The Lorch Lecture at Cranfield University

Given by Jonson Cox, Chair of the Water Services Regulation Authority (Ofwat)
12 September 2013

Good evening.

I am delighted to be here at Cranfield, an institution which has led much of the thinking about the implications of new technology and new models of working in our sector. I was a member of the Court of the University for six years, but never sure how much of a contribution was possible – so I am pleased to be here to contribute now.

I took up the role of Chairman of the Water Services Regulation Authority nine months ago. It was put to me that water regulation needed a new approach and a new way of working.

Ofwat needed a new strategy which would find the simplest and best ways to get better value for customers; a strategy that sought to replicate the competitive pressures of market forces from which monopolies are otherwise sheltered; a fair deal for investors and a new engagement with the industry and stakeholders demonstrating independence and a robust approach. At the same time I wanted to see us maintain a constructive, but respectful, tension between companies and regulator.

It hasn't been easy. Relationships between the regulator and the companies were not in a good place; the licence modification issues of 2011 and 2012, which I inherited, showed a wide gulf between an ambitious regulator and potentially complacent monopoly companies.

Turning to my slides, my colleague who drafted these reflected some of the challenges of my early months in his first slide. The boomerang refers to my return to the industry on the other side of the table. Perhaps some thought I was gone for good, only to see me re-emerge as Chairman of their regulator.

I've taken a lot of "poacher turned gamekeeper" comments. I and my family have taken all sorts of criticism planted by rather obvious suspects, seeking to undermine my credibility with exaggerated reports of conflicts, earnings, etc given my background in two companies in the sector. That's what the thick skin on the slide refers to and the need to treat criticism as water off a duck's back.

In fact this job is worth doing and doing well in a way that moves the sector forward. Those who seek to deter challenges to the sector should remember that I have been through a number of tough turnarounds and I don't give up lightly.

So let's turn to the challenges that I posed six months ago. I raised six of these and I'd like to review progress: customers, the environment, financing, PR14, evolutionary reform and board leadership and governance in the sector.

1. Customers

Top of my list was customers. The heart of our role is to ensure customers are protected from monopoly behaviour and that water companies are subject to the same pressures as firms in competitive markets to perform and improve for the benefit of their customers.

At the start of my tenure, water company directors would talk of how much better price and service were compared to twenty-five years ago in the water industry. These comments appeared oblivious to the massive improvements in other sectors in the economy. There now seems to be more acceptance that customers want more than just price and service: customers want to know if they can trust big business in all respects – and none more so than providers where they have no choice.

Recently economist life has been pretty rotten for customers: the price of water has gone up by14% in the last two years while incomes have come down by 5 to 10%. There is not so much evidence that costs have gone up for water companies to match the revenue increases – hence the level of dividends and returns which we see.

One of the issues I raised for customers is how to ensure customers participate in the significant outperformance of the sector during the current AMP period. To date we have seen some benefits from 'unearned' gain shared with customers, although this is only a first and modest step. I would like to emphasise the custom and practice in the sector whereby leading companies consider and balance pain and gain earned from reasons beyond management action.

We recently received an application for an IDoK, an application to increase prices within the control period, from one company in relation to costs incurred related to bad debt and private sewers to which there has been a vigorous customer reaction. Other companies contemplated such an IDoK but chose also to recognise the balancing or larger gains that all companies have seen from the macroeconomic effects of low bond rates and high retail price inflation.

In a competitive world, where companies compete for their customers, they would balance the rough with the smooth without needing a regulator to pick up cudgels on the behalf of customers.

We have seen some good responses to my challenges on affordability. Six months ago companies were talking of modest real price increases for customers in AMP6.

My colleague Sonia Brown earlier this week discussed a range of scenarios over five years for the next five-year period. It will be important for companies to engage with their customers to decide what they want from the next period. From the scenarios she has run, using an average city analyst projection of WACC, it does seem possible for average bills to come down by between 1.4% and 2.5% per annum over the period. This means that an approach of constant nominal prices for water and wastewater, as an average, may be attainable for leading companies if that is what their customers would prefer and if compatible with legitimate investment needs and service improvements. We will certainly be looking for evidence that companies have consulted their customers on these possible outcomes.

2. The environment

My second theme was about the environment. The points are well known. Particular focus over recent few months has been on water resources and sustainability. Surplus water is in the wrong place; water is expensive to move; we continue to have instances of over-abstraction in environmentally sensitive areas, etc.

The historic pattern of abstraction is not efficient resulting in unnecessary pressure on the environment. Ofwat has rightly sought to use specific mechanisms to allow companies to trade surpluses, rather than invest in new resources, if these are cheaper or more sustainable. We want to incentivise new entrants to bring new resources into supply and to make use of surplus water from other companies.

Data problems have sadly prevented us going as far as we would like to in the coming AMP with financial incentives, but we will create reputational incentives and downsides for companies through the abstraction incentive mechanism.

We have been clear that we will remove the apparent bias to capex through our use of totex.

The slides in my presentation demonstrate an example. The water in South West Oxfordshire in Thames is lower cost than water for the central zone of Affinity Water, so a trading opportunity may arise removing the need for new resource investment in Affinity's areas. You can see that under the numbers shown here we would create a benefit to incentivise Affinity to acquire water by trading rather than physical investment.

3. Financing

My third challenge was financing. The points I raised were:

1. The increase in debt levels, with leverage over six years rising from 57% to an average of 70% of the assets financed by debt. We've reviewed that against a backdrop where many other parties have raised concerns with us about high leverage. So far, acknowledging the benefits of a securitised structure, we are not yet persuaded of a higher systemic risk for an individual company.

2. This doesn't mean to say that our worries are over: we remain concerned about the impact of high leverage on management behaviours, risk aversion and the risk of contagion in capital markets if a company enters 'lock-up' or if a company fails. We have concluded that on-going monitoring and reporting on financial structures and performance is important.

3. We have raised questions about complex holding structures and this has included factors such the use of shareholder loans. While I have no comment on tax policy per se, as it is for government not regulators, some of these structures at holding company levels don't create for customers the sense of 'trust' or 'fairness' especially in a monopoly, a critical basic public service, where corporate standards must be very high. I believe that customers would like to see simplicity in structure and financing which would create trust in today's post financial crisis world. We recently met with a very large financial institution, looking to widen its interest in the sector and who in the past would have championed these complex structures; I was pleased to hear their

preference for simple, trustworthy, lower leveraged structures appropriate for the very long term. I hope others will follow suit.

