Speech from Rachel Fletcher: Regulators and the social contract

Beesley Lecture, Institute of Directors, Wednesday 16 October 2019

The times they are a changin'

This evening I want to discuss a set of ideas with you which could – and perhaps should – fundamentally change many of the companies we work in, regulate or advise.

I'm going to talk about corporate social purpose.

In some ways, this is not a new idea. Benjamin Franklin talked about businesses "Doing well by doing good" 250 years ago. Part of the power of the idea is that it signals a return to a form of capitalism that may have existed before Milton Friedman and the Chicago School asserted that the sole purpose of firms is to make money for their owners.

Several forces are coming together to push for companies whose purpose is to deliver for 'people and planet', and to recognise that this will not be delivered through the notion of shareholder primacy.

Public concern about the impact that big business has on our environment and society – whether through carbon emissions, income inequality, or employment practices - is greater than ever. This has made its way into our political debate with live questions about the ownership and legitimacy of utilities in particular.

Influential commentators, like Martin Wolf, Will Hutton and even The Economist are articulating the case for an end to capitalism as we know it. The premise is that capitalism needs saving from itself. Academics, like Colin Mayer at Oxford, are presenting alternatives such as purpose-led companies.

And the corporate world is responding. In August, The Business Roundtable, America's largest business group, pledged to adopt a more inclusive corporate goal reflecting social as well as economic wellbeing and elevating the interests of customers, staff, suppliers, communities and the environment.

More than 3,000 companies worldwide are now constituted as B-Corporations – with a legal structure to protect the interests of stakeholders beyond just shareholders.

Larry Fink, the founder and CEO of Blackrock has been promulgating this shift in his now much anticipated annual letter to shareholders. His rallying call is that:

"Society is increasingly looking to companies, both public and private, to address pressing social and economic issues". His warning is that companies that ignore this demand will "stumble and fail".

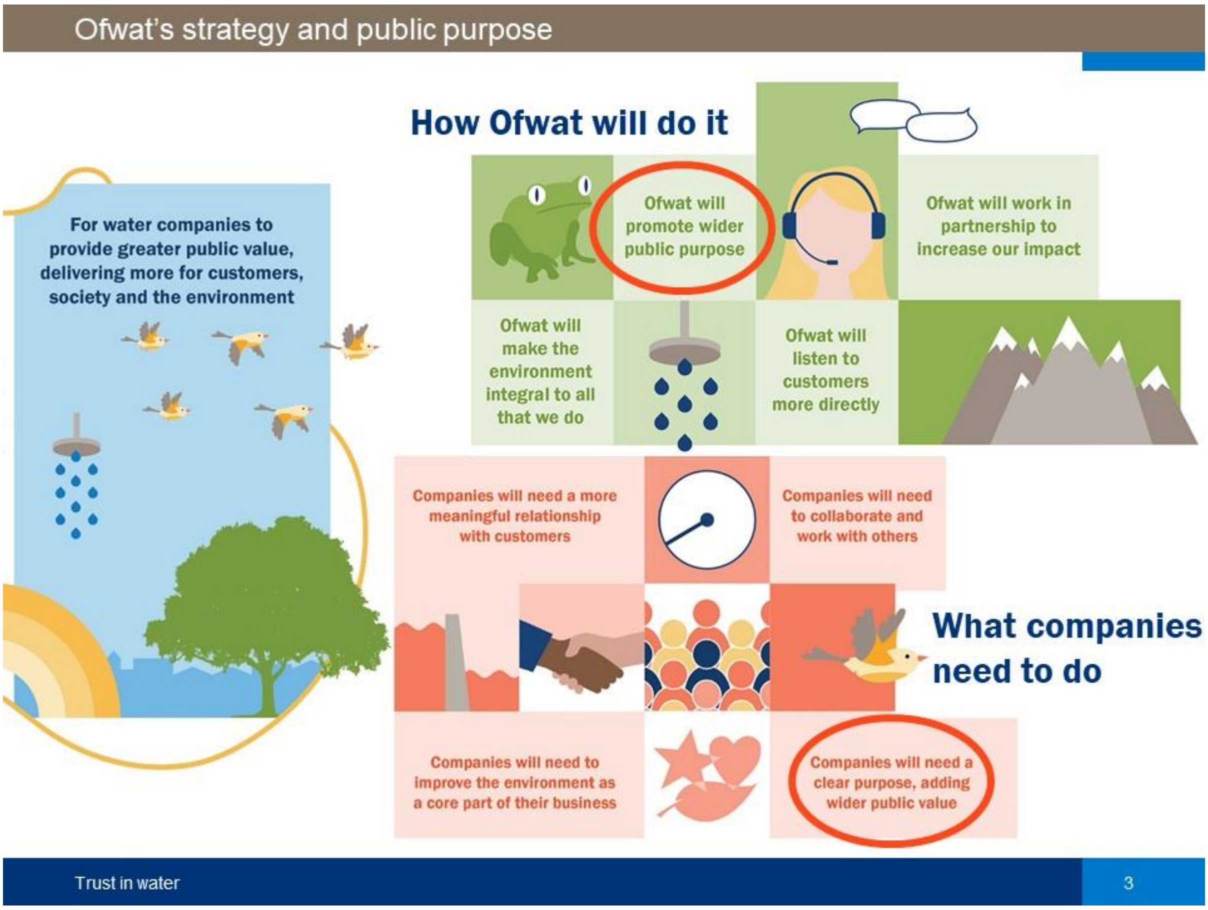
So, things are changing before our eyes in a way that might make the world a much better place.

There is much that is relevant here for the water sector and its regulator and that's what I want to explore tonight.

