Water today, water tomorrow

Observations on the regulation of the water sector

A lecture by **Jonson Cox**, Chairman of the Water Services Regulation Authority (Ofwat)

Royal Academy of Engineering

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Introduction

At the Efra Committee last year I said that my priorities as the new Chair of the Water Services Regulation Authority (WRSA) would be customers, water resources, financing, evolutionary reform, a fair outcome from the 2014 price review (PR14) and governance of the sector.

Since taking up my appointment, I thought it would be sensible to talk to a wide range of stakeholders about whether I had identified the right priorities, the links between them and the issues that were seen to be pressing, including those that relate to the way in which the regulator performs its role.

I started my consultations from the view that all those involved in the sector share a common objective of providing an exceptional public water service, financed under private 'franchise'. The regulator's statutory duties are well known. While delivering these, we need to ensure that we are driving companies to reach the service and efficiency levels seen in competitive markets. We must also ensure the continued delivery of these essential services and that the risk of failure by an operating company does not fall on customers or the public purse.

There was broad agreement on the priorities I had identified and many of the people I talked to asked me to publish my findings. I am grateful to all those who talked to me for their time and constructive directness.

This note sets a composite personal observation based on feedback I received from customers, customer representatives, company board members, equity and debt investors, new entrants, advisers and other regulators. I also list the questions and actions that I think it poses. By April the WSRA Board will have three additional members and this will be the time to revisit our strategy. I am keen that the Executive and the WSRA Board share our thinking openly and we will draw on feedback to date and any further responses to this note.

It is structured as follows.

- Customers (page 3)
- Water resources (page 6)
- Financing water companies (page 8)
- Evolutionary reform (page 14)
- A fair outcome from PR14 (page 18)
- Board leadership and governance (page 20)

A point strongly made to me by some customer and public interest representatives was the belief that corporate behaviours, public trust and transparency of companies ranked equal with price and service in maintaining legitimacy in today's world. In that context, transparency of corporate structures, tax avoidance through shareholder loans in complex holding structures, poor disclosure of remuneration structures and the priority placed by water companies on shareholder returns were all cited. Examples of well-known and respected global consumer brands which have recently been damaged by such issues were also quoted. **The point was made to me that public trust is hard won and easily lost.**

As this generation of customers is paying to address past neglect and to build resilience for the future, these issues of legitimacy are important. As an industry we need companies to maintain the willingness of customers to pay for the overhaul of the water and wastewater service. In the recent charging announcements the absence of companies taking ownership of, and being accountable to their customers for, their bills was remarkable. This resulted in a focus on the regulator instead. But it is for companies to maintain support for the legitimacy of the service, especially where their shareholder returns considerably exceed those assumed by the regulator. While my meetings with customers in the South West illustrated the risks of losing legitimacy, in a number of parts of the country – and some where I did not expect it to be the case – I found that other customers were also critical of the relationship and the approaches of their own companies in service, price and corporate reputation.

Incentives are a crucial element in focusing the management of any business. There was much criticism of the reward packages awarded to management. While it is not for the regulator to take a view on the level of reward, we must take a view – on behalf of the customers of this monopoly public service business – as to whether the remuneration of management puts the right emphasis on customer outcomes as well as on shareholder success.

Ofwat used to write to remuneration committees expressing a view on company performance. In my meetings with independent non-executive directors and chairs, I was unable to get a clear picture of the significance of customer outcomes in overall remuneration decisions. In some cases reporting did not appear to conform to best practice under the Code. Approaches varied between a low emphasis on customer outcomes and, only in very few cases, an equal emphasis with shareholder returns.

Many parties including the regulator have raised questions about the sustainability of highly geared structures compared with the more conventional models that resemble the notional capital structure used to determine the cost of capital in price limits. Some felt that the highly-leveraged models were risky, unsustainable and discouraged innovation: others did not. My experience of successfully running companies at both ends of the leverage spectrum gives me some insight into both sides of this argument. Questions were rightly asked about the ability of these structures to endure in a less intrusive, higher-risk, less rules-based model of regulation sought by managements.