4. I challenged the returns on equity in the current asset period, with dividends up to one quarter of regulated equity as a percentage of equity invested; I was surprised that companies had not taken the opportunity, of such returns, to de-gear or to share gains with customers. One chairman told me that these high levels of dividend were in effect a contractual right; maybe they are, but a broader view is needed in the public service world. We can see that, for most companies, dividends were a little lower in the year 2012-13 but they still remain high in absolute and relative terms.

5. I was pleased to see companies emphasising the further investment that they have brought about for economic growth of about £620 million over the current AMP and to see that some were foregoing potential IDoKs which would have been worth about £100 million, recognising the gain they had had from macroeconomic factors.

I do want to take this opportunity to make clear something about tax. I made a specific comment about the complex holding structures and the effects on customers' trust, and I stand by that comment; others have wrongly reported this as a general concern about tax. To be clear, a regulated company benefits significantly from capital allowances associated with their investment and this – as I have previously said – is a good thing from which customers benefit. I repeat that our concern is around perceived financial engineering at holding company level in a critical public service. Customers see this as unduly complex and don't see the associated financial efficiency as fair, when customers themselves don't benefit from the gains made.

4. Evolutionary regulatory reform

My fourth priority was evolutionary regulatory reform and ensuring that regulation develops progressively to meet the challenges of the future and to harness market forces for the benefit of customers.

We've had quite a lot of pushback to points I've raised here: what's wrong with existing model of regulation; water regulation has been very stable and is known as the 'gold standard' of regulation world-wide. Why change anything?

Over the last five years, Ofwat's Chief Executive, Regina Finn, has rightly raised a number of questions to challenge the status quo. These show that regulation as practiced by Ofwat over the last decade has run its course and improvements are needed. In particular:

1. Productive efficiencies are reducing: in the current period they will likely be half the gain made in previous periods, as in AMP4 they were half those in AMP3.

2. Intrusive regulation gives little opportunity for companies to excel. In my own experience of leading two companies to, or close to, the frontier of performance in the sector, it was deeply frustrating to see 'one size fits all' regulation which gave a well performing company little opportunity to benefit from being a sector leader. Our approach to PR14 changes this radically.

It's also worth going back to the structure of the industry. Over 90% of the assets are in a network-based 'natural monopoly'. If we include some wastewater and water treatment that proportion rises to 95%. The private investors who predominate in this sector particularly want, as I understand it, regulated monopolies. A sector with 95% of its assets in a 'natural monopoly' is about as good as it can get for those who want regulated monopolies.

But, at either end of the supply chain there are opportunities. Retail represents 9% of revenues while a miniscule part of asset value. Water resources represent 5% of revenues while a smaller part of assets. Diminishing productive efficiencies under the current structure require us to find dynamic and allocative efficiencies from setting different controls and incentives at the two ends of the supply chain. These moves will enable new offerings to business customers who are clamouring for the opportunity of better and different services, and for entrepreneurial new entrants to bring new water resources into supply.

Some might see treatment as being in this area for different regulation. With a few exceptions, I see little reason for these to move out of the asset regulated category over the next decade.

The Water Bill will enable us to make some early moves in incentivising different ways of pulling new resources into supply. We have been surprised by managements who almost universally lobbied to prevent having the **option** of legally separate retail. Some investors in the sector – particularly debt – have made very clear to me that they would welcome the ability legally to separate retail. This would reduce the risk and therefore the cost of capital for the natural monopoly. It might see the consolidation of retail activities into fewer, larger, more efficient retail organisations (other utility sectors have no more than six big retailers). I am surprised that investors in the companies and who sit on their Boards did not see the advantage to the regulated monopoly – which is what they appeared to want to invest in – of having the **option** to achieve legal separation which could also be in customers' interests. It does strike me that managements and their owners sometimes show divergent priorities. Time has now passed for the option of legal separation in the near future.

5. PR14

I set out that we should deliver an outcome to PR14 which puts customers' interests at the forefront while allowing a fair return and appropriate incentives.

Our PR14 process does set a new frontier in all respects allowing less intrusive regulation for those companies that put together really good plans. Next spring there **may** be a small number of enhanced companies who will know their outcome from the review, benefit from early financing and an early start to their capital and efficiency programmes. This will have a significant reputational and economic advantage. To achieve this requires a well-balanced, ambitious, 'best and final' plan of the sort a company would make if for example it was bidding to retain a valuable franchise and could lose it. Enhanced status will need to be a plan that is very strong in all respects.

One of the biggest drivers in the outcome will be the companies view on financing. Some independent non-executive directors have lobbied me that we should set the cost of capital now for the sector to make their life simpler. We won't do that. Companies must face reality and put their own best foot forward as they have just as much information as we do and more. For us it will be a material litmus test of the realism of their plan that they recognise the way in which financial markets have moved.

Incidentally, I have also been asked how we would protect a company which was seeking 'enhanced' status and put its best foot forward only to find financial market conditions change and we adopt a better deal for subsequent companies. I can assure aspiring enhanced companies that there is no intention to disadvantage them as a result of an early determination.

6. Governance and board leadership

This has taken much time and is a really important issue. A regulatory purist might have some difficulty in understanding why this is an important issue for an economic regulator, and ask why it is not solved by capital markets. If we are to be a less intrusive regulator we must see evidence of really effective boards. For me, with experience of four previously state-owned enterprises, all of which I joined at a point after their businesses had got into difficulties, Board leadership is immensely important. I've seen how good Board leadership can make a real positive difference as well as the converse.

I promised to start with the Water Services Regulation Authority Board and we have recruited three additional strong new non-executives and now our new CEO. Other new posts are in recruitment. We've taken a new approach to engagement with companies and investors. I believe our conversations have been open, honest and robust where necessary, while at the same time listening and signposting the direction of travel.

I have had some comments from companies about "lobbing boulders in the pond" with views on the quality of Board leadership, transparency and governance in the sector. These factors do matter to the public and now routinely raise headlines such as those shown on this slide with MPs calling for more transparency in other utility sectors. When I read these I thought we can genuinely say that in water we are "on the case". It is better to pre-empt stronger action by making improvements now.