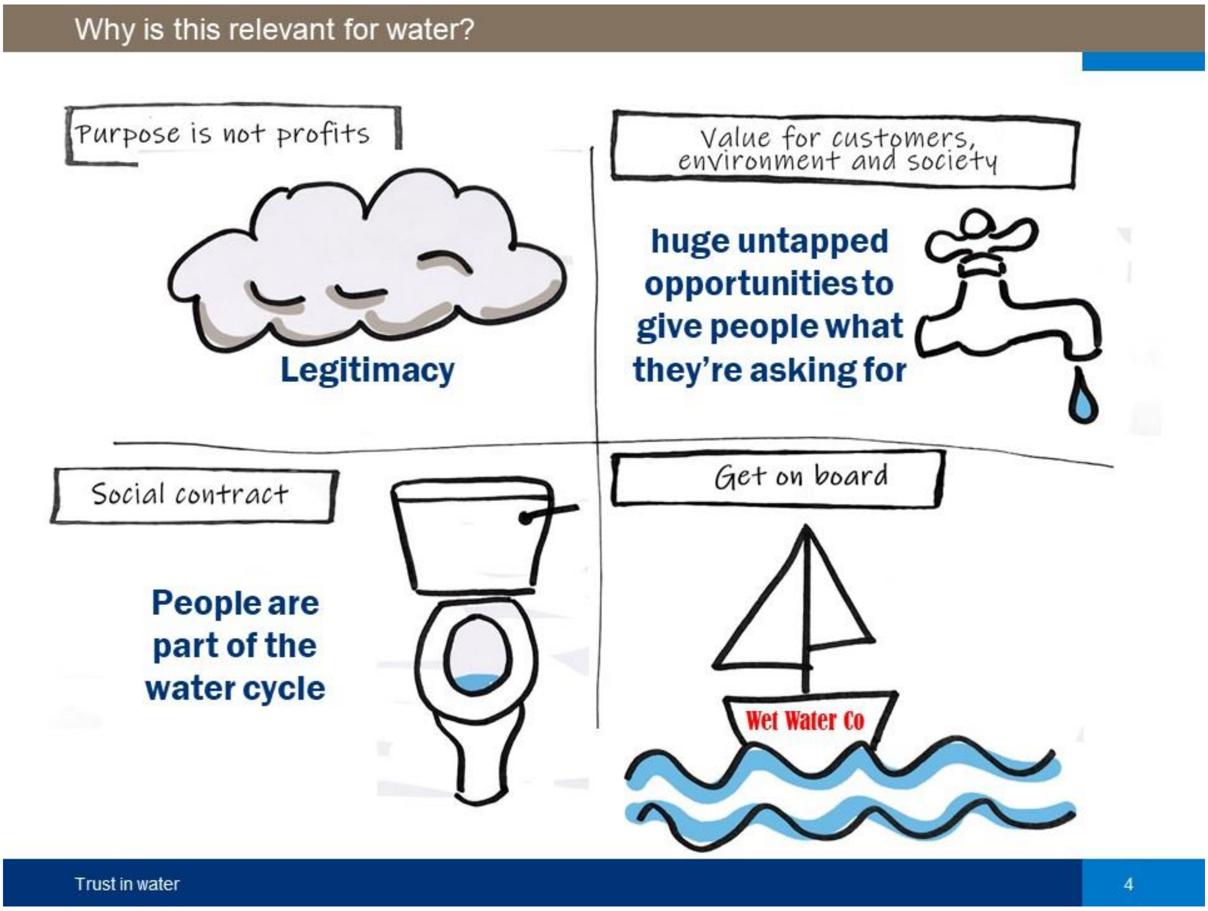
But before I start, let me be clear. This is not a talk about ownership – that was last week's lecture. The idea of social purpose is entirely compatible with private ownership and can even enhance returns. Many of the features apply as much to mutualised companies (like Welsh Water), co-operatives or state owned enterprises as they do to those in private ownership.

1. Why does this agenda matter to water?

The social purpose agenda has influenced us in Ofwat as we've been developing our strategy for 2020 onwards. It's why one of our three goals is "for water companies to provide greater public value", why we say we will "promote public purpose" and why we are calling on companies to "have a clear purpose".



There are four reasons I think this agenda is so relevant for water.



Purpose is not profit

First let's start with a question. What's the point of business? The standard business school response has been to say - to make as much money as possible within the confines of the law. But is this right? The key assertion of those pushing for purpose-led companies is that corporate entities exist to provide our needs, and be a source of prosperity. This is not an attack on profits but a re-articulation of what profits should be earned for. They argue that the conflation of profit and purpose is part of the reason such fundamental questions are being asked about our economic system.

This feels relevant to the water industry. Concerns that some owners have run water companies as a financial asset, not an essential public service provider, have damaged the industry's legitimacy. There is a cloud hanging over the entire industry and one reaction has been Labour's renationalisation policy.

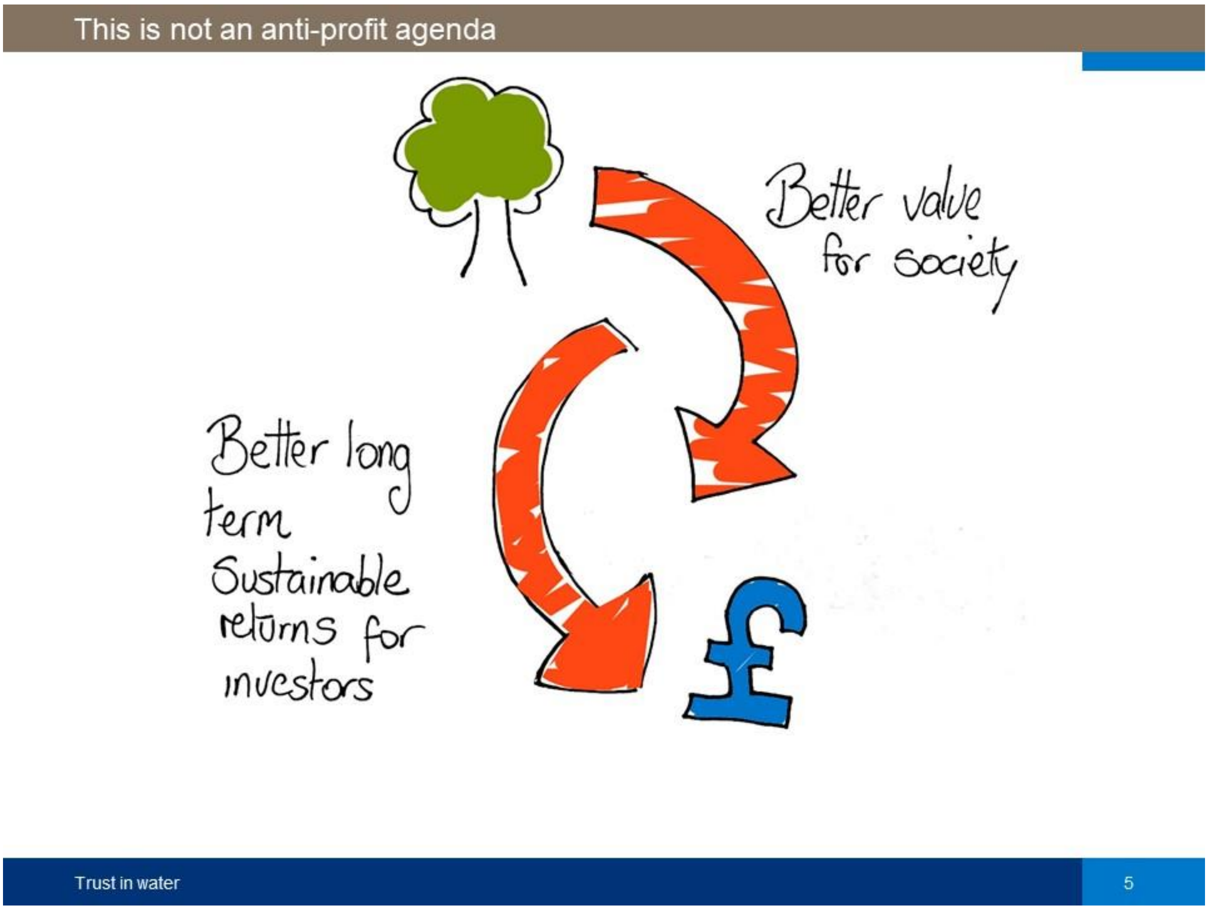
This cloud is lingering despite the industry's achievements over the last 30 years and some of the very positive developments which I'll talk about this evening.

