
Why change is needed?

Speech given by Rachel Fletcher, Chief Executive Moody's UK Water and Regulated Networks 10 October 2018

"Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate"

I think that observation, from Larry Fink, founder and CEO of Blackrock, brilliantly sums up why change is needed in the water sector.

Before I expand on this, let me be clear about one constant. That is the continued need for the water sector to be able to attract finance to meet customers' needs. The company PR19 plans suggests a sum of £50bn is needed for this purpose over the next 5 years alone, so this financeability is important. But in this context, Larry Fink is making two points. One is that society now expects companies to provide benefits to all stakeholders not just reward its shareholders. The second, is that sustained financial success is critically dependent on achieving this aim

I'm not at all convinced the water sector meets this test. And while the sector has many of the ingredients to live up to this ambition, the current situation should concern us all – regulators, employees, investors. It's something of deep concern to customers. And it's one of two reasons that "change is needed".

Many in this audience sit on the Boards of water companies or hold senior management positions. Collectively we have significant power and influence. So let's have a look at some of the metrics around how the sector is delivering for society.

Performance

Let's start with the sector's performance – with the important caveat that sector wide figures mask some significant variations across England and Wales.

- According to a study commissioned by Water UK, productivity has flat lined, growing at an annual average rate of only 0.1% since 2009. ¹
- This sits alongside qualitative evidence that the sector lags behind others in adopting new technologies – for example to anticipate and remedy bursts and other problems in the network before they disrupt customers' lives.
- In 2016/17, 22% of all water produced was lost through leakage, a figure which has remained pretty static since the early part of this century. This creates a strain on the environment and undermined the sector's ability to call on customers to use water wisely during the hot summer this year
- There are frequent incidents which raise questions over resilience. During the Beast from the East last winter, 60k customers were off supply for more than 12 hours. Only a small proportion of vulnerable customers appeared to get support from their water company during that severe weather event.
- The volume of complaints to water companies has been stubbornly static over the last few years, despite incentives within the regulatory framework to improve customer service. Last year half of the water companies saw an increase in the number of customer complaints.

Behaviours

Let's also look at company behaviours. To many people, it looks like some companies are more focused on taking money out of the business than delivering for customers, communities and society.

The Consumer Council for Water's recent Water Matters Survey is illuminating on this. In 2017, the main reason customers said they had low trust in their company was the view that they are "only concerned about money". This is a marked jump from 2016 when this reason ranked third. So why might that be?

¹ Water UK, Frontier report - <https://www.water.org.uk/news-water-uk/latest-news/water-uk-publish-frontier-economics-report-productivity>

- Gearing in the sector has increased since privatisation, with a number of companies close to or above 80%. While investors have benefited from increased returns from high levels of cheap debt, customers haven't shared equally in those benefits.
- Some dividend yields continue to look out of step with what has been achieved for customers, despite a challenge from Ofwat 5 years ago to address this
- And, with the economy-wide attention on executive pay, in some companies, financial metrics outweigh customer outcomes in executive bonus policies.

These shortcomings in both performance and behaviour have been of real concern and the need to confront them has been shaping our work, including in recent months. This performance and behaviour have together created the perfect conditions for the debate about renationalisation to take hold.

I want to dispel the view that the focus on the water sector is a passing phenomenon, whipped up by the press and politicians, and that if only Ofwat and others would say less about the companies shortcomings and say more about the many good things the sector has done (more blue flag beaches, falling water bills) the public discontent will blow over and things will go back to how they were before.

I simply don't think this is tenable. The criticism of the sector as a whole has struck a chord with the public. It has landed at a time when many are bearing the consequences of a decade of low real wage growth and where the public cost of corporate failures has repeatedly hit the headlines. There is an increased public interest in seeing more "fairness" in how companies behave and growing expectations on service and concerns about the environment.

This feels no more acute than in the delivery of essential services like water. The spotlight will continue to be on the sector – and rightly on us as a regulator, as we see from the Select Committee and Treasury – until these concerns are addressed head on. And unless we address these issues, it will be difficult to achieve the predictability that investors desire.

The sector faces very significant future challenges

There is another reason why change is needed. The sector faces very significant challenges - climate change, population growth particularly in already water stressed areas, reduced abstraction levels. The National Infrastructure's recent report estimated that we need an extra 1,300MegaLitres of water supply into our system by 2030. And that's after taking radical steps to tackle leakage and improve water efficiency. They also predict that if this is not achieved, the cost of water shortages could be as high as £40bn a year.

Not only do these increased water demands need to be met - they need to be met efficiently so that water remains as affordable as possible. And in doing so we need to go beyond protecting the environment to enhancing it. Because in parts of our country thirst for water is already putting our unique rivers and ecosystem under strain. If we fail to address these future needs, the current challenge to the reputation of the water sector will feel like a pin prick.