I have also been generally pleased with the sector reaction. We've seen companies take steps to improve disclosure in their results for 2012-13 – with further to go by next year. As well as improving the quality of their Boards. After long and productive discussions, I will be writing to companies next week setting out an approach which will allow an innovative self-regulatory approach, reflecting the range of ownership structures in the sector, while demonstrating that they meet or exceed a core set of principles. In developing these principles companies will see that we have listened to the comments made. We will continue to hold to established precedent of the principles of the UK Corporate Governance Code and the requirement for the regulated company, holding the licence, to act as if a standalone listed plc.

We will recognise the opportunity for privately held companies to develop their own code allowing investors a seat at the Board table, without needing an extra independent director to match each and every investor director as the Code might be taken to imply. Companies should remember that we have received very strong views from others than company Boards on the standards we should set; our principles strike a pragmatic position. A few may seek to challenge but I hope that most will conclude that in the interests of sector legitimacy we have taken a fair and straightforward approach to improving standards of transparency, disclosure and governance.

To bring this to a close, my opening slide referred to some of the challenges in taking up the position as Chairman of a regulatory organisation. It certainly has been a challenging nine or ten months. I do believe we are in the process of taking Ofwat forward. We have added new dimensions to our strategy. I have been delighted to make the appointment of our new CEO and I look forward to working with Cathryn to take the agenda forward and finalise our forward looking approach. For my own part I would now look forward to stepping back to the less intensive role of a non-executive Chairman than the first year of my tenure has been. However, I rather fear that PR14 is going to make the coming year as intensive as the last year.

Thank you.

Jonson Cox, Chair of the Water Services Regulation Authority (Ofwat)

12 September 2013

...coming back into the sector



Images © nazreth, leonardobc, George Thomas

My six priorities…and progress

1. Customers

2. Water resources

3. Financing water companies

4. Evolutionary reform

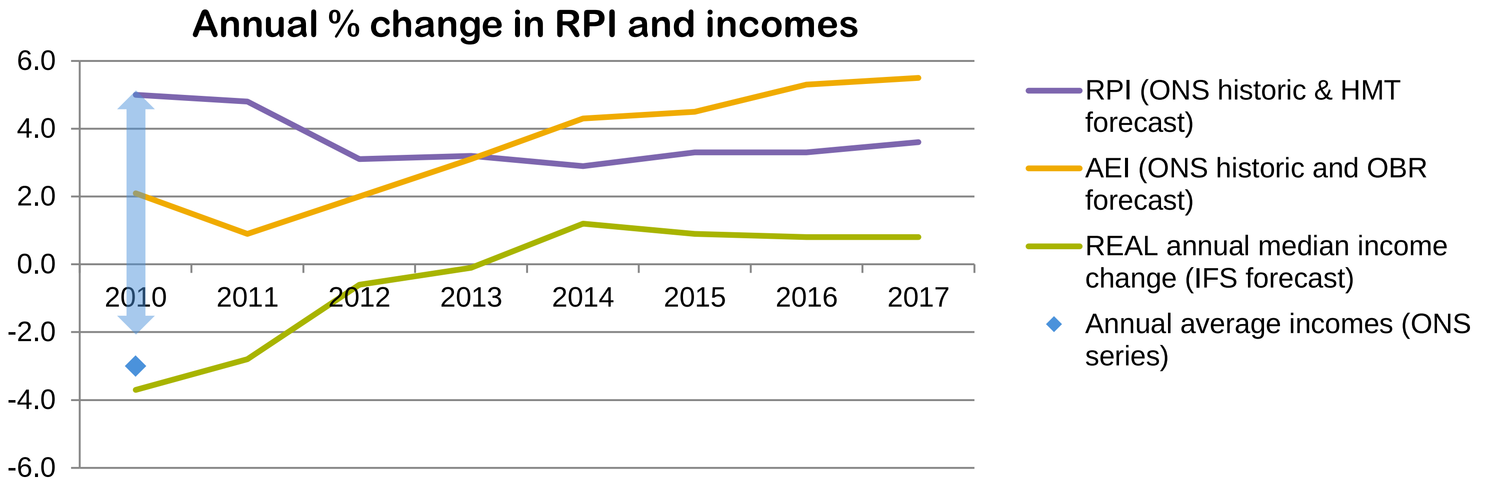
5. A fair outcome to the 2014 price review

6. Governance and board leadership

Getting the best outcome for customers

…but company outperformance from exogenous factors remains strong

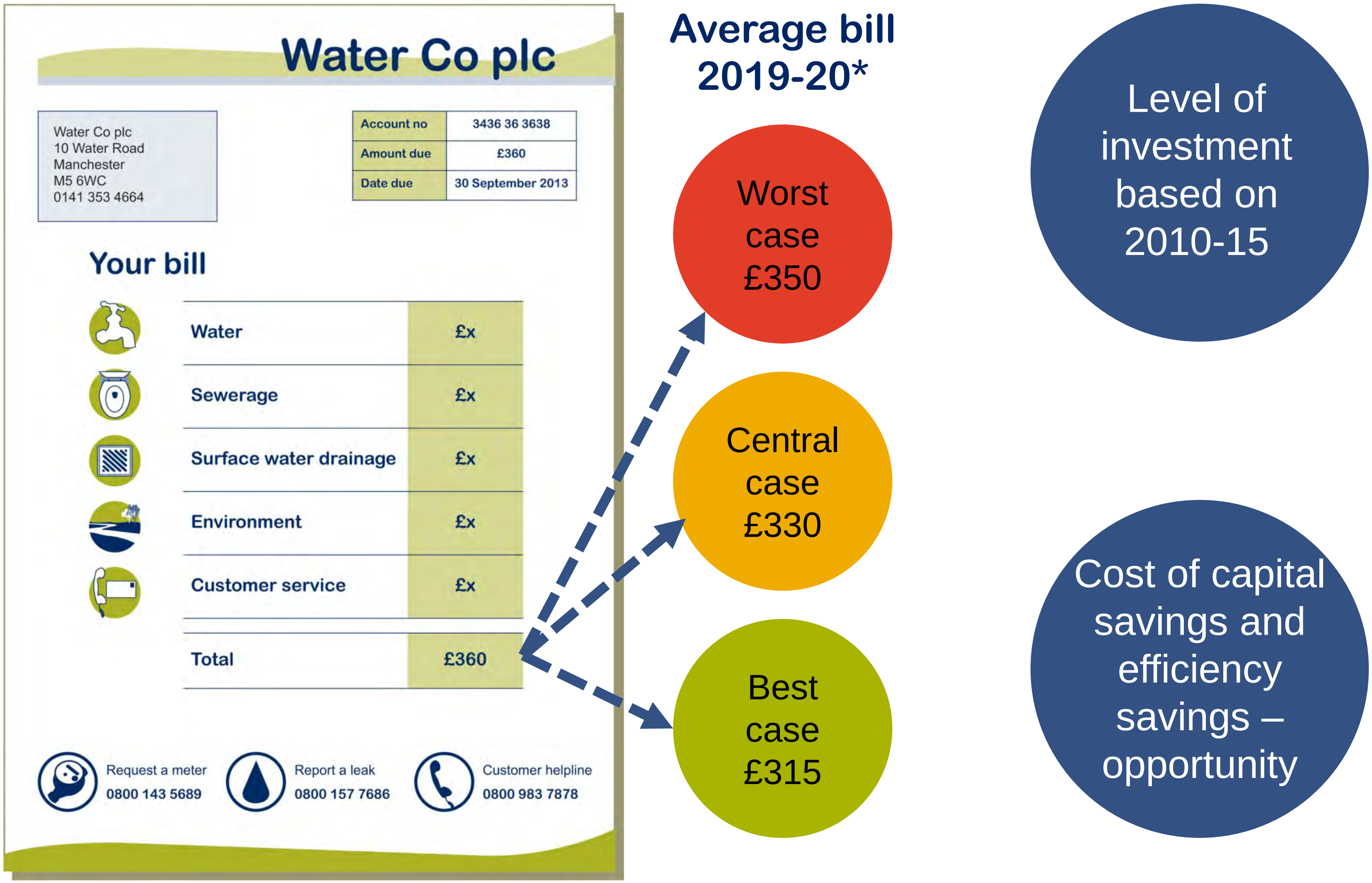
Outperformance from factors beyond management control in 2010-13 period:
About £1,400 million from RPI
About £600 million from cost of debt