In particular, there has been widespread criticism of the financial engineering undertaken by Macquarie when it owned Thames Water, with questions about how much this contributed to performance failings ranging from a terrible record on leakage through to significant pollution events.

But it isn't only Macquarie's behaviour that has been called into question. For a few years Ofwat has been introducing measures to focus the attention of owners and the boards of water companies more squarely on meeting society's needs. I'll talk about these measures later.

In a vibrant, competitive market the unethical actions of a corporate can lead to its demise. People vote with their feet and the company either changes its behaviour or risks losing market share. Those of us approaching middle age can remember the boycott that finally resulted in Barclay's pulling out of Apartheid South Africa in the '80s. By contrast, in an uncompetitive sector, socially unacceptable behaviour brings the risk of Government or regulatory intervention.

The business case for responsible capitalism stretches well beyond avoiding a beating, whether at the hands of the market or policy makers. There is something much more positive to focus on here.



A growing body of academic research – much of it emanating from the Harvard Business School - suggests that companies that embed a clear purpose beyond profit maximising outperform their peers financially both on the stock market and in accounting terms.

No doubt some would pick holes in this research. But the growing interest from the investor community in public purpose, suggests there is something in it. Assets managed worldwide under Environmental Sustainability and Governance funds stood at $30.7trn at the start of 2018.

There is also a strong intuitive case that companies with a clear raison d’etre will gain business benefits.

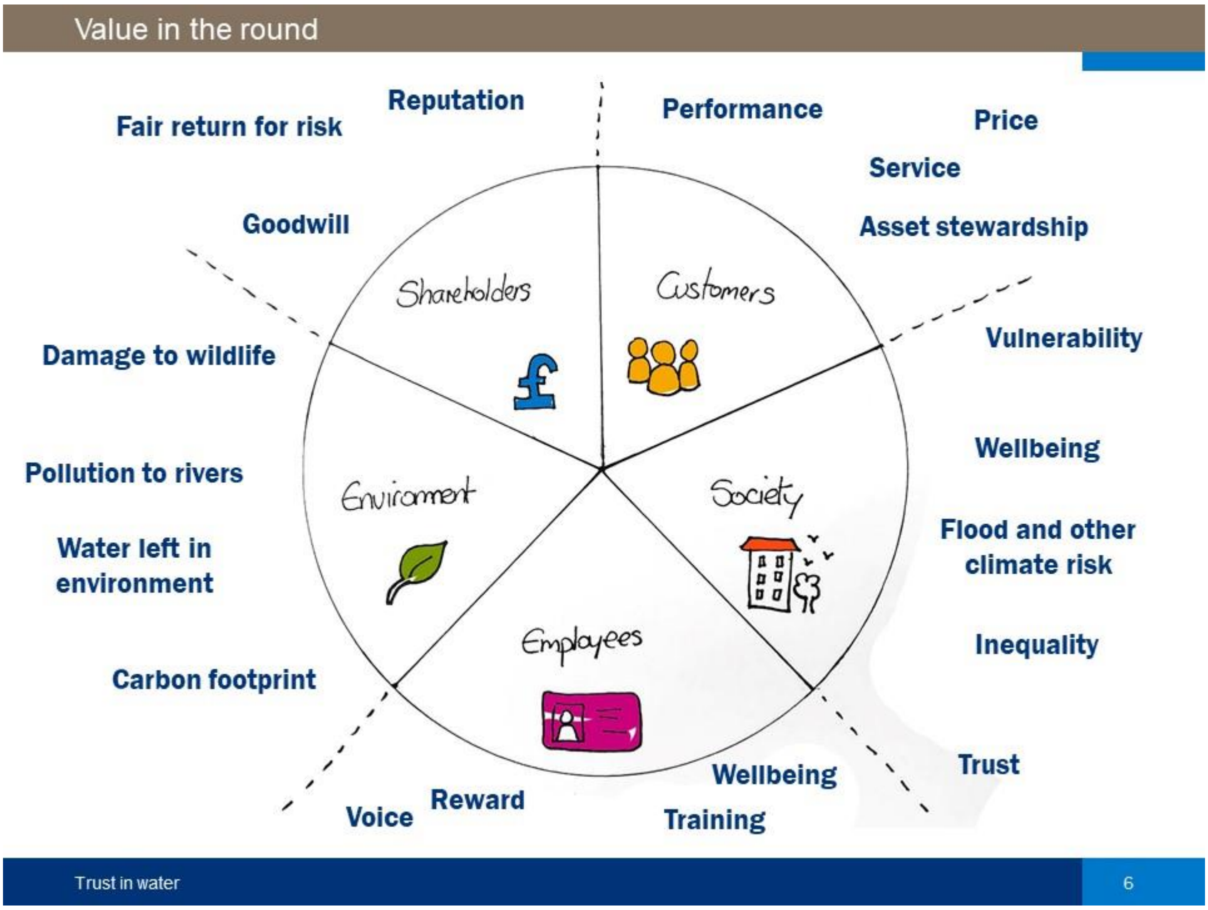
They should be better at attracting, retaining and getting the best from their staff. Research suggests that companies whose staff have a strong belief in the meaning of their work, demonstrate better financial performance. At the other end of the spectrum, we know from the Energy & Utilities Skills association that the poor reputation of the water industry curbs its ability to recruit the very skills they need to address their business challenges.

Companies that can demonstrate they deliver something socially useful are able to attract new sources of funds as we're beginning to see from water company green bond issuances which are often significantly oversubscribed.

And if the company is clear about its core purpose, and this runs through the organisation, there is less risk of a toxic culture leading to corporate failings in whatever guise they may take. And this is a further link that interests and attracts investors, especially those from ethical funds.

Social value – value in the round

The second reason the debate is important is because it recognises the public value that corporates can create - or destroy. It asserts that the purpose of companies is not just to provide goods and services that people need, but to take responsibility for the wider impact their business has on the environment, employees, and society as a whole.



This is relevant to the water industry which relies heavily on the environment for water supplies and to dispose of treated waste, and where companies have a clear geographical footprint.

The social contract agenda recognises that there is only a fine line between the interests of the consumer and the interests of the citizen. And that people increasingly care about the wider impact of the companies they buy from.