The regulator has previously taken the view that the capital structure of the companies (and consequent risks) is for the boards and shareholders to determine. This remains the case only as long as a structure does not create risks which could, on failure of a company to meet its obligations, pass liability or risk back to customers or to the public purse – or indeed damage the legitimacy of the entire sector. Public interest rightly expects the economic regulator to ensure that vital public services today and the ability to fund investment in future are not put at risk by corporate structures. The regulator has a role in ensuring structural risks are managed effectively.

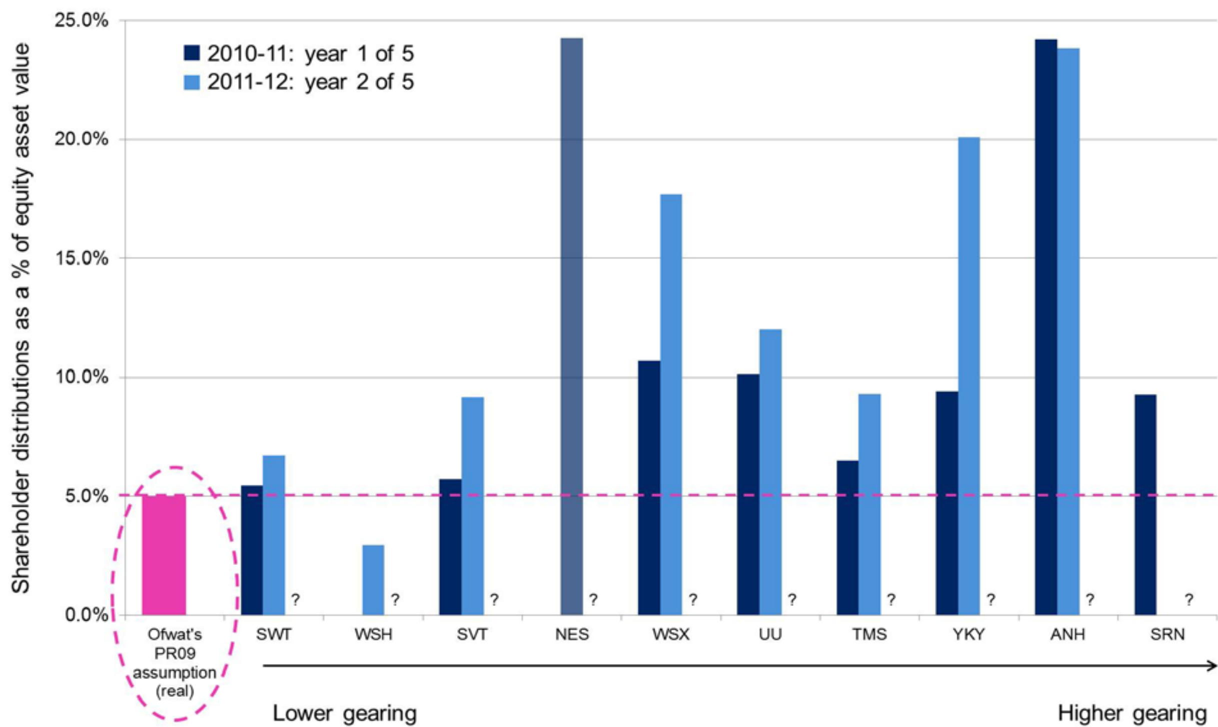
The use of a notional capital structure was introduced in the 1990s to encourage conservative companies to increase leverage to an efficient level. Twenty years later this notional structure is significantly more conservative than most companies' actual structures. A single cost of capital approach may have had the perverse consequences of providing a strong incentive for companies to gear up. Proponents of securitised structures claimed that the risks of failure had not increased proportionately to the leverage, if at all. My response to this is that if risks have not increased then the elevated equity returns we observe must be unfair to customers. While the equity cost may be higher in a thin equity structure, none could point me to evidence that it rose in a linear fashion with leverage. The continuing trend for water companies to be sold for prices around 130% of RAV only suggests that the regulator's adopted cost of capital is too high and the premia reflect excess demand for these assets.

One of the additional concerns raised with me about the new financial models is a considerable lack of transparency in the multitude of on- and off-shore holding companies. People regard the structure and risks as being clearer in listed companies. I return to some of these concerns in the governance section.