Sources: ONS, HMT, OBR and IFS (2013)

Tough time for customers – bills rising, incomes falling, big impacts on the horizon
Companies must maintain customer legitimacy

What could we expect from bills in 2015-20?



*Expressed in 2012-13 prices

Water resources

Image © WWF

Improving the management of our scarce water resources and the resilience of services

Removing the ‘capex bias’

Historic model is a ‘return on capital’ approach and Ofwat has treated opex and capex differently

Opex £ for £ in bills

Capex spread over longer period

Various people have suggested that there is a ‘capex bias’

At PR14 we propose to adopt a ‘total expenditure’ or ‘totex’ approach – treating opex and capex the same

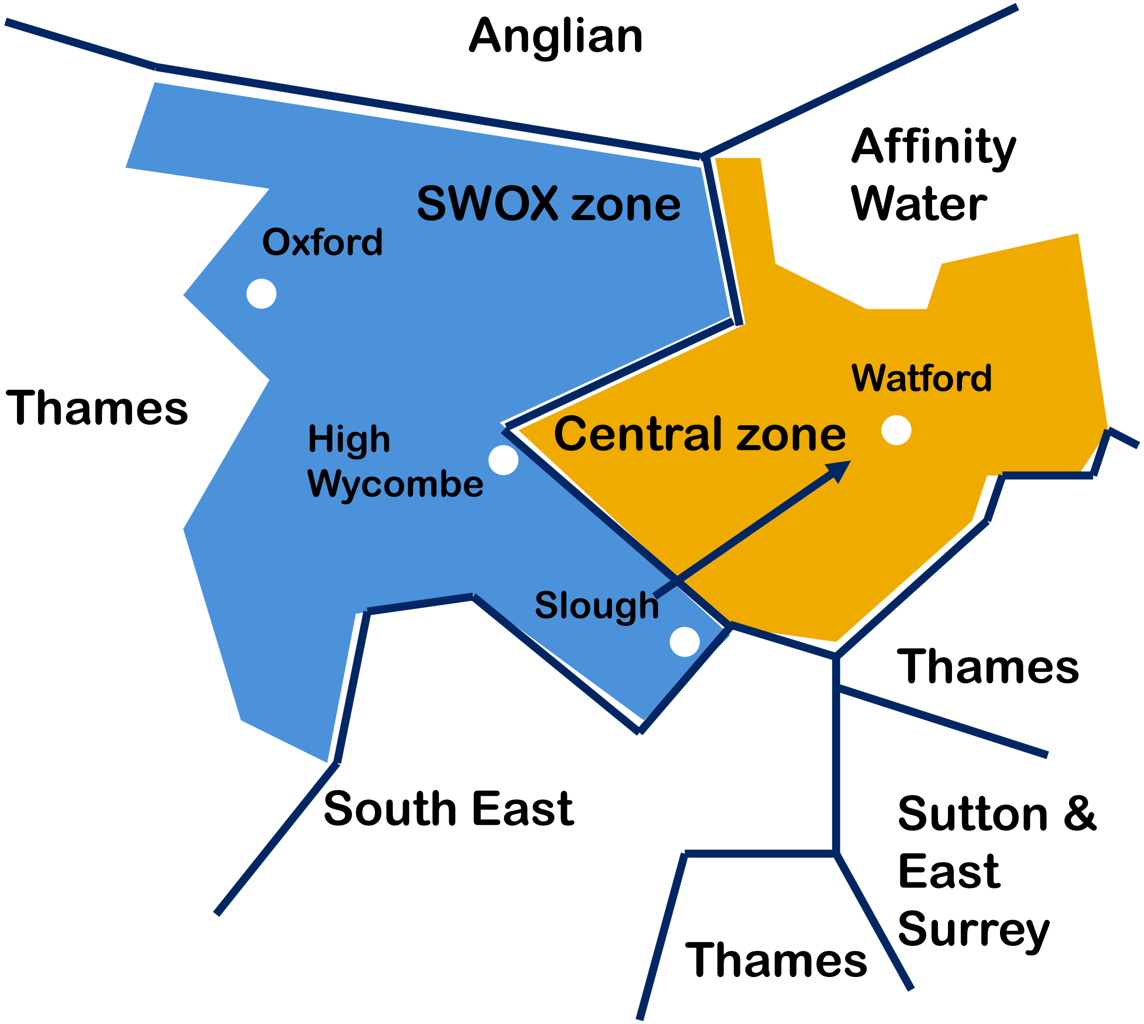
Companies set their ‘total expenditure’ out in their business plans

