future investment, enabling companies to address the pressing issues facing the industry. If Ofwat fails to create the right conditions, consumers are likely to see continued underperformance with no significant improvement in the next review period. The stakes are high, and substantial progress is needed from Ofwat before the final determinations at the end of the year. Failure to make progress risks further eroding investor confidence in the sector, which, according to Barclays analysts, has already negatively impacted the broader investment sentiment towards the UK.

1) The proposed investment plan in the PR24 draft determinations is insufficient to enable companies to tackle the sector's challenges effectively.

Whilst we welcome the belated acknowledgment in the draft determinations that bill increases are necessary to support the ambitious investment plans proposed by companies, it is crucial to recognise that had this decision been made earlier, such as during the PR19 process, the sector would be in a better place than today.

It is now abundantly clear, given the unprecedented scale of investment now needed, that consumer bills have been kept artificially low in comparison with the scale of investment the sector needs to address resilience issues. These have been created by the combination of historic and outdated infrastructure, and changing environmental and climate pressures.

This delay in action has forced the entire industry into a reactive stance, necessitating a significant increase in the level of investment allowed by Ofwat. However, the current draft

[1] Earwaker, John. First Economics. The England & Wales Water Industry: Economics / Economic Regulation. April 2024

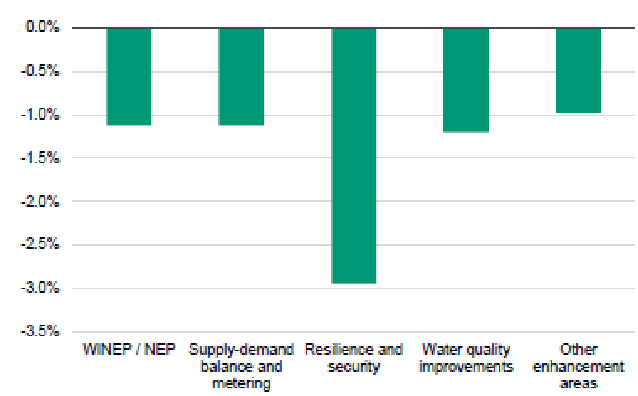
determinations still fall short in providing sufficient funding to meet the stricter performance commitments and the expectations of customers and the government. This underfunding sets the stage for continued challenges, as companies may struggle to achieve these elevated targets, potentially further damaging public trust and investor confidence.

- **Insufficient funding vs. increased expectations**: The PR24 draft determinations propose a 16 percent overall reduction in expenditure, including a 25 percent cut in enhancement spending, which undermines the sector's ability to meet rising challenges such as reducing sewage spills and improving environmental resilience. Whilst Ofwat has increased performance targets, like a 13 percent tougher requirement for sewage spill reduction, the funding provided does not align with these heightened expectations, and once again risks setting companies up for failure.

- **Impact on long-term infrastructure and service reliability**: A 7 percent reduction in day-to-day operational funding threatens the sector's capacity to maintain and replace essential infrastructure, posing risks to long-term asset health, resilience and service reliability. The reallocation of some enhancement tasks to base expenditure further exacerbates the underfunding issue, potentially leading to increased service failures and environmental breaches.

Exhibit 4

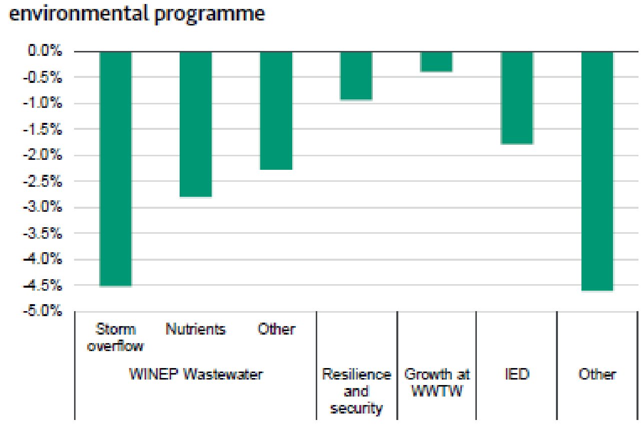
Water enhancement cuts focused on resilience



Shortfall calculated as a percentage of overall water and wastewater enhancement totex request.

