Jonson Cox speech at Water Industry City Conference, 1 March 2018

This is the speech as drafted; the actual words spoken and delivered on the day may vary from the draft

Introduction

Good morning. I am delighted to be here once again. I have always seen this conference as an opportunity to think aloud. Today is no different. I want to share my reflections on the state of the sector. That includes the sector's progress and the problems it has yet to resolve.

A crisis of confidence presents great moments of opportunity. And it is in that vein that I want to share some emerging ideas as to how the sector could 'hit refresh' and offer a renewed commitment to customers.

Before we get to all that, let me reflect on some positive developments. And I should say – after seeing our wonderful, low cost innovation Spark! programme, led by Margareta and Freddie, I feel very old world doing this as a speech.

Chief Executive

I want to begin with a recent change at Ofwat. Among the responsibilities of a Chair in a public body, I believe the most important is to appoint a Chief Executive to run the organisation.

Just over four years ago I had the pleasure of appointing Cathryn Ross. So much was achieved under her leadership to put Ofwat back in a strong and challenging position to the sector, as befits an independent economic regulator. But, as you know Cathryn moved on to new challenges at the end of last year.

I am delighted to have appointed Rachel Fletcher as our new Chief Executive. Rachel joined us early in January and is already making her mark. We're very lucky to have recruited such a high calibre CEO. Rachel will complement the strengths of our existing leadership team and will lead Ofwat through PR19. While making sure PR19 is delivered robustly and effectively, she will also be thinking about the strategic direction of the organisation and sector now and beyond 2020. I look forward to working with Rachel over the coming years.

Where are we coming from?

Five years ago, exactly, shortly after I'd been brought in to sort out the breakdown between companies and regulator on licence changes, I set out six themes that were key to the sector moving forward. My agenda focused on customers, resilience, financial structures, protection of the environment, the evolution of regulation and effective Board leadership and governance. These themes have helped set our agenda for the last five years. They were embedded in PR14 and will be even more important in the coming price review. They have shaped many of the developments delivering real benefits for customers, the environment and wider society.

Let's start with customers. We introduced the independent customer challenge groups in PR14 which will continue, with higher expectations, in PR19. This requires companies to invest more in their relationships and engagement in line with our new customer experience measure, CMEX.   I recently met with the CCGs to discuss the coming review. Theirs is a weighty task, requiring real independence of thought and wide-ranging challenge.

Some companies have stepped up to the PR14 efficiency challenge in an impressive way. In the first two years of this AMP period more than half of companies outperformed their innovative TOTEX allowances which were set at PR14. Customers benefit in the short term because our incentive regime means cost savings are shared. They benefit in the future because the current best levels of efficiency will set the standard for all in the next period and will contribute to prices falling - in real terms - for a decade. And initiatives like United Utilities' recent affordability summit, have brought together a range of agencies to support customers in difficult circumstances or struggling to pay their bills.

Our PR14 incentives for outperformance, matched with penalties for underperformance, emphasised stretching achievement. Severn Trent has led the way in showing what ambition can achieve and has earned material outperformance payments for significant improvements in internal and external sewer flooding. Anglian is earning a reward on leakage improvement. Among the WOCs, South Staffs has earned rewards on cutting interruptions to supply.

On the other hand, sadly I must note that a few companies face significant penalties - £76m in total (and it could have been more but for the caps on the incentive regime in this period) - for failing to meet the standards they promised. This money will be returned to customers because they are not receiving the service they were promised.

Many of the companies that are performing well on cost efficiency are also earning outperformance payments for delivering above their commitments. The converse applies too. If you look for a correlation between financial structure and customer performance, the evidence is more mixed. I would just note that two of the major cases on performance that we are investigating concern highly leveraged companies [HLCos]

The Board of any company plays a vital role in strategy, assurance, and overseeing delivery for customers. We were not convinced the leadership of boards in this sector was as effective as could be. Our Principles of Board Leadership meaningfully improved the quality of board leadership. We have shown in the last year that where a Board does not perform for customers, we will shine a light on this and call for change. This is not a step we take lightly. We do it to protect customers when it's necessary. I am glad to welcome changes in the company in question.

Another benefit for customers is in operational resilience. We allowed funding in Severn Trent's price limits for the Birmingham resilience project which will provide the city with two water sources from the end of 2019. We allowed funding - in PR09 and at PR14 - for Wessex Water to invest £230m in its water supply grid, a project due to complete this year which will redistribute surplus water.