All expenditure treated the same – so no bias towards capital intensive and potentially unsustainable solutions

Companies’ free to choose their own run-off rates – so flexibility between paying for investments today versus tomorrow

Approach seeks to remove any capex bias and encourage more sustainable investment solutions

Encouraging sustainable trading



Cost of water in SWOX zone of Thames less than Central zone of Affinity so trading opportunity may arise, removing need for new resource investment in Affinity's area

Cost of export (£NPV)	£90 million
Cost of internal source (£NPV)	£100 million
Benefit of trade	£10 million

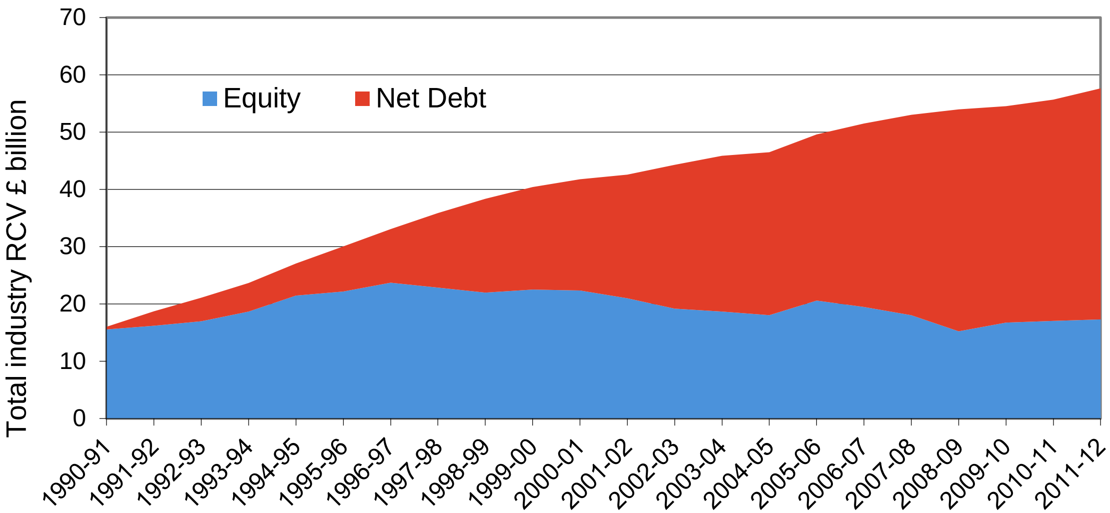
SWOX= Swindon and West Oxfordshire

Image © Stockvault

Ensuring water companies' financial structures are sustainable and there is a fair sharing of pain and gain between companies and customers

Notional capital structure – efficiency or risk?

3. **Ensuring water companies financial structures are sustainable and there is fair sharing of pain and gain between companies and customers**

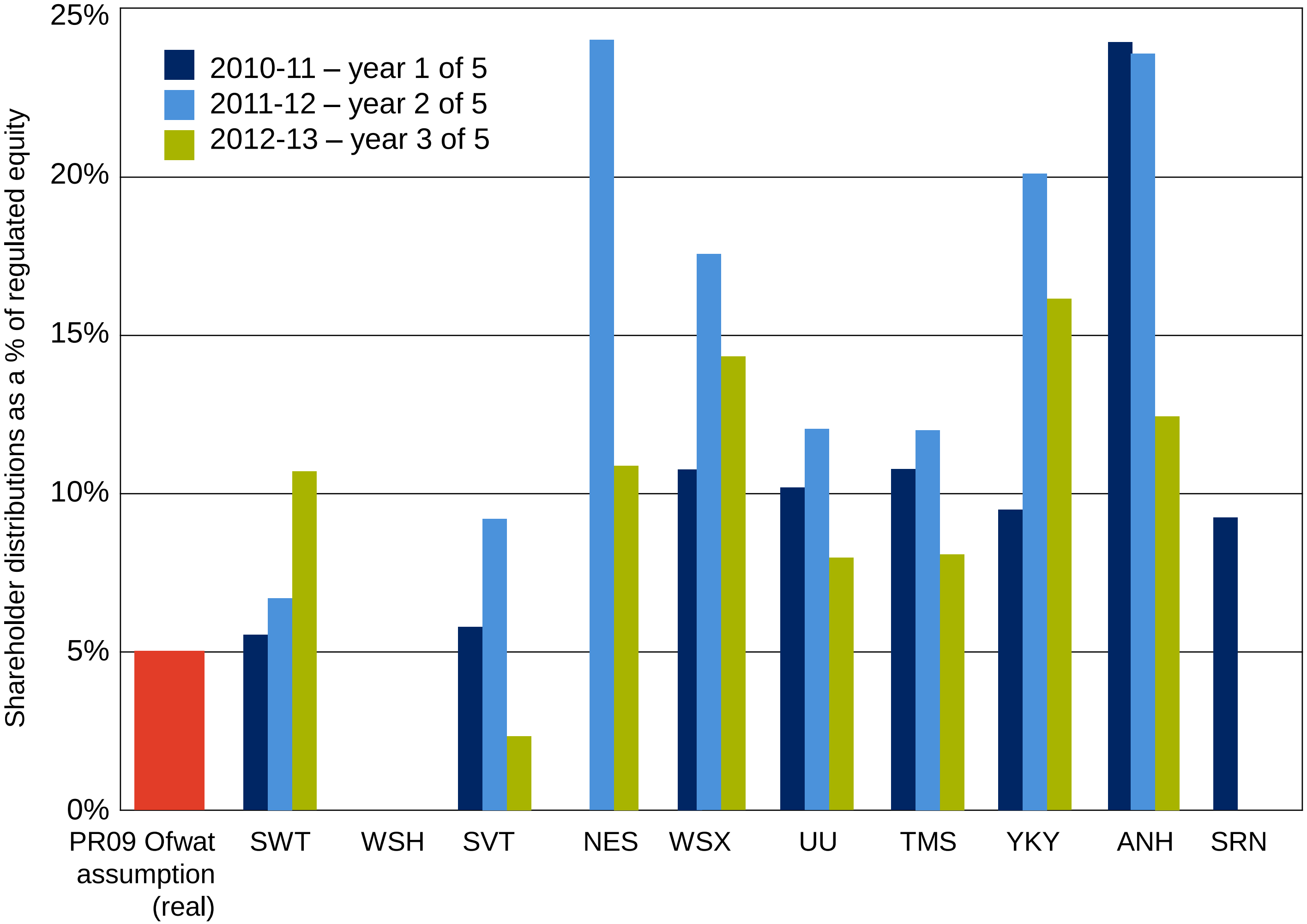


Source: Ofwat

Have been reviewing gearing issue in detail:

