Cathryn Ross speaking notes – Moody's 2017 UK Water Sector Conference, 17 October 2017

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Good morning everyone. It's great to be here. And thanks to Neil and the team at Moody's for inviting me.

When I agreed to talk at this conference I said I'd talk about the challenges and opportunities for companies through the coming price review. I'd expected to recap on a lot of the things we have been talking about for a while – the impact of a tougher efficiency challenge from Ofwat for companies, the impact of lower financing costs, the effect of more money at risk dependent on delivery for customers, what we're looking for from business plans…

But since I planned that speech it feels like a lot has happened. Indeed, it feels like we are now in the middle of a conversation not about how the current model for the sector could or should deliver more for customers, but about the very legitimacy of that model.

The Labour manifesto for the election included a promise to renationalise the industry - a promise reconfirmed at the recent Labour conference - along with a commitment to renationalise a number of other industries. Jeremy Corbyn singled out water companies, saying, and I quote:

"Take the water industry. Of the nine water companies in England six are now owned by private equity or foreign sovereign wealth funds. Their profits are handed out in dividends to shareholders while the infrastructure crumbles the companies pay little or nothing in tax and executive pay has soared as the service deteriorates".

At least for those with long memories, maybe isn't so surprising that the Labour party is looking to renationalise.

But let me give you some other quotes:

"Water privatisation looks little more than an organised rip-off. Quite why this natural monopoly should not operate through not-for-profit public interest companies is ever less clear".

"Some of the UK's privatisations, notably in water, have failed".

"The scandal of privatised water is going to blow. Water firms promised efficiency. Instead they have brought unsustainable debt that the public will have to redeem"

"If the Tories want to defend free markets they must reform the useless regulators that let airlines and utility giants treat us like dirt"

Where are these quotes from?

Well, the first two are from editorial content in the Financial Times. The third is from Nick Cohen in the Spectator. The last is from Alex Brummer in the Daily Mail.

And I include them because I think it is very important not to misread the legitimacy challenge the sector is facing right now as a party political one. It isn't. It is much more fundamental than that.

Why the great debate?

I know that, to some, the current debate feels rather as if it came out of nowhere.

After all, if you look at what the sector has achieved for customers and society since privatisation there really is a good story to tell.

Customers are 5 times less likely to suffer from supply interruptions, 8 times less likely to suffer from sewer flooding, and 100 times less likely to have low pressure. More than two thirds of our beaches are classed as excellent and more than a hundred have those much-coveted blue flags.

More than £140bn of investment has gone into the sector since privatisation. And yes bills have risen to accommodate this. But costs haven't spiralled out of control as they have in some other sectors – our efficiency challenge has kept costs in check and bills a third lower than they would otherwise have been. On average, customers pay less than a penny per litre of water delivered, and wastewater taken away, treated and returned safely to the environment.

It is a great story. It really is.

But if you look at the water sector through a different lens, the debate is less surprising.

If you have ever listened in to a group of customers talking about water issues you don't get long into the discussion before someone says something along the lines of

'I don't know why we pay for it at all, it just falls from the sky'. Of course, customers do understand that collecting, treating and transporting water costs money. And that somewhere along the line someone needs to pay for those costs. But what those conversations are telling us, is just how differently people think about water. Not in the same way as they think about consumer goods, or even energy or banking, but as a human right, something more akin to healthcare and education.

Those of you who were around at the time of privatisation will remember that this was one of the one of the arguments against privatisation. Now, there is no necessary conflict between private ownership and public service. But for some people, it just didn't feel right that something so fundamental would be provided by privately owned, profit-making companies.

Our democratically elected representatives are having that debate right now. And it's a choice for government not regulators so it isn't a debate we are participating in (unless we need to correct a few facts). Although I'm looking forward to that item on our agenda later…

The fact of the matter is that right now we do have privately owned companies providing water and waste water services, these human rights on which we all depend. But the fundamental question about the legitimacy of this model, the question that was asked at the time of privatisation, didn't just disappear. And we need to ask ourselves both why it is being asked again explicitly right now, and what it means.

