
Speech from Rachel Fletcher – A “social contract” for the water sector

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Thank you very much for the opportunity to take part in this topical discussion on a subject which chimes with me personally and with the organisation I lead, Ofwat.

I’m going to talk about the case for a social contract in the water sector, what that might mean in practice and the role that my organisation - Ofwat – sees for itself as the regulator.

The case for a social contract in the water sector

The case for a social contract in the water sector covers three elements:

- Firstly, there’s the legitimacy case;
- Then there’s the business case;
- And finally, the environmental case.

Let’s start with **legitimacy**.

I don’t think anyone will disagree with me when I say that the water sector’s public reputation has taken something of a battering over the past year in particular.

Fundamental questions have been raised by politicians, academics and journalists about who should own our water services, how they are run and whose interests they serve.

Society’s attitude towards the water sector is shifting. It is quite obviously the case that it is no longer enough for a water company just to provide a reliable supply of safe drinking water and waste water services at a reasonable price.

Even where these basics are achieved – and we know there have been some failings - customers are taking an ever greater interest in where their money is going. They care about the dividend payments and tax affairs of their company and the more widely topical question of executive pay.

They also want the company to contribute to society and protect the environment. And in the context of low real wage growth, the squeeze on public expenditure and high profile corporate failures which have harmed the public, not the owners, I don't think these expectations are going to go away.

In this new climate therefore, if companies are to be seen to be legitimate and to maintain public trust, the message which is coming through loud and clear is that for providers of a public service in private ownership, a new contract is needed.

Now let's look at the **“business case”** for the social contract.

Larry Fink, founder and CEO of Blackrock makes the business case for a social contract very succinctly when he says:

"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"

Larry isn't referring specifically to water companies of course, but his words resonate all the same. His message is that any company that wants to survive over the long term, needs to be driven by more than the profit motive.

I think investors will only get the stability they are looking for – and the sector will only reliably be able to attract investment for the long term - if companies recognise and address society's demands head on.

Finally, we come to what I'd term the **“environmental case”**.

We have one of the highest per capita consumptions of water in Western Europe. We often think of ourselves as a wet island, yet many of our river ecosystems are put under strain by over-abstraction.

With population growth and climate change, this situation could get worse, not better. To prevent this, we need a suite of radical changes and this includes giving customers and businesses the tools to use water more efficiently.

But if companies are to be successful in bringing about this change in the demand side, they need to be trusted by customers. They need to be trusted to do their bit to protect the environment and show they are not just looking to customers to change their behaviour. They need to be trusted to have customer interests at heart if they are to be successful in encouraging the adoption of radical measures such as grey water systems, water recycling and other water efficiency measures.

Just this summer – one of the hottest of record – there was the prospect of a hosepipe ban and people were being asked to use water wisely. Many people asked: “*why shouldn't I fill up my paddling pool or water my garden when my water company is leaking so much water*”? This perfectly demonstrated the environmental case for a social contract.

If we are to meet the country's long term needs for water, while protecting our environment, the companies must lead by example and show they are driven by much more than the profit motive.

What could a social contract mean in the water sector?

So that is the case – as I see it – for a social contract in the water sector.

But what could that social contract mean in practice?

We are not talking here primarily about new rules and regulations – I will come on to talk about the implications for regulations in a moment.

I think the social contract has to be much deeper than a set of externally imposed rules. It involves engaging the passion for serving customers and the environment that I know sits with many who work in and lead the water sector. It involves bringing these wider elements into play, so that the company is not just focused on profit maximising within a set of regulatory constraints.

This ownership for addressing a wider set of challenges, for making a positive contribution to society needs to infuse the culture and leadership of the company and drive everything the company does.

So let me be clear what I think could be the key elements of the so called “contract”.

The foundation stone would involve the company doing the basics right, based on a deep understanding of, continual feedback from, and a relationship with the customers it serves.

The company would examine its own corporate behaviours and ensure that these withstand scrutiny in all respects. The company would uphold the highest levels of corporate governance.

The company would have links into and an understanding of the community it serves – whether this is geographically defined or defined in other ways. And it would be looking to benefit or support the community across the full suite of business decisions it makes – procurement, employment, expenditure, investment.