Concluded no systemic risk for higher leverage of Regco
Holdco shareholder loans and tax for HMG
Raised moral obligations and legitimacy
Some acceptance that, for example, Cayman Island holding companies not appropriate for essential utility
Ongoing monitoring through next price review and changes to notional gearing

Challenges on pain/gain sharing are reaping early rewards



No cash to customers, but early wins:

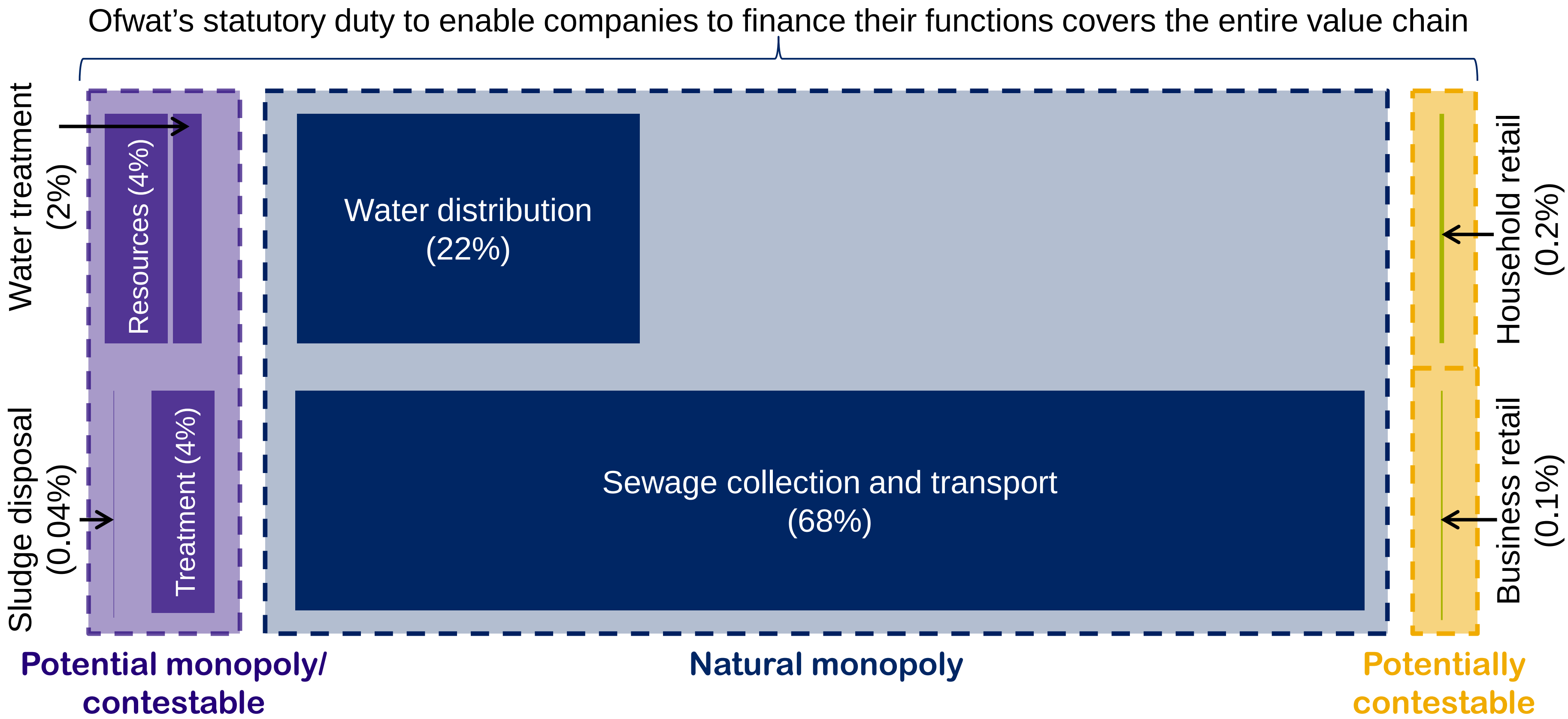
IDoKs withdrawn – about £100 million savings for customers
Further investment for growth about £630 million