There are signs that things are beginning to change

Having painted this picture of doom and gloom, I want to be clear: there is much that is positive to build on. I've spent the last 9 months visiting companies up and down the country. My overwhelming impression is that people at all levels are galvanised around meeting the needs of customers. Senior people in the companies are increasingly recognising that delivering a positive contribution to society is not a "corporate social responsibility" side-issue but something that should shape their entire business.

There are also some signs that performance is improving. In the first three years of the PR14 period for example:

- water supply interruptions fell by 20%; and
- sewer flooding incidents reduced by 14%.

Incentives can work. And with PR19 these will be sharper and should drive more of the improvements and efficiencies that matter to customers.

We are only weeks into considering the PR19 plans. So there's a limit to what we can conclude from them at this stage. But with the new challenges Ofwat has presented to the industry there has been a seismic shift in the industry's willingness to listen and be accountable to the people it serves. Companies have engaged 1.5m customers directly in developing their PR19 business plans. If this is embedded in BAU – which some companies have well underway - it could become a powerful driver of sustained change.

- The plans involve a 90% increase in the number of customers receiving help with their water bills (an extra 1.4m households).
- And with the commitment across all companies to reduce leakage by at least 15% by 2025 we are already seeing an increase in the take up of new technologies, techniques, and, most importantly, new thinking.

On corporate behaviours, there is a steady increase in the independent challenge to companies – through independent NEDs having a stronger position on company

Boards and with independent Chairs becoming the norm. We have also seen more investors such as pension funds coming into the sector who are targeting steady long-term returns.

With Ofwat's focus on financial resilience in PR19, and the requirement to share outperformance from high gearing with customers, some companies are taking steps to de-leverage. Company plans suggest there will be a range of policies linking executive bonus and dividends more closely to delivery for customers. There are interesting proposals to return more money to communities, for example through customer shares and community dividends.

These are positive developments but much more is needed. And if the industry is to truly transform, it needs to stop waiting to be challenged by Ofwat, and take bold steps of its own. I'm waiting for a company to make radical and speedy improvements before the new regulatory settlement is in place. Ultimately, we'd like company Boards, not Ofwat, to be taking ownership of and leading the moves to restore legitimacy. And that is what sits behind our work on Board leadership principles.

Water Resource Planning

Before I close, I want to speak briefly about the changes under way relating to water resources and environmental issues.

At present too much water resource planning is done by each company in isolation, with trading between companies sitting steadily at only around 4%. We all know we will not arrive at the best solution for the country or the environment by continuing with this approach.

Groupings of water companies have begun to devise regional plans. Ofwat, the Environment Agency, Defra and the companies are collaborating on a new national framework to give these regional plans coherence and rigor. Overall the objective is to enable the industry to seriously consider the case for inter-regional and national transfers and for new storage assets that could serve multiple companies.

Questions remain about who would commission, build and own these assets. There is no obvious reason why this – or indeed any other - large discrete infrastructure should be funded through the wholesaler's RCV. Ofwat is committed to addressing these questions, and pursuing the greater use of markets.

Within the next few years we should have a water resource planning approach that meets the needs of the country in an optimum way.

Alongside this there is exciting work being done in many companies on catchment management. This typically uses low capex approaches to provide a whole system solution (for example working with farmers to reduce nitrate and metaldehyde run off into the water source).

Not only is it often lower cost, it produces “natural capital” benefits (such as better quality rivers with improved amenity value), and provides a vital connection between the water company and the community it serves. What could be better for restoring trust? And what could be a better foundation for a conversation with customers about their water use? We need to see water companies learn from each other so that these practices become more widespread. We need the industry to capture the spirit that drove this innovation in the first place and to bring it to other parts of their business.

What's next?

So where next?

I strongly believe we need change in the sector. But we are also beginning to see the early signs of what a future water sector could look like and deliver.

Over the next few months we will engage with a range of customers and other stakeholders to build a vision which resonates with the general public and has broad buy in across stakeholders.

I don't want to prejudge the outcome of this exercise, but customer research the companies have done largely echoes Larry Fink's point. It suggests that people want companies to add value to their local economies, societies and environments – as well as deliver a reliable service at an efficient price. And they are looking to be assured that investors earn fair rewards for being committed to, and supporting the long-term delivery of these benefits. My challenge to companies is – don't wait for Ofwat to do this work. Take the initiative to become the water company of the future now.

And what does the future mean for Ofwat? We have moved a long way in recent years. There are signs that new regulatory tools – outcome focused incentives and a drive to improve Board Leadership are having a positive effect. But we need to change too. We don't assume the approaches we are using now will drive the significant change needed for the future.

So in parallel with concluding the PR19 regulatory settlements using the methodology we have set out, we will consider where next for water regulation. We

will engage with the helpful recommendations from the EFRA Select Committee published yesterday and participate actively in the welcome review Treasury has commissioned into water, energy and telecoms regulation. But in considering water regulation beyond PR19, we will also engage widely with all concerned – government, other regulators, consumer bodies, companies and of course the investor community.

I'm inviting you to engage with us on this important quest.