And last but by no means least, I want to take a moment to remind us all that the public service this industry provides is fulfilled by dedicated women and men on the front line, all of whom have a massive commitment to their jobs and to the public. There is little I find more humbling in this role than a day spent with a frontline team and I commend them all.

Yet, while noting all this good progress, now is not the time to sit still and look back at all that's been achieved. I don't think the sector has gone far enough. A renewed effort is needed.

Legitimacy

You have all seen the fundamental and high-profile challenges to the legitimacy of the sector, and - it's important to be very specific here - the challenge to some of the practices of the highly leveraged companies.

Let me read you some quotes:

From the Secretary of State, Michael Gove: "It is undeniably the case that privatisation and the injection of private capital has brought in investment which has improved infrastructure. But if …. public support is to remain durable, we can't have offshore tax havens and other jurisdictions being used … to provide corporate benefits……..."

From the Shadow Chancellor, John McDonnell: "The next Labour government will call an end to the privatisation of our public sector, and call time on the freeloading water companies that have a stranglehold over many working households"

From the Financial Times: “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”.

And from customers on social media (display tweet): “Good case for the renationalisation of water being set out on #r4today - in the last decade (yes the #austerity decade) about £18bn has been paid out to shareholders.”

I could go on…. Except for a few notable performance failures, principally in London, the challenges to the sector are about corporate behaviour and aggressive financial structures.

I’d like to explore this through three different lenses:

1. The customer lens

Customers’ interests and “trust and confidence in water” are fundamental to the way we lead in Ofwat. Customers deserve this most essential service to be affordable, resilient and delivered with outstanding customer service. They pay for their water company to be financially stable and efficient. It is common sense that a resilient financial structure is a pre-requisite to resilient operations and service. I need hardly mention the disruption that is currently seen in other areas of public service in private hands where companies’ financial structures have not been resilient.

What must customers feel about the headlines we’ve all read recently? They read of high dividends, high debt, complex holding company structures and off-shore companies, be they in the Channel Islands or the Cayman Islands. The apparent one-sided benefits from these practices, enjoyed by the HLCos, bring doubt and consternation and are not seen as consistent with public service behaviour. The more they read about it, the less they like it. They do not have the sense that their water company is on their side, but rather that it is more interested in boosting financial returns. The customer on the Clapham omnibus may not understand the detail but he knows the ‘settlement’ doesn’t feel fair.

I've said many times before: it's an immense privilege to hold a monopoly public service licence. The public has every right to expect the highest standards of corporate behaviour and resilience from water companies.

2. The business lens

My conversations with Chairmen of companies and other senior business figures often turn to what sits behind this loss of public trust. In business terms, many attribute the root cause to the high levels of debt that some regulated companies' Boards have chosen. For many, alarm bells start to ring somewhere around 70% debt to enterprise value, let alone the 80%+ we see; the converse is asking what happens to the company's risk profile if the equity buffer in the company is eroded to less than 1/3rd of enterprise value. I recognise these sentiments from my own experience of three successful restructurings of overleveraged companies. Remember, customers' bills relate to our notional structure, under which the 'equity buffer' would be about 40%.

There is no magic number below which the "equity buffer" suddenly becomes ineffective. It's a continuum of increasing concern alongside other factors to consider too – such as the company's credit rating, cost of debt, interest cover ratio, record on operating performance – including enforcement action, pension deficit, and frankly its reputation in areas like the use of off-shore companies. So, through this second lens – that of business – there are questions to ask, too.

3. The economic regulation lens

The third lens is that of economic regulation. Economic regulation ensures that monopoly businesses deliver for their customers – now and into the future. We allocate risk effectively to get the best outcomes for customers. So, risks associated with operational performance – for example leakage, supply interruptions, asset failure – are best allocated to companies to manage. The same is true of total expenditure and financing costs. It is, therefore, right for regulated companies to determine their capital structure provided they carry any risk associated with that structure.

It's clear from recent reports that both Moody's and Standard & Poor's see that some companies – HLCos - need to act to maintain their credit ratings, ahead of a challenging regulatory review in PR19.

Early steps to address the issues of reputation and highly leveraged companies: what should companies be doing now?

You've all seen the letter that I recently received from the Secretary of State and know that I will respond in a month's time. The issues he raises are for the companies to address, but as independent regulator, the government rightly turns to us as the 'responsible party' to help corral what is required. Let me share aloud how we might respond. Just to emphasise - these are early thoughts, thinking aloud. Many of the points are quite technical – but they are for this financial audience.