As someone who suffered the bitter taste of fair trade coffee and worthy vegetarian meals throughout my 20s, I'm now astonished at how ethical products are increasingly the norm, command a premium and actually look or taste good. According to the Ethical Consumer Business Market Report the UK market has doubled in the 7 years to 2017, to reach £80bn.

As regulators we need to recognise what people are demanding from the companies they buy from and bring it into our framework. This is not a call for water companies to solve all of society's woes. But for them to be responsible stewards as they carry out their functions.

This focus on social value takes the water industry back to its roots. Companies like Bristol Water and others, were set up under private ownership over 150 years ago to improve public health through clean water. Something today we take for granted.

Now the spotlight is on the environment and in particular the condition of our rivers. There is significant pressure from environmental groups and angry anglers on companies – and regulators - to be more proactive and act with more urgency as they see their local streams deteriorate. Water companies are in a perfect position to reduce the impact of abstraction on biodiversity and to find ways to reduce the damage that waste, agricultural and other pollution does to our water courses. The industry's legitimacy – and Ofwat's success in securing the interests of future generations - increasingly rests on addressing this.

It's ironic that this recognition of the social and environmental value that water companies can provide and destroy is not given prominence in the Water Industry Act and doesn't feature explicitly in the water companies' licences. I am pleased to say it does, however, get a mention in the Strategic Policy Statement which both the UK and Welsh Governments have recently given to Ofwat.

We are not starting from scratch.

Earlier this year Ofwat introduced binding principles of Board Leadership and Governance into the licences of all the water companies. The first principle requires each Board to set a purpose for the company that recognises the needs of its wider stakeholders as well as its shareholders, and to ensure that culture aligns.

Already we are seeing purpose statements reflecting an awareness of the companies' social purpose. So for example Thames Water's stated purpose is "To build a better future for its customers, region and planet". Southern Water's says "We provide water for life to enhance health and wellbeing, protect and improve the environment and sustain the economy".

So far – so good.

In May this year Water UK issued a commitment from all the English water companies to explore enshrining public interest within their business purpose. One company (Anglian Water) has already changed its Articles of Association and several others are following suit.

It goes beyond words. Companies already take actions to provide a wider social benefit. Many have been working with farmers for years to reduce agricultural pollution from rivers. Steps are being taken to reduce the carbon footprint of treatment works and to convert waste to biogas. Companies have formed partnerships to help people in debt.

But this is small scale and not yet core business. And I'm not convinced that the net benefits to society are anywhere as great as they could be – or where they need to be for the industry to meet society's expectation. This is recognised by the industry itself. Which is why in the Public Interest Commitment the companies are also announcing ambitious goals for the sector on carbon, plastics, leakage, water poverty and social inclusion.

These are eye-catching commitments, particularly the goal to get to net zero carbon by 2030, where this is the first industry to make such a promise. I watch with interest to see how these are implemented.

Contract with society

Thirdly, corporate purpose implies a commitment direct from the company to society (hence the term "social contract"). In the water sector it also speaks to the two way relationship between people and their water provider.

People are part of the water cycle – some more than others!

How we use water and what we put down the drain has a significant impact on the job of the water company, the costs they incur and their ability to address challenges like how to provide water to a growing population. Our water consumption is one of the highest in Europe. Over 70% of sewer pollutions originate from people flushing wet wipes and fat down the drain. We need to address this if we are to keep water affordable and reliable into the future and save our rivers and the wildlife within them.

What's apparent is that people are reluctant to change their own behaviours if they think their water company isn't doing its bit. A failure to address leakage in particular makes it harder to get people to save water.

The social contract offers a way through this - an opportunity to make strides on strategic issues that would not be possible without a trusted relationship between the company and the community it serves. And this is, perhaps, the most exciting thing about the social contract agenda – offering benefits to shareholders as well as to society.

Intrinsic purpose

Finally, this debate suggests that the delivery of public value should be intrinsic – a purpose and an agenda that the company takes on board – not one that is imposed on it.

For me as a regulator there is lots to be interested in here. Our regulations will always be imperfect. No matter how hard we try there will be loopholes that companies can exploit if they want to make profits at the expense of consumer and wider public welfare.

Regulation can be slow and inflexible and if companies wait to be told what to do by Government or us, progress on important social and environmental issues will also be slow and fall behind people's expectations.

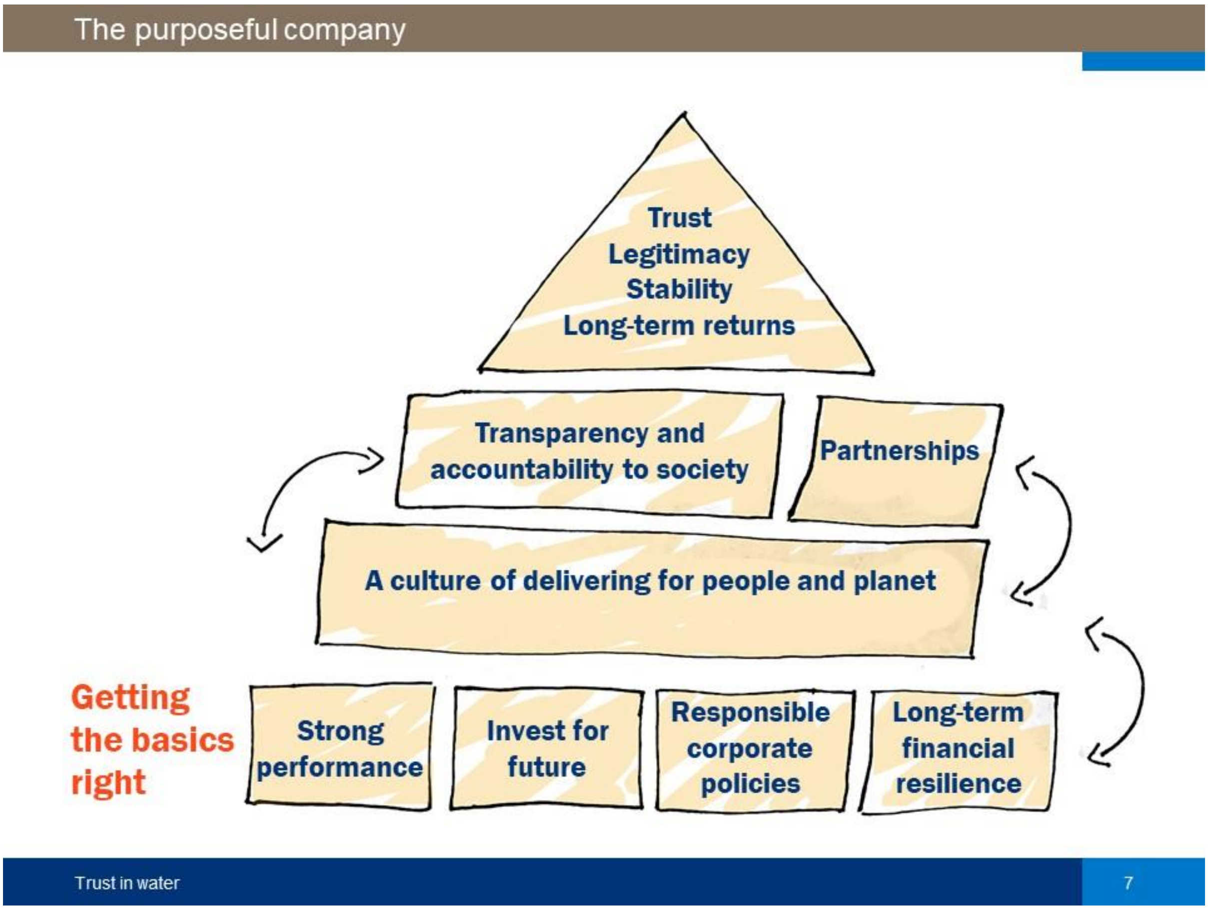
We hear the criticism that our regulations are overly complicated and difficult to understand. If we address the things society is demanding through more regulation, there's a risk that we stymie innovation and get in the way of the company doing the "right thing".

