

How regulatory reform can promote investability

30 January 2026

Executive summary

The Independent Water Commission (IWC) highlighted key failures of the regulatory regime in water, and how these have contributed to sub-optimal outcomes for customers, the environment and investors. Change is needed to restore trust in the system of regulation and provide confidence to customers, investors and wider society. The government's White Paper—which provides a high-level view of the direction for reform—recognises the need for predictable regulation, with steady and stable returns for investors, to promote delivery of the public interest.

Delivering the sector's objectives requires unprecedented levels of investment. Over the next 25 years, companies expect to invest £275bn-£300bn delivering network improvements. This is on top of the investment needed from companies to deliver a step change in capital maintenance, which is expected to grow considerably in the coming years relative to historical levels.

Companies need to raise significant sums of new equity capital from investors to finance this investment. For this capital to be forthcoming, the regulatory framework needs to give investors confidence that they can earn a competitive rate of return with balanced levels of risk exposure. A lack of investor confidence in the regime will lead to either i) **higher bills** as a result of higher financing costs; or ii) **forgone investment** if companies are unable to access capital on reasonable

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terms. Restoring investor confidence is therefore fundamental to delivering the public interest.

Government and regulators must *not* assume that investors will continue to invest on any terms. A combination of regulatory policy decisions and a large-scale investment programme have significantly changed the sector's risk profile and the proposition facing investors. This is driven by a number of factors, including the following.

- 1 Increasing obligations on companies, with a larger and more **complex capital programme** across the sector.
- 2 A shift in **dividend expectations** as companies finance substantial growth in the asset base.
- 3 A lack of **stability in regulatory policy**, leading to reduced predictability of returns.
- 4 **Highly punitive incentive mechanisms**, with only four out of 16 companies earning the base return on equity, on average, over the AMP7 period (i.e. 2020–25), and a general expectation across investors that—without change—they are likely to lose money from such mechanisms in future.
- 5 Significant environmental liabilities, with a **risk of 'double jeopardy'** through non-price-control sanctions.
- 6 A greater risk that shareholders will be required to fund **asset health deficits** without the regulatory regime providing for cost recovery.

Crucially—by affecting perceptions of returns that will be earned in future—these issues are affecting critical investment decisions *today*.

Against this backdrop, there is a pressing need for a renewed focus on **investability**. That is, there is a need for political and regulatory focus on ensuring that the sector is attractive to investors, and can therefore raise the equity capital needed to finance investment. Immediate changes are needed to achieve this, including:

- **a rebalancing of the risk/reward proposition on offer at PR29**, so that investors are not exposed to excessive levels of downside risk;
- **a reduction in the overall level of risk exposure**, to ensure that it is in line with the risk tolerance of utility sector investors;
- **a recognition that water sector investors are likely to require a steady flow of dividends** to commit further investment, and cannot rely entirely on capital growth as the sole basis of their returns.

Economic regulation should also take greater account of the long-term requirements of the sector—in terms of future infrastructure, consumer and environmental needs, and long-term financing requirements—rather than focusing exclusively on five-year regulatory periods. This should aim to provide greater transparency over long-term trade-offs and challenges, as well as give investors confidence in their exposure to asset health deficits. Providing investors with greater long-term certainty over returns and cost recovery will help to reduce the cost of capital, which is a significant component of customer bills and is therefore in their interest.

The current industry reform programme provides Defra with a once-in-a-generation opportunity to re-shape how companies are regulated and investor sentiment towards the sector. Change needs to happen at pace, to restore trust and confidence in the system of regulation across stakeholders. The implementation plan is key to driving this change at pace. **Uncertainty around the direction of travel will affect investors' assessment of risk and dilute inward investment, which will have negative consequences for customers and the environment.**

The IWC and the government's Water White Paper (WWP) have recognised the importance of a regulatory system that supports investment, and have identified many of the shortfalls with the historic approach to regulation. The recommendations laid out by the IWC, and taken forward by the WWP, provide a potential path to more company-specific regulation that can address many key issues facing the sector.

However, **some of the proposed reforms risk undermining investability**, and do not seem aligned with a regulatory environment that provides a fair rate of return with balanced levels of risk exposure. This paper outlines our specific concerns alongside recommendations for Defra as it refines its reform programme, including the following.

- Providing early visibility on the scope and shape of the next price review (PR29)—as well as who will be responsible for running it—and initiating a review of the incentive framework underpinning the price control. **These are fundamental to investor decisions around whether to commit new capital to the sector, and need to be addressed urgently.**
- **Recognising asset health as an urgent priority** and setting out a plan for how this will be addressed, including on how existing asset health deficits will be funded and over what timeframe.
- Reconsidering certain IWC recommendations that risk undermining investability, including in terms of the role of the sector regulators in WACC estimation, the steps that are

needed to ensure that returns are competitive with international comparators, the framework for regulatory appeals, and the scope of the supervisors' powers in relation to board decision-making. **As a general principle, it is important that companies and shareholders retain ownership over their plans and business decisions.**

- **Providing detailed, instructive guidance to the existing regulators** on how to interact with the industry in a way that supports investability during the transition phase, including any early work on developing approaches to PR29.
- **Promoting coherent regulation** through better aligned institutions with clearly defined responsibilities, and a single counterparty for companies.
- **Developing a robust process and timetable for the longer-term reforms** that will not be in place for the next price review—in particular, those relating to strategic planning frameworks and regional system planners.
- **Developing a balanced scorecard to measure progress in areas that really matter to stakeholders.** This should help to rebuild public confidence, by showing how bill payments are being used to deliver improvements in water quality and resilience as well as fewer leaks and spills.

1 Introduction

In July 2025, the Independent Water Commission (IWC) published its recommendations for reforming the England and Wales water sector.¹ The IWC's final report set out 88 wide-ranging recommendations intended to drive a 'fundamental reset' in the industry and restore public trust. Defra has reviewed the recommendations and set out its overarching plans in the government's WWP.²

Following publication of the WWP, the government is expected to publish a transition plan, interim Strategic Policy Statement (SPS) guidance to Ofwat, and Ministerial guidance to the Environment Agency. There remains a high degree of uncertainty over how these

¹ Independent Water Commission (2025), '[Final Report](#)', 21 July.

² Defra (2026), '[A new vision for water](#)', 20 January.

recommendations will be taken forward and over what timeframe, but they have the potential to lead to substantive change.

A key principle underpinning the proposed reforms is that the regulatory system should contribute to a stable environment with fair returns, thereby supporting investment into the sector.³ In this paper, we consider whether the recommendations are aligned with this aim and identify areas in which further thinking is required as Defra takes forward the reform programme.

2 Context: the investment challenge facing the England and Wales water sector

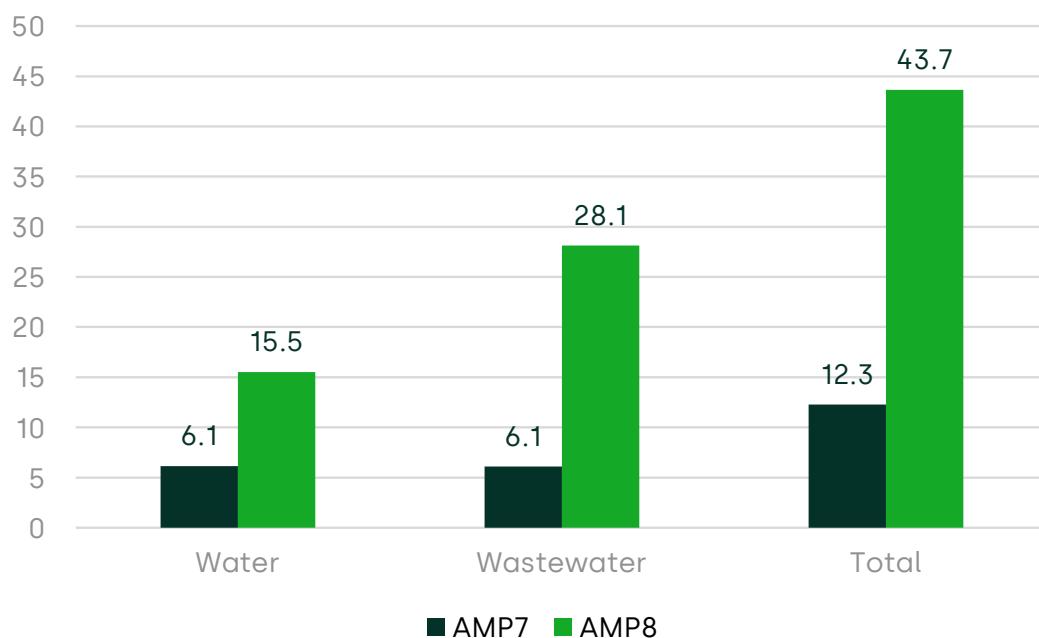
Before considering the reforms set out in the IWC report and WWP, it is worth restating the investment context in which the reforms are taking place, and the sizeable investability challenge that the sector faces.

Water companies will invest an unprecedented amount of capital over the next 25 years, with significant growth in regulatory capital values (RCV) as companies invest in enhancements to their networks. The first significant uplift in spending has been provided by Ofwat's PR24 settlement, under which companies have been granted total expenditure allowances of £104bn over the five years of AMP8 (2025/26–2029/30).⁴ While expenditure on day-to-day ('base') activities will increase, the primary driver is new enhancements to the network, with an industry-wide enhancements programme that is roughly four times the size of AMP7. This is illustrated in the figure below.