The damage to the reputation of the sector is being caused principally by those companies who have adopted what the public see as inappropriately aggressive financial structures for a public service utility. It's damaging the whole industry. The responsibility for fixing this must sit squarely with the relevant companies. Their CEOs and regulated company Boards need to face up to this urgently. Here are the steps we are taking:

i. We have said consistently that some companies must take action now to address apparently weak capital structures to maintain resilience into the long-term and an acceptable investment-grade rating. We continue to engage with these companies. We expect to see sound, stress-tested capital structures, not just solutions which simply 'scrape by' into AMP7. We will continue to enforce companies' obligations to resource and manage their operations so that they deliver networks and outcomes that are fit for purpose now and in the future. Unless companies can meet this test, they may need to replace some of the equity earlier taken out, and shouldn't that equity be unencumbered (i.e. it cannot be debt at a higher part of the same corporate structure where the interest burden passes to the regulated company)?

ii. The tool of transparency is very helpful in the areas where trust has been damaged. For the business year 2017-18 onwards, we expect all companies to publish a comparison of returns on actual regulated equity compared what it would be under our notional financing.

On the slide is a preview of the returns using last year's numbers for two of the HLCos, Anglian and Southern. All of this can be derived from publicly available information. A customer might well understandably say that by having about a half of the equity that their customers pay for, both have flattered their equity returns and dividend yields by up to two times. There may be an element of outperformance on totex and performance incentives, but it appears that a significant part derives from a thin equity structure. Companies will have to explain this to their customers, who paid for the cost of a notionally-financed prudent structure.

The company's business plan to be submitted in September 2018, must show long-term financial resilience. Our first level of scrutiny will ask 'can the company meet its obligations over at least the next decade?' We shall want to see that the company has the equity strength to manage the risks the regulator properly allocates to the company, under a full range of stress tests.

Those companies whose capital structure differs significantly from our notional structure will have more work to do to convince us that they are financially resilient. Plans that need a lot of attention may well be placed in our 'significant scrutiny' category, with its much tougher financial consequences. Where a company's track record has included aggressive-looking structures, or dividends that raise questions, those companies not only need to persuade us, but will have to explain convincingly to the public they serve, how these practices will deliver resilience'.

Aggressive dividends are at the heart of the public distrust. We intervened on this back in 2013 when some HLCos were distributing to their investors amounts that, if continued could distribute cash equal to a large part of value of the regulated equity in just five short years - not sustainable in the public mind.

The opportunity to address dividends is right ahead, in companies' PR19 business plans. As part of demonstrating their financial resilience, companies will need to explain the role of their dividend policies, taking account of the perspective of the communities they serve. Surely we have the right to expect these to be entirely consistent with their role in society, and to win the trust of their customers? In a public service company, one would expect the company to share its success with customers at least as much as with shareholders and to have regard to the perception of fairness.

This already happens automatically, of course, through the price review when companies outperform on the efficiency targets and the outcome delivery incentives we set. My challenge to companies is to think how to share financing outperformance.

I'm delighted that, having in recent days talked with a few progressive companies, both listed plc and HLC, we see that they are thinking this way. If I synthesise what I have heard, without embellishment, here is an example of what a progressive company's four step dividend policy might say:

- a 'gateway' to any dividend pay-out, is that the company is delivering what it promised its customers;
- base dividend will be at about the level in Ofwat's notional structure (currently, say, 4%), adjusted downward pro-rata if the company maintains a thinner equity structure;
- an outperformance dividend, set in a way that ensured cash to investors was matched first by cash to customers in the form of bill reductions 1;
- strong regard to employee interests ensuring that fair and appropriate payments were made pre-dividend to employee interests including pension deficits

[1] Allowing that out-performance from operating efficiencies may already have been shared under the PR19 methodology

Doesn't that begin to sound more like a public service utility than, at the opposite extreme, the type of dividend policy that might be perfectly acceptable for private equity in competitive markets? I'd encourage all companies to reflect on these ideas as they consider their own dividend policy and how it can be used to make a contribution to financial resilience, rebuild trust and ensure investors and customers are rewarded for outperformance too.

You can all see that financial resilience and dividend policy are crucial to delivering PR19 with customer confidence. We set a high-level expectation in the December methodology for initial assessment of plans. You can expect Rachel and her team to set out more granular thinking about this over the next month or so.

Lastly, there is a place for Board Leadership and Governance Principles, which we are currently reviewing, to strengthen the independence of the regulated company Board. It's important for customers to know that there are strong independent influences on the Boards of regulated companies.

We are looking at the governance around key decisions, such as payments from a regulated company to a company higher in the corporate structure where we would expect to see that only directors substantially independent from investors were present for such decisions. I've always thought that capital has a place at the table in a privately-owned company, but we have to ask again - in the light of current issues - whether independents shouldn't be a majority?

