National Infrastructure Commission | The Second National Infrastructure Assessment: Baseline Report

Yorkshire Water Submission of Evidence

February 2022

Introduction

The National Infrastructure Strategy, published in November 2020, contained a welcome recognition of the central role of private finance in delivering infrastructure investment to meet the challenge of climate resilience, particularly in sectors such as water which are subject to economic regulation.

It stated that over time, UK economic regulation had worked well and had provided a stable platform with safe and predictable returns, attractive to international investors. However, it also suggested that some changes to regulatory systems, short of wholesale institutional reform, would be necessary to maintain that stability so that the steady fall in levels of international investment could be reversed.

These changes included clearer policy guidance from government to regulators which would set out how regulatory decisions should be framed to help deliver government policy. It also proposed a greater say for local government and mayoral combined authorities in setting investment priorities. Aside from these proposals it also said that HM Treasury would be undertaking a review of economic policy, leading to the production of a policy paper in the course of 2021.

The NIS was particularly welcome in the water sector as it was strongly felt that Ofwat, the economic regulator had delivered an unbalanced price review in 2019, which artificially depressed consumer prices reducing the revenues necessary to finance adequate capital investment.

Unfortunately, since the publication of the NIS, little of the promise contained in its content has been delivered.

The proposed cross sectoral guidance for all economic regulators has only just appeared in the diluted form of a letter from the BEIS secretary of state. The policy guidance from Defra to Ofwat, critical in shaping the next price review, is a disappointing document which although prioritising environmental improvements, said little about how to finance the private investment necessary to achieve them.

This lack of clarity is particularly unfortunate given the clear public desire for a significant increase in investment by water companies to improve river water quality.

The HMT review of economic regulation has taken some time to emerge in the form of a BEIS document. Whilst we recognise the pressure on Treasury teams over this period, this means that an opportunity for progressive evolution of economic regulation has been missed. In water this means that Ofwat will approach the next price review with largely the same policy parameters and approach used in PR19.

Indeed recent consultation publications by Ofwat on financial resilience and risk and return suggest that their approach to PR24 is likely to be even more hostile to investors than that which was encountered in the last review. Given the urgent need for increased environmental and climate response investment, this is of particular concern to Yorkshire Water and its investors.

We would welcome the chance to meet with the NIC to discuss what we see as the potential implications of the current position on investment in water infrastructure.

Levelling Up

As one of the major employers, investors and landowners in Yorkshire, Yorkshire Water firmly believes that tackling regional inequality in the UK must remain a top political and policy priority. From 2009 to 2019, Yorkshire and the Humber experienced growth in output per job of just 0.5% – the lowest figure of any region in the UK[1]. Regional productivity across Yorkshire and the Humber is now 17% below the national average[2]. As the Prime Minister remarked earlier this year, "it is an astonishing fact that 31 years after German unification, the per capita GDP of the North East of our country,

[1] https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/bulletins/regionallabourproductivityincludingindustrybyregionuk/2019

[2] https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/bulletins/regionallabourproductivityincludingindustrybyregionuk/2018

Yorkshire, the East Midlands, Wales and Northern Ireland is now lower than in what was formerly East Germany."[3]

Unlocking significant regional investment is vital if the UK is to make progress on this agenda. Yet local economies, particularly in Yorkshire, are highly vulnerable to the harmful effects of climate change, impacting investors' confidence to invest in our region. We are already seeing an increasing number of severe flooding incidents, including in 2019 and 2020, and these are set to further increase in frequency and intensity because of climate change[4]. The economic damage caused is severe: in Calderdale, West Yorkshire, the 2019/2020 floods led to £43.3m in direct losses and £25.1m in indirect losses[5]. The floods caused shop premises to close for an average of 13 days, with a 31% drop in sales for the first month after flooding[6]. For each £1 of direct losses, there was 63p of additional losses across the local and regional economy.

Our sector has a specific responsibility to secure the resilience of our water and sewerage networks. We are specifically responsible for ensuring water systems are resilient to flooding and reducing the risk of flooding from our networks[7].

Through our intrinsically local identity – embedded in local communities, economies and the environment – we can help provide the local leadership necessary to address the issue of flood resilience in an integrated way.

We have unique relationships with a range of regional stakeholders, including local authorities, other landowners and utility providers. By leveraging these relationships, we can create public-private partnerships that not only develop resilient water and wastewater services, but also improve the strength of our local economy, mitigating the effects of climate

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[3] https://www.gov.uk/government/speeches/the-prime-ministers-levelling-up-speech-15-july-2021

[4] https://www.yorkshirewater.com/media/fhvjtkao/submission-to-the-efra-select-committee-flooding-inquiry.pdf; https://www.unep.org/news-and-stories/story/how-climate-change-making-record-breaking-floods-new-normal

[5] https://environmentjournal.online/articles/flooding-leads-to-millions-of-pounds-in-economic-damage/

[6] Ibid.

[7] https://www.legislation.gov.uk/ukpga/2014/21/section/22

change, whilst also harnessing our community's skills and strengthening regional supply chains.

Both DEFRA and Ofwat recognise that partnerships between water companies and local organisations to address specific challenges are essential to maximise social and environmental value. DEFRA's Strategic Policy Statement (SPS) to Ofwat states that solutions to many challenges can come through "strong local engagement" and "partnership working across catchments and regions."[8] It argues that the impact of environmental investment by the sector should "be maximised through co-funding with other sectors and green finance opportunities." Ofwat's early indication of its approach to the next price control (PR24) also notes the importance of companies working in partnerships to deliver common goals.[9]

Separately, the National Infrastructure Strategy set out an ambition to improve alignment between public and private infrastructure investment, and to ensure local authorities, metro mayors and devolved administrations are able to contribute more to price control processes.[10]

Recognising the value of joint partnerships, we are currently working with the West Yorkshire Combined Authority, and other organisations (including the Environment Agency, the National Trust and the Yorkshire Regional Flood and Coastal Committee) to develop a West Yorkshire flooding and resilience partnership. This would start by creating a partnership in the Aire Catchment through the creation of a commercial structure and legal entity that can raise capital and revenue funding to support the Leeds natural flood management (NFM) programme and deliver wider environmental improvements. It would bring greater resilience and growth to the area and could eventually help push an integrated solution to tackling flood management in one of the areas most affected by flooding historically.