Customer representatives and others (including debt investors and other regulators) raised the question of dividends. The regulator has undertaken preliminary analysis to inform the debate. The financeability duty applies at the level of the regulated entity and the regulator has no obligation to underwrite change of control premia paid by investors. The analysis has looked, therefore, at the shareholder distributions made by the regulated companies to their HoldCos. Looking at these payments over AMP5 it is clear that most regulated companies are paying dividends well above those assumed in the last periodic review. At the top end of the range, companies have been paying out close to 25% of their equity asset base ('equity RAV') to their holding companies in each year of AMP5.

Shareholder return is made up of the cash distribution (dividend) and of the growth in the value of the equity. Equity RAV is a proxy for equity in the absence of market valuations. Figure 2 shows shareholder distributions and figure 3 shows equity RCV growth – both are compared against Ofwat's 2009 price review (PR09) assumptions for the first two years of this AMP when data are available. The two added together give an approximate measure of total shareholder return. For simplicity, the elements are set out separately but an overall view of total shareholder return needs to factor both elements together.

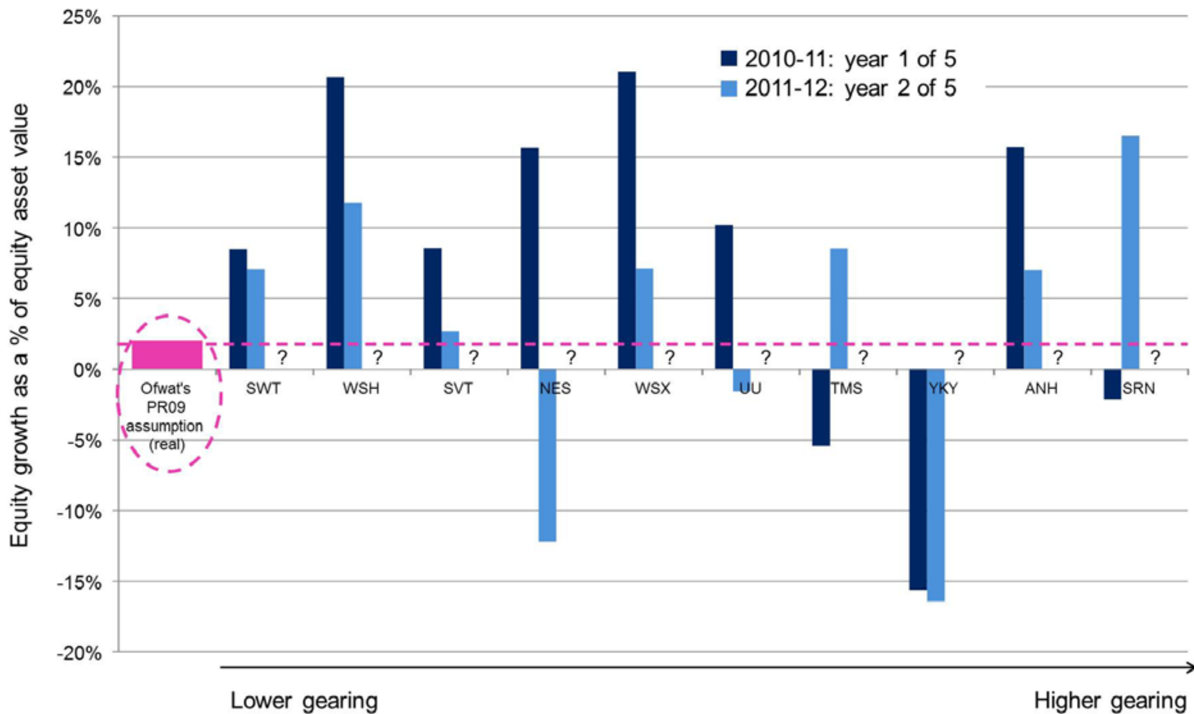
Figure 2 Company shareholder distributions versus Ofwat PR09 assumptions (%)[2]



These shareholder distributions compare with Ofwat's assumption of 5% of equity asset value real cash dividend payments in its notional structure each year over the five year period. It will be interesting to see what happens to these distributions in the remaining three years of the period.

