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Rt Hon Michael Gove MP
Secretary of State for Environment, Food and Rural Affairs
Nobel House
17 Smith Square
London
SW1P 3JR

9 April 2018

Dear Secretary of State,

You wrote to me on 31 January about the behaviour of water companies, and particularly that of the highly leveraged companies. In your speech at the City Conference you called for a water industry that works for everyone. You also said, given their monopoly status, that managements and boards have a special responsibility to work as diligently for their customers and the natural world as for their owners.

You have kindly acknowledged that we too have been striving to get the water sector back in balance. But we want to go further. We too consider that the corporate behaviour of some water companies has diminished trust in the delivery of this most vital service. Some companies are seen as focused on financial engineering at the expense of public service. The service failures following last month's freeze-thaw, combined with concerns about the risk of drought, have also damaged trust in water.

I promised you a fuller response in April. These are the key steps in our programme to get back to a proper sense in this sector of public service provided under private ownership:

- We will make sure that water companies do not use financial engineering to inflate one-sided returns to investors, or are rewarded at the expense of their customers. We are taking action to reduce what companies can reap from high gearing and to require them to share benefits with their customers in the form of lower bills.
- We will set even tighter standards to make sure financial structures are robust and that customers are protected if things go wrong. We will increase our requirements for longer term financial strength of regulated companies and will look at tighter ring fencing arrangements.

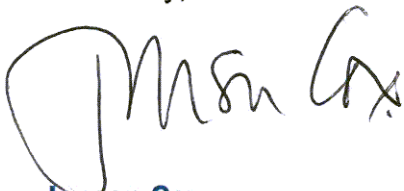
- Dividend payments undermine public trust when they are out of line with what is seen as reasonable for public utilities. We expect Boards to set out clear, appropriate dividend policies and meet obligations to customers and other stakeholders before making dividend payments.
- In similar vein, we shall also expect boards, from here on, to win customer confidence by setting and explaining bonuses and performance pay for executives by reference to exceptional delivery for customers.
- We want water companies – who benefit from captive customers and regulated returns - to put customers and their interests at the heart of what they do. We will be reforming companies' licences to reflect this aim so it is clear to all current and future owners and executives. We will also strengthen our ground-breaking work setting out how boards of these public service companies must adhere to exemplary standards of leadership and governance.

Looking ahead, a wider conversation is needed about the right type of water service for the future and what this means for regulatory and legislative frameworks. We expect the sector to take the lead in engaging with customers and the wider public about how it can redefine its role and rebuild trust.

I hope you will agree that the overall proposed programme, detailed in the attached annex and on which we will consult as is normal, will put the water sector back in balance. It will redefine how the vital public service of water and wastewater is provided under private ownership.

We would welcome your support. The annex also highlights where we may need further powers from the Government to achieve this strategy. We expect companies to recognise the need to step up and deliver changes. I have had very helpful indications of support in principle from chairmen across the sector. I'm sure you'll also be interested to hear directly from companies about their commitments to support change.

Sincerely,



Jonson Cox
Chair

Annex to letter of 9 April 2018 to Secretary of State

We are taking a number of actions to make sure the sector is fair, open and reliable for customers. These sit alongside the methodology for PR19, published in December last year:

Sharing financial outperformance

We will consult on a new mechanism to require companies to share any financial outperformance from higher gearing with customers. This will sit alongside mechanisms already in place requiring companies to share outperformance from operational service and capital schemes. It will apply to companies who load their capital structures with materially more debt, and less equity, than the 'notional' structure customers pay for.

Dividend policies

We know that the level of dividend pay-outs from highly leveraged companies aggravates customers and the public. We expect transparent dividend policies in companies' five year plans. Boards should consider whether obligations and promises to customers have been met before paying dividends. Boards must be clear on the sharing of financial outperformance between reductions in bills to customers and outperformance payments to their investors. Dividend policies should take fair account of employee interests such as pension deficits.

