Monday 26th October 2020

GIIA CMA Water Price Determinations Provisional Findings Consultation Response

Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading institutional investors in infrastructure. Our members operate in 55 countries across 6 continents and are responsible for over US$800bn 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, supplying over 50% of the UK population's water supply.

GIIA members have drawn our attention to the CMA's provisional findings on Ofwat's proposed 2020-25 price controls published 29th September 2020 and we are keen to express the perspective of institutional investors in infrastructure. This letter therefore acts as a high-level position statement on behalf of the investor community on the issues raised by the findings. By way of background, many of GIIA's members are active across various markets in many sectors, including in energy networks, transport, telecoms and social infrastructure and not exclusively the water sector in the UK.

1. Key points on the provisional findings

GIIA believes that it is fundamentally important for regulation to ensure that consumers pay a fair price for their utilities, whilst at the same time making sure that the UK is able to attract the level of investment required to build resilience against climate change impacts and to meet the legally binding commitment to achieve Net Zero carbon emissions by 2050. It is also important that the regulatory system enables the water sector to make the investment required to meet resilience challenges, which are only likely to increase in coming years due to a combination of growth pressures and changes to drought and flood risk associated with climate change[1]. This is supported by the fact that customers consistently place a high priority on ensuring that their services remain resilient to the challenges of climate change and demand growth and can be relied upon now and in the future.

This will require extensive investment in the UK's infrastructure over the coming years and decades and the associated costs must be fairly allocated to provide inter-generational equity between current and future consumers of UK utility services. GIIA's upcoming joint report with PwC on private infrastructure investment and Net Zero finds that around £40bn per annum on average is required to be invested across key infrastructure over the next 10 years. This level

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

of investment will need to be sustained beyond 2030 in order to reach Net Zero by 2050 – and it is all the more urgent in water given the sector's commitment to reach Net Zero by 2030[2].

GIIA also understands and supports the need to strike the right balance between the sometimes competing interests of short-term affordability for the consumer and the longer-term investment required to address resilience and climate change challenges, as well as the legitimate expectation of fair returns to investors. However, it is GIIA's belief that the optimum balance was not struck in Ofwat's proposed 2020-25 price controls, which, we feel, placed too great an emphasis on short term affordability to the detriment of longer-term sustainable investment objectives, whilst undermining the ability of the water sector to deliver the performance improvements and investments their customers have signalled they wish to see.

The CMA's provisional findings indicate that some adjustments are needed to Ofwat's price determinations in order to achieve the right balance, and we agree. We feel that the approach the CMA has taken in its provisional findings are better aligned with the interests of customers both now and in the future and are more likely to enable the investment required to build resilience into the UK water networks, a key priority of UK water customers. This will, in turn, support the delivery of the water industry's transition to Net Zero carbon emissions by 2030 whilst still delivering a substantial c.9.3% cut to customer bills.

We also agree with the CMA's broader conclusion that ensuring that UK infrastructure sectors remain an attractive investment proposition is highly important, given the fundamental role that infrastructure will play in delivering on the government's 'Build Back Better' and climate resilience agenda. Investors also need to have confidence in the long-term stability of capital which can be achieved by developing a regulatory framework that encourages investment rather than penalises private investors.

2. Risk-reward and company financeability

The risk of regulatory settlements making UK utilities an un-investable proposition runs contrary to the government's wider strategic policy agenda, as echoed by the Chancellor of the Exchequer at Conservative Party Conference 2020 where he said "…returns need to be set at a level that incentivises investment…particularly at a time when we need to do quite a lot of upgrading of our network and infrastructure to make this transition to a Net Zero world. So regulators have got to balance that; protecting consumer bills, incentivising regulation and ensuring innovation and competitiveness in the industry. Those are all things that are important"[3].

It is therefore encouraging that the CMA provisional findings place a clear emphasis on the need for a balance to be struck between risk and return and that the CMA found Ofwat's price determinations to have unduly increased levels of risk for companies (notably from asymmetric outcome delivery incentives (ODI's)) which, together with the other elements of the determination, undermined water companies' financeability. We also agree with the CMA that Ofwat's primary statutory duties to both a) fund water companies and b) protect customers, complement one another and are not mutually exclusive.

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[2] Water UK, 3rd December 2019: URL
[3] Chancellor of the Exchequer at Conservative Party Conference with Enterprise Forum, 5th October 2020

In their submissions to Ofwat at the Draft Determinations stage, water companies relied upon Ofwat's "early view" of the Weighted Average Cost of Capital (WACC) which is lower than that calibrated by the CMA in their provisional findings. At the Draft Determinations stage, companies clearly highlighted that the overall settlement set out by Ofwat was not financeable and that the early view WACC could only work if other aspects of the price control were amended to remove the asymmetric downside risk. We therefore welcome the CMA's steps to recalibrate the risk-reward balance by removing some, but by no means all, of the downside risk. This will make cost sharing rates less penal and more equitable, and enable companies to operate a financeable business model whilst still protecting customers and keeping costs low by recalibrating the WACC to a level 0.54% higher than Ofwat's. This means customer bills will still fall by c.9.3% for the four companies, compared to the last price control (rather than Ofwat's 12.6% average fall).

GIIA also supports the CMA's view on the financeability of the companies and in ruling out artificial adjustments as a means to fix financeability problems, which were proposed by Ofwat including the use of PAYG/RCV run-off, restriction of dividends and equity injections. If the WACC is set too low, the CMA has stated there is a legitimate concern that notionally geared companies would be unable to retain strong investment grade credit ratings. We also concur with the position of the CMA that the metrics used by the regulator to measure company financeability should be in line with established best practice (including those used by the world's leading ratings agencies) and not the product of Ofwat's own econometric analyses.