Water companies interact with their customers and communities every day. If you've visited a water treatment works – and I've seen a few - you will know they monitor the quality of water coming in from rivers on a second by second basis. Companies are in a much better position than we are to spot where things are going wrong or see the opportunities to make things better.

For all of these reasons the idea that companies will get on board, will get behind and do their bit in delivering great outcomes for society and for the planet is hugely attractive.

2. What does it mean for the company? – Not easy

Before I talk about what the public purpose agenda might mean for us as a regulator, I want to touch briefly on what it means for the companies. In short - it ain't easy. If I have one worry it is that some companies think that they are already doing all it takes to be a purpose-led company.



If a water company is to be purpose led, it involves more than an inspirational purpose statement. It needs a relentless focus on delivering for its customers, investing for the future and challenging itself hard to address weaknesses in financial and operational resilience before taking money out in dividends or executive bonuses. For some companies there is still much distance to travel before even getting the basics right.

If there is a genuine response, it will involve companies considering their wider impact and opportunities to improve public value in all decision making and all parts of the business.

Bringing about this shift will require a culture change – from Board room to the customer service desk. And critically the engagement of middle management. Research shows they are key to turning the purpose into action and into better corporate and financial performance.

It will require the company to think about how it gives citizens a voice and how to provide the transparency to allow stakeholders to hold them to account. We see some companies making progress with this – for example South West Water has decided to hold open annual meetings as well as giving its customers a share their business. There is a role for open data and technology to make this more accessible.

And finally it will involve much more partnership working within the sector and with those in other sectors. Water companies are beginning to work together to address the Public Interest Commitment ambitions. We are yet to see if this bears fruit but there is no doubting the energy which is being brought to bear.

3. What does this mean for regulators and regulation?

Much has been written about what it means to be a purposeful company and the benefits it can deliver. What this means for a regulator has not been interrogated. And in Ofwat we're only beginning to work this out.

But let me share some thinking we've done about our role in:

- promoting social purpose;
- monitoring and measuring it;
- protecting customers from paying too much; and
- deciding what benefits they should pay for.

Promoting

A key goal of our new strategy is for companies to provide greater public value. We say we will do this by "promoting the wider public role" that companies play. But there is a question about whether we should be more directive and assertive in this task.

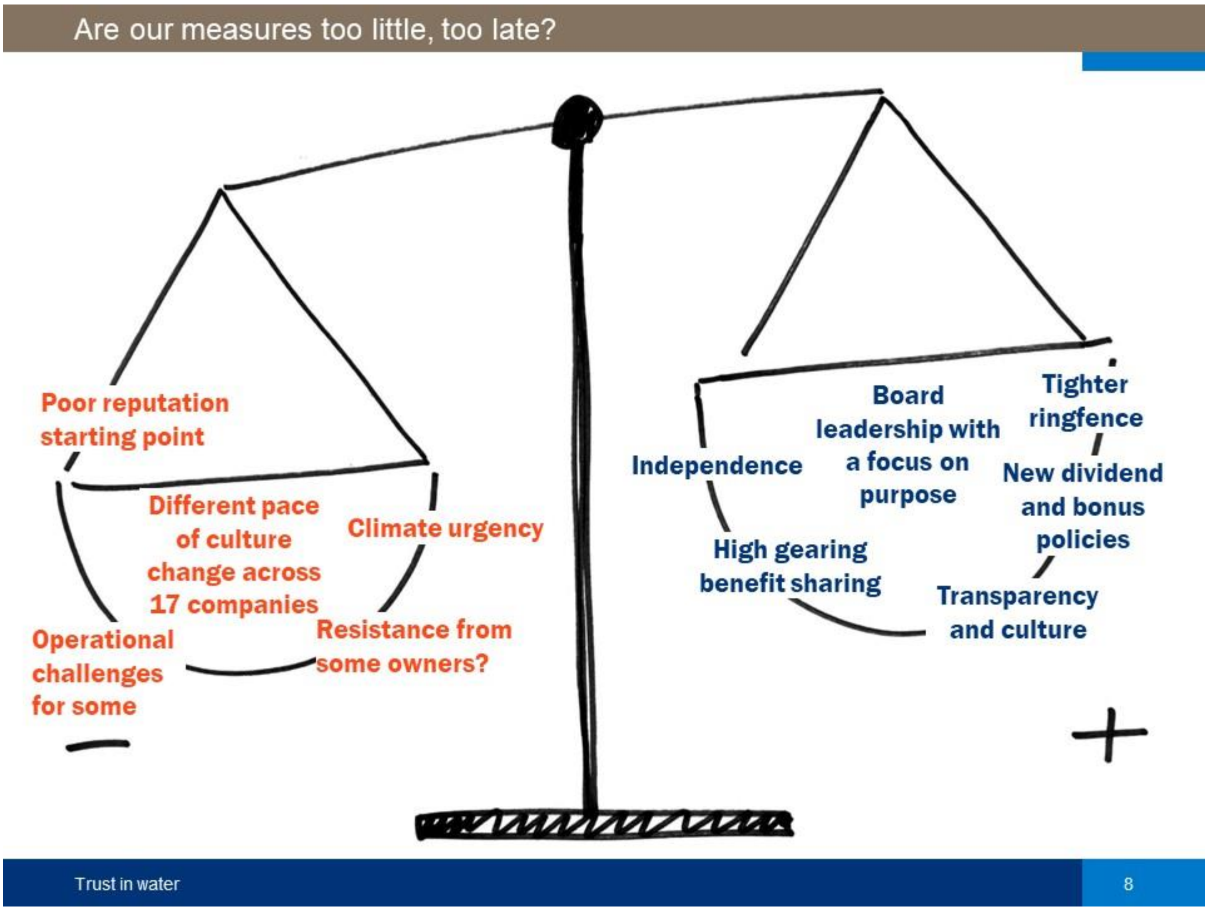
The fun bit is acting as a cheerleader, raising the importance of social purpose at events like tonight.