[2] Note: Shareholder distributions exclude intra group interest payments but include special dividends. Distributions are influenced by gearing rates – where companies choose a more highly geared structure equity holders may expect somewhat higher returns to remunerate them for additional risk. However, shareholder distributions look exceptional. Company acronyms include South West Water (SWT), Dŵr Cymru (WSH), Severn Trent Water (SVT), Northumbrian Water (NES), Wessex Water (WSX), United Utilities (UU), Thames Water (TMS), Yorkshire Water (YKY), Anglian Water (ANH) and Southern Water (SRN). For companies that have adopted a securitised structure in the period figures have been adjusted to ensure a consistent treatment of shareholder distributions from the RegCo to service interest payments at the group or holding company level. NES's shareholder returns for 2011-12 relate to a corporate restructure. Source: Ofwat analysis based on published company accounting information.

Figure 3 Company equity RCV growth versus Ofwat PR09 assumptions[3]



Some noted the context in which these cash returns have been paid to shareholders.

- This is a time when the sector needs to go on investing to meet its obligations.
- Most companies across the economy are de-leveraging if they can.
- Some of the water companies need to strengthen their balance sheets to support future growth in their asset base, whereas these distributions have unnecessarily weakened balance sheets.

The context begs a number of questions, including the following.

- Are such high dividends and the associated reduction in equity a prudent policy?
- Do they lead to an over-reliance on debt as the source of funding?
- Do such high levels of return represent a fair balance between customers and companies in austere times?

[3] Chart shows growth in shareholder value as change in notional equity as a proportion of opening equity. Figures will be influenced by a range of factors including the companies financing cycles and capital programmes. Figures for Yorkshire (YKY) and Northumbrian (NES) are negative. We understand that this is down to a) YKY planning to step up gearing (reducing the derived equity) to 85% over 3 years since a change in their financial structure and b) NES had transferred to it acquisition debt on the back of a recent change of ownership. Source: Ofwat analysis based on published company accounting information.

Furthermore, it appears that a significant part of the returns derives from factors outside the control of management and boards: the high level of retail price inflation, to which revenues and asset bases are indexed, and the exceptionally low interest rates on debt compared with those assumed in PR09. Given that the licence relates to a long term monopoly public service, I would have hoped that companies would have shared gains that derive from external factors with their customers ('gainshare') just as pain is shared with customers ('painshare') through, for example, notified items. In the past, companies have done this. I have personal experience of doing so in two companies, without regulatory intervention. I found it regrettable to hear a very senior representative of a company with very high dividend pay-outs rebuff the suggestion that it should share gains with customers, relying on a 'contractual' argument at the same time that the company claimed to be customer focused.

The Welsh model adopted by Dŵr Cymru does provide a form of gainshare with customers, although this is not open to other companies that operate under different structures.

It is also important to observe that not all the institutionally-owned companies have adopted highly leveraged structures nor do they all have such high dividend policies. Discussions with one WaSC recently taken private by a corporate demonstrated a conventional view of expected funding and dividend levels.

Finally, it seems a sensible idea, in the public interest, as proposed by some external parties without sophisticated financial resources, that we reintroduce an appropriate targeted annual report on financial and efficiency performance, dividends and capital structures which will enable parties to form a better view on the sectoral risks.

Questions we must consider

- How should we respond to concerns about the growth and risks of highly geared or 'securitised' financial structures for the public and customer interest?
- What role does the approach of setting a single cost of capital using a single notional level of gearing play in incentivising companies and investors to adopt a highly leveraged structure, and should we seek to encourage a reversion to more equity intensive models?
- How can we introduce a more balanced pain/gain share between customers and investors? How should this recognise exceptional gains accruing to shareholders from leverage, especially if the risk of failure to meet licence obligations is increased?
- The reintroduction of a targeted annual comparative appraisal of financial performance, structure and risks.

Evolutionary reform

Ensuring regulation develops progressively to meet the challenges of the future and to harness market forces for the benefit of consumers

There are two inter-linked parts to the reform agenda: first, reform of the way a monopoly utility is regulated; and second, the extent to which the scope of monopoly activity can be reduced by opening segments of the value chain to competitive market forces. In discussions of water reform, these two are not always distinguished. The term 'competition' is sometimes used loosely in the sector to describe regulatory reform that belongs in the first, not second category.

