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Insights

'ENGLAND'S WATER MARKET - INVESTMENT, INNOVATION, INFRASTRUCTURE AND COSTS FOR END USERS'

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SUMMARY

The Bryan Cave Leighton Paisner Infrastructure team attended the excellent Westminster Energy Environment & Transport Forum conference: 'England's water market - investment, innovation, infrastructure and costs for end users' on Thursday 18 July 2019, and in this blog post we summarise the main trends and topics discussed.

OVERVIEW

The conference was held on the morning of the latest Ofwat PR19 announcement on draft determinations (more on that later), and so was very timely.

Speakers were from the following organisations: National Infrastructure Commission, Ofwat, the Environment Agency, CCW, Waterwise, the National Audit Office, ratings agencies, consultants and law firms.

Firstly we heard from the water lead from the National Infrastructure Commission (NIC), who gave an overview of the capacity for the provision of clean water. Due to climate change we need 3000Ml/day just effectively to stand still. Hence the NIC recommends additional supply and demand reduction combined to reach 4000Ml/day, with the twin track approach of demand management and new supply to balance cost. Widespread smart metering is sought, by 2030.

The NIC is still awaiting the Government's response to its proposals.

POLICY. A NATIONAL FRAMEWORK FOR WATER?

The Environment Agency's representative touched first on water resource planning. In August 2018 a joint letter on 'Building resilient water supplies' was published which, amongst other matters, was followed by publication of the draft water National Policy Statement (NPS) for Nationally Significant Infrastructure Projects (NSIPs) (consented through 'DCOs') in November 2018. Regional water groups need to consider resilience, cost efficiency, wider needs (e.g. environmental improvement) and a cross-sectoral approach.

The role of a water resources national framework would be to articulate national and regional need, to set expectations and to identify barriers. Emerging results from the EA were then expounded - noting that the national deficit was expected to be around 3900Ml/day by 2045 - the potential for water transfer schemes was important and merits more investigation, as well as careful use of drought orders. The EA plans to publish the national framework in December 2019. In the Q&A it was suggested that the UK is well behind other countries in producing this framework.

FUTURE PRIORITIES FOR REGULATORS AND MONITORING PROGRESS

Next up was a representative of the National Audit Office, who noted the NAO’s recent report ‘Regulating to protect consumers in utilities etc’. The report concluded that: 1) regulators have a good insight into consumer issues, but aren’t clear about what they want to achieve in addressing them; 2) regulators need to manage trade-offs when protecting consumers, often overlapping with government social policy; 3) regulators could do more to measure and report consumer outcomes in a helpful way; 4) regulators don’t have a good overall understanding of their influence over consumer outcomes and the impact of different regulatory approaches.

THE PRICE REVIEW PERIOD

A speaker from Ofwat then spoke about PR19, and the announcement that morning on the draft determinations for the remaining 14 water companies. Investments included the new reservoir proposals in the south east. In terms of affordable water bills, Ofwat is looking to reduce bills by 12% (before inflation), and provide 20,000 customers with help from hardship funds. Ofwat continues to drive water companies to give better customer service, reduce leakages, be resilient, offer value for money, and implement improved environmental protection steps.

In terms of innovation, Ofwat’s equation was: outcomes + total expenditure = flexibility + freedom. In particular, where water companies innovate and share their innovations with other water companies, to the benefit of the whole water sector, incentives should be offered.

As to risk and return - Ofwat is proposing the lowest allowed cost of capital since privatisation, a further reduction of 0.21%. At final determination (due 11 December 2019) Ofwat feels it could be even lower.

OPPORTUNITIES AND CHALLENGES FOR THE NEXT PRICE CONTROL PERIOD?

Several speakers then presented on this topic from their varying perspectives.

From a credit perspective, there are 6 issues: nationalisation fears, low returns (pressure, especially those with expensive long dated debt), cost efficiency, service performance (and financial penalties), competition in the future, & Brexit uncertainty. Which all means that there is a broadly negative outlook from a credit rating perspective.

Drought risk - implementing measures to prevent drought risk in advance costs £21bn; but being reactive and responding to supply problems after a drought event costs £40bn. There was therefore an opportunity to save by investing. Other opportunities touched on were: mandatory water efficiency labelling, water neutrality in development proposals, metering, getting water into the national conversation (eg the NIC) and water efficient procurement.

What do customers want? It was said that CCW focuses on water bill levels above all else, and yet some water companies have customers saying that they'd actually prioritise other things like flood resilience, the environment. How does this tension get resolved?

SECURING FUNDING

In terms of funding, the conference heard an overview of the licensing regime for water companies by Ofwat and the funding mechanisms available. This touched briefly on the basics around Instruments of Appointment and condition B, the Regulatory Capital Value, & allowance of Weighted Average Cost of Capital. The macro picture is now one of concern about undue profitability for infrastructure investors, balanced with customer service - and the regulator and Labour are of course watching closely (see later in respect of nationalisation).

Thames Tideway Tunnel (TTT) was then referred to, in terms of the Regulated Asset Base (RAB) delivery mechanism, and whether this could be used again elsewhere in the industry.

Finally Direct Procurement for Customers (DPC) was touched on (see Appendix 9 of the Ofwat 2020 Delivery Water report); with the proposed threshold of £100m totex, which is a 'trigger' rather than an absolute threshold. The process can be launched at varying points within a project programme.

What would be cheapest for customers? The view was that the TTT model was for a specific circumstance, and DPC is unproven - hence there's insufficient data to yet properly analyse what is best for customers.

ENGINEERING AND INNOVATION

So how are the necessary projects delivered? After a brief summary of the usual programme of a project, the point was made that decisions made early in a project life cycle, stay with the project over its lifecycle i.e. they become constraints. The opportunity for change and associated value creation is at its greatest early on, and diminishes as the project moves forward.

The Project 13 approach was referred to, in terms of the wider team coming together to deliver common outcomes. If the water industry is to meet the challenges that society faces, the view was that the industry needs to think differently.

Innovations need to come early in the programme - as late innovation can often add cost as it can override earlier decisions and commitments.

NATIONALISATION

Next we heard from speakers about the prospects of nationalisation and its implications. Since privatisation in 1989, the industry has taken on £50bn of debt and has paid out £56bn in dividends - and whilst the link is complex, this might be said to be part of the story for Labour's views on nationalisation now. But is incentive regulation working? And would the public really mind if the industry was nationalised?

Practically, it was suggested that the Government could purchase the holding companies, with a regional water authority overseeing. What isn't clear is whether price setting will become more political (comparison was made to TfL, and the London Mayor choosing to not increase transport fare levels in London). As to investors, it seems likely that there will be very uneven outcomes for investors.

So if Labour came into power, the legislative first question is how nationalisation might occur. Could a Parliamentary Bill give just general powers? The issue is at what level the nationalisation decision occurs - and the ability of third parties to impact that decision and its details. And then what exactly would be nationalised - the equity and the debt? What does that mean for the price paid? Finally as to compensation, could there be a disparity between international and domestic investors and the payment of market value?

This is not intended to be comprehensive but is a summary to reflect the views of the organisations speaking.

RELATED CAPABILITIES

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MEET THE TEAM

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