HOUSE OF LORDS

Industry and Regulators Committee

Corrected oral evidence: The work of Ofwat

Tuesday 19 July 2022

11.50 am

Watch the meeting

Members present: Lord Hollick (The Chair); Lord Blackwell; Baroness Bowles of Berkhamsted; Lord Burns; Lord Cromwell; Baroness Donaghy; Baroness McGregor-Smith; Lord Reay; Lord Sharkey; Baroness Taylor of Bolton.

Evidence Session No 7 Heard in Public Questions 65 - 71

Witness

I: Lawrence Slade, CEO, Global Infrastructure Investor Association.

Examination of Witness

Lawrence Slade.

Q65 **The Chair:** Welcome to the second panel of today's sixth meeting of the committee, which is investigating Ofwat. I am delighted to welcome Lawrence Slade, who is the CEO of the Global Infrastructure Investor Association. He will now start by giving us a few words on what that very fine sounding organisation does.

Lawrence Slade: Thank you to the committee for the invitation to join the meeting today. The GIIA was formed back in 2015 to represent the interests of the global community of infrastructure investors. Today, we represent about 90 companies, 70 of which are infrastructure funds. Many are well-known and familiar names from around the world. It is a cross-section of the investor community, with banks, insurance companies, pension funds and sovereign wealth funds from literally all corners of the world.

Together, they have somewhere in the region of $1.3 trillion worth of infrastructure assets under management around the world and, of course, several hundred billion of that is invested here in the UK, particularly concentrated in the utilities sector, whether that is gas, electricity or, in today's case, water, but also, increasingly, in telecoms.

There are numerous touchpoints around the world and here in the UK, where you will be interfacing with assets that are owned by private infrastructure investors. I hope that is a good enough intro to who we are and why we are here today.

The Chair: Thank you very much indeed for that.

Q66 **Lord Reay:** Good morning. Can I ask you about investor appetite? From an investor standpoint, how attractive is the UK water sector? Has political pressure related to environmental issues, particularly the use of storm overflows, had any effect on the attractiveness of the sector for investment?

Lawrence Slade: I suppose, just to frame that a little bit, overall in the last couple of years we have seen the investor appetite towards the UK improve. We run a pulse survey twice a year that helps us track that against other global markets, and we are seeing a general improvement in the UK of late. In the water sector, we have recently seen some deals that indicate that there is still an appetite to invest in the sector, which is almost reflected in some respects by the point that we are seeing infrastructure as a general asset class becoming more popular—in some respects, I am afraid to say, off the back of the pandemic—and being a good addition to general portfolios. Generally, water is still seen as an okay area.

There are concerns around the level of regulatory intervention compared to some of the other UK markets. Undoubtedly, you are right in your comment about the political noise and the public awareness of the issues. Some of the reporting, as you have heard from Water UK, does not reflect the true situation of the market itself.

Lord Reay: There was a research report last month from JP Morgan, which is separate from the investment side. It said that it was turning cautious on the sector, because "the regulator will challenge the companies to be more efficient while meeting environmental objectives—this may require further reinvestment in the coming years, limiting outperformance".

I should add that the research from investment banks is not always correct and can often be wrong, but I was just wondering whether you believed there was merit in the view that the challenges the water companies face may not have been reflected in the share prices yet.

Lawrence Slade: I do not think I could necessarily answer that in terms of the share prices. We represent privately held companies. However, it is fair to say that the sector as a whole faces tremendous challenges, as do a number of others. We cannot run away from the fact that climate change is still very much with us. It is not as if we have come out of the pandemic and left that behind us. The scale of investment that we need to make, right the way across our utility sectors—and water is a huge part of that—is still writ large.

The critical thing here is how we all work together and bring the various stakeholders together. Of course, water is quite a complex ecosystem and we regularly hear the argument just against the individual water companies, whereas, in fact, to get the true picture, you need to look at various parts of the economy, including the building and development community, planning and agriculture et cetera.

It is something that we have to take right the way across the scene, and arguably we have not done that as effectively as we could, but that is not just a role for Ofwat. There are several other bodies that need to be involved in those conversations to make sure that we are looking at all the causations around the issues and addressing where the investment is needed right the way across the board.

Lord Reay: How would you say the attractiveness to your investors in the water sector compares to other countries and to other utilities in the UK?

