Brexit: potential implications for the water sector in England and Wales

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Following the vote on 23 June in favour of the UK leaving the EU, this note presents initial thoughts on some key areas where the outcome of the referendum vote may affect the water sector in England and Wales.

1 Macro drivers and possible impacts

The vote to leave the EU is contributing towards uncertainty in financial markets. This uncertainty is likely to continue until the government activates Article 50 of the Lisbon Treaty, which starts the two-year withdrawal process, and greater clarity emerges as the negotiations on a UK–EU trade deal take place. Uncertainties about the impact on the social, political and economic dimensions of the UK are expected to remain for a long time. Several commentators have already revised their projections for key macroeconomic variables, such as economic growth and inflation over the short to medium term.

Possible longer-term effects of Brexit on the water sector in England and Wales may include the following.

- While there may be uncertainty in financial markets, water companies, as relatively low-risk assets, might be less affected than other sectors in the economy in terms of impacts on the cost of equity and cost of debt.
- Slower growth in the economy overall may mean that growth in water companies' customer base and their wholesale revenues are lower than anticipated. However, the revenue-cap mechanism that applies to the water companies means that revenue shortfalls within the regulatory period are expected to be 'made good' at the next price review.
- Wholesale revenues may be higher than projected in nominal terms as a result of higher inflation and the automatic indexation of those revenues to inflation. While this 'inflation hedge' is a key attraction for investors, higher bills in nominal terms may exacerbate non-payment (and bad debt) and have negative effects on customers' willingness to pay for investment.

- While nominal revenues may be higher, so may costs. Companies could see some upward pressure on costs in the form of slightly higher energy costs and increased wages if immigration is restricted in the longer term.
- However, in the medium to long run, the effects described above would be expected to be addressed in future price reviews through the price control reset process—a process that happens every five years.
- As regards future growth in the regulated asset base, in addition to forecast lower rates of housebuilding driving lower growth in connections, water companies may also see a reduction in future investment in the water environment, much of which is driven by environmental policy from the EU that is transcribed into national legislation.

2 Wider implications

As noted, the process for the UK leaving the EU is covered by Article 50, the provisions of which allow for a maximum of two years of negotiation before the UK must exit the EU. Given the complexity of the negotiations required, the talks are likely to take the full two years, implying their conclusion towards the end of 2018 at the earliest.

This timetable is likely to have important implications for water companies, as negotiation of any free trade agreement is likely to coincide with the business-planning process for the next regulatory period (2020–25), with companies due to submit plans on 3 September 2018.[1] Therefore, companies will need to prepare plans within the context of greater uncertainty about cost and growth projections, and investment requirements, than in past price reviews.

Another relevant consideration is that the process of leaving the EU will place a significant amount of work on the civil service. At least in the short term, this might have a knock-on effect on how quickly the civil service is able to prepare new legislation in order to introduce reforms in other (non-Brexit-related) areas. In the water sector this might affect the planned introduction of household retail competition: while the Treasury previously signalled that government wanted to begin the transition to household retail competition before the end of this parliament,[2] the vote to leave the EU might cast some doubt over that timescale.

Another consideration is that the European Investment Bank (EIB) is a large provider of finance for the UK water sector. It is currently unclear whether it will continue investing in the sector in the future, which could reduce the availability of finance for the sector in the longer term.

[1] Ofwat (2016), 'Water 2020: our regulatory approach for water and wastewater services in England and Wales', May, p. 226.
[2] HM Treasury (2015), 'A better deal: boosting competition to bring down bills for families and firms'.