Excludes dividends to fund interest receivable but includes special dividends

Evolutionary reform

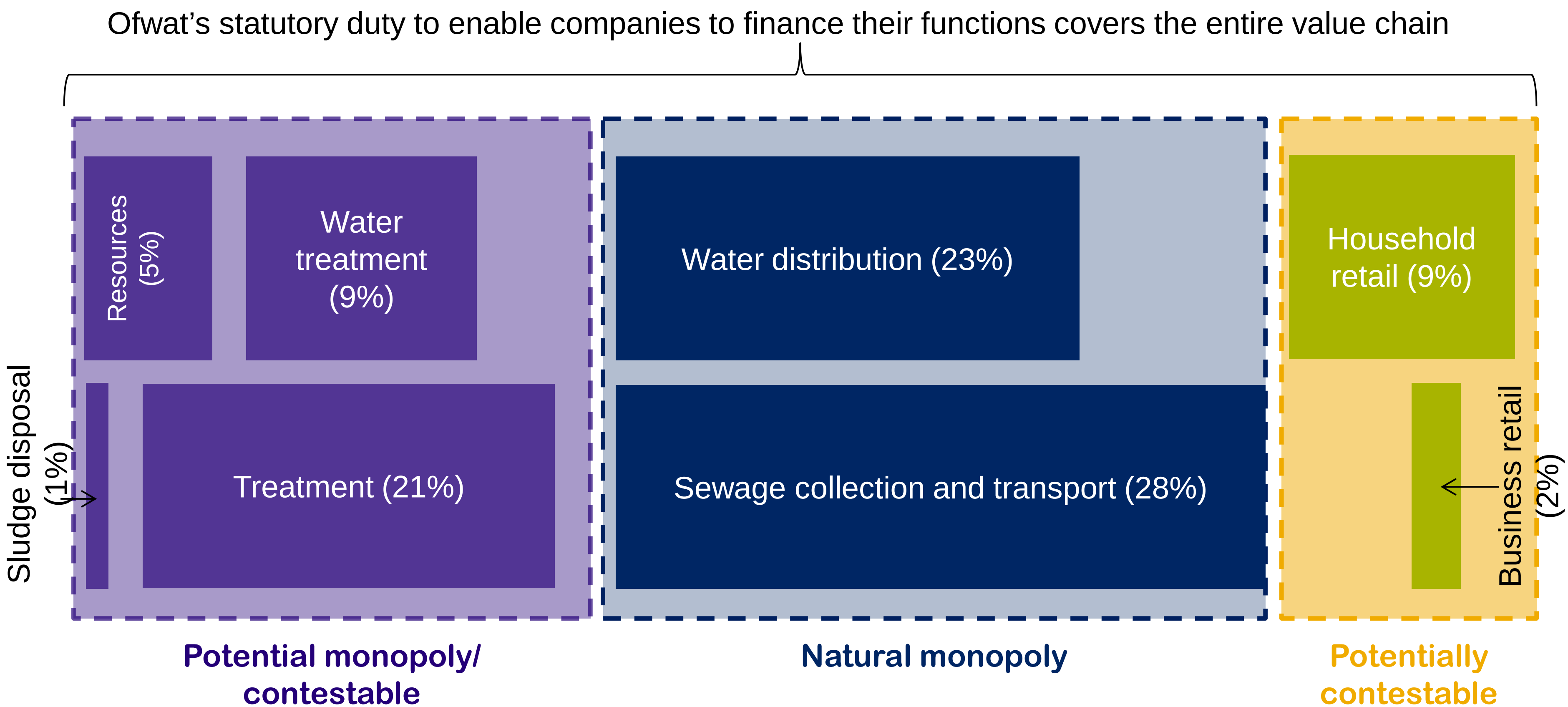
Ensuring regulation develops progressively to meet the challenges of the future and to harness market forces for the benefit of consumers

The water and sewerage value chain and asset values



Source: Ofwat, Companies accounting data 2011-12. Based on the net book value of assets as % of water and sewerage total assets

The water and sewerage value chain by revenue values



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

Evolutionary legislative and regulatory change

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

Water Bill proposes evolutionary change that we support

Final Bill removes ‘network’ entry entirely but keeps upstream water, sludge and retail opportunities which carry benefits

Future reforms to abstraction licensing also likely to support trading

Regulatory reforms propose gradual process of information and cost discovery during next AMP

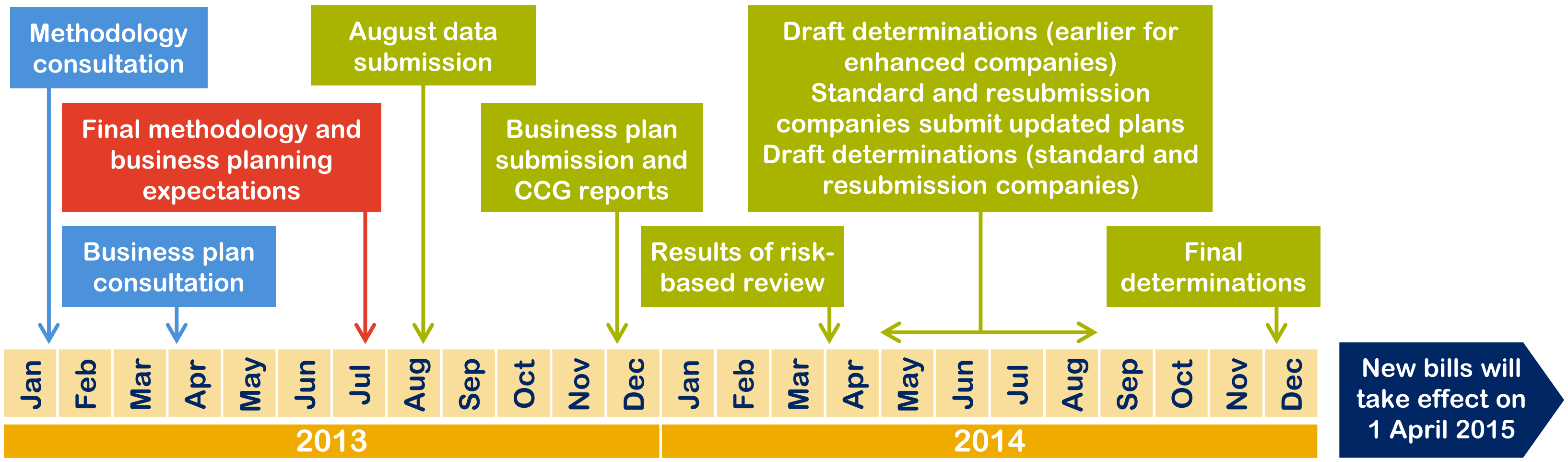
Improves regulatory challenge to monopolies as much as promoting entry

A fair outcome from the 2014 price review

Delivering an outcome to PR14 which puts customers' interests at the forefront while ensuring a fair return for investors and appropriate incentives on companies

2014 periodic review is at a critical stage

5. Delivering an outcome to PR14 which puts customers' interests at the forefront while ensuring a fair return for investors and appropriate incentives on companies



Key issues:

An evolution in the price review model but a tight timescale

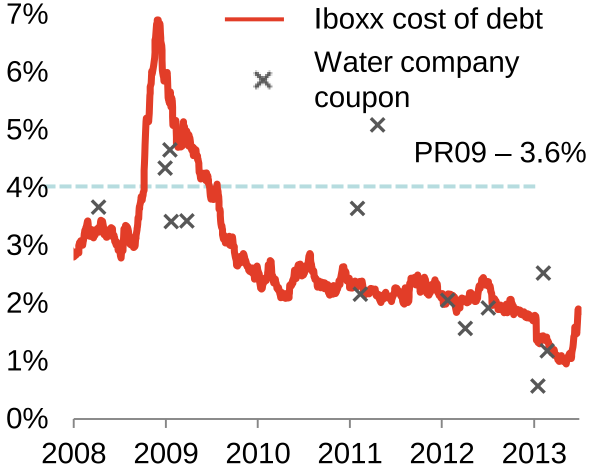
More responsibility with companies to decide on their proposed package