Lawrence Slade: If I pick up anecdotally on comments we have received from investors, the attractiveness compared to other markets varies from middle ranking upwards. There is a sense that, over the past few years, the relationship with, for example, Ofgem has been slightly more positive and slightly more engaging than with Ofwat. Equally, from the conversations we have had over the last few months with Ofwat, as we head into PR24, I sense a greater willingness to engage with the investor community, to try to understand where the problems are and to have that active dialogue.

Lord Reay: Finally, in terms of investors' views of Ofwat and its role, how well does it engage with your community?

Lawrence Slade: It has a challenging role in managing everything, as I have said there, but I would go back to one of my earlier points. Often, the companies and Ofwat are considered to be the sole cause of the problems as opposed to part of the ecosystem. On the one hand, we have a difficult job in explaining just how complex the water sector is and the number of different parties involved in it.

At the same time, just reflecting on earlier comments, while there has definitely been a more troublesome relationship with the regulator over the last few years, we have had, certainly from our experience just recently, some positive engagement. If we can keep that level of engagement up as we approach PR24, which, as you know, is out for consultation at the moment, and keep that process of dialogue open, that bodes reasonably positively for the future.

Q67 **Lord Sharkey:** Lawrence, you have welcomed the strategic policy statement, but you expressed a concern that there is no real mechanism for holding Ofwat to account for delivering against these strategic priorities. In your view, are there any particular failings on Ofwat's part that can be attributed to this lack of accountability?

Lawrence Slade: You are right: we have made no secret of what we consider to be the importance of strategic policy statements. We have been very clear in our conversations with the regulator and, indeed, with government on this particular point. The issue that you are referring to is where the overall oversight and scrutiny of a regulator's performance is against said strategic policy statement.

Where we feel that that has fallen down is that there does not appear to us to be a really solid, formal way of understanding the regulator's performance against that. As we have said, there might be a means by which an existing or perhaps new parliamentary committee could provide that oversight and, at times, challenge just how well the regulator, in this case Ofwat, is performing against that overall strategic policy. For example, is it getting the balance right—I am sure it will come up later this morning—between keeping bills down and, as Water UK said, ensuring that we can raise the required level of capital for investment going forward?

Lord Sharkey: You have also noted that there are inconsistencies between utility regulators, which may not be terribly surprising, but could you briefly outline what you think are the major inconsistencies or the ones that matter, and whether there are overarching principles that could be applied across the utilities sector?

Lawrence Slade: One at the top of the list is the WACC—weighted average cost of capital—and the different methodologies that seem to be used across regulators. We have just spent a lot of time and money with the CMA revising and looking at the cost of capital, and it seems illogical that we then restart that process, so perhaps we can look afresh at how that can do it.

We are quite encouraged by the organisation of the UK Regulators Network—UKRN. In our recent *Regulating for Investment* report, we suggested that perhaps UKRN should have more of a statutory footing as a body that can bring the regulators together more formally and try to ensure that there is more of a consistent approach. I completely agree with you, however, that you are not going to have every regulator acting in exactly the same way, because they are different markets. However, from an investor point of view, if you get a level of consistency across the regulated markets, that has to be a positive thing.

Looking at the cost of capital issues is one. There is another area that is worthy of mention and reflects our current economic circumstances too, which is working across groups of regulators to address how we are dealing with vulnerable customers. It is accepted that there is, unfortunately, a fairly significant group of customers who may need help or extra management, and seeing that managed appropriately and consistently across regulators would be useful too.

Q68 **Lord Blackwell:** Is there enough strategic oversight of the water sector? We have heard from various witnesses of the challenges facing the multiple bodies that are involved. There are significant questions about how the industry will meet the environmental standards. The Environment Agency is involved alongside Ofwat. Does there need to be some single body that, as it were, lays out how all this is co-ordinated and a strategy, in order to provide a clearer framework, or is that up to the Government? How do you see that?

Lawrence Slade: That is a very good question, and it is a difficult one. There have been various moves to try to provide a little more co-ordination and oversight. RAPID—the Regulators' Alliance for Progressing Infrastructure Development—which includes Ofwat, the Environment Agency and the Drinking Water Inspectorate, is an example that seems to be moving in that direction.

Overall, I go back to the point I made earlier. Just handling our water supply, literally from when it rains through to when it reaches a customer's tap and other areas, involves such a complex ecosystem that it requires better oversight in co-ordinating the scale of investment, not just for the next five but for the next 10, 20 or 30-plus years.