I returned to the sector at a point where a very long-drawn-out discussion about reform of regulation had resulted in controversial licence proposals and a breakdown in relations. I encountered a range of attitudes towards regulatory and market reform. I also encountered criticism of the regulator's approach. The process has not been satisfactory for either side – regulator or companies. One observation I received is that Ofwat engaged at the level of 'principle' without sufficient detail and the companies engaged from a point of starting with the 'contract', that is, the detail of the existing licence. If this was so, it was unlikely there would be a meeting of minds. We have now settled the issue in a pragmatic manner and with a licence commitment by companies to engage constructively and cooperatively in future.

A large proportion of the sector is a natural monopoly. The historic model of regulation has many positives including the low cost of borrowing it attracts. Change should not put this at risk. At its narrowest this monopoly is the core network infrastructure constituting about 90% of the assets in the sector and about 50% of revenues; a wider definition would include the treatment plants for water and sewerage which would constitute about 95% of the assets and about 80% of the revenues. Under any scenario the sector will be significantly regulated. The disparity between the proportion of assets and revenues derives from the differing amounts of opex, maintenance and capital charges between different parts of the value chain. In the heat of the licence debate, I am not sure all participants in the sector had made themselves familiar with the economic structure.

Figure 4 The water and wastewater value chain by asset values[4]

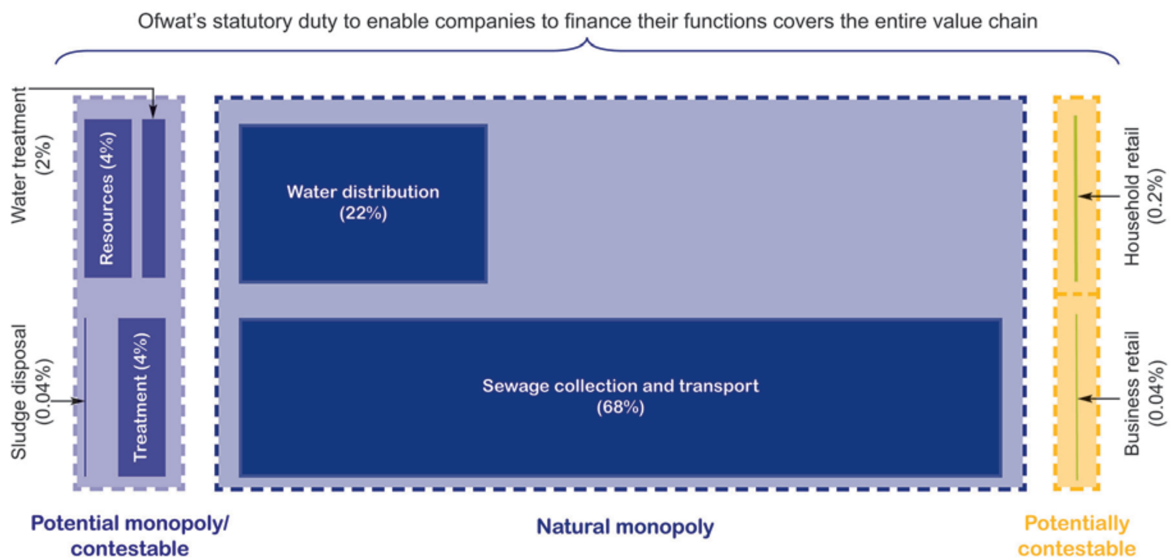
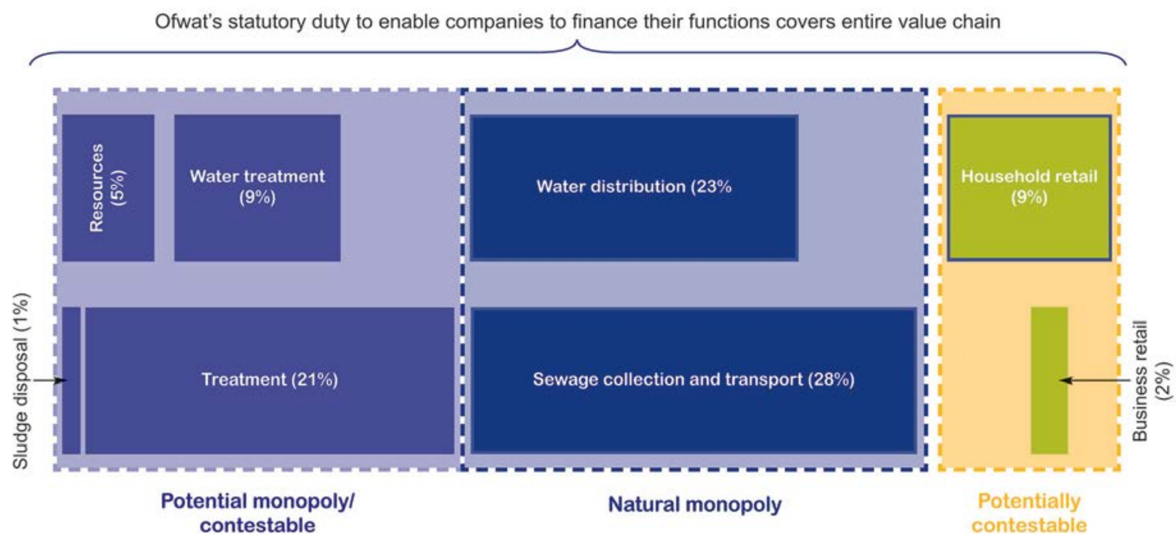