The CMA has also determined the WACC to be the primary factor in ensuring that an efficient firm can finance its functions, disregarding the position of the regulator in proposing the aforementioned measures as ways to improve financeability regardless of the WACC. We therefore agree with the CMA's findings that Ofwat had set the cost of capital too low to provide for a reasonable level of return for investors. Even with the improvements to the WACC that the CMA has proposed, returns to investors will still be some 30% lower than at PR14.

We also agree with the CMA's position that the design of Ofwat's Gearing Outperformance Sharing Mechanism (GOSM) was not supported by robust evidence and that the GOSM, at least in its current form, should be removed from the price control. We feel that there has been an over-assumption of a 'shareable benefit' arising from higher levels of gearing as well as an over-simplification of the relationship between gearing and financial resilience. Careful consideration should therefore be given to any replacement mechanism or remedy in the future.

3. The CMA is still proposing a significant cut to bills and a very stretching settlement

It is worth highlighting that the CMA's provisional findings, as a whole, still present the water sector with some of the biggest cost gaps in companies' operating history and one of the largest reductions to bills of any recent regulatory determination with customer bills falling by c.9.3% compared to PR14 (rather than Ofwat's 12.6% average fall). There also remain stretching and unfunded service level improvements, with the real risk of ODI penalties for failing to achieve them and improved, but still asymmetric, cost sharing rates in the event of overspends.

Recent comments from international rating agencies such as Moody's also highlight that even with the improvements to allowances made within the provisional findings, they expect ratios to be at the lower end of their expected levels[4]. Additionally, the CMA is still proposing the lowest ever WACC the industry has seen, and the CMA WACC level remains at the bottom end of the range expected by the water companies. That being said, GIIA welcomes the provisional findings from the CMA on the basis that they enable a higher level of investment than would have been the case under the Ofwat Final Determinations - investment which will be fundamental to delivering the resilience to UK water infrastructure as well as supporting the recovery from the Covid-19 pandemic.

4. Re-applying established regulatory principles

The CMA has signalled some important changes to the position that Ofwat had taken in its PR19 Final Determination which are welcomed by GIIA. The CMA has sought to avoid some of the complexities that Ofwat had seemed intent on building into the water price review process by concerning itself with the internal management and corporate governance of the businesses with the intention of mitigating against impacts of perceived overt risk taking. It is worth highlighting in this regard, that water companies already have a rating requirement in the license, meaning they are prevented from taking excessive financial risks. The steps that CMA have outlined in their provisional findings will have the effect of simplifying the approach to UK utility regulation which, in our view, had become overly complicated.

The provisional findings also help to provide direction on the principles for future economic regulation in the UK across sectors other than UK water utilities, which is a welcomed step in the right direction.

5. Measures adopted by the Water Industry Commission for Scotland

It is encouraging to see that the Water Industry Commission for Scotland (WICS) has recognised the scale of the challenge, admitting that bills for water services in Scotland will have to increase so that investment can meet the climate challenge and deliver resilience in water infrastructure assets. WICS will publish its final recommendations in December but has warned that "if we do not invest sufficiently today there is a risk that we slide backwards" and has stressed that delaying the investment "would risk even higher bills, reduce service reliability and water quality" and prevent carbon neutral targets being achieved[5]. The proposed increase set out in the WICS Draft Determinations will enable Scottish Water to invest an extra £1 billion to improve infrastructure, taking the total to £4.5 billion of investment to 2027.

GIIA notes the differences in revenue and in the customer base served by Scottish Water compared to companies operating in England's regulated water sector[6]. However, GIIA believes that the steps taken by WICS to recognise the step change increase in investment required for enhancement, whilst continuing to apply pressure on Scottish Water for base cost efficiency targets, is a sensible approach which should be replicated by Ofwat. WICS' measures will also be accompanied by additional support for vulnerable customers and has been developed through a co-creation process with customers, stakeholders, Scottish Water, Scottish Government and WICS.

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[4] WaterBriefing.org, 28th February 2020, URL
[5] The Herald Scotland, 9th October 2020, URL
[6] For example, Anglian, Bristol, Yorkshire, Northumbrian = £3.44bn revenue collectively, 2019/20, Scottish Water = £1.46bn 2019

6. Summary

Private investors in UK infrastructure are committing to deploy long term capital. They are seeking regulatory stability, as well as a clear policy framework that incentivises investment alongside a fair, merits-based appeals system. We believe that the CMA's provisional findings are a step in the right direction towards creating a regulatory environment that attracts private capital without penalising investors and supports the investment required to build resilience to climate change, as well as stimulating the post-pandemic economic recovery.

We are also clear on the need for customers to pay a fair price for their water services and we support the CMA's position in seeking to strike a fair balance between customers and investors. The CMA's provisional findings have taken appropriate steps to redress that balance by delivering one of the largest cost reductions to bills of any recent regulatory determination and imposing a stretching settlement for companies, whilst also enabling a higher level of investment than would have been the case under Ofwat's Final Determinations.

The CMA's provisional findings are also significant not just for the immediate impact on investor sentiment, but also in terms of providing direction on principles for the future of economic regulation in the UK in a wider sense, and are therefore to be welcomed by the international infrastructure investor community.