Executive pay

You have raised explicit concerns about executive pay in this sector, which has all the economic security of a regulated-return monopoly. Pay policy is for each company's independent directors and its shareholders. We expect boards of monopolies to set out the policy and determine awards of performance pay by reference to exceptional delivery for customers, for example in terms of cost savings, and service outperformance. Transparency on the relationship between pay policy and outperformance or bill reductions by way of exceptional delivery will help customers see how performance pay is earned in providing a public service.

Financial resilience

When companies submit their five-year plan in September 2018, we will require them to show capital structures which are resilient for the long-term, have a robust investment-grade rating, and can support their obligations to customers in all foreseeable circumstances.

Board leadership

It is right that water companies, as providers of monopoly public services, are held to the highest standards of corporate behaviour. We will update our code on board leadership and governance to protect the integrity of the regulated companies further. This will include defining the role of independent non-executives in decisions on all financial flows from the regulated business to the holding company.

Ring fencing

We will seek to strengthen ring fencing arrangements and the commitments from ultimate controllers. We will continue to use change of ownership in companies as a backstop if changes are not agreed earlier. The changes will improve the integrity of the regulated business and provide customers with greater protections should things go wrong.

Transparency

Starting with the upcoming financial reporting season, companies will publish a comparison of profits and dividends on their actual capital structures, with what those returns would be under the 'notional' structure that helps to set customers' bills. This will highlight publicly where high leverage is flattering profits.

Complex financial structures

There has been public criticism about the bewildering complexity of securitised companies' corporate holding structures. We welcome responsible capital from around the world but we see no reason for overly complicated structures which have created the perception of undue focus on financial engineering. Of the securitised companies, some have now pledged to simplify their arrangements. Most have now acknowledged they need to remove the Cayman entities which companies used to support their securitisation.

We expect the measures we're taking on financial resilience to lead to a progressive reduction of the highly leveraged balance sheets. As a result, securitisation may well become redundant.

Actions requiring licence changes

We govern the behaviour of companies through their licences. We want these licences to reflect what is expected of those privileged to run and own public service monopolies.

Customers at the heart

We are considering introducing a high-level principle to the licence, making it even clearer that companies must put customers and their interests at the heart of everything they do. We will encourage companies to explore what it means to be a first-class modern provider of water and wastewater services. This may also involve introducing a more specific overarching responsibility in relation to resilience in the long-term to reflect Ofwat's new regulatory duty.

Strong, consistent licence conditions

We will also consult on licence conditions that:

- provide a stronger and consistent ring fence around the regulated business to protect its integrity and its financial strength;
- ensure robust commitments from ultimate controllers; and
- bind all companies to our Principles of Board Leadership, Transparency and Governance.

Company support

Licence changes are most readily achieved with company support. Engagement so far with Chairs and CEOs has indicated a general willingness from most companies to support the direction set out in this letter. Many, while very supportive, remind us that the specific factors you raised in your letter relate to the highly leveraged, whose behaviours have attracted particular concern. However, the chairs and boards of some of these latter companies, have also indicated their support. While I hope we can promptly achieve these licence changes with company support, we may need your support, and potentially new powers, for this part of our plan. A more up-to-date regime for updating licences would be consistent with a modern regulatory regime for the sector and with the powers of other regulators.

Further strategic questions

The points you have raised challenge the water sector to evolve further to maintain public trust and confidence. We are looking to the sector to take the lead in thinking

about how they put customers at the heart of everything they do. This may involve them considering:

- how the views of customers can be properly represented in the way their companies are run;
- how companies can be better at sharing water resources
- what lessons can be learned from water companies in different jurisdictions, who raise market capital and deliver comparable improvements in service without the public concerns you have raised.

There are also new challenges ahead, not least those associated with meeting the ambitions the Government has set out in the 25 Year Environment Plan and the requirement to integrate water companies' operations with modern approaches to catchment management. These will involve all sector regulators and Government continuing to work together to consider the appropriate regulatory and legislative frameworks to meet these challenges and ensure the needs of customers are met into the future.

Next steps

Ofwat's Chief Executive, Rachel Fletcher, will issue an implementation letter to companies setting out how we will progress these plans during the rest of this year.

We will be embarking on the programme immediately and with your support and the lead we want to see from companies, we aim to make very substantive progress over this coming business year 2018-19.