Figure 5 The water and wastewater value chain by revenues[5]



[4] Source: Ofwat analysis based on companies accounting separation data 2011-12. Uses net book value of assets as % of water and sewerage total assets. Note: water distribution comprises raw and treated water distribution; sewage treatment comprises sewage and sludge treatment.
[5] Source: Ofwat analysis based on companies accounting separation data 2011-12, using an indicative revenue measure as percentage of total turnover. Note: water distribution comprises raw and treated water distribution; sewage treatment comprises sewage treatment and sludge treatment. Numbers do not add to 100% because they are indicative only as companies do not currently report actual revenues split by business unit.

The extent of market reform in England is limited currently to the introduction of choice for certain non-household customers over their retail service and the potential introduction of separate price controls. This could be followed by further initiatives in water resources and sludge treatment. Compelling arguments have been made from a range of parties for introducing competitive forces in these areas. The introduction of market forces into treatment of water or waste in England poses issues that require longer consideration. Some have argued that equal results may be achieved by changes to economic regulation.

It is important to note that the Welsh Government has not yet set out its policy position on these reforms and, while we await this with interest, there is an expectation that it may take a different position.

The reforms of the price control for PR14 make a step forward in trying to put the responsibility for making the difficult choices and developing a balanced plan with companies. I return to this in the PR14 section of this note. There remain linkages between market reform and regulation through price controls. The move to a less intrusive model of price control in part relies on using market forces where efficient to do so.

I have listened carefully to the complaints of company boards that the regulator needs to be clearer in setting out the case for reform and for the regulator and companies mutually to respect legitimate disagreement. From my business and regulatory perspective, the regulator of a monopoly has to create a level of constructive tension for change. This does not preclude it adopting a consultative and listening approach but it must reject moving at the pace of the ‘slowest common denominator’. Failure to move forward progressively will sooner or later invite the use of the more draconian tools open to the economic regulator, including market references to what will be the Competition and Markets Authority.

There is a debate about the extent of incentives for change. I noted that some companies made the point that they needed rewards for changing – exemplified by a WaSC director reported last month as saying publicly: “… the additional risk of moving from our current position is not adequately compensated by the benefits”. A regulator’s view of the public interest, looking at the level of current returns, could be that reform is a necessity not necessarily to be incentivised. My view is that there should be incentives for progressive companies, but the debate should not start from a point where companies expect to be paid more to move from the status quo.

A fair outcome from PR14

In a sector with such a significant natural monopoly, the price control will remain a key part of the regulatory model. The regulator has set out a new approach to PR14, placing greater responsibility on companies to develop their plans in consultation with their customers and rewarding companies whose business plans are well balanced and well evidenced. The regulatory model will seek to provide a wider range of incentives (and penalties) for companies and give choices over how strong the incentive rates are to encourage innovation and a less risk-averse culture.