³ Defra states in the WWP that: 'We want investors to be confident that the new rules underlying this regulated sector are stable, predictable, and will secure returns over the long-term. When investors put their money into the water industry, they do so in the knowledge it will be many years before infrastructure is built and operational. They need to be given confidence that returns will be fair, stable, and predictable across the lifespan of their investment.' Defra (2026), '[A new vision for water](#)', 20 January, p. 24.

⁴ Ofwat (2024), '[PR24 final determinations: Expenditure allowances](#)', December.

Figure 2.1 The enhancement programme has quadrupled in size relative to AMP7 (£bn 2022–23 prices)



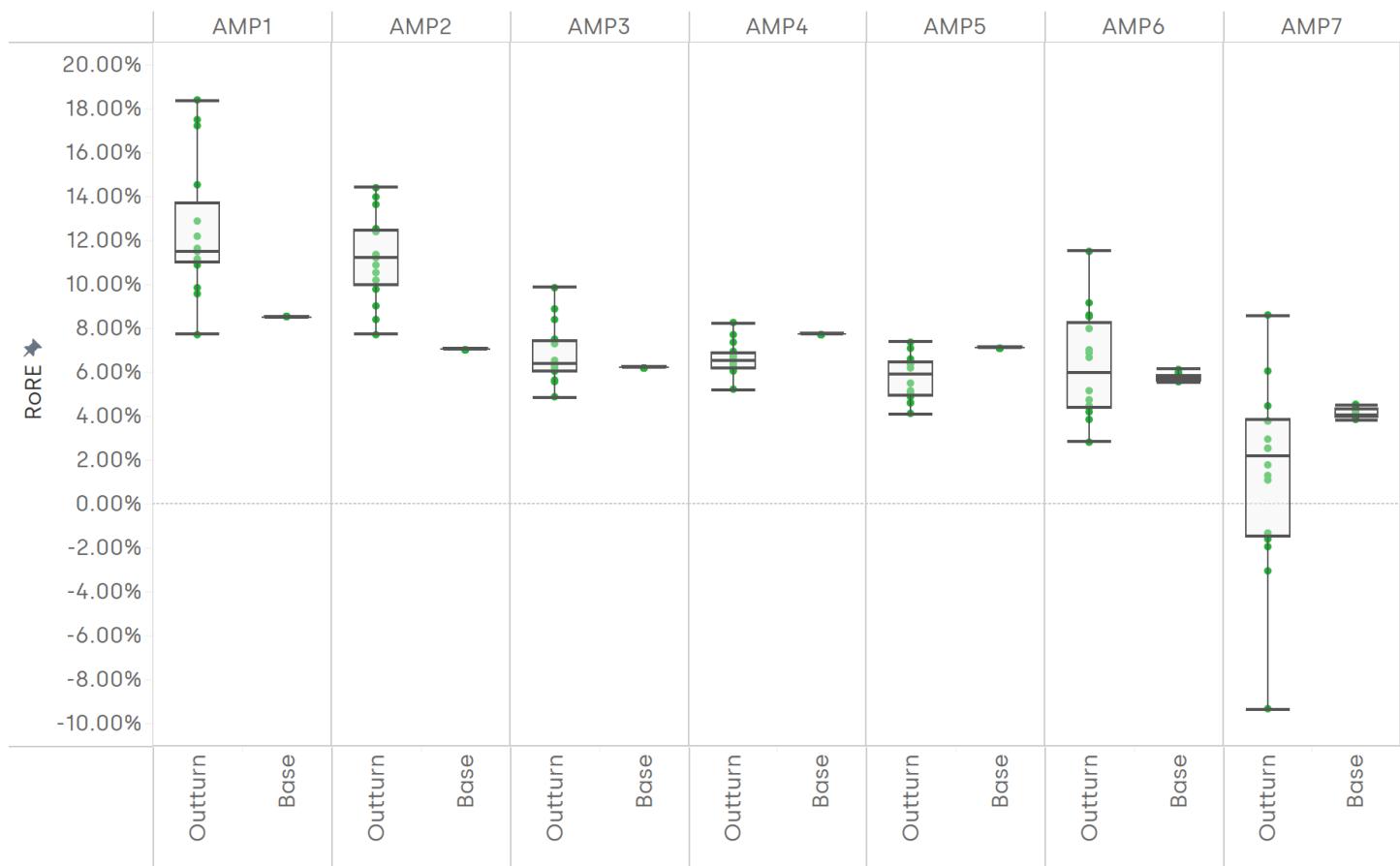
Source: Ofwat (2025), 'WCPR data report 2024-25', October, table 'Enhancement Data'; Ofwat (2024), 'PR24 final determination – efficient expenditure allowances - summary tables', December, table 'Table 54 Enhance aFS_RPEs'; CMA Provisional Determination.

Importantly, this uplift in investment is not confined to AMP8. Company long-term forecasts indicate potential enhancement investment of £275bn–£300bn between 2025 and 2050.⁵ These figures relate solely to increases in enhancement expenditure—however, there is also a recognition across the industry that a step change in capital maintenance expenditure will be needed, further increasing the size of the financing requirement.

This investment programme comes at a time when returns have been low, and levels of financial resilience have deteriorated. Outturn water sector returns have fallen over time. This partially reflects a decade of low interest rates and cheap corporate debt following the financial crisis—however, there has also been a tightening of the base returns allowed by Ofwat and more pronounced under-performance relative to regulatory allowances. This is illustrated in the figure below.

⁵ Based on company long-term delivery strategy documents produced during the PR24 process.

Figure 2.2 Trends in regulatory returns over time: base vs outturn RoRE (AMP1–AMP7)



Note: RoRE = return on regulated equity.

Source: Oxera.

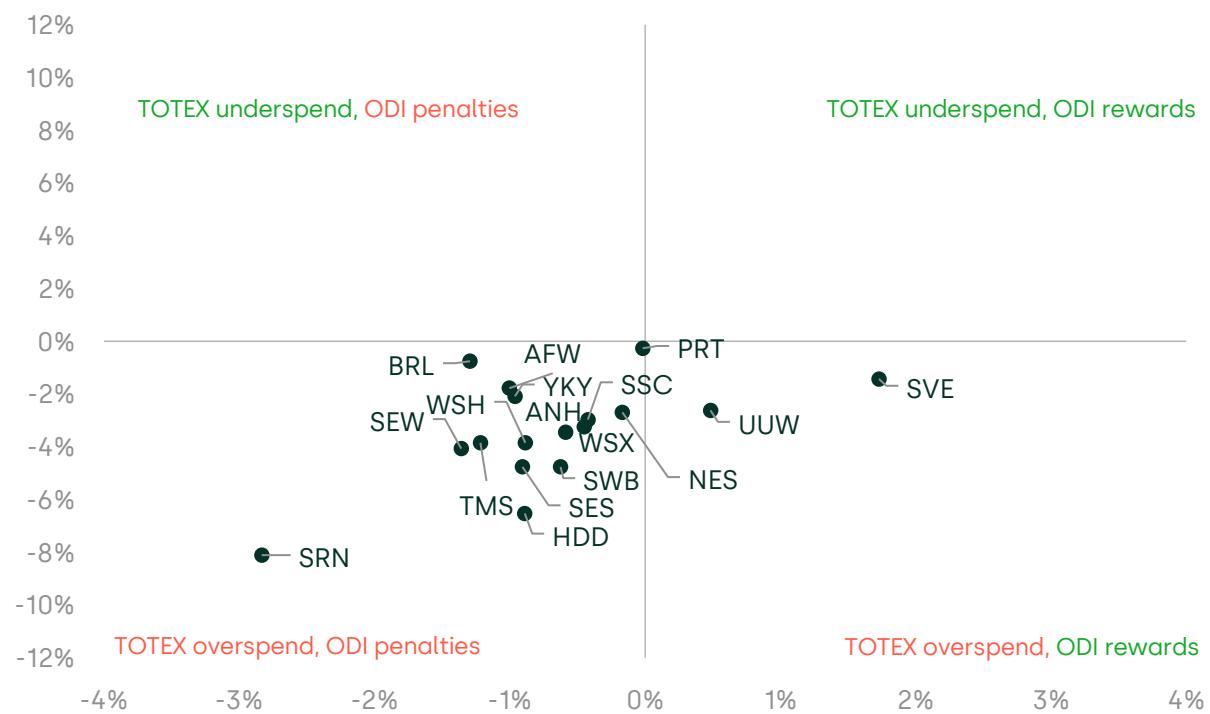
Ofwat's latest annual publication paints a stark picture in terms of industry financial performance.⁶ Historically, Ofwat's determinations have led to a mixture of outperformance for top performers and underperformance for weaker performers. However, the most recent price control (AMP7, 2020–25) was challenging for the whole sector in terms of operational performance relative to regulatory expectations, with lower returns and less scope for outperformance across the industry.

All companies overspent their total expenditure (TOTEX) allowances and most paid net outcome delivery incentive (ODI) penalties. **Only four out of 16 companies were able to earn the base return on equity, on average, over AMP7.** As shown in the figure below, we note that Anglian

⁶ Ofwat (2025), 'Monitoring Financial Resilience Report 2024-25', 5 November.