The recent approach by Ofwat has moved in that direction, but we would argue not enough, in providing the investor community with a long-term horizon of where the investment is going, so that you can work with the global investment community in providing capital and having a sense of the scale of investment that is needed over the longer term.

There could, as we have said from time to time, be a greater role for the National Infrastructure Commission in laying that out and costing future plans, but it certainly requires a little more co-ordination between the bodies involved in this to make sure that we understand all the issues that are being faced, so that you do not find yourself attacked on one side by the Environment Agency and on another by Ofwat.

Let us get those conversations together and provide a little more clarity as to how we need to approach these things and organise the scale of capital investment over the longer term. The more certainty you get on that side of things, the better the impact in the long term on customer bills.

Lord Blackwell: Do investors have any sense at the moment of what that scale of investment over the next 10 or 20 years will be to meet all these environmental standards and maintain supply continuity? Is there a figure that investors are thinking about? How confident are you that that would be funded?

Lawrence Slade: Suffice to say, it is very difficult to put a number on that. The NIC has tried in the past and suggested that it is in the tens of billions—£20 billion just around net zero. We can come back to you on precise figures for that. It will vary from company to company, given the different nature of their regions.

Of course, we do not know what the impact of climate change, the issues and the exposure to resiliency and adaptation costs will be across the country because, frankly, things can change so quickly right now. Several very dry summers will have a tremendous impact on water capacity in different parts of the country. It is no joke to say that in some cases it is, arguably, raining in the wrong parts of the country.

Unlike the electricity or gas system, we do not have an integrated water grid, so we could face not insubstantial issues around the corner, which could require massive investment that is not booked in at the moment. That is the point that I am making about constantly engaging all stakeholders in these conversations and allowing a certain level of flexibility in any funding settlements to enable the water companies to respond to any imminent challenges.

Lord Blackwell: Is co-ordination going to work? In the energy sector, there is a proposal for a future system operator. Is there a need for something like that, particularly dealing with interconnection, perhaps, between the water companies going forward?

Lawrence Slade: There is a certain element of wishing that I could see the future to provide you an accurate response to that. From the conversations we have had with investors in the run-up to this, there is a certain willingness to look at that idea and to see that there might be an opportunity, as you say, Lord Blackwell, particularly around the issues of interconnectivity or moving water from one part of the country to the other, which could be a scenario that we face in the future.

To our mind, having a stronger scrutiny role with government would not be a bad thing. As we look to the challenges of climate change generally, having more of a helicopter view across the government departments would be no bad thing, so that planning and permitting, for example, is tied into the strategic objectives of a particular regulatory sector. These are things that we could do better. We have not done our best on them over the last few years. As we head into the 20s and 30s, having that oversight view right the way across government is going to be critical.

Q69 **Baroness McGregor-Smith:** Good afternoon, Lawrence. It is a pleasure to meet you. In a recent report, you called for regulatory stances to move away from short-term outputs and to have more alignment with long-term infrastructure plans. When you think of the gap, I guess, and the imbalance in favour of short-term outputs, what would be the impact of the moves that you are advocating?

Lawrence Slade: It is lovely to meet you too, and thank you for the question. There is an obvious point here that, regardless of whether you are the operator of an asset or the investor, we need to be very cognisant of the end customer. We need to provide appropriate levels of value for the end customer and we should never lose sight of that point, but we also need to achieve the correct levels of investment. Infrastructure investments are, in general, long-term plays. The scale of investment needed can be over 20 to 30 years or more.

If we can work with all stakeholders, taking what we know today and picking up on the comments I just made to Lord Blackwell—not wishing to contradict myself—we should be able to plan fairly well the scale of investment that we need to meet some of the challenges we have already discussed, but also allow an element of flexibility in there, so that they can be flexed up or down as situations require. If we get that long-term planning right, we give the companies and, therefore, the investors the confidence in the direction of travel, and we get the regulatory approach in place, the impact on bills should be minimal.

However, we need to engage with the consumer and with the end user, because there will definitely be costs. As a sector, as an investor, as the regulator and as the Environment Agency, we need to manage those conversations and structure the required levels of investment in the best possible way, so that we are achieving the cheapest cost of capital. Bills may go up in the future—or they may go down—but, regardless of that, we are achieving it in the most effective way for the customer.

Baroness McGregor-Smith: How aware is the consumer of the challenges for the sector going forward, given what could happen to bills, for example?