In a similar way, the company would not limit itself to simple compliance with environmental regulations. It would understand the impact it is having on the environment and would be constantly looking for new ways to improve the ecosystem it is built on.

All of this will involve innovation, whether this is using social media to engage with customers and communities, innovative partnerships to improve the environment and help hard to reach customers, or new technologies to provide the basics better and more cheaply.

It might mean opening up the company to more public scrutiny, say by open meetings – so that it is held accountable for its performance across these dimensions. Taking on a more explicit social purpose may lead the company to ask some interesting questions, about the kind of people who should be on the company board, the kind of investors that should be brought in and even whether the community should have a wider interest ownership stake in the company.

We are beginning to see companies move in this direction with some interesting ideas emerging in company business plans.

But make no mistake, bringing about a new social contract will be a journey for the water sector, unlike any it has taken since privatisation. And I believe it is vital for every water company to be an enthusiastic participant on that journey.

Ofwat’s role in the social contract

But what about us in Ofwat? What role can we play in introducing a social contract in the water sector? As I’ve said, this isn’t as simple as introducing new rules. This is about shifting the culture within the companies, which is not a nut regulators have managed convincingly to crack.

Let me share some of the things we are doing and the questions we ask ourselves as we consider our regulatory strategy for the future.

We set outcomes and incentives. And they can and do drive improvements for customers, society and the environment. But there is a risk with any regulatory regime, that the company is just focused on complying with what the regulator wants and loses touch with and a sense of responsibility for what is important for customers, society and the environment.

To counter this, in PR19 we've encouraged companies to propose bespoke performance commitments based on their engagement with their customers and based on their own understanding of the needs of their local communities and environments. This is our attempt to get the companies to think beyond compliance and to find out what is needed to meet the “social contract”.

One of the key questions is whether in doing this, all companies have taken ownership of these wider challenges. Or whether a game is being played where the company looks to set commitments it can easily meet to boost its returns. In our work in the price review, we will do all we can to guard against that. And as we think about our strategy beyond PR19 we need to learn from experience and amend our regulatory approach so that we driving the right behaviours.

We will also be thinking carefully about how we can regulate to encourage the innovation that is needed to meet the multiple dimensions of the social contract. We have inbuilt incentives and facilitate innovation through an outcomes based approach. We are introducing markets to drive innovation. New businesses in the value chain also drive new behaviours, new attitudes and change cultures across the sector as a whole. There is certainly more we want to do here.

Unlike many regulators, Ofwat has also set out the principles it expects companies to adhere to in the company's board leadership and governance. We are currently revising these high level principles and looking to make these binding through the licence.

We see these principles – and a strong voice from independent non-execs - as a way to get the companies to think about their role along the lines we are discussing today. This should drive the gold standard in transparency and corporate behaviours that I see as a fundamental component of the social contract. We haven't yet finished this work and we're taking on board the comments we've received so far. But I think this is an essential step to shift mindsets in the sector.

Finally, as the regulator of the sector we have a leadership role to play. What we say about where the industry should be going can send clear messages to current

and future investors and executives about what it means to be in this sector. We’ve started work on a Vision for the sector with the intention of setting out a picture for the future that has buy in from companies and other stakeholders, and chimes with customers. We’d love to engage with those in this audience as we shape this Vision.

We’ve been meeting ordinary people from all walks of life and asking them to tell us, in their own words, what water means to them and how they see water companies of the future.

We’re already starting to see some quite consistent themes come through in these conversations – all of which chime very much with the essence of the social contract - such as the importance of encouraging public service providers to be more ambitious for society and to play a more active role in the community and the environment.

Given the consistency of these themes, water companies don’t need to wait for Ofwat to finalise this Vision. They should – and some are – get on with the task of making the deep seated and pervasive changes needed right now.

Summing up

To sum up. This is exactly the right conversation to be having in the current climate. A broader view of what it means to be a private owner of a public service like water is needed if we are to build the legitimacy of the sector, ensure it is investable for the long term and meet the environmental and other long term challenges the industry faces. In Ofwat we are committed to playing a full role to drive this change. But at its most fundamental this requires companies, their owners and managers to take an ownership for this wider set of business drivers.

I think we are beginning to see that penny drop in some companies. But it is not consistent or pervasive. I hope that today marks an important step forward.