But it's not all wine and canapes. We are putting in place a series of measures to attract investors more naturally aligned to this agenda. Alongside the new Board Leadership requirements, we are strengthening the regulatory ring fence, reducing the gains from high gearing, providing new guidance on intercompany loans for parent companies and demanding responsible policies on dividend and executive rewards that consider what has been delivered for customers and the environment.

We will consider whether to offer a differentiated price control process to those with a proven track record in delivering against this agenda. And will look to join forces with others like the Environment Agency to bring reputational incentives to bear on those who are slow to act.

This approach respects the "intrinsic" aspect of the social contract agenda – it gives companies space to adopt and embed a purpose for themselves.

But with this approach will the industry move quickly enough to address the challenges it is facing? And will all 17 companies get on board?



Alternatives involve imposing an overarching public value licence condition on all companies. Or we could place a more formal 'fit and proper' test on future owners. We could consider a senior managers regime, like the FCA has introduced where executives are held directly accountable for their conduct and competence.

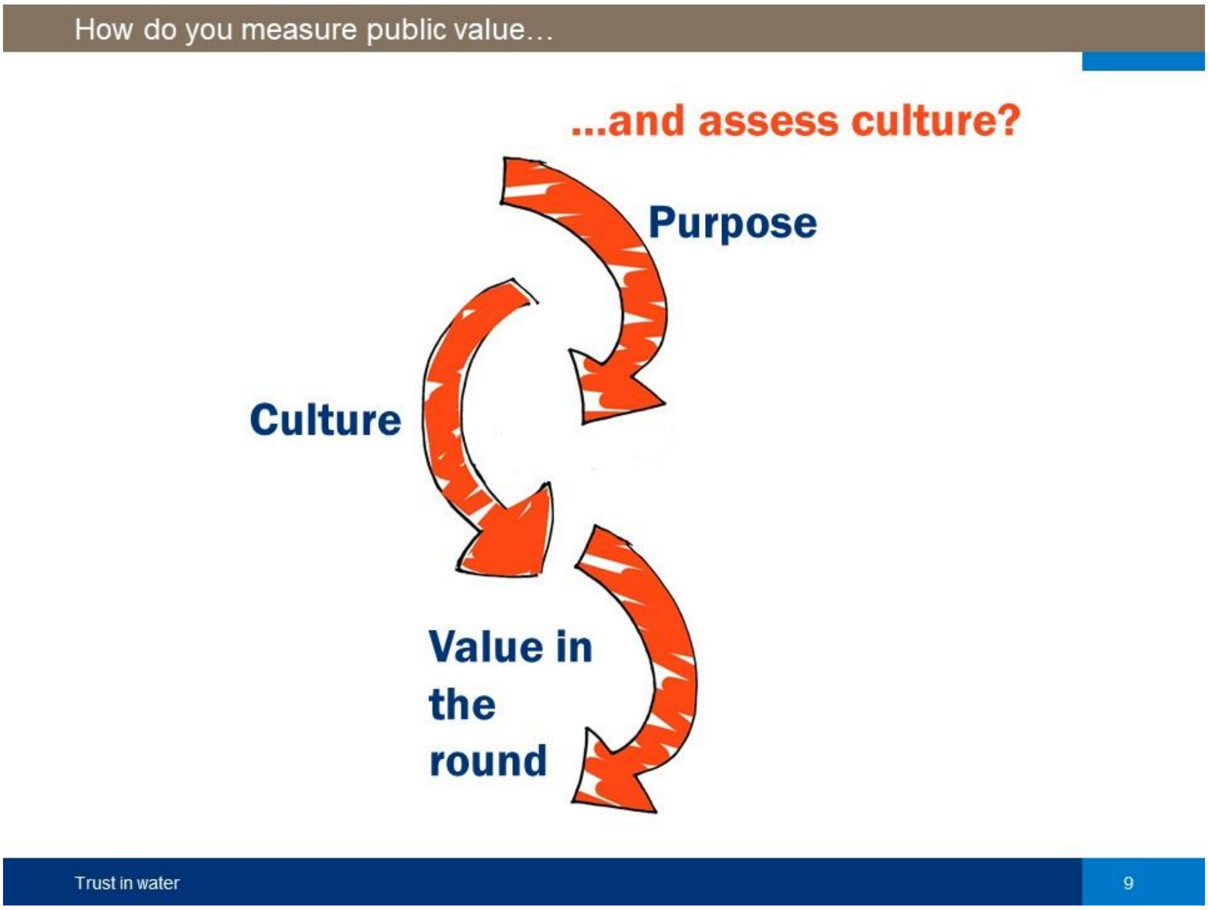
For some commentators these steps would address an omission made 30 years ago at privatisation when the public service nature of these companies was overlooked.

As we move into the next regulatory period and watch the progress that companies are making themselves, we will keep these options in mind.

Monitoring and measuring

The second challenge involves assessing whether any real change is coming about as a result of companies adopting a public purpose. This, after all, is not a matter of switching to a new ideology – but about making things better on the ground.

Measurement is an important issue to crack.



There is a serious risk of “purpose washing”. So transparent measurement of what each company – and the industry as a whole - is delivering is important. Without this, cynicism could quickly set in.

We also need to know if we are succeeding on our goal of companies delivering more for society and the environment. Because if we’re not, we will need to change tack. Better measurement of these outcomes may also allow Ofwat to include social and natural capital outcomes in future price controls.

Many organisations now offer frameworks for measuring and evaluating a company’s sustainability and some water companies are already beginning to use them. While it would be nice to think we could leave measurement to others, Ofwat may have to play a role in moderating, endorsing and collating these assessments to form a picture of the industry as a whole.

As well as measuring outcomes, Ofwat may also need to do more to understand the company’s culture.

Culture is a leading indicator of the extent to which the company is likely to be able translate its purpose into improved outcomes. A better understanding of culture might also allow us to assess the level of risk the company poses, the level of regulatory scrutiny they should attract and the extent to which they need rules rather than principles to operate within.

The FCA, the air safety arm of the Civil Aviation Authority and the Drinking Water Inspectorate are increasingly interested in assessing corporate culture. They work in a context where no amount of regulatory scrutiny can substitute for a company’s ownership and commitment to achieving prudent or safe operations.