Lawrence Slade: In some respects, that is the $64 billion question. I do not mean to be brash about it, but there is sometimes a misunderstanding about the weather conditions we have in the UK, the processes that have to be gone through in terms of how our water supply is managed in the future, the very different regional impacts that our weather has at the moment and how we might wish to plan for those going forward. It is a very different situation in the London region compared to other regions just in terms of the gravitational effects of supplying water and the energy that is required to pump water around.

It is part of a greater conversation that we need to have about how we all have a part to play in the future, and how we can use and conserve water and energy as we head into the next decade. I do not think that those are bad conversations to have. They are responsible conversations to have as a country.

Baroness McGregor-Smith: Just moving back to the point about long-term infrastructure, when you take a look at the recently published draft mandatory methodology for the price review from Ofwat, what do you think about that in relation to the balance between short and long term?

Lawrence Slade: There is a consultation open on that until the beginning of September, and a number of our investors with water holdings will be responding to it. I guess what I am trying to say there is that it is a live debate right now.

The initial feeling across the industry is that it is a definite move in the right direction, and that there are some good points and some not so good points that we will be engaging on with the regulator. Overall, they have picked up some of the points about trying to get that balance right, but there is still a conversation to be had about getting more of a long-term view on these things and, to the points I made earlier, allowing more innovative spend or having a more flexible approach.

Q70 **Lord Burns:** Good afternoon, Lawrence. Can I press you a bit further on this question of the investment that will be needed in the water sector to both meet future demand and improve environmental performance? The number of £20 billion came up earlier, which you quoted from someone. Can the water companies fund that level of investment, and what weighted average cost of capital would they face? We want to try to see what the impact of that would be on customer bills. Do you have any ready reckoner or any easy way to describe how you would see this process working? Are we saying that 3% is the required rate of return? How do we translate this into bills?

Lawrence Slade: There is probably no easy answer to your question, and that is not me trying to avoid it. I must admit that I do not have a ready reckoner with me. We can perhaps look at whether there is some ancillary information that we can send through to you and the rest of the committee.

Overall, we do not see—and it is a well-worn quote, but at the moment it is true—a shortage of capital ready to invest in infrastructure. It is also fair to say that, for that capital to come into the water sector in the UK, we need to make sure that the terms are correct. It is pensioners' money and it comes from all sorts of sources. From a responsible investor point of view, we have to make sure that we get the best return.

It is very much, I am afraid, down to a conversation with the regulator and the investor, making sure that we are running the assets in the most efficient way, that we understand the scale of investment needed over the coming decade, and that, from an investment community point of view, we understand what the outlook is going to be.

Lord Burns: Can you give us any hints about what the range of that might be in terms of the WACC that is going to be necessary?

Lawrence Slade: It would not be appropriate for me to do that right now.

Lord Burns: Would it be possible to get more competition into investment in some of these projects? We would be interested to know whether the Thames Tideway project has any characteristics that might make it suitable for wider deployment in terms of getting some of these infrastructure projects under way.

Lawrence Slade: As I said in our report, there are almost certainly areas within the sector where greater competition can be brought in. Thames Tideway is often quoted in infrastructure generally as a pretty innovative way of dealing with a massive piece of infrastructure that needed funding, so one should certainly look at it as an example of what can happen.

The issue is perhaps making sure that, if one is looking at putting projects out to competitive tender outwith the monopoly provider, if you will, you are talking about projects of sufficient scale. If you are going to go out to a tender like that, it costs money, often into the millions, in terms of preparing and managing these things and bringing consortia together, so you have to make sure that the scale is there. You also have to understand how that project will be managed thereafter. Is a separate operating company going to be set up for that asset, or is it going to be handed back to the monopoly water company?

The answer is a guarded yes, as long as we get it right and the scale of investment is in place. Again, that will vary from company to company. Smaller water companies may decide that the hurdle, if you like, is lower than the bigger ones. Overall, the answer is that, if appropriate, it could have a positive impact.

Q71 **The Chair:** There are areas of tension between Ofwat and the water companies. There are lively debates on the level of gearing. It would appear from several witnesses that the returns that the water companies are getting are far greater than they should be getting, and Ofwat is going to have to look at that carefully. Then there is the overall issue of an investment of probably several hundred billion to get the infrastructure in the shape that it should be. The consumer can bear only so much.