Water was one of the companies whose outturn RoRE (1.1%) was significantly below the base RoRE (4.4%) in AMP7.

Figure 2.3 TOTEX and ODI performance in RoRE terms (2020/21–2024/25)



Note: ANH, Anglian Water.

Source: Oxera based on Ofwat (2025), 'Monitoring financial resilience 2024/25', November.

Investor sentiment towards the sector has weakened as a result.

Investors' and ratings agencies' views on the attractiveness and stability of England and Wales water has fallen in recent years.⁷ Credit rating agencies have downgraded their views on the stability and predictability of Ofwat's regime (in some cases, by multiple notches), leading to tighter financial thresholds—see the table below.⁸ As credit

⁷ The Global Infrastructure Investor Association's quarterly infrastructure pulse survey shows that unattractive regulation is a key barrier to investment in UK infrastructure: 'the UK's regulatory regime remains a major barrier, with ongoing uncertainty around the future regulatory model likely to be adopted in sectors with a high level of private capital.' Global Infrastructure Investor Association (2025), ['Infrastructure Pulse Q2 2025'](#), 10 June, p. 8.

⁸ For example, Moody's has stated that: 'There has been a material and sustained weakening of credit quality for nearly all companies amid continued public scrutiny and heightened political and regulatory focus. Across the sector, previous decisions, such as prioritising affordability and shareholder distributions, have contributed to underinvestment and exacerbated the sector's

ratings have fallen, debt costs have increased, which is not in customers' interests.

Table 2.1 Credit ratings have declined, with several companies in dividend lock-up

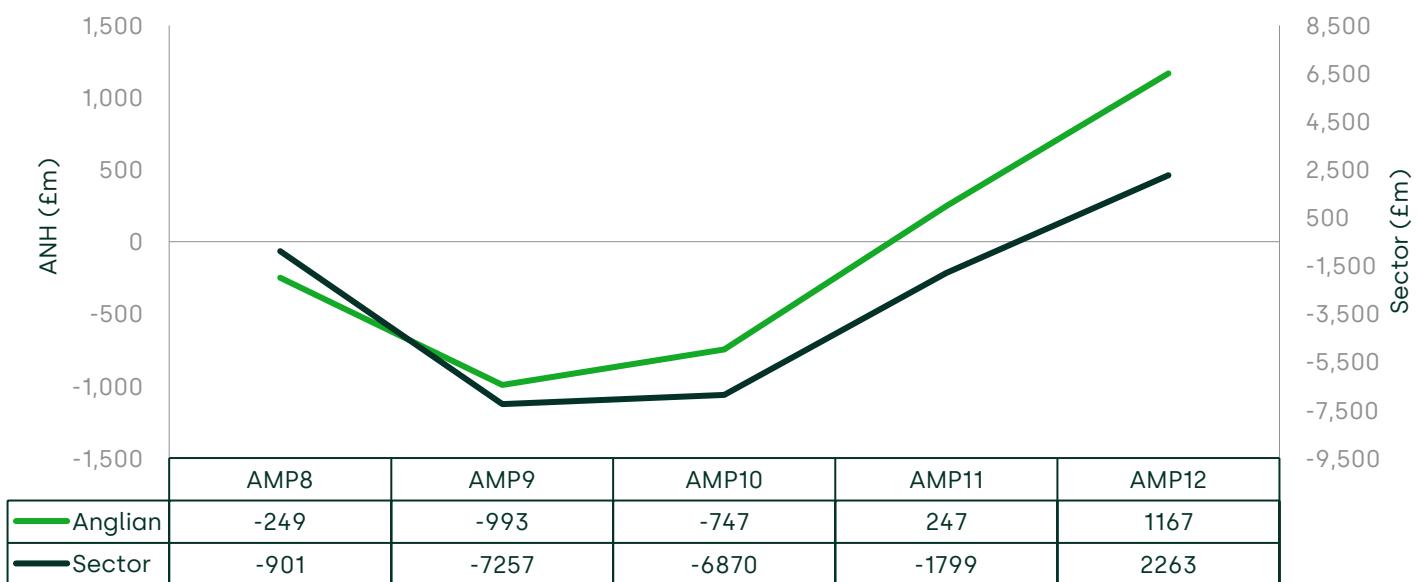
Company	Lowest monitored credit rating	Company	Lowest monitored credit rating
Affinity	BBB+ Negative	Southern	Ba1 Stable
Anglian	BBB Stable	South East	BBB- Negative
Dŵr Cymru	BBB+ Negative	South Staffs	Baa2 Stable
Hafren Dyfrdwy	BBB+ Stable	South West	Baa1 Negative
Northumbrian	BBB+ / Baa1 Negative	Thames	Caa3 Stable
Portsmouth	Baa2 Stable	United Utilities	BBB+ / Baa1 Stable
SES Water	Baa1 Negative	Wessex	BBB+ / Baa1 Negative
Severn Trent	BBB+ / Baa1 Stable	Yorkshire	Baa2 Stable

Source: Ofwat (2025), 'Monitoring financial resilience 2024/25', November, pp. 15–16.

The investment proposition has also changed. The switch to sustained negative net cash flow to equity fundamentally changes the investment proposition, since dividend-paying stock owners now need to provide new capital on a regular basis, or sell their water company stakes to other classes of investor with potentially higher return requirements. It should not be assumed that existing investors will continue to invest at any cost/risk level. The cumulative net dividends for Anglian and for the sector are shown in the figure below.

exposure to changing weather patterns, population growth and shifting expectations. Regulatory targets have become more demanding and penalties for those that fall short have continued to rise... We believe that the predictability and supportiveness of the regime has reduced.' Moody's Ratings (2024), '[Moody's Ratings downgrades Southern Water to Ba1, on review for further downgrade](#)', 13 November.

Figure 2.4 Cumulative net dividends, ANH vs sector (WaSCs only) (£m real, 2022–23 prices)



Note: Sector refers to water and sewerage companies (WaSCs) only. We assume no de-gearing of the notional company in this scenario.

Source: Oxera analysis.

The investability challenge is exacerbated by increasing global competition for infrastructure capital. The UK is competing globally for investment, and potential investors have a range of options for where they deploy their capital. For example, in European energy, the European Commission has estimated investment requirements of €584bn in electricity grids over a decade.⁹ Attracting investment requires stable, proportionate regulation and returns that are competitive relative to other investment opportunities of comparable risk.

All of this points to a need for a renewed focus on investability. For 30+ years, Ofwat and other economic regulators have rightly focused on driving efficiency improvements. However, the recent over-focus on keeping bills as low as possible is not in customers' long-term interests.¹⁰

⁹ European Commission (2023), ['Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions \(COM2023\): Grids, the missing link – An EU Action Plan for Grids'](#), 28 November.

¹⁰ This is recognised in the IWC report, which states: 'Overall, the Commission does see evidence that there was pressure from government and the regulator to keep bills low in Price Reviews between 2009 and 2024.' The Commission also notes how this has led to under-investment. See Independent Water Commission (2025), ['Final Report'](#), 21 July, p. 204.

The scale of this investment programme relative to the past warrants greater regulatory attention on investability.

The interests of future consumers are inextricably linked to getting this right. A lack of investability will ultimately harm future consumers and undermine the development of resilient infrastructure and economic growth. In our work for Water UK in responding to the IWC's call for evidence, we highlighted that the impact of this could be felt in one of two ways.¹¹

- **Forgone investment (due to reduced access to finance).** If the sector were perceived to be uninvestable and companies were unable to attract new equity, there would be a shortfall of c. £152bn in investment across the sector by 2050—even if no dividends were paid. This equates to over half of the expected enhancement spending over the next 25 years,¹² and reflects the significantly diminished capacity of the sector to finance capital programmes from internal funds.
- **Higher bills (due to a higher cost of finance).** Bills are highly sensitive to the cost of capital, and higher perceived risk is associated with a higher cost of capital. Illustrative analysis (using PR24 regulatory parameters) shows that the impact of a credit rating downgrade on the cost of capital could be equivalent to a £14–£27 increase in average household bills in the long run.

3 Principles of a regulatory system that supports investment

The question then turns to how the regulatory and policy framework can best support the required investment, while also ensuring that other public interest objectives are met (e.g. customers receiving value for money for the investments that they fund through bills). The water sector is not alone in balancing these twin (and potentially conflicting) objectives of investability and affordability—and, indeed, they are

¹¹ Oxera (2025), '[A sustainable and investable framework for the England and Wales water sector](#)', prepared for Water UK, 23 April.

¹² As forecast in companies' long-term delivery strategies.

central to regulatory design issues in GB energy networks and European infrastructure networks more generally.¹³

Over the course of PR24 and in response to the IWC's call for evidence, Oxera engaged extensively with industry stakeholders and investors on the topic of investability.¹⁴ Drawing on this engagement, our submissions on behalf of Water UK, and our subsequent conversations with stakeholders, we have identified several principles that the policy and regulatory framework should adhere to in order to promote investment. These are summarised in the table below.