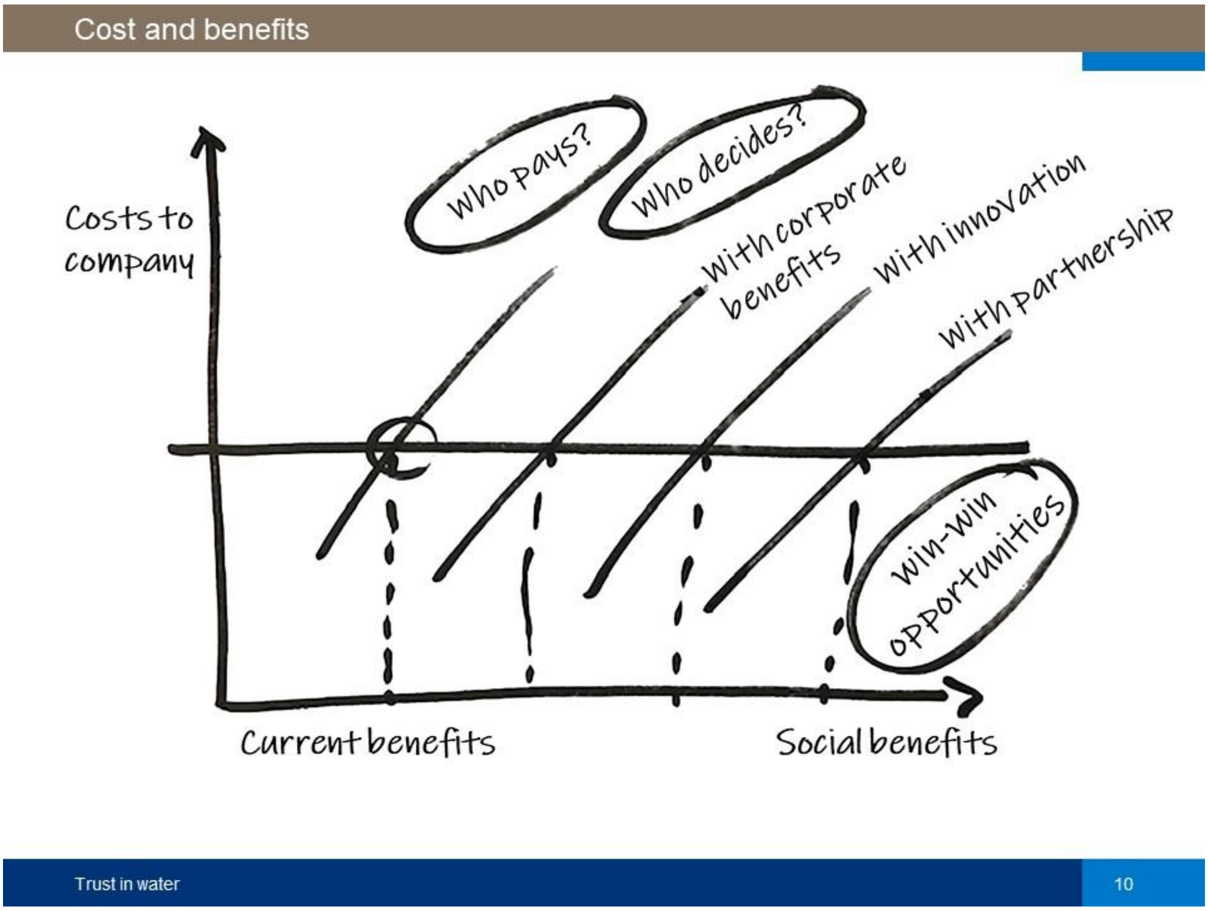
We see these and other regulators taking an interest in the psychological safety of employees and the diversity of views being aired in the organisation.

There’s an interesting reflection from the enforcement case we have just concluded on Southern Water – who was found to have been falsifying the results from their waste treatment works. Individuals who conducted the cover up stood to earn very little financial reward. And the company’s whistleblowing policy actively dissuaded from speaking up if they felt something was wrong. For the board and the exec team at Southern, the current turn around challenge is as much about culture as it is about operations. This needs greater recognition across the industry as a whole.

Will it cost more?

One concern is that the shift to purpose driven companies could result in higher bills for customers. Even with a social contract, water companies remain monopolies and so we worry about these things.

Indeed the question of cost will only become more pertinent as the industry starts to think about delivering on its Public Interest Commitments and responding to the pressure to improve the quality of rivers, all of which could have a high price tag.



This diagram shows how we are beginning to think about this challenge. It shows the different cost curves associated with delivering a particular social or environmental benefit.

One question is whether companies routinely factor in the benefits to the corporation that could arise from delivering public or environmental value above and beyond what they are required to do by law or regulation. There are some interesting cases of companies thinking more imaginatively and with the mindset we'd expect from a public benefit company.

South Staffs Water has introduced customer drop-in centres in Wednesbury. These help their customers understand their bill, get debt advice and other assistance. They provide significant social value. The centres cost the company a small amount of money. But this is expected to more than pay off in terms of reducing bad debt and making it easier for the company to reach its targets for identifying vulnerable customers.

Companies like UU and Yorkshire are putting their own money into supporting social tariffs and a number of companies fund reservoir visitor centres, recognising the payback to the company over the longer term, including in goodwill and to their reputation.

The second thing to note is that the opportunities for solutions that add further public value without driving up costs for the company – and even reducing them in some cases - are largely untapped. Of most interest is the use of nature based solutions in the water and waste treatment processes. These might involve the water company working with others to prevent pollution at source or implementing sustainable drainage solutions. These are normally considerably lower cost than traditional concrete end of pipe solutions and provide significant environment benefits as well. However, while growing they are not yet a mainstream activity in the sector.

What often holds companies back from adopting these and other approaches that will add public benefit is habit and the comfort of the familiar, rather than cost per se.

Another barrier is the transaction costs involved for example in working with dozens of farmers in a catchment area. The good news is that market solutions are addressing this issue with Entrade for example providing a platform to allow companies to select the farmers with the cheapest bid. This platform has reduced the cost of nature based solutions by 40% - savings that can be shared between customers and the company, along with important environmental benefits.

Regulators have a role too in ensuring that our rules don’t unintentionally drive companies only to reach for traditional methods. Here the totex and outcome based approach is important and needs to develop yet further. I’m pleased as well that the Environment Agency is beginning to consider offsets and trading to allow greater use of nature based solutions.

The opportunity for “win win” solutions from the company’s perspective multiply massively when partnerships are brought into the equation. Partners often bring money, new ideas and different skills to the table. This mitigates the bill impact for the customer and helps to reduce risk to the company as well as increasing the chance of the project being successful.

A good example is the partnership that several companies have with the National Trust. A huge proportion of public water supply originates on NT land. The Trust has an objective to improve the environmental sustainability of their land. This means they are able and willing to jointly fund schemes to reduce pollution and alleviate flooding through tree planting and slowing the flow of rivers.