Fast-tracking and clear incentives for well developed and balanced packages

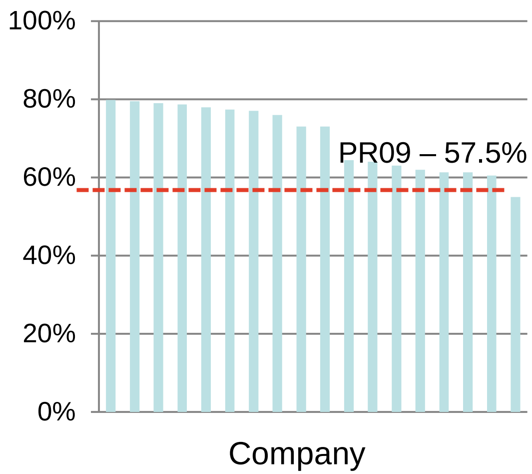
Companies to propose own WACC – we will determine what is reasonable

Market trends point to declining cost of capital

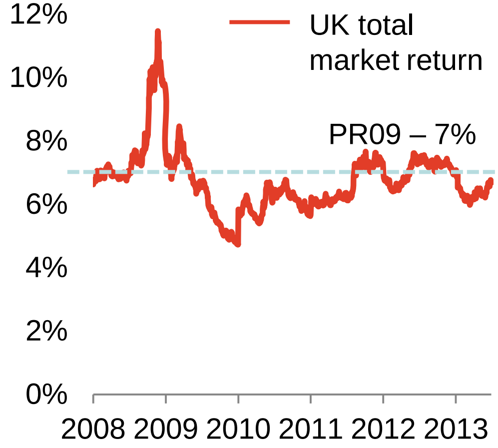
Cost of debt has declined



Gearing has increased



Market equity returns have remained stable



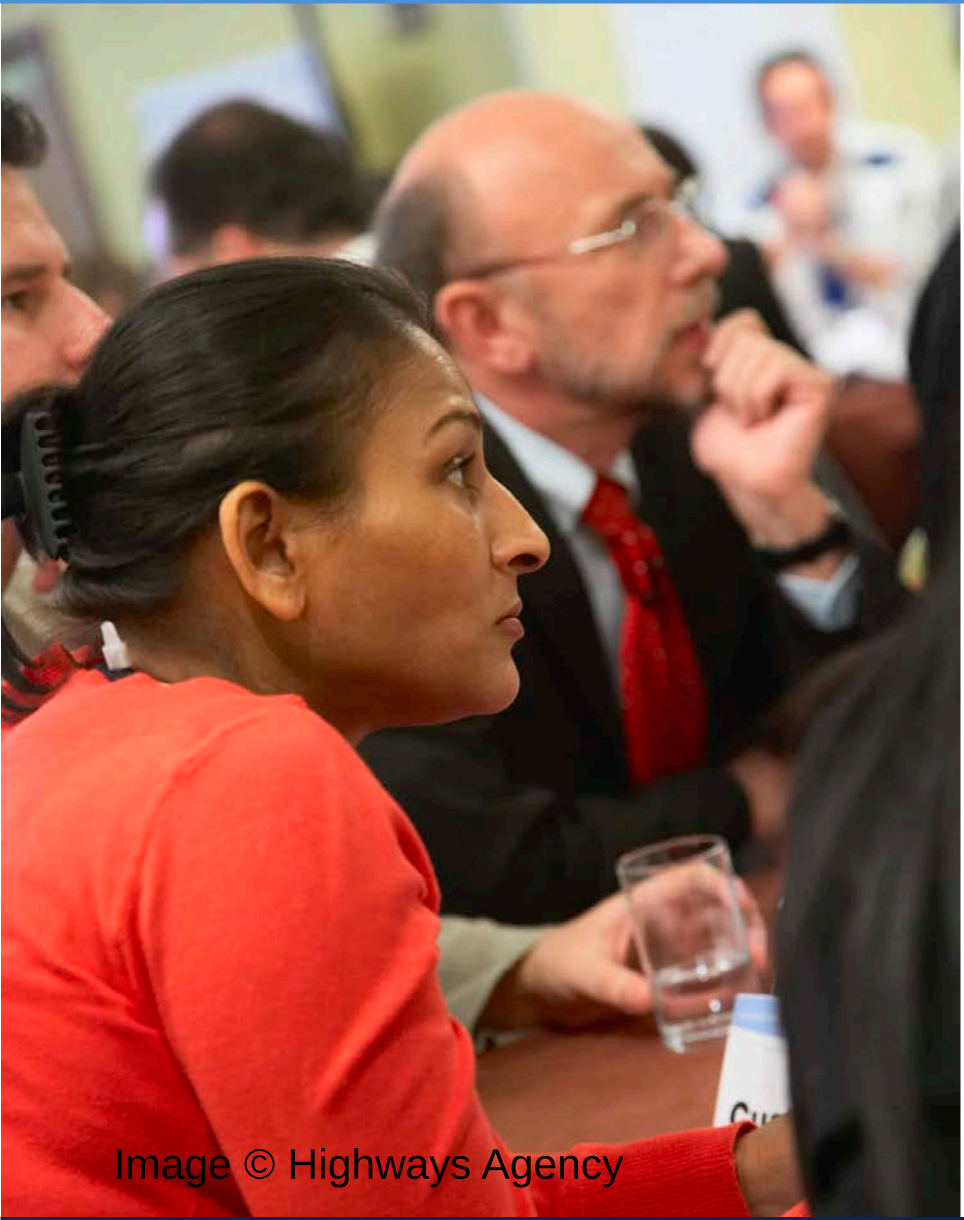


Image © Highways Agency

Building a capable and independent Water Services Regulation Authority Board and ensuring effective sector governance

Distrust over energy prices valid, say MPs

Energy watchdog ‘not using its teeth’

Lords say Amazon-style tax avoidance schemes must end
The Guardian

Image © Dominic’s pics

ENERGY COMPANIES

MPs call for more transparency from the Big Six

Our work on reviewing board leadership and governance has had some early wins

Met with several companies and investors

Recognition of value of sector specific principles

Expecting companies to build on disclosures in their accounts this year and strengthen board leadership

Working on Regco and Holdco principles but looking to sector to take the lead, meeting or exceeding a core set of principles

An innovative self-regulatory approach