Against that background, and with those tensions and that requirement, is there any sign that investors are getting a little nervous about putting more money in? In particular, there was a case of one of the water companies that had to be restructured, which led to significant write-offs of debt. Has that sent a rather negative message through the industry, or is the industry still looking at the sunny side of the street, which is jolly good returns and an opportunity to invest more and get a decent return from a monopoly business?

Lawrence Slade: To come to one of your last points there, any investor wants to make a return, and profit is not a bad thing in that respect, but I would say that some of the media portrayal of returns in the water sector is wrong. As you heard earlier, not every company issues dividends and many companies have not issued a dividend for some time, which is indicative of the tougher regulatory settlements that there have been.

Our regulatory environment has the ability to respond to that and to crack down appropriately, as we have seen. Sometimes that leads to tensions with the companies and, if the regulator and individual investors were here, they would say, "That's appropriate. We don't agree with this. We didn't agree with the capital allowances that they put in. That's why we went to the CMA". One of the benefits of the UK's regulatory structure, particularly in the water sector, is that we have that appeals mechanism to come into place.

Would I expect regulators and investors to agree all the time? No, I would not. As per a conversation I had quite recently with them, a robust, honest conversation is entirely appropriate. Having the environment where we can do that is the right thing.

The recent media interventions and the recent restructuring of business show two things. When things go wrong, it is the investor who loses their shirt, not the customer. When things go wrong, there are companies still willing to invest in the sector, which shines a positive light on the water sector overall. To attract the longer-term transformative scale of investment, which is the critical part, not just the transfer of equity, we need to make sure that, from an investor point of view, I can see a decent return, as you put it, over the long term, albeit where I carry the risk, not the customer, and can see a way of improving the asset, of creating the investment and of providing the highest possible value for my customers.

The Chair: In terms of the relationship between Ofwat and the companies when it comes to looking at the level of capital investment, do you feel that there is enough discussion between the two parties, so that, whatever the size of this extra investment, it is being carefully thought through, those items that can be done by, as it were, environment-based schemes have been separated out, and the concrete and steel side of the investment has been properly prioritised? Is there proper engagement between the companies and Ofwat to determine that, so that, when the financing model is fixed, it is clear that there are sufficient funds to address the prioritised investments over the next five or 10 years?

Lawrence Slade: It is almost public knowledge that one of the areas of disagreement between the investor community and the regulator is the sense that the regulator has become too involved and too engaged in trying to look at and regulate the funding models that are engaged by the sector. Ultimately, that element should be one for company boards and not necessarily for the regulator. There has been an ongoing debate around that and it is a clear area of disagreement between the regulator and the sector.

Is there enough engagement? As I said as part of my opening comments, we have seen an increased level of engagement of late, as part of the run-up to PR24, and that is wholeheartedly to be encouraged.

You raise a very valid point around making sure that these funding structures are correct and that they are done in the best interests of the customer, but we have to bear in mind that water is very different from other sectors that have been in the news for company failures. The oft-quoted point around electricity and gas suppliers, where company failures have led to £2 billion being added to customer bills, is not replicated in the water sector. When there has been a company issue, as I said earlier, it has been the investor who has, effectively, lost the shirt off their back, not the customer. That is why the debate is there: "Hang on, Ofwat. Please concentrate on the outcomes as opposed to looking at the financial gearing", when we do not necessarily see a link between that and customers' bills.

The Chair: So you are saying that, notwithstanding some of the inevitable tensions, the level of co-operation and discussion between Ofwat and the companies is adequate to address the issues of significant increases in investment that will be required over the next five to 10 years. There will be a debate about how they are funded and the extent, or otherwise, to which they might be funded from consumers.

Looking at the industry as a whole and taking a holistic view, it is vital that the boards of companies are clear about what is to be prioritised and the required level of capital investment, and that that should be part of the settlement.

Lawrence Slade: Absolutely, yes, and we agree with Ofwat that the role of the board is critical here and that we should be leveraging that, just looking at company law, for example, and the role of independent non-execs.

Just to come back to your point, it is fair to say that the relationship between the assets, the investors and Ofwat has probably been too confrontational over the past few years. The point I was making earlier is that it is very positive that we are seeing, on both sides, an improvement in that and a desire to work better together in the interests of customers.

Do I think that we have the whole thing yet? No. There is more to go, but it is positive that there is a desire to work better and a need for us all to work better.

The Chair: On that uplifting note, thank you for joining us today and for your answers.