Exhibit 5

Wastewater enhancement cuts are heavily weighted towards the environmental programme



Shortfall calculated as a percentage of overall water and wastewater enhancement totex request.

Source: Moody's Ratings – Ofwat's PR24 Draft Determinations

2) The draft determinations fail to create an attractive investment proposition, making it difficult for the water sector to secure the capital it desperately needs.

The draft determinations fall short of making the UK water sector attractive to investors. The proposed Weighted Average Cost of Capital (WACC) is inadequate, offering returns that are only marginally above risk-free investments and significantly lower than those available in regulated sectors in other countries. This low return is exacerbated by the high operational risks from stricter performance targets and reduced funding.

Additionally, concerns over regulatory stability and potential changes to capital structures have further undermined investor confidence. As a result, the sector faces challenges in attracting and retaining the essential capital needed for its development and environmental commitments. If the sector remains unattractive to investors, it risks failing to secure the investment necessary to address its pressing challenges and future-proof its infrastructure.

To ensure long-term sustainability and resilience, it is crucial that the regulatory framework is adjusted to offer a more compelling investment proposition.

- **Inadequate returns relative to risk and market standards**: The draft determinations set a WACC that is insufficient to attract investment, especially in a higher interest-rate environment. Even in cases where there is an absence of a negative return skew, the proposed nominal cost of equity of around 6.8 percent offers only a slight premium over risk-free rates and is barely above the returns for senior debt holders in the UK water sector. This rate is also significantly lower than those available in other regulated sectors globally, making the UK water sector less competitive for investor capital. Additionally, the proposals to cap dividends at a level (4 percent p.a.) that is below the current market-implied dividend yield of any listed companies, further diminishes the sector's appeal.

- **Increased risk and regulatory uncertainty**: Investors face heightened operational risks due to stringent performance targets and limited funding, which are not adequately compensated by the allowed returns. The regulatory framework's perceived instability, including potential changes to capital structures and an overall unfavourable risk-return profile, exacerbates concerns. This situation has led to a notable erosion of investor confidence, discouraging the influx of necessary capital.

- **Need for a competitive investment environment**: To attract and retain investment, Ofwat must offer a balanced risk-return profile that justifies the capital and risk investors undertake. Currently, underfunding and stringent regulatory measures dissuade investment, as evidenced by the stagnant performance of listed companies. This stagnation underscores the urgent need for a more compelling investment proposition to secure the funds necessary for critical infrastructure improvements and the sector's sustainability.

3) Ofwat has imposed stringent new constraints on water companies, hampering their ability to deliver the ambitious investment programs required for sector improvement.

In the PR24 draft determinations, Ofwat has introduced several new and challenging elements that restrict companies' operational flexibility and financial agility. These include an increasingly interventionist approach to executive bonuses, which limits companies' ability to incentivise and retain key talent essential for driving performance. Additionally, the draft determinations propose a ban on dividend payments for companies exceeding certain gearing thresholds, which increases the need for equity capital whilst simultaneously deterring new equity investors, as the goalposts continue to move.

Ofwat's proposed increased involvement in boardroom decisions, particularly around gearing levels, further restricts companies' financial strategies and operational decisions. Compounding these restrictions are the tougher outcome delivery incentive (ODI) targets that demand higher performance whilst limiting funding options.

These measures create a difficult environment where companies are expected to meet ambitious targets with constrained resources and reduced financial flexibility, ultimately risking the successful execution of necessary investment programs and the sector's overall resilience.

Conclusion

The current challenges facing the UK water industry highlight that recent determinations have failed to strike the necessary balance. We urge Ofwat to reassess its draft determinations to provide adequate funding and create an attractive investment environment. This reassessment is crucial for restoring investor confidence and equipping the sector to meet future challenges effectively. We look forward to further engagement with Ofwat to ensure the water industry remains robust, resilient, and capable of attracting necessary investment capital whilst rebuilding public trust.

Yours sincerely,

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