One purpose of the price control process is to ensure that companies subject themselves to the same level of business pressure to improve efficiency and outcomes for customers as would companies subject to competition. Those pressures are brutally strong in today's markets.

While the changes to the regime for operating cost and capital expenditure incentivise more honest approaches, there are significant areas where it is not clear that we have moved forward from the conventional 'bidding process' where the company puts forward a position more advantageous than it expects to get. I have in mind particularly the input on the weighted average cost of capital (WACC). The WACC is one of the biggest items in the determination. I am familiar with the process of boards and the industry, taking a view of the regulator's likely determination and then each adding a 'negotiating range' to that number. It would be healthier if we could find the means to encourage straightforward, individual approaches from companies rather than an industry-wide 'bidding approach'. This would help companies frame the balance in their plan between investment levels, risk and affordability.

During the price control process companies may ask the regulator to decide that customers should accept risks outside the companies' control through notified items. If this is done it would seem reasonable that this should be matched with gain-sharing arrangements. The most effective way for this to happen would be for companies to take on responsibility of proposing both pain- and gain-sharing mechanisms in their individual business plans and to show fairness in these that could be understood by customers. The need for this was exemplified by those participants who argued to me that a regulator is inherently likely to be too prudent in their approach.

Many stressed to me their support of strong board leadership and governance – particularly by independent directors. While this is my first regulatory appointment, I agree with the governance concerns. I have had the experience of joining the boards of four formerly state-owned or public service companies all of which have been in prior difficulties, causing an impact on their customers. In each case, I observe that this was not uncorrelated with governance of the company concerned.

It is important that failure of a vital public service should not bring liability or risk to customers, the public purse or an interruption to a vital service. To support effective boards, in the 1990s Sir Ian Byatt began a process to introduce licence changes which require independent non-executives on water company boards, clarity of the financial relationships between a regulated entity and its parent, and companies to have particular regard to what is now the UK Corporate Governance Code. Overall this has had the effect that regulated companies are required to act as if separate listed businesses. These requirements, and the cash lock-up provisions, served the public interest well, for example, in enabling two WaSCs to survive the failure of their parent groups.

Participating stakeholders pointed out that the world of corporate governance has moved a long way in the past decade, during which time the structure of most of the water sector (excluding the few listed plcs and the Dŵr Cymru structure) has become considerably more opaque. The structure of and participation in boards has changed whether formally or in practice and participants were concerned both in the context of the regulated company and, for the privately held companies, in relation to the complex opaque structures and influence of the holding companies. I deal with these issues in turn.

At the regulated company level, the principle of having particular regard to what is now the Code is broadly established in most licences but it seems that the current principles of the Code are not widely observed. I met with independent members of the regulated company boards to explore the reliance the regulator could put on their independence. I met some impressive NEDs, but was left concerned by five points, most of which might be seen as contravening the principles and provisions of the Code:

- (i) in some companies the regulated company is seen as an ‘operational board’ with strategy and structure reserved for investor boards;
- (ii) independents were not in a majority;
- (iii) chairmen were not always independent of management or investors (a point that some investors said could limit board effectiveness);
- (iv) some NEDs in highly leveraged companies did not seem to grasp the complexity and risk of these structures, and the controls required; and

(v) the absence of a clear role by independents in setting the structures of management incentives.

Learning from other sectors, it is inconceivable that the regulator could responsibly countenance moving to less intrusive regulation for individual companies unless they can demonstrate outstanding levels of board leadership and governance, at least in accordance with ‘best practice’ as set out in the Code. Therefore, in the public interest, the regulator will consider updating to current standards the measures adopted in licences in the 1990s, either by swift voluntary agreement or by formal amendment.

For the smaller WoCs, it might be appropriate only to require observance to the appropriate standards for small companies.

Participants pointed out to me that at least one other regulator applies a ‘fit and proper test’ when approving the appointment of NEDs. It is important that responsibility and accountability for effective board leadership remains with company owners. So it would not be helpful for the regulator to become too interventionist in the appointment of company boards. But it may be appropriate for the regulator to consider the process and criteria by which Ofwat might approve the appointments of NEDs, taking into account the overall balance of skills on a board. This should be addressed by companies in their annual risk and assurance review in the same way listed companies review their board composition and performance in their annual review.