I don't think it is about what the sector is delivering…

As I said earlier, I don't believe that the sector's legitimacy is being questioned now principally because of what customers are getting for their money.

Yes, there is a lot more water companies can and should be doing to improve the overall customer experience today and keep pace with how expectations are going to evolve in (I would argue the not too distant) future. But nobody is saying that £1 a day for all a household's water and waste water needs is bad value. And indeed, CCW's surveys show customer satisfaction more than 90%.

So, if the debate isn't being driven by what customers are getting, what it is about?

[… it is about the how.]

I think it goes back to the essence of how the public feel about these vital public services being provided by private companies. Companies with shareholders. Shareholders who expect to make a return.

It is easy to imagine that shareholders are somehow unconnected to real people. And that isn't always the case. Pension funds have long been attracted to long term sectors like this, especially given the inflation hedge they provide, which helps match their liabilities. The BT pension fund has been present in the sector for a while, for example, the Universities Superannuation Scheme is a recent entrant and we may well see others in the next few months.

But further, what I think is being picked up on in the debate right now is a feeling that these companies are not being run in the interests of the people who depend on their services. And there is a view that the public interest is somehow necessarily in conflict with the interests of shareholders, whose interests win out.

I don't think there is such a necessary conflict. But I'm in no doubt that if we are successfully going to meet the legitimacy challenge that is being posed to the sector we need to be able to demonstrate that these companies are indeed being run in the public interest.

This is in part a challenge for regulation…

Part of the answer here is economic regulation. I completely accept this. We are an important part of that system through which privatised companies deliver for the public good. And I have said for a long time that economic regulation, when it is at its best, is about aligning the interests of capital and company management with those of customers.

In this context, and I speak as someone who before I took up this job regulated Network Rail, I would note that private shareholders with a interest in their returns can be a powerful thing. If there are private shareholders, regulators can allocate risk to those shareholders. And if those shareholders care about their returns, regulators allocating upside and downside risk to them causes them to change their behaviour, and change the behaviour of the management of their companies. As the regulator, we can, and should, ensure that companies and their shareholders make money by doing stuff that matters to customers – aligning their interests.

Over the past few years we have very consciously taken steps to improve this alignment.

There is no doubt, with the benefit of hindsight, that it had been too easy for companies and their shareholders to make money by gearing up and outperforming the WACC, rather than by improving operating efficiency, innovating and delivering for customers.

In PR14 we started to address this. We set the lowest ever cost of capital in regulated UK utilities, at 3.6% for the wholesale businesses. We set our totex efficiency benchmark at the upper quartile, and removed any glidepath. Alongside this, we introduced financial upside and downside that reflected the extent to which companies delivered the outcomes their customers cared about… or didn't (although this being a new thing we capped that money at risk at +/- 2 percentage points on RORE). We welcomed proposals like South West Water's WaterShare, which shares outperformance between customers and shareholders.

In terms of making sure that companies make money when they do things that benefit customers, it was a big step in the right direction.

And in PR19, as you will have seen from our methodology consultation, we are taking the opportunity to build on this and go further.

We have acknowledged the criticism from the NAO and others that we have set too high a WACC in previous reviews. We believe strongly that setting our price control based on a notional capital structure is the right thing to do – it is not appropriate to allocate the risk associated with capital structures to customers who cannot influence this and are not well placed to bear it. But we have proposed to change our approach to the WACC for the next review.

We have said we expect to place less weight on history, which we have (finally) learned is not the best predictor of the future, and more weight on market observations and future expectations. We can and should be looking, for example, at what the premiums paid for stakes in water companies are telling us about expected equity returns.

We have said we expect to index the cost of new debt through an ex post true up in the next control at the sector-wide level, which effectively eliminates any premium for forecasting risk.

And we have already said that we think the weighted average cost of capital in PR19 will likely begin with a 2 – we will give our estimate of the indicative WACC in December alongside the final methodology. A fair return for the level of risk inherent in these businesses, yes. And still some incentive for individual companies to seek out financing efficiencies. But definitely less scope for easy outperformance.

