

Department for Environment Food and Rural Affairs

Government's strategic priorities for Ofwat

GIIA consultation response

27 September 2021

1. Background to GIIA

- 1.1. 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.
- 1.2. 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>).
- 1.3. In the UK, GIIA members are responsible for:
 - Major investments in 17 of the UK's 20 airports, which account for 94.4% of total passengers.
 - Supporting almost 120,000 jobs in the nation's privately owned ports.
 - Supplying 2/3 of UK household's water needs.
 - Providing an additional 14 million households with full fibre internet while continuing to invest in 5G technology.
 - Producing 32% of the UK's entire renewable energy capacity.
- 1.4. In addition to these vital sources of foreign direct investment, our research shows that more than 8.5 million UK pension pots are invested in UK national infrastructure via specialist infrastructure funds, helping to deliver a stable return for UK citizens in their retirement. In transport, renewables, utilities, digital and social infrastructure, GIIA members are investing across the UK to deliver the infrastructure needs of UK citizens and supporting the wider economy.
- 1.5. In relation to the consultation paper 'Government's Strategic Priorities for Ofwat' published July 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 consultation questions.

2. The UK's economic regulatory framework

- 2.1. For the last 30 years, good 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.

2.2. 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 Wales¹.
- Ofwat estimates annual average water bills are £110 lower than they would have been if companies had remained in the public sector².
- 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 France³.
- Annual productivity growth for the water and sewerage sector has averaged 2.1% since privatisation, with a total improvement of 64% since privatisation⁴.

2.3. While we accept that there is pressure on household bills, in recent years, economic regulation in the UK has been too heavily focused on short-term outcomes, such as bill reductions, at the expense of long-term investment. The system has also tended to be captured by short-term political interests which has created instability for investors right at the moment at which private investment is needed most.

2.4. There is now an urgent need to update the regulatory framework so that it remains fit for the greater challenges ahead, and the starting point should be for regulators to move away from short-term bill reductions as the primary focus of their regulation and towards unlocking the huge private investment required. Without carefully considered action, we risk being unable to act with the necessary urgency to achieve long-term policy objectives such as the transition to a Net Zero economy.

2.5. Environmental challenges will also increase in coming years due to a combination of growth pressures, changes to drought and flood risk associated with climate change⁵ and through the Environment Agency making reductions to the amount of water that companies are allowed to abstract from rivers.

2.6. A fundamental part of the reform that is needed, is the issuing of strategic guidance from the government to the regulators, in this case from DEFRA to Ofwat, encapsulated in the Strategic Policy Statement Process.

3. Strategic Policy Statement recommendations

3.1. In relation to the draft SPS published on the consultation website, GIIA expresses the following views:

3.2. Need for investment: the SPS should more clearly prioritise regulation which incentivises investment in the UK water sector. It is interesting to note that the SPS provided to Ofcom by the Department for Digital Culture Media and Sport in 2019, specifically makes this point by saying that the government encourages “stable and long-term regulation that incentivises network investment...The Government’s view

¹ Water UK, Michael Roberts’ response to Labour’s Clear Water report (2018), [URL](#)

² Ofwat, Affordable for All (2011), [URL](#)

³ IWA Statistics and Economics, [URL](#)

⁴ Frontier Economics, Productivity Improvement in the Water and Sewerage Industry Since Privatisation (2017), [URL](#)

⁵ Environment Agency, Water Supply and Resilience and Infrastructure (2015), [URL](#)

is that promoting investment should be prioritised over interventions to further reduce retail prices in the near term”⁶. This approach should be replicated in the DEFRA SPS for the water sector given the need for investment to meet long term strategic policy challenges such as delivering Net Zero.

- 3.3. Detail and timeframes: The current SPS as drafted sets out four overarching strategic priorities but fails to provide the requisite detail as to how these can be achieved by the regulator. This leaves a gap in the understanding of what the government expects Ofwat to do operationally, to meet these priorities. Paragraph 13 of the SPS for example states that: “Companies need to prioritise environmental planning and delivery to reduce pollution and considerably improve their environmental performance, while delivering long-term value for money”.
- 3.4. This broad statement does not provide sufficient clarity as to the measures that Ofwat should take to achieve this ambition and, furthermore, does not allocate timeframes to how government expects Ofwat to deliver long-term value for money. Whilst the SPS focusses on the need for Ofwat to enable markets that drive innovation and sustainable investment, there is also a notable absence of any mention of the role that private investment can play.
- 3.5. Partnership working and multi-agency approaches: The SPS places a strong emphasis on water companies achieving more through partnership working across catchments and regions with a notable prioritisation of local engagement. It is clear that across the landscape, this represents an opportunity to deliver best value to customers and the environment, for example through coordinated approaches to flooding, resilience and environmental improvements.
- 3.6. However, the current SPS is not directional enough on this issue, and therefore potentially opens the door for Ofwat to apply an impossibly high bar when determining definitions of ‘strong local support’. The SPS should provide a clearer direction on how it sees that local engagement should be enabled by the regulatory system, so that the interpretation of the duty by the regulator is not at odds with that intended by the Department.
- 3.7. Net Zero: It is a positive development that the SPS references the commitment of UK water companies to reach Net Zero by 2030. However, the SPS should more clearly direct Ofwat to work with water companies on the basis of the 2030 timeframe in the wider context of meeting Net Zero across all sectors by 2050.
- 3.8. Intergenerational equity: the SPS should go further in providing clear direction that Ofwat should ensure that consumers get the best possible value for money in the short-term and benefit from high-quality service delivery whilst protecting customers from future price rises. Future customers’ interests must be protected through the delivery of new capital investment and long-term projects as part of the transition to NetZero and it would be helpful for the SPS to reference this.