Turning to the HoldCo structures, the listed structures are already subject to the listing rules, so my comments are confined to the private companies. Companies owned by financial sponsors attracted considerable criticism. This was in relation to their opaque complex holding companies, the lack of clear disclosure of interests, the allegation that these companies use shareholder or other additional loans at the HoldCo levels purportedly to achieve tax efficiency or tax avoidance (an issue of significant public concern at present) and the reserving of strategic issues to these boards beyond the scrutiny of independents.

The regulator had already commenced a review of the highly leveraged structures before my arrival, and this should continue urgently. It has to be right that the holding structures of a vital public service are a matter of public interest. The failure of such structures would pose risks that go beyond the equity interest of the financial sponsor or funds to whom they have sold an interest. Highly leveraged private equity-style structures have failed in other sectors, and the regulator should not allow such risks to have an inappropriate effect on other parties than equity. Nor would the regulator want to see the position arise where the reputation of the sector as a whole is tarnished by the loss of legitimacy that is occurring in certain previously respected consumer brands through the use of devices such as additional leverage above the efficient level of leverage in the RegCo purely for shareholder gain without advantage to customers. We already see negative commentary in the press about some of these structures in water companies.

The best remedy to this widespread concern is to require transparency, in the public interest, of the holding structures enabling markets and interested parties to form a better view. One option could be an annual disclosure statement for each of the onshore and offshore holding companies of:

(i) the debt and equity structures, including the purpose of additional debt above the RegCo;
(ii) directors' interests in those structures and the nature of those interests; and
(iii) governance of these companies to the standard of the Code.

In this context I am reminded of the assurances that some of the longer-term pension funds gave me of their commitment to high standards of corporate social responsibility and I can only assume they would have no problem in principle with such requirements. This is not just a water sector issue and the same concerns have been articulated by Government.

A voluntary approach would be serially responsible if this could be drafted with a small selection of the owning financial sponsors, supported as need be in implementation with financial directors and the auditors of companies. This could then become a requirement of owning groups in the same way as the Condition P undertakings. In the absence of a prompt joint approach, the regulator may wish to consider a more formal route to implementation.

Questions we must consider

- Has the regulator considered and implemented all the recommendations put forward by David Gray? How do we engage better in future to avoid repeating the difficulties with licence reform?
- The ongoing capability, capacity and resources of the organisation to deliver on its statutory duties and its strategy to deliver a new approach.
- How can we continue to ensure that water company governance and performance is as transparent and effective as possible, conforming to the changes in best practice standards of corporate governance in recent years?
- Does the structure of remuneration and interests (whether provided by RegCo or a superior company in the structure) meet the disclosure standard required of listed boards?
- Should Ofwat set additional requirements on the governance and disclosure of companies, either through changes to licence conditions or through requirements under the regulatory accounts, to better reflect the rules for listed companies and addressing the concerns noted above? Or, should it wait and see if companies take action to ensure governance and disclosure meet the letter and spirit of the Code and the Listing Rules during the 2012-13 reporting period? Should Ofwat engage with the sector's auditors on this?
- What steps by the regulator would support the highest standards of water companies' board members and overall board skills? Is greater transparency required?

Concluding remarks

This note is a reflection of the views and comments I heard during my discussions with various key stakeholders across the sector and some of my own personal observations. I have grouped these around the six themes that I highlighted to the select committee at the time of my appointment because there has been very little disagreement among stakeholders that these were the right areas on which we need to focus. What is clear from those discussions is just how much more we can do to continue to build on the success of the sector in future, to reduce the cost of the service to customers and to ensure the public confidence in a robust water and wastewater sector is maintained.

I would like to thank stakeholders for participating in these discussions in such an open and candid way. This note is not a consultation but if there are further issues or concerns that any parties wish to raise in a succinct and constructive manner then please do feel free to contact me. I hope that we can continue to have an open dialogue as we move forward.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide consumers with a good quality and efficient service at a fair price.

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