One estimate puts the savings associated with joint commissioning like this at £1bn a year.

We are a long way off understanding the limits to these “win win” solutions – what innovation might be forthcoming and what partnerships might be formed in the endeavour to reduce carbon or plastics which are, after all, big challenges for corporates around the world?

There are social benefits which customers are willing to pay for. But they should only be asked to pay *once other options have been explored* – not as a first port of call which is what tends to happen now.

Who decides?

As we exhaust the opportunities for lower cost options or those which others will pay for, there are questions about the public benefits customers should pay for and who makes these decisions.

This issue has surfaced to an extent in the debate around public benefit companies, with The Economist, for example, raising valid concerns about corporatism overtaking democratic decision making and highlighting the risk that the views of the educated, opinionated, and rich drown out the voice of the less empowered.

Ofwat’s approach has been to allow companies to earn funding and rewards for outcomes which customers are willing to pay for – where we place a high bar on the quality of research and justification for the expenditure.

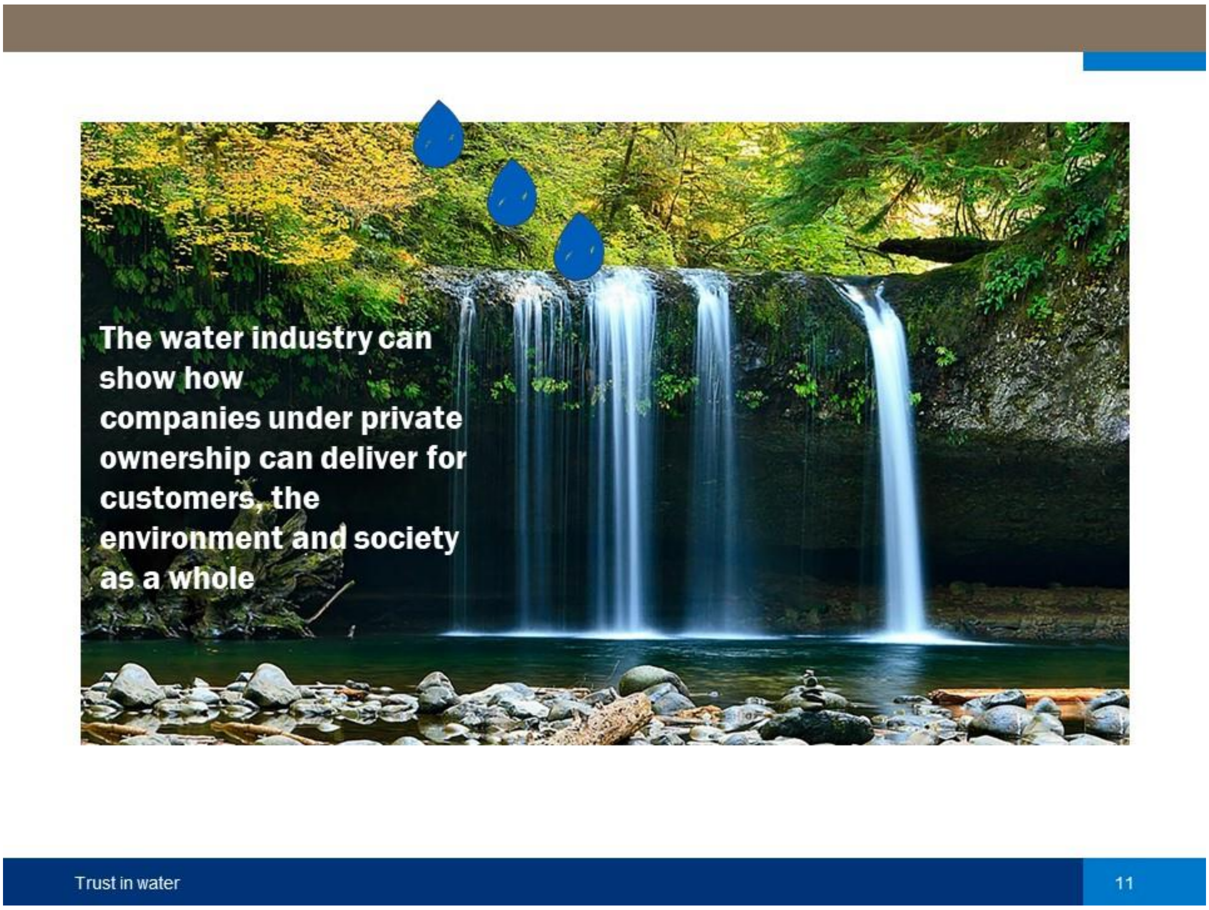
But customer research techniques, particularly on willingness to pay, are not fully robust. They may not always be the best approach for setting the nature and level of the social benefits companies provide.

A priority for Ofwat in the coming years will to be to learn from the PR19 experience, and to review our approach to the role of customer research. In particular, we may need to think further about how local communities can be empowered and diverse interests can be heard.

We may also need to think whether the targets for some public benefits should be decided through cost benefit analysis rather than customer willingness to pay. And if this involves a material cost to customers and hasn't been translated into a statutory target, this leaves the regulator with an interesting dilemma.

Here the National Infrastructure Commission in its recent report on regulation offers a way through. It recommends a new mechanism that makes it easier for regulators to gain guidance from government when facing big intergenerational or other distributional issues. So, the best way through is for us to work closely with Government. The implicit message from the NIC (if I read them correctly) is that regulators shouldn't stand back and wait for Government to fill policy gaps but be proactive in coming forward with recommendations where there is an opportunity to achieve something positive for society through the companies they regulate.

Summing up



In summary my argument goes like this:

The attention on corporate purpose may well be pertinent economy wide. But I think it i**s particularly relevant for the water industry**.

We should all – including Ofwat – raise our game. The ambition is for water companies that deliver greater benefits for customers, society and the environment as they carry out their business that their owners achieve long-term returns for doing so.

Or, to use John Kay's expression, it's about creating – "hybrid entities" – that deliver public services using commercial disciplines.

Water companies are uniquely well positioned to work as social purpose companies given their strong geographical and environmental footprint, the public service they deliver and the public ethos which runs through many who work in the industry. They can use the dynamic that comes from private ownership to bring innovation, creativity and efficiency to this task

My question is – if the water companies can't make a success of this – who can?

This won't be a walk in the park for the companies and there are also tricky questions for Ofwat if we are to go down this route. But if we succeed it could allow a reset of the relationship between Ofwat and industry. One with fewer detailed rules and where co-operation in solving strategic challenges is the norm.

With commitment, action and energy, the water industry can rebuild the legitimacy that has been lost in recent years. They have an opportunity to lead the way in showing what companies can deliver for people and planet.

This evening I hope I've helped you understand why that is our goal.