[8] https://www.ofwat.gov.uk/wp-content/uploads/2021/05/PR24-and-Beyond-Creating-tomorrow-together.pdf; https://consult.defra.gov.uk/water-services/government-new-sps-consultation/

[9] https://www.ofwat.gov.uk/wp-content/uploads/2021/05/PR24-and-Beyond-Creating-tomorrow-together.pdf

[10] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938539/NIS_Report_Web_Accessible.pdf

To achieve this, however, we will require a blend of public and private investment and revenue streams, and additional access to green finance. This will require support from the government and from Ofwat.

Upfront financial support through government allocation of grant funding and debt support is needed to unlock the pilot projects and de-risk early-stage investment. Government funding will be critical in supporting project delivery and will complement existing capital funding that we are ready to provide. Ensuring relevant future funding rounds are designed to support public-private partnerships (such as our West Yorkshire partnership) and give due consideration to the wider benefits from such schemes will be essential to making such partnerships possible and unlocking the wider benefits they offer regional economies and societies. Guarantees issued by the UKIB will also help de-risk early-stage investment and lever significant private funding.

Separately, the current regulatory framework acts as a barrier to us forming partnerships. To address this issue, this paper proposes a series of changes to overcome the barriers to partnership investment and help unlock changes that can help the West Yorkshire partnership materialise.

First, greater weight should be placed on wider social benefits in Ofwat's framework. This will help ensure each investment's wider social benefits are taken into account and ensure greater alignment with unlocking long-term value.

Secondly, Ofwat should assess partnership investments on a whole-life basis, reflecting the differences in the profile of costs and benefits of different investments over time. This would address the issue of different investment options for similar objectives having different pay-back periods to one another and avoid the risk of disincentivising investments in innovative partnership projects which may pay back over a longer time period than traditional assets.

Thirdly, Ofwat should provide greater certainty around the treatment of partnership investments in water companies' regulatory asset bases. It must ensure that its regulatory accounting treatment does not disincentive investment in partnerships where they deliver benefits to customers.

Fourthly, developing a mechanism for within-period funding would be useful to align the funding cycles of different organisations. This would help facilitate this and other partnerships when third parties are most able to commit funds, addressing the rigidity of the current regulatory framework.

Streamlining Regulation

Regulation of the water industry is complex. There are multiple different regulators, with different responsibilities and statutory planning processes. The price control process, led by Ofwat, has become a four-year long process that consumes significant management and regulatory time and resource and has become inaccessible to non-regulatory experts.

This level of complexity has implications for public confidence in the water sector, the accountability of the regulatory regime and for the sector's ability to deliver solutions that tackle local and national challenges.

A more streamlined regulatory regime would help in at least three ways:

1. It would make regulatory decisions and processes accessible to bill payers and elected representatives – ensuring regulators can be held to account for their actions and boosting engagement in water companies' future plans to help make sure they reflect consumer needs and priorities.

2. It would reduce costs and management distraction for both regulators and water companies – ensuring tax/bill payer resources are spent on delivering better consumer outcomes rather that navigating bureaucracy.

3. It would unlock innovation to deliver wider government priorities – increasing capacity for companies to focus on innovative solutions or ways of working, such as nature-based solutions.

Ofwat has itself begun to explore how it can streamline the next price control (PR24) in its early thinking around the PR24 methodology. As Ofwat develops its proposals, and government considers the future of regulation in the UK[11], this paper sets out a series of specific recommendation for how the regulatory regime can be streamlined:

1. Ofwat should consider adopting a negotiated settlement approach for large, long-term new investment projects.

2. Establishing a single independent body to decide the cost of capital for each regulated sector.

3. Aligning the timeframes for the statutory plans that water companies are required to prepare and deliver.

4. Increasing Ofwat's visibility in the regions.

5. Reducing the number of performance commitments and simplifying incentives at PR24.

Improving Delivery in Partnership

To unlock the investment to deliver the West Yorkshire project, we would need both upfront financial support for pilot projects complemented by changes to the regulatory framework which currently prevents water companies from working with partners to meet common objectives. In particular:

[11] Through both BEIS' Reforming the Framework for Better Regulation consultation and HMT's forthcoming policy paper on economic regulation.

• There is a lack of clarity around how social benefits are considered by Ofwat when assessing investment proposals.

• Partnership investments are not assessed on a whole-life basis.

• There is insufficient certainty on the regulatory accounting of jointly owned assets.

• There is no mechanism for within-period funding.

The following recommendations seek to unlock financial support for the early stage of the partnership, and to address these regulatory barriers:

1. Financial support through grant funding and debt support to unlock pilot projects

2. Ensure Ofwat captures social benefits when assessing investment proposals

3. Ensure Ofwat assesses partnership investments on a whole-life basis

4. Provide certainty on the regulatory accounting of jointly owned assets

5. Develop a mechanism for within-period funding

Thank you

For more information contact:

Daniel Macey
Corporate Affairs Advisor
dan.macey@yorkshirewater.co.uk

@yorkshirewater
facebook.com/yorkshirewater
yorkshirewater.com