We have also said that we expect a tough totex efficiency challenge for companies in PR19. From what I can see about how some companies are embracing our outcomes and totex framework to really change the way they operate – indeed we will hear from one of those companies later - I expect we will see a significant shift in the efficiency frontier in PR19. In the first two years of this control period, on

average companies are reporting that they are outperforming their regulatory cost allowances, with the average outperformance at 0.7% and the highest outperformance at 3.5%. And we have also said that we expect to take a more forward looking approach to our upper quartile benchmark for PR19 too. I think this is particularly important when you consider the two year lag between data that is available to us at the time we do our review and the end of the control period.

We have said that we expect to see more money at risk relating to outcome delivery in PR19. We are seeing already how well companies are responding to the opportunity to earn additional rewards. Although across the sector there is only very modest outperformance, at an average of 0.14% RORE – twelve out of the seventeen have reported rewards in the first couple of years of this control period, some at frontier shifting levels.

And in PR19 we expect to do more, across our common performance commitments, to ensure that where companies make money from outperformance on delivery, it is where they are really contributing to a frontier shift for the whole sector, to the benefit of all customers over the long run.

And running right the way through the review, we are placing greater weight on two things.

The first is the long term. Frankly, the five year control periods have never been a barrier to long term thinking - regulated sectors like this have levels of certainty and predictability over delivery and cost recovery that competitive sectors can only dream of. But in PR19 we are doing more. For example by encouraging - with government and quality regulators - a 25-60 year look ahead in water resource management plans. And by supporting ten year indicative performance commitments beyond the control period, extending to 2035. And through our emphasis on long term resilience in the round.

And the second thing that runs right through PR19 is innovation. We have said that companies that are genuinely innovative in their plans will benefit from an uplift of on their equity return, and those companies will access greater rewards where they deliver against their plan for customers. I know there is a debate about whether we have put enough on the table for genuine innovation – we'll see.

We are yet to conclude on the final methodology. But all of these sorts of changes will deliver a really major step forward, building on PR14, to improve the alignment of the interests of companies and their shareholders with those of customers.

But again, it isn't enough. The sector cannot expect the regulator to meet its legitimacy challenge for it.

Companies and investors need to do their bit

In part this is about responding to the regulatory framework, with the changes to it that I have already discussed.

On that, I was interested in what I thought was an unduly pessimistic note in some of the responses to our methodology consultation.

Some responses expressed concern that in making the changes we are making to the incentive framework we were somehow skewing incentives to the downside – that today's average company would lose money tomorrow.

But for that to be true you would have to believe that the company who is average today does nothing to improve. And in reality, I think that is very unlikely indeed.

After all, we know that companies have lots of opportunity to improve efficiency and delivery. We have published several reports ourselves recently highlighting best practice in the sector and beyond on things like vulnerability, bad debt and resilience. I know that quite a few companies are working with leaders in their field from beyond the water sector and beyond the UK on things like behaviour change. And I know some companies who, using things like technology exchanges, are taking advantage of the experience and expertise in the supply chain.

And we also know that companies do respond to incentives. Water companies in general have a pretty good track record at minimising downside risk. And some have done a good job in realising upside too. I have given you some examples of where we have seen that already in this control period. That 0.14% outperformance on ODIs, for example compares to an expected 0.6% expected underperformance at the time of the last review…

And of course, by publishing our methodology, and our indicative WACC for PR19 so much earlier in the process we are giving companies even more scope to act now to improve their position.

So I don't buy the pessimism of returns skewed to the downside. I'm actually feeling pretty optimistic that companies and investors will act on their ability and incentive to improve. I believe they will do their bit to respond to our incentive framework to deliver more for less for customers.

But again, going back to the debate about private provision of essential public services, I still don't think that's enough.

If it was the debate would stop at regulatory reform, rather than extending into renationalisation.