¹³ This trade-off is summarised well in the UK's ten-year infrastructure strategy: 'The government is clear that economic regulation needs to provide greater transparency, predictability and confidence to investors, with returns that are internationally competitive and reflect the scale and complexity of the infrastructure delivery challenge. However, the government also recognises the constrained finances of many households and the need to build credibility and trust with consumers. Getting this balance right is critical.' HM Treasury and NISTA (2025), ['UK Infrastructure: A 10-year strategy'](#), June, p. 40, para. 2.24.

¹⁴ See, for example, Oxera (2024), ['Investability at PR24'](#), 27 August; Oxera (2024), ['PR24 Investor Engagement Report'](#), October; Oxera (2025), ['A sustainable and investable regulatory framework for the England and Wales water sector'](#), 23 April.

Table 3.1 Principles for an investable regulatory framework in England and Wales water

Area	Guiding principle
Clarity over public policy	The government should seek to provide clarity over long-term policy and trade-offs, with a firm commitment to promoting investment and securing investability.
Allowed returns	Investors should expect to earn fair and competitive sector returns that are comparable with wider infrastructure investment opportunities.
Incentives and risk	The regulatory arrangements should provide a balanced incentive package with an appropriate level of regulatory risk exposure for a sector that needs to deliver £250bn+ of enhancements and a step change in capital maintenance in the next 25 years.
Accounting for company-specific factors	The regulatory framework and regulatory expectations placed on companies should recognise company-specific factors, including regional differences in objectives, priorities and asset bases.
Effective business planning framework	The business planning framework should promote openness and transparency in understanding investment needs to ensure that companies are genuinely incentivised to propose the plans required to deliver the right long-term outcomes for customers.
Asset health	The future system should provide an improved approach to infrastructure resilience to ensure that networks are being maintained for future generations.

Source: Oxera.

4 Are the proposed reforms aligned to these principles?

4.1 Clarity of government policy

Why is it important?

Water companies invest in long-lived assets, which often have lifespans exceeding 50 or even 100 years. The greater the clarity over the long-term policy for the sector, the better informed investors will be about how their investments will be treated in future and the direction of travel that the sector is following. This can, in turn, help to reduce risk, lower financing costs, and promote long-term strategic planning and cost-effective investment over multiple AMPs. This is particularly important in the context of balancing multiple (often conflicting) policy objectives,

including network resilience, affordability, environmental outcomes and investability.

In the past, there has been a lack of political and regulatory clarity on how critical trade-offs should be made. As the IWC noted, the most recent Strategic Policy Statement (SPS) from the government set out more than 50 expectations of Ofwat. Investor engagement has highlighted that policy uncertainty and inconsistency (as well as waning confidence in regulators) have affected investor sentiment.¹⁵

Where is proposed reform going in the right direction?

The IWC report was unambiguous on the critical role that government must play in providing clear strategic direction to the water sector and its regulators. Importantly, it recognised that government and regulatory policy has contributed to under-investment and an erosion of the sector's credit ratings over the last decade.¹⁶ The IWC called for a system-wide, long-term National Water Strategy with a minimum 25-year horizon that sets the direction across all aspects of the water system, and sets out a clear framework for regulators to manage trade-offs between priorities. More detailed guidance to the regulator(s) would be provided through a new Ministerial Statement of Water Industry Priorities.

Likewise, the IWC recommended that investment planning should be carried out under a 5/10/25-year planning model—a recommendation that the WWP confirms will be carried forward.¹⁷ This should help to provide greater transparency and understanding of long-term implications for capital requirements, returns to investors and charges to customers. This has been a significant issue (as raised by companies during PR24 and the ongoing Competition and Markets Authority, CMA, redeterminations) with Ofwat's regulatory model, and the focus on five-year control periods. While companies prepared long-term delivery strategies, setting out scenarios for network enhancement over 25

¹⁵ Independent Water Commission (2025), 'Final Report', p. 320, para. 749.

¹⁶ The IWC 'believes that government and regulator pressure on bills played an important role in what can now be seen as underinvestment over this period [between PR09 and PR24]. Prioritising the objective of low water bills over other objectives is, of course, a strategic decision for government... [However], strategic trade-offs and guidance need to be transparent and consistent, and take into account longer-term consequences.'

¹⁷ 'To further strengthen planning, we will introduce a 5/10/25-year planning approach. This will provide short-term funding certainty to water companies for the first 5 years, more indicative funding commitments for the following 5 years, and set out high-level funding needs over a 25-year horizon. The price review cycle would then act as 5-year checkpoints in long-term delivery plans, not delivery sprints.' Defra (2026), '[A new vision for water](#)', January, p. 25.

years, these were given minimal attention in Ofwat's Final Determination.

Areas that require further thinking

These proposals are essential to increasing investor confidence in the market. However, having a strategy and set of priorities is only half of the battle: they will also need to be the right ones. The government will need to avoid a repeat of the mistakes from previous SPSs. It must give clarity to regulators over priority outcomes and be more explicit about how trade-offs should be managed, both during the transition period (via an updated SPS) and over the longer term (via the National Water Strategy). The WWP does not comment on how this prioritisation will be achieved and, indeed, makes no mention of the National Water Strategy.

In this regard, there are a number of areas where political direction is needed, as follows.

- The strategic imperative of addressing the historical capital maintenance backlog, and getting the industry on a more stable forward footing. This could include timelines for how quickly the economic regulator should be seeking to address this backlog.
- The development of a structured process/framework for assessing the costs of environmental improvement, and development of guidance from government on how to trade off customer bill impacts against improved environmental performance.
- More generally, how the economic regulator should make intergenerational trade-offs, to ensure an appropriate balance and smoothing between short-term efficiency/affordability and longer-term resilience/security.

While the IWC recommendations and WWP have generally been well received, and provide an indication of the direction of travel, there is heightened short-term risk and uncertainty while the government takes forward the proposals. The scale of the change—which combines the most significant change to the regulatory model since privatisation with a large institutional reorganisation—and the number of new areas mean that implementation risk is high. A clear implementation plan and timetable are needed for how this will be taken forward, with a focus on how the economic regulatory framework will evolve to provide the necessary balance to incentivise the sustained investability of the sector.



Box 4.1 Oxera recommendations in relation to government policy

- 1 The revised SPS will be a critical document in signalling to the industry and investors how regulators are expected to engage with the market during the transition period and beyond, and the extent to which this will be any different from the past. Defra must provide Ofwat with a clear steer on how to take forward its work and its expected culture and mindset towards the sector during the transition.
- 2 Defra's implementation plan must focus on the most critical policies, as opposed to making incremental progress against all 88 recommendations. From an investment perspective, the key short-term focus should be on the scope and shape of the next price review (PR29). Fast progress is needed to signal to investors that PR29 will support necessary investment and will not be a repeat of recent price reviews.
- 3 Defra should develop a balanced scorecard to show how it will measure progress in the areas that really matter to stakeholders. We discuss this further in our paper on balanced scorecard.¹

Note: ¹ Oxera & Anglian Water (2026), 'Monitoring Progress: A balanced scorecard for the water sector', January.

Source: Oxera.

4.2 Fair and competitive sector returns

Why is it important?

As noted above, the water sector competes with other sectors globally for investment. The level and stability of returns that investors expect to earn are a key determinant of the attractiveness of the sector to debt and equity capital. There are two main elements to this:

- 1 the allowed rate of return (i.e. the headline WACC that is used in the price review);
- 2 the variability of actual returns around the base return, due to regulatory incentives and risk-sharing.

The IWC showed evidence that allowed returns have been lower in water than in other regulated utilities over the last two price reviews.¹⁸ Outturn water sector returns have also fallen over time. Five companies (Dŵr Cymru, Southern Water, Thames Water, South East Water and SES Water) reported negative returns on regulated equity on average over AMP7.

If expected returns are too low to compensate investors for the risks that they bear in investing in water assets, new capital will not be forthcoming and the public will not benefit from network investment. The effects of this may not be seen immediately, but could instead play out over the long term.

Where is proposed reform going in the right direction?

The IWC acknowledged many of the concerns raised by companies and investors in relation to the returns on offer in the water sector, and the extent to which these are consistent with the riskiness of the regulatory package.

Specifically, the IWC's report recognised the importance of the WACC in promoting investment, that the UK water sector competes globally to attract capital, and that returns have been too low in recent years.

The WWP similarly recognises the need for the regulatory framework to provide investors with a 'fair bet', with 'a return which adequately reflects the risk they take, helping to re-establish the water sector as a place for steady and stable returns'.¹⁹

Areas that require further thinking

The IWC's primary recommendation in this area was to pass the baton to the CMA. Specifically, it recommended that the CMA should be given responsibility for:

- setting a common WACC methodology;
- setting components of the WACC that are not specific to the sector under review (e.g. the risk-free rate and the total market return);
- setting standards and guidance for the setting of sector-specific components of the WACC;

¹⁸ Independent Water Commission (2025), '[Final Report](#)', p. 220, Figure 16.

¹⁹ Defra (2026), '[A new vision for water](#)', January, p. 8.

- monitoring how these are applied by the sector regulators.

In combination with the proposal that the appeals framework be changed from a full redetermination to appeals on specific grounds, this would mean that there is a more limited appeal route in relation to the setting of allowed returns. Given the evidence, cited by the IWC, that investors see appeals to the CMA as a necessary cross-check on critical regulatory decisions, this could undermine (rather than promote) investor confidence during a period of significant change for the sector.