And if it's not already transparent, we may want to ask companies to set out how their delegated authorities between their holding companies and regulated companies operate. Those delivering a critical public service through a monopoly must embrace higher expectations of board leadership and governance in the interests of the customers and society they serve.

Moving forward: a renewed commitment to getting back in balance.

In my experience, the public often believe that regulators have been too cautious - especially when you look back to the period in water of 2002 to 2009 where some companies took on such high leverage. With the steps we've taken over recent years, and initiatives set out today, I think we've got our house in order.

The initiatives we have underway are important 'Tier1' activities. Looking more widely, I think it will take more than this to demonstrate that the sector is sustainably honouring the privilege that it holds and its duty to customers. It still needs a further 're-set' and renewed commitment to 'Tier 2' initiatives to put things back in balance and to serve the needs of customers, the public and wider society. I welcome the constructive support from some companies in recent days for both 'Tier 1' and 'Tier2'.

We must start, right now, not after PR19, to redefine what it takes to be a trusted provider of an essential public service. How do you, companies, really put customers and the good of society first? What are your duties to protect against failure? I'm delighted that we're not alone in thinking about this. A few progressive companies have shared some thoughts about this. In developing PR19 we had an innovative 'marketplace for ideas' forum. We'll be doing the same here and welcome contributions.

I should say this is not the first time: there was a crisis around the turn of the century, for other reasons, which brought about Welsh Water/ Dŵr Cymru as a community owned company. Yorkshire had a plan to be owned by its customers - an interesting idea but one which didn't get legs.

And to drive forward and embed change effectively, we must look to the licence which is the vehicle to define and control the behaviour of monopoly companies, and, through our ultimate controller conditions, the way their owners behave towards the company. So, I will express my thoughts in terms of the licence changes, which we will progress now but in a broadly defined way that enables each company to find its own way of improving the situation.

As a principle, we are considering embedding in the licence a duty on the company to put customers' and society's interests at the heart of their business. That is broad-reaching and sets a clear principle to guide the behaviour of the Boards of regulated companies as they find their way to a new approach.

Secondly, we are all concerned about resilience. We mean resilience in respect of capital structure, operations and service - now and for the long-term. We have that duty in the way we act at Ofwat; it's not clearly enough set out in the licences of the companies and I propose it should be. I would expect, as part of coming up to modern standards, companies have a standard obligation to maintain an investment-grade rating, appropriate 'lock-up' procedures if the company loses its investment-grade status and standard 'ultimate controller' requirements.

These changes need to be considered urgently. We all know that the process for licence changes is clunky, and our Board is considering asking the Secretary of State for support - which a number of companies indicated they could support five years ago - to rationalise and make simpler the process for bringing about licence changes.

The hard work is not just for us at Ofwat. I'm delighted that I've had really positive responses to some proposals from companies across the spectrum, including two of the HLCs – Yorkshire and Thames - who have given clear commitment to reforming their balance sheet and bringing leverage down to the low to mid 70%s under much simpler corporate structures.

Conclusion

I do want to bring this speech to a close. I have set out two levels of responses to the issues raised by societal perceptions of the financial structure of some water companies. The 'Tier 1' steps are underway and we will embark immediately on 'Tier 2'.

There are still other long-term questions - you could call it ‘Tier 3’ - which society may call for if we don’t make sufficient rapid progress to restore legitimacy on all the points raised above. In the public context of the failure of public services under a private franchise, the Government may ask ‘Is the 25 year notice period on a company for revocation of its licence too long?’ As regulators, we may ask, ‘Is it still appropriate to allow companies to set actual capital structures so far removed from our notional structure?’ Other critics may ask ‘Should a company that takes a more aggressive structure receive a different cost of capital?’ We’re not proposing to go there, but unless the industry moves forward on the steps I have indicated above, and achieve a ‘re-set’, these existential questions may be pressed on us.

So I would say to the sector: if I were the boss, chairman or an investor of any water company affected by the issues we’ve discussed, I’d be right on the front foot trying to contribute urgently and positively to Ofwat’s programme. There is nothing in this for a responsible long-term investor to fear. I would be fully aware that the Secretary of State has invited Ofwat to propose where new powers might be needed, but as you know there’s a lot we can do with our current powers, so I’d be getting right behind the programme I have set out today to support a ‘re-set’ now.

I say to everyone here today – it is in your hands to secure the ongoing legitimacy of, and trust in, the water industry.