So again, what is it about these private providers of essential public services that people are calling out?

There are a few themes here – you heard some of them in those quotes at the start: there is a view that boards that are stuffed full of investors and making every call in their interests rather than customers; a suspicion that investors are lining their own pockets today at the expense of the long term resilience of service delivery; a concern about lack of transparency.

We stepped into this debate four years ago, when Jonson led the call for improvements in board leadership, transparency and governance in the sector. We established a set of principles and companies agreed to comply or explain and report against them.

And these have really helped – companies and investors have worked with us, risen to the challenge.

We have seen companies strengthen the independent representation on their boards and their committees, ensure that those boards are appropriately focussed on the regulated company and improve the quality of reporting on their governance and ownership structures.

But there is still more to do.

Many of you will have seen Jonson's recent piece in Utility Week on holding Thames Water to account. Although the piece was about Thames, he was very clear that we expect all companies to do more on board leadership transparency and governance. In particular, to improve the quality and transparency of their reporting on how they deliver for customers and society as well as investors – giving it equal prominence with their financial reporting. We also expect a clear comparison in annual reports of highly leveraged companies between the financial flows on the basis of their actual capital structures and what those flows would have been under our more conservative notional structure. And we will expect companies to be able to demonstrate how their management rewards give appropriate weight to performance for customers.

Similarly, we have over the last few years done a lot to highlight the importance of long term financial resilience in the sector. I think there is a much greater awareness among companies and investors now that when we say the risk associated with a company's choice of capital structure and financing decisions rests with the company

and its investors, we mean downside as well as upside. And we are starting to see one or two companies – we will hear from one later – reforming their capital structures. Which we welcome.

But again, there is more to do.

We will soon be publishing these year's financial monitoring report. I'm sure you will read it when it comes out. But one thing I do want to call out now is the need for all companies and their investors to take ownership of their long term financial resilience, and, if necessary, to take action now to secure it.

Why do I stress this now?

Because, while there is some cause for optimism, which I have mentioned, I do genuinely worry when out of the 17 companies we regulate, 6 - 5 if I'm feeling generous - have failed to provide us with long term viability statements going out at least 5 years. In response to last year's returns from companies we emphasised the importance of that 5 year look ahead, and yet we still don't have that for all companies.

And, in case you were wondering, we were not asking for it for the good of our health, but rather to provide us with assurance that companies and investors were doing what they needed to do to make the decisions they needed to make to secure the long term financial resilience of these long term businesses – rather than simply planning to come back cap in hand to customers at some point.

I'm conscious I won't be around for the price review itself, but I'm struggling to see how the absence of those statements – and indeed in some cases the absence of assurance that companies and investors are doing what they need to do now to get their house in order – won't undermine the credibility of the business plans we will get from those companies. They will get an opportunity to put this right, but I have to say that time is short.

So where does this leave us?

I genuinely meant it when I said earlier that the sector has a good story to tell about what has been achieved since privatisation. But I hope that everyone associated with the sector realises that this gives no grounds whatsoever for complacency.

The good news is that, as I have set out, I think that right now the sector has the best opportunity in decades to address its critics.

In part this is about the opportunity companies have in PR19 to deliver on the 'what' – to do more for customers and society – to engage with customers on how that headroom created by lower financing costs and efficiency improvements is distributed between lower bills, improvements in service and improvements in resilience.

And, critically, it is also about the opportunities we all have to improve on the how.

The opportunity to demonstrate that companies are operating in the best long term interests of customers and society, with investors getting a fair return. Rather than – as some suspect – solely operating in the best long term interests of their shareholders with customers and society getting what they can be persuaded to accept.

Do I think the sector will seize these opportunities?

Yes I do.

Partly because one of the things I observe when I visit companies is the strength of the public service ethos that flows through them.

Partly because I observe some companies already acting and taking ownership now and others – as we move closer to PR19 – realising what they need to do.

But also because, if I had any doubt, the current debate about the fundamentals of the model that underpins this sector should serve as a wake up call to even the hardest of hearing.