While the IWC's envisaged approach could lead to greater consistency across UK regulated sectors in terms of economy-wide parameters, WACC allowances would still need to reflect fundamental differences in risk (and hence required returns) between sectors. In practice, there may only be three parameters—the risk-free rate, total market returns and tax rates—that should be the same across all sectors. (There could, for example, be good reasons why the cost of raising new debt—identified in the IWC's report as one of the parameters that could be set by the CMA—might vary across sectors. Indeed, yields on water bonds are currently higher than those on energy bonds.)

Moreover, transferring responsibility for the WACC to a different body would not, in itself, address the issue that UK returns need to be competitive with global comparators in order to attract capital. At a minimum, the WACC-setting process should take account of market cross-checks, including the returns that are available internationally.

It is also important to remember that setting the allowed rate of return will never be an exact science. There remains a risk, particularly as regulatory asset bases grow in size and bills become more sensitive to WACC allowances, that economic regulators will have an incentive to choose the lowest feasible value for each WACC parameter in a bid to minimise bill impacts. Regulatory mindset—and the policy/strategic guidelines that the regulator is operating under—will play an important role in ensuring that regulators set allowed returns in a way that promotes investment.²⁰

²⁰ The CMA has acknowledged that the cost of capital needs to be attractive given the scale of investment required: ‘Ensuring that regulated companies can attract debt and equity capital at reasonable cost is critical to enabling the companies to operate their businesses efficiently, and to deliver the investments needed to provide the appropriate level of service to customers… We conclude that in the unique circumstances of this AMP a modest degree of aiming up can overall benefit customers. This is because it might reduce the risk of the sector being unable to attract new capital to finance the large-scale capital programme needed to deliver improvements in service and resilience. A successful delivery of the capital programme is ultimately in customer interests.’ Competition and Markets Authority (2025), [‘Water PR24 references Provisional Determinations’](#)

We therefore consider that it is important, as Defra takes forward these reforms, to consider:

- what evidence and methods will be needed to ensure that returns are globally competitive;
- the scale of the investment required in the near and longer term; and
- the role that redeterminations play in providing investors with confidence that the right answer will be arrived at.



Box 4.2 Oxera recommendations in relation to securing competitive returns

- 4 Defra should be clear on how allowed returns will be set in a way that ensures global competitiveness. This should include:
 - the use of market data and cross-checks, especially returns from other sectors raising capital in the UK and globally;
 - aiming up where needed, given consumer welfare asymmetry due to under investment (as acknowledged by the CMA in PR19 and PR24).
- 5 Existing appeal mechanisms should be maintained, at least during the transition phase, to give investors confidence that they will be able to challenge decisions that would result in inadequate returns.

Source: Oxera.

4.3 Provide a more balanced suite of regulatory incentives

Why is it important?

As outlined above, the base allowed returns set at price reviews will influence investment incentives. However, beyond assessing whether a base return is adequate, investors will assess the variability of returns.

[Volume 4: Allowed Return, Risk & Return, Provisional Determinations, Next steps - Chapters 7–10'](#), 9 October, paras 7.13 and 7.577.

The incentive package—and the resultant distribution of risk once the price control is in flight—will therefore also affect investment decisions.

Ofwat's regulatory model, shown in the figure below, has introduced a vast array of regulatory mechanisms that alter the distribution of risk—including outcome delivery incentives, cost-sharing factors, real price effects, an outturn adjustment mechanism, a return adjustment mechanism, cost of debt indexation, notified items, and bespoke uncertainty mechanisms. The package of ex post regulatory mechanisms and the regulator's approach to setting allowances ex ante will together shape the balance of risk, expected returns, and the attractiveness of the sector to investors.

Figure 4.1 Price control incentives/mechanisms at PR24

Primary incentive mechanisms		Additional ex post reconciliations	
Outcome delivery incentives		Outcomes	
Common (24 PCs)	Bespoke	Outcomes aggregate sharing mechanism (O-ASM)	Outturn adjustment mechanism
Price control deliverables		Deliverables	
Time incentives	Non-delivery incentives	Delayed Delivery Cashflow Mechanism	
TOTEX cost sharing		TOTEX uncertainty mechanisms	
Base (determined by QAA)	Enhancement (40:40)	Large schemes, IED and EPR (25:25)	Business rates (10:10)
Business plan incentive			
Cost sharing rate	Financial reward / penalty	Protection from movements between DD and FD	Storm overflows
			Third party services
			PFAS
		Gated allowances	Bespoke UMs
		Enhanced engagement schemes	Delivery mechanism (TMS and SRN only)
		Labour RPEs	Bioresources notified item
		Energy RPEs	Cyber security

Note: Other mechanisms: revenue forecasting incentive, water trading incentive, land sales, retail reconciliation, bioresources reconciliation, tax reconciliation, cost of debt indexation.

Source: Oxera.

Within the investability paper that we developed during PR24, we highlighted the following two considerations here.

- 1 **The balance of upside and downside risk**—if investors determine that there is a downside skew in returns and that the price control is therefore not a 'fair bet', this could compromise investability.

2 **The overall level of risk exposure**—traditional providers of infrastructure capital (e.g. pension funds) typically have a low tolerance for risk. Once the risk exceeds a level that is compatible with core infrastructure investing, they may exit and be replaced by other classes of investor. Consequently, the scale of risk exposure should also be an important regulatory consideration.

The table below shows the outturn RoRE returns across companies in AMP6 and AMP7, with the range becoming much wider and more skewed to the downside in AMP7.

Table 4.1 Outturn RoRE ranges in the last two AMPs

	Low	High
AMP6	2.8%	11.5%
AMP7	-9.3%	8.5%

Source: Ofwat (2025), '[Monitoring financial resilience 2024/25](#)', 5 November; and Ofwat (2020), '[Monitoring financial resilience 2019/20](#)', 2 December.

A central outcome of a regime that is designed to support investment should be that companies face a balanced risk package with an appropriate level of regulatory risk exposure reflecting the investment requirements of the sector. We noted that there are multiple ways in which this could be achieved: for example, by moderating the level of return at risk under the various incentive mechanisms, or by providing greater protection for companies against service performance risks and changes in circumstances, which lie outside of their control.

Where is proposed reform going in the right direction?

The IWC expressed its view that the water industry will be best served by investors that take a long-term investment approach, and Defra states that the reforms outlined in the WWP have been designed with the perspective of long-term investors in mind.²¹ It has recommended a fundamental review of the incentive package to ensure that it provides a risk–return profile that is attractive to these investors. This includes removing the quality and ambition assessment of business plans, and

²¹ Defra (2026), '[A new vision for water](#)', 20 January, p. 24.

reviewing the outcome delivery incentives framework and customer measure of experience metric.

A review of the incentive framework and the level of return at risk is needed, given the sector's shift in capital intensity. The details of the risk–return framework will need to be worked through, with a focus on ensuring that there remain appropriate incentives for improvements in performance and rewards for leading companies. Supervision should allow for better tailoring of performance expectations and rewards/penalties to regional circumstances.

A key concern raised by companies and investors during our engagement has been around the interplay between regulatory incentives and non-price-control incentives (e.g. enforcement action), and specifically the extent to which this creates 'double jeopardy'. The integration of the economic and environmental regulators should be used as an opportunity for more joined-up assessment and incentivisation of performance.

Areas that require further thinking

One risk associated with reform is that it could result in another reset of the way in which performance is measured. Part of the rationale for moving to an outcomes framework in PR14 was to consider the outcomes that matter over the long term. There was discussion at the time of multi-AMP incentives and performance trajectories. Instead, the performance regime has changed at each subsequent price review, which makes it difficult for stakeholders to determine performance trends over the longer term and masks underlying absolute improvements. There needs to be agreement on the things that really matter and greater consistency in how these are incentivised from one price review to the next.



Box 4.3 Oxera recommendations in relation to regulatory risk and incentives

- 6 There should be a full review of the incentive framework ahead of PR29, with a moderated level of RoRE risk exposure (at company-specific levels) to provide a fair risk–return package. Consideration should be given to wider use of cost pass-through mechanisms during the coming investment phase.

- 7 This should still provide the potential for rewards to companies for leading performance or delivery of large performance improvement, while holding companies to account if they do not deliver what they have indicated they will.
- 8 There should be no negative skew in the revised risk/incentive package by design.
- 9 The review of the incentive package should seek to identify which aspects of the package have been effective and which have created unintended consequences. Several of the pervading regulatory principles underpinning Ofwat's approach—e.g. the concept of a notional upper-quartile company and the idea that historical comparative analysis of 'what base buys' can be used to calibrate performance incentives—should be reconsidered.¹
- 10 The frequent changes to the performance framework have contributed to the loss of stability and predictability in regulatory decision-making. The review of the incentive package should seek to identify the areas of performance that will be measured and incentivised over the long term.
- 11 In designing the PR29 price review, the regulator should carefully review the 'package effects' of price review and non-price-review regulations and demonstrate how the double jeopardy of previous reviews has been controlled for.
- 12 As recognised by the WWP, the number of regulatory mechanisms should be streamlined to reduce complexity and unnecessary duplication.²

Note: ¹ We discuss issues with 'what base buys' further below in relation to asset health. ² Defra (2026), '[A new vision for water](#)', 20 January, p. 26: 'We will therefore instruct the regulator to rationalise the incentive framework so that it is simpler, more predictable, and is not duplicative.'