4. Nature-Based Solutions

⁶ DDCMS, Statement of Strategic Priorities for Telecommunications (2019), [URL](#)

- 4.1. The SPS is clear that Government expects Ofwat to encourage companies to increase their use of nature and catchment-based solutions to achieve environmental benefits. To deliver nature-based solutions (NBS) in the water sector, it is fundamentally important to begin with a catchment first approach which looks at the issues within a whole catchment (whether flooding and resilience, water quality, improving ecological status) and assesses the mix of interventions which water companies and others need to make to deal with those issues, of which NBS will be one. The regulatory framework should then encourage a blended solution for the whole catchment.
- 4.2. This will require a refocus away from short-term bill reductions as the primary focus of regulation, towards enabling the long-term investment that is required to adopt NBS at scale. It would also be beneficial to link the Water Industry National Environment Programme and proposed Methodology for PR24 to the delivery of Environment Bill targets expected to be set for mid-2030s. If the costs and benefits of different options are considered by Ofwat on a five-year basis, and with environmental commitments usually needing to be delivered within a single five-year period, treatment wetlands that can take seven or more years to design, build and mature to full performance are left at a distinct disadvantage.
- 4.3. NBS will also not be appropriate in all cases but an in-the-round assessment of environmental risk and a catchment first approach by default will unlock the potential for more NBS. To achieve this, the regulatory system needs to look above and beyond the existing 5-year asset management periods as well as looking at whole-of-life costs.
- 4.4. This is a missed opportunity within the SPS as currently drafted. The SPS should provide a clearer direction to Ofwat that the regulator should act to facilitate the uptake of NBS by focussing on long-term outcomes as opposed to those tied to 5-year asset management periods. A clearer statement of intent from the Department to Ofwat via the SPS would be helpful in this regard to ensure that the regulatory framework for PR24 provides sufficient certainty that NBS driven investment will be appropriately incorporated in both PR24 and beyond, reflecting the commitment to such approaches from investors.

5. Regulatory accountability

- 5.1. The current SPS provides clear direction that Ofwat should hold companies to account for their performance against targets such as reducing personal water consumption, but it does not provide clarity on how Ofwat will be held to account by Government for delivering against the SPS's strategic priorities. There is currently no formal agreed mechanism for Ofwat to report to Government on its performance against the SPS. Alternatively, the Department could require Ofwat to produce an annual report to the Secretary of State with performance metrics against the objectives outlined in the SPS.
- 5.2. There could also be a role that Parliament could play in this process. For example, the SPS could provide direction that Ofwat should be required to report to the Environment Food and Rural Affairs Select Committee on an annual basis, where MPs could scrutinize the performance of the regulator against the priorities of the SPS, much in the same way as other public bodies are held to account through the

Parliamentary Select Committee process. This would also provide public transparency and help to instill public confidence in the operations of the regulator in the market.

- 5.3. Most importantly, from the perspective of investors, Ofwat should be required to demonstrate how decisions on the price review process align with the SPS's objectives. This would help investors to see a clear thread between the overarching statement made by Government and the delivery of regulation in the market.

6. Company financeability

- 6.1. The SPS should also provide direction to Ofwat on the importance of company independence, particularly around financeability and corporate governance. 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.
- 6.2. In its approach to the PR24 process, 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 concern in the investment 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.
- 6.3. The SPS should clearly provide direction that Ofwat's approach to all future regulatory price determinations should fully account for the findings of the CMA in their final determinations on PR19. This would provide confidence to investors that the regulator cannot unilaterally diverge from the ruling of the CMA in its operations in the market.

7. Summary

- 7.1. The draft SPS should provide more clarity on the expectations placed on Ofwat by government in delivering against the strategic objectives set out in the draft. It should be clearer around the measures Ofwat can take to enable the uptake of Nature-Based Solutions and should also set out a clear formal process for how to hold Ofwat to account in delivering against the SPS core objectives.
- 7.2. The SPS should provide a clear direction to Ofwat that the regulator should take steps to ensure that the decision of the CMA final determinations on PR19 are adequately reflected in the regulator's day-to-day operations and in the approach to future regulatory price determinations. The SPS should also be clear that economic regulation in the UK water sector should move away from a focus on short-term bill reductions and towards unlocking the investment required to meet long-term policy objectives. Failing to do so would represent a missed opportunity to update the regulatory framework so it remains fit for the great challenges ahead.

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