Source: Oxera.

4.4 Recognise regional priorities, characteristics and circumstances

Why is it important?

The water sector faces myriad, complex, intergenerational challenges, including water supply pressures, adapting to climate change, tackling environmental problems, and meeting the needs of a growing population. These challenges present differently across operating

regions given their unique geographic circumstances and local priorities, and companies face different risks based on their business models, operating regions and asset bases.

The current regulatory approach, with fixed allowances and incentives set through a largely one-size-fits-all comparative approach, has been ill suited to tackling these regional differences. While regional characteristics (e.g. exposure to climate and operational complexity) are a core driver of the overall level of risk borne by investors, this has consistently not been recognised in the price review process.

Where is proposed reform going in the right direction?

The IWC recognised the problems of relying on comparative competition when setting revenue allowances and performance expectations, and the need to account for regional and company-specific factors within the regulatory model. Benchmarking can be a powerful tool—and should be part of any economic regulator's toolkit—but over time the weight that has been placed on the econometric models has increased, while the understanding of companies has reduced.

Economic regulators understandably worry about the risk of being captured by the complexities of their industry, but effective regulation also requires technical sector knowledge which is built through constructive engagement. As the circumstances of the sector have changed, and the priorities shift from cost efficiency to growth and investment, economic regulation needs to be grounded in a deeper understanding of the businesses.

The IWC report called out the need for a regulatory system that is more forward-looking and better able to reflect regional needs within investment and regulatory decision-making. It recommended that a more supervisory approach to regulation be adopted, with company-level supervisors gaining a more complete understanding of each individual water company.²² The WWP has confirmed that it will require and support the new regulator to adopt a supervisory approach.²³

Such a model could provide greater ability to account for regional and company-specific differences, while allowing for pragmatism over strict

²² The IWC also proposed the introduction of regional system planners, to help ensure that water companies' investment programmes deliver national objectives while taking into account regional needs and priorities. The WWP refers to regional system planning, but leaves open the question of the institutional arrangements. We discuss the role of regional system planning under the new arrangements in our paper. Oxera & Anglian Water (2026), 'Aligning institutions', January.

²³ Defra (2026), '[A new vision for water](#)', 20 January, p. 19.

adherence to theoretical econometric models. Indeed, effective supervision would need to enable decision-making to reflect the local realities faced by each company/region. Interventions could be better targeted and tailored to individual companies, and new sources of data could be considered.

Areas that require further thinking

From an investability perspective, the greater focus on individual companies' circumstances is regarded as a positive development. However, our recent engagement with investors indicates that concerns remain. In particular, investors have raised concerns that:

- a supervisory model inherently requires greater discretion/use of judgement, which makes it harder to predict and quantify potential outcomes (if implemented and communicated poorly);
- the combination of supervision and price controls is largely untested, and investors will need to see it in action. For example, Moody's has indicated that its default position would be to downgrade the stability and predictability of the regime to Baa until it sees evidence of how the system works in practice.²⁴ This is contrary to the stated objective of the government within the WWP;²⁵
- linked to the above, the supervisory framework needs to promote *predictability* of decision making as it is unpredictable regulation that particularly undermines investor confidence;
- the IWC's recommendations would allow for greater interference in boardroom decisions, in the form of enhanced powers of direction, the ability for the regulator to block changes in control, and the ability to impose capital requirements. Where there is potential for political or regulatory intervention in Board decisions, this will be seen to increase risk for investors.²⁶ These recommendations therefore present a risk to the government's overall objective of creating a stable regulatory environment that is attractive to inward investment.

²⁴ Moody's (2025), '[UK Water 2025: Fixing Water](#)', 16 October.

²⁵ The Commission states: 'Government should explore amending Ofwat's duty to make it clear that "stable and predictable regulation" is also required to ensure companies can finance their functions both by raising debt and attracting equity.' See Independent Water Commission (2025), '[Final Report](#)', 21 July, p. 327.

²⁶ Moreover, there are risks associated with governments shaping corporate decisions (not all of which will turn out well) and—at the extreme—of them becoming shadow directors of private businesses.



Box 4.4 Oxera recommendations in relation to regulating for regional circumstances

- 13 Ensure that the future regulatory approach demonstrates how an understanding of regional, company-specific factors has informed future price reviews.
- 14 Defra should reconsider the scope of the supervisors' powers in relation to board decision-making in order to ensure that it is consistent with promoting investability.
- 15 Recommend that careful interim measures are applied while the new regulatory system establishes itself (e.g. by initially applying downsides only in 'shadow' form to avoid the risk of miscalibration, or by applying a return-adjustment mechanism that falls away over time).
- 16 Provide guidance to the existing regulators on how they can support investability during the transition phase, inclusive of any early work on developing approaches to PR29.

Source: Oxera.

4.5 Effective business planning framework

Why does it matter?

Effective economic regulation relies on good-quality, accurate information from the regulated company. Cognisant of information asymmetry and the potential incentive for companies to seek to 'game' regulatory forecasts, economic regulators have wrestled with how to incentivise companies to provide accurate forecasts and business plans to inform price reviews.

At PR09, Ofwat sought to introduce a menu regulation approach that was intended to incentivise each company to submit a business plan that best reflected its true expected costs for the regulatory period. This approach was subsequently dropped—in part due to its complexity—and replaced by other business plan incentives, including fast tracking and financial rewards/penalties based on the 'quality' of the submitted business plan.

At PR19, Ofwat introduced its Initial Assessment of Business Plans (IABPs), which took the form of assessing companies' plans across a range of subjective test areas.

At PR24, this evolved into the quality and ambition assessment, which rewarded or penalised companies based on Ofwat's assessment of the level of quality and ambition of the business plan.

In practice, over these past two price reviews, the criteria for assessing 'quality' and 'ambition' meant that it became an exercise in rewarding/penalising companies based on how closely their forecasts aligned with what Ofwat considered to be the right answer from its benchmarking models. On the cost of capital, there was a clear correlation between companies that 'used' Ofwat's pre-determined view of the cost of capital and those that were penalised for using alternatives when developing their business plan proposals.

In our experience of advising companies throughout PR24, the quality and ambition assessment had a significant impact on companies' decisions around their business planning. However, the design of the QAA (and its application alongside a cost assessment framework based on top-down benchmarking) meant that, rather than promoting truthful forecasts, it created a new set of unintended consequences that, crucially, were not in customers' long-term interests.

- First, company decisions over what level of cost to include in the business plan became shaped by what the company believed Ofwat would allow, rather than what operational teams considered they truly needed to spend. That is, companies were incentivised to tell Ofwat what it wanted to hear, rather than reflect the investment that companies considered necessary to maintain and operate their respective regional networks. This is most evident through the material disconnect between base costs and the emerging evidence on the sustainable level of asset maintenance.
- Second, Ofwat has persistently misrepresented the service levels proposed in business plans as being forecasts of achievable levels of performance across all measures for a given level of expenditure. This is not the case, as these levels were largely companies' proposals for setting incentives to improve performance in critical areas such as compliance and pollution. This has a material impact on the overall calibration of the balance of risk.
- Third, since companies that were seeking to make significant performance improvements were more likely to need to spend more than indicated by the models, the QAA was more likely to

punish those that were already under-funded and/or less financially resilient. Indeed, three of the four companies whose business plans were considered to be inadequate at the Draft Determinations stage (South East Water, Southern Water and Thames Water) sit within Ofwat's 'Action Required' categorisation within its monitoring financial resilience report. At final determination stage, the QAA led to a financial penalty of £141m for Thames Water, as well as exposing it to worse cost-sharing rates than the rest of the industry, thereby further penalising a company that was already materially underfunded relative to its plan.

All of these aspects of the QAA are negative from an investability perspective.

Where is proposed reform going in the right direction?

The IWC recognised that the QAA incentivised companies 'to submit business plans close to Ofwat's views' and that 'this could have deterred companies from submitting plans for necessary spending on the capital maintenance and/or enhancement of assets in the first place, where this was not in line with Ofwat's view, and even penalised them for simply making the case.'²⁷ It recommended that the QAA be withdrawn. The WWP upholds this recommendation by calling for the abolishment of the QAA.²⁸

Areas that require further thinking

The use of business plan incentives that require companies to align to pre-defined regulatory expectations is emblematic of a 'parent/child' regulatory mindset that assumes, by default, that companies cannot be trusted to tell the truth. The supervisory assessment of plans is an opportunity to foster more open and candid, two-way conversations between the regulator and the company to understand the process adopted to develop the plan, as well as the key strategic issues and risks. This has been a central tenet of the model of ethical business practice and regulation (EBP&R) adopted in the Scottish water sector.²⁹

²⁷ Independent Water Commission (2025), '[Final Report](#)', p. 182, para. 386.

²⁸ Defra (2026), '[A new vision for water](#)', 20 January, p. 38.

²⁹ Water Industry Commission for Scotland (2024), '[Strategic Review of Charges 2027-2033: Final Methodology](#)', 12 December, p. 7: 'We adopted the principles of EBP&R, which requires candour and transparency in all communications between regulator and regulated company. This approach facilitated open and honest discussions about the long-term challenges the industry faces and how to address them. Our SRC21 regulatory approach emphasised the importance of working together

This will require both companies and regulators to change their approaches. On the one side, companies will need to respond to supervision in the appropriate way—taking ownership for doing the right things, producing information that builds trust, and preparing business plans that are ambitious but deliverable. On the other side, there will need to be a willingness from the regulator to engage on difficult issues, even where these have cost implications.



Box 4.5 Oxera recommendations in relation to effective business planning

- 17 One principle underpinning supervision should be to encourage open and transparent discussion of requirements and critical strategic issues.
- 18 The regulatory approach to business plan assessment, and the incentive package that sits alongside it, should encourage open forecasting, rather than alignment with what the regulator is likely to allow.

Source: Oxera.

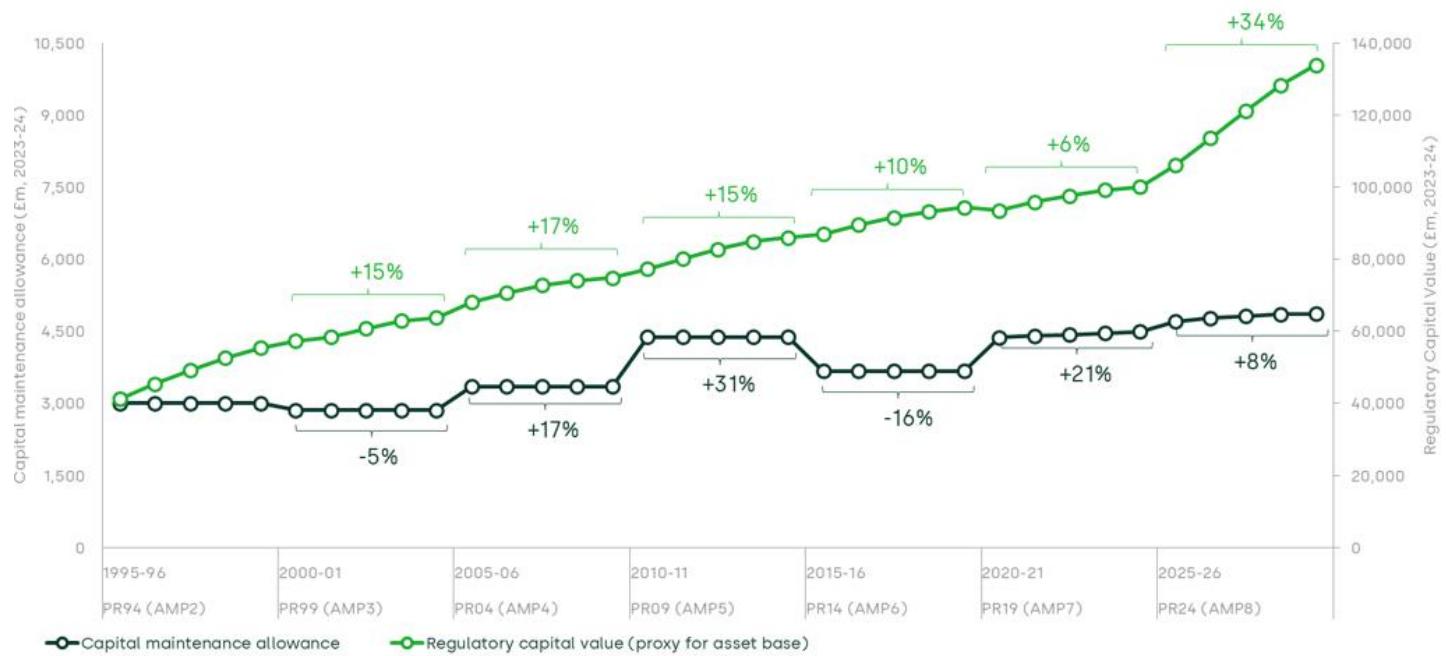
4.6 Asset health

Why does it matter?

Within the UK water sector, there has been growing concern over whether the current regulatory system has adequately promoted and measured infrastructure resilience, and provided companies with sufficient levels of funding for long-term infrastructure resilience. One potential indicator of concern is that growth in capital maintenance allowances has not kept pace with growth in new assets (and their future replacement needs) over the last 30 years, as shown in the figure below. The figure also highlights the variability of capital maintenance allowances—e.g. with large cuts in allowances for AMP6.

to tackle industry challenges, such as delivering net zero emissions by 2040 and investing to replace Scottish Water's ageing assets.'

Figure 4.2 From PR94 to PR24, RCV has increased by c. 230%, while capital maintenance allowances have increased by c. 60%



Source: Oxera (2025), ['A new approach to performance and supervision in the England and Wales water sector'](#), p. 15, Figure 2.1.

In contrast to the approach taken in England and Wales, the Scottish water regulator (WICS) has worked collaboratively across stakeholders to understand long-term asset health requirements and the implications of this for annual funding. This approach is summarised in Box 4.6 below.



Box 4.6 Case study: the approach to asset health funding in Scotland

The Water Industry Commission for Scotland (WICS), as well as the government and other industry stakeholders, have recognised the scale of the asset replacement challenge facing Scottish Water and, at the SRC21 review, sought to apply a more bottom-up approach to funding asset health. Oxera worked closely with WICS and Scottish Water to co-create this framework in the run-up to SRC21.

WICS explicitly chose not to follow Ofwat's approach of considering capital maintenance within econometric benchmarking models. Instead, WICS and Scottish Water worked collaboratively to develop a bottom-up framework for

determining the long-run asset health needs across a range of asset classes. This granular approach required an assessment (for each asset class) of the available evidence on asset lives and the cost associated with replacement, repair and refurbishment. This formed a foundation for assessing the asset replacement liability and the required level of annual investment needed to meet this liability as it crystallised.

Source: Oxera. Further detail on this approach is set out in Sutherland, A. (2025), '[Insights from debates on Asset replacement in Scotland](#)', May.

Appropriate regulation of asset health and operational resilience is important to investability, since investors will take account of asset risk when assessing whether to invest in a sector. If the regulatory framework is consistently underfunding infrastructure resilience, investors will either be required to fund these shortfalls on an ongoing basis (by overspending allowances), cut back on other areas of investment, or take on greater asset risk not captured in the allowed returns. Unfunded asset replacement liabilities will undermine performance and have the potential to be highly damaging for sector investability.

Consequently, in our work on behalf of Water UK in response to the IWC's call for evidence, we argued that:³⁰

- the price review framework should take greater account of the long-term requirements of the sector (in terms of future infrastructure needs, consumer needs, and environmental needs), price paths, and performance trajectories, rather than focusing solely on distinct five-year price controls;³¹
- a new framework is needed to give companies and investors confidence that efficient increases in asset maintenance investment will be funded in future control periods, including enhanced regulatory measurement of asset health;
- capital maintenance should be assessed outside of base cost models;

³⁰ Oxera (2025), '[A sustainable and investable regulatory framework for the England and Wales water sector](#)', prepared for Water UK, 23 April, section 4.3.

³¹ This could include providing greater certainty on expenditure allowances over the longer term to support multi-AMP major infrastructure projects.

- investors require confidence in their exposure to historical asset deficits and should not be required to fund shortfalls that are the result of historical regulatory decisions.

Where is proposed reform going in the right direction?

The IWC left no question that there is a significant asset health problem that needs to be addressed in the water sector. The future regulatory system must shift to ensure that companies will have the means to maintain a healthy asset base, and have the right information on the condition of their assets to provide stakeholders with confidence that they are effectively maintaining the condition of their assets. This means enhanced measurement of asset condition, as well as greater clarity on the levels of capital maintenance required and the amount of funding that is being made available for capital maintenance

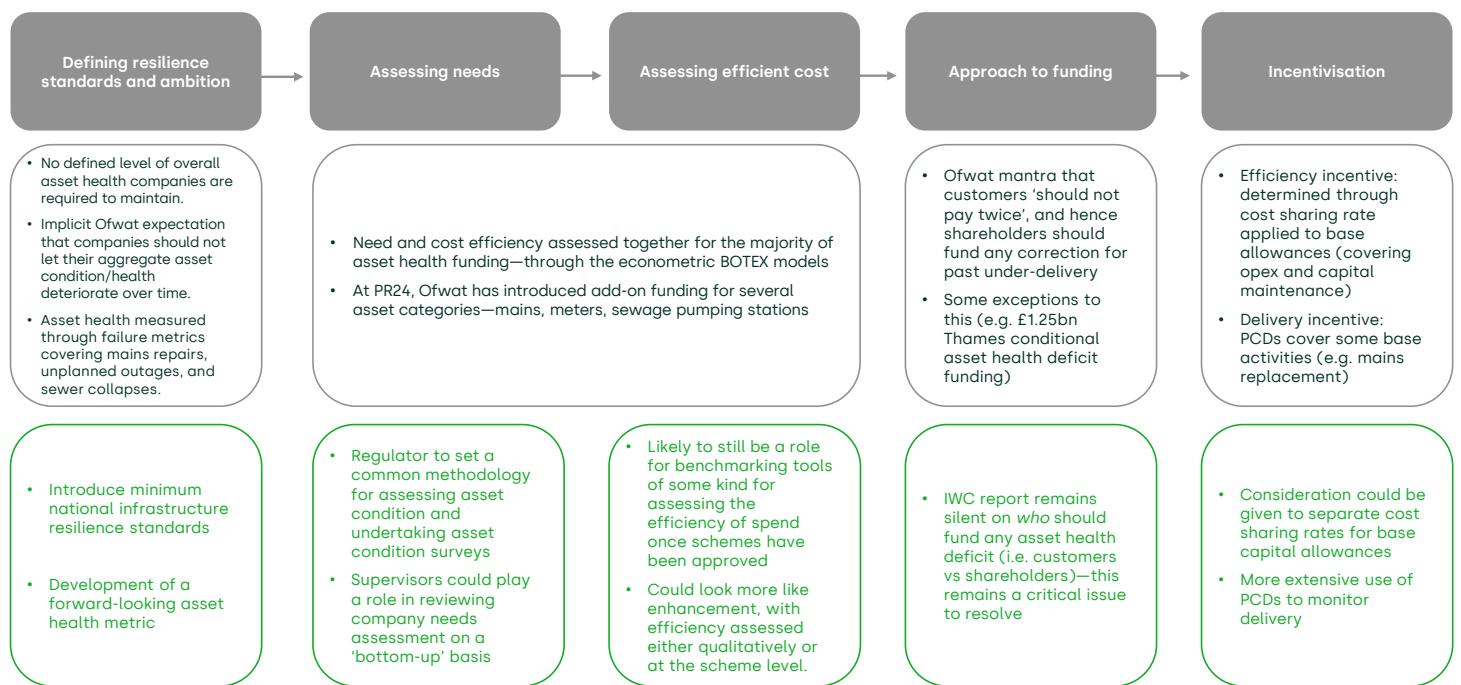
We see the following five key steps in the regulation of infrastructure resilience.

- 1 Standards and ambition—how the regulator defines and sets an agreed industry-wide standard for the level of asset health that companies are required to maintain.
- 2 Assessing the levels of required asset maintenance/replacement activity that are needed to meet these standards on a 'forward-looking' basis.
- 3 Assessing the efficient cost of delivering the required activity.
- 4 Approach to funding—i.e. who pays for any current asset deficit, and whether these costs are passed on to customers or borne by shareholders.
- 5 What efficiency and delivery incentives are placed on capital maintenance spend.

As shown in the figure below, the IWC recommendations have the potential to change the process by which capital maintenance requirements are identified and funded. In particular, the IWC called for the development of infrastructure resilience standards, and supervisors could play a role in assessing the level of investment needed to meet these standards. The WWP indicates that the proposal for statutory resilience standards will be taken forward, along with working with companies to improve asset mapping.³²

³² Defra (2026), '[A new vision for water](#)', 20 January, p. 37.

Figure 4.3 Potential changes in the approach to asset health under a supervisory framework



Note: BOTEX = base expenditure, PCD = price control deliverables.

Source: Oxera.

Areas that require further thinking

While the IWC's recommendations were clear, and consistent with a move towards a more sustainable and long-term approach to asset health, they are far from a clear roadmap to achieving this goal.

The main outstanding question is one of funding: namely, how and over what horizon the existing asset health deficit should be removed, and who should bear the cost. The industry reset envisaged by the IWC may be the time for recognising the faults of the previous regulatory system, so that the asset health deficit can now be addressed for future generations. However, the WWP remains silent on how this will be funded.

A further concern in this space is that Ofwat has continually sought to fit the assessment of capital maintenance allowances into a 'what base buys' framework. Indeed, Ofwat has continued to adopt this approach for the PR24 asset health change control process and has asked companies to provide information on 'what base buys' for different classes of asset. This approach is ill suited to assessing company-specific, forward-looking asset health requirements. In particular, the

framing of this issue through the lens of 'what base buys' results in allowances that reflect:

- industry-wide trends, rather than company-specific factors;
- what has historically been delivered from base allowances (i.e. 'what base bought'), rather than what can be delivered in the future; and
- wider operational and environmental factors that affect companies' overall decisions.

This top-down, industry-wide, backward-looking approach to capital maintenance needs to give way to a bottom-up, company-specific, forward-looking approach to asset health.

Progress on asset health is needed urgently. The CMA, as it did at PR19, has provisionally determined that this is an industry-wide issue that should not be assessed within its redetermination, and has chosen to pass the problem back to Ofwat. The further deferral of this issue (as previously happened at the PR19 redetermination) is of high concern to the sector. Ofwat's forthcoming cost change process provides an opportunity for companies to request additional allowances for the final years of AMP8. However, this is no substitute for a long-term asset health framework that provides new regulatory tools to ensure that it is funded and avoids the peaks and troughs seen in Figure 4.2



Box 4.7 Oxera recommendations in relation to asset health

- 19 The assessment of required asset health funding needs to be embedded as a core part of future price reviews. This should be one of the key priorities of the economic regulator, as it has been for WICS in Scotland.
- 20 The assessment of asset health requirements should be company-specific and forward-looking, rather than assessed through an industry-wide, historical comparative 'what base buys' framework.
- 21 Companies require clarity over funding for asset health catch-up, with the quid pro quo being asset monitoring systems and transparent health-rated asset registers.
- 22 Regional supervision should allow for regional variations in asset health funding but with national sharing of best practice (where there are increased

incentives to share ideas if less weight is placed on cost benchmarking).

Source: Oxera.

5 Implementation of the reforms

Defra now has the task of taking 88 recommendations and turning them into a coherent package of reforms that work in practice. Legislative change will take time, but there is a need to act quickly so that customers and the public can see visible change, and companies/investors can plan for what comes next. Preparations for PR29 will shortly be underway and stakeholders will need to understand what they are working towards.

Consequently, the transition plan should prioritise the most critical issues and policy decisions rather than seeking to make incremental progress against all 88 of the recommendations tabled by the IWC. Key decisions at this stage include the following.

PR29

- Providing visibility on the parameters of the next price review as soon as possible to reduce medium-term uncertainty. This might take the form of a simpler, more targeted review with removal of some of the unnecessary complexity. The approach that is adopted will need to ensure that the scale of investment required to deliver improvements is attractive to equity and debt.
- Identifying strategic priorities for the PR29 review, including an urgent focus on capital maintenance.
- Setting out responsibilities for the development of the new regulatory framework—i.e. whether Ofwat will be tasked with taking forward the PR29 methodology or a new body will be established to do this.
- Providing clear guidelines to the current regulators as to how they should approach their work and their mindset towards the sector during the implementation phase.

Longer term

- Developing a robust process and timetable for the longer-term reforms that will not be in place for the next price review—i.e. those related to strategic planning frameworks and regional system planners.

A clear priority issue is who should take forward the design of the new regulatory arrangements. Given the criticism of Ofwat within the IWC report, it seems untenable that this responsibility should fall solely to Ofwat. At the same time, there is a risk of a vacuum in decision-making around key regulatory design choices unless there is a body with a clear mandate to take this forward.

One option would be to stand up a Shadow Regulator—with the combination of skills and capabilities envisaged by the IWC—to lead development of the new regulatory framework. This would provide a clean break from the past, while ensuring that critical work on regulatory design is taken forward.³³ If parliamentary and fiscal conventions prevent such a body from being created, an appropriately resourced regulatory policy group could be established to play this role on a non-statutory basis.

Alternatively, Defra needs to be very instructive to existing regulators during the transition phase. This means giving detailed guidance on how the regulators are expected to interact with the industry, expectations for a reset in the regulatory relationships and mindset, and how the regulators are expected to take forward reform initiatives to deliver meaningful change and restore confidence in the regulatory system. Promoting investment should be central to this guidance.

6 Summary

In this paper, we have set out our view as follows.

- The long-term public interest in relation to the water sector is reliant on the delivery of an unprecedented level of investment over the next 25 years. The regulatory framework needs to be

³³ There are numerous precedents for shadow bodies being set up to prepare for regulatory reform in advance of legislation being in place—such as Ofcom, the Digital Markets Unit within the CMA, and (most recently) the Shadow Football Regulator.

de-risked and investable in order to support the achievement of the sector's objectives.

- The IWC recommendations and WWP provide a potential path to more company-specific regulation that can address key issues facing the sector, including the asset health issue that has, to date, not been adequately addressed.
- However, some recommendations risk undermining investability, and do not seem to be aligned with a regulatory environment that provides a fair rate of return with balanced levels of risk exposure. In particular, further thinking is needed around the role of the sector regulators in WACC estimation, how returns can be made competitive with international comparators, the framework for regulatory appeals, and the degree of influence that the regulator would have over board decisions.
- The implementation plan is key to driving change at pace. There are some potential 'quick wins' that could be targeted—including the establishment of a shadow regulator (or an appropriately resourced, non-statutory regulatory policy group) to take forward key regulatory design questions that should sit with the independent regulator, rather than government. Other recommendations from the long-list of 88 can wait, subject to there being clear processes and timelines for taking forward some of the more fundamental changes to system/strategic planning.
- Critically, the sector needs more certainty over PR29. It is vital that planning for PR29 is commenced—considering which parameters need to be under review and how this process can be streamlined—to give investors confidence that investment will be promoted.