Keynote address from Jonson Cox

Utility Week City Conference, London, Friday 6 March 2020

Introduction

I'm delighted to be here together – the first UW City Conference - to share and test thinking early in 2020 and the new decade.

It's also the start of a new five year AMP. We have been thinking a great deal about how we can embrace challenges and grasp the opportunities before us.

Today I'm going to talk about five matters:

1. The many events and changes of the last few years for the water sector
2. The big picture of our direction of travel now and for the future
3. PR19. I'll describe what we set out to do in PR19 and what we achieved
4. The continuity of work this year on public purpose
5. Forward looking investor proposition and why I believe water remains a core and attractive infra sector for debt and equity, and our approach to M&A.

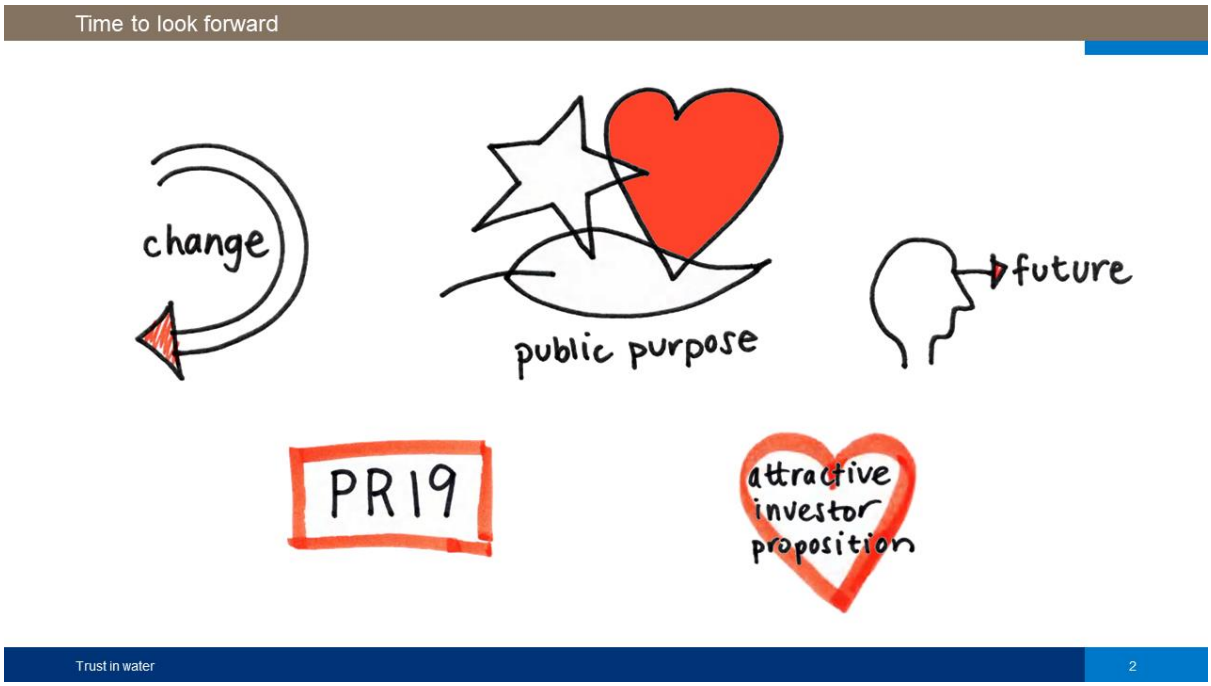
Time to look forward

The journey of privatisation has had many successes and a few big mistakes. For what is and should be 'core infra', it hasn't always appeared that. I have had three roles over a twenty five year career in water, partly sorting out mistakes of privatisation:

- Yorkshire's loss of customer trust in the mid-1990s;
- Anglian's complete loss of investor confidence in the mid noughties through loss-making global diversification and inept attempts to outsource all its core water business while gearing up to 84%.
- And as Chair of Ofwat realigning the purpose and behaviour of companies with the public legitimacy that is so core to a modern utility's licence to operate.

I know that the water sector can be driven by nostalgia and looking back. I can't tell you the number of times I've heard or read – even last year - a defence of the sector preceded by: "Before privatisation…". That was 1989 – over thirty years ago.

So, let's not hark back to the distant past as our North Star. Let's turn 180 degrees and get comfortable, excited and motivated in looking forward, in the provision of a public service deploying and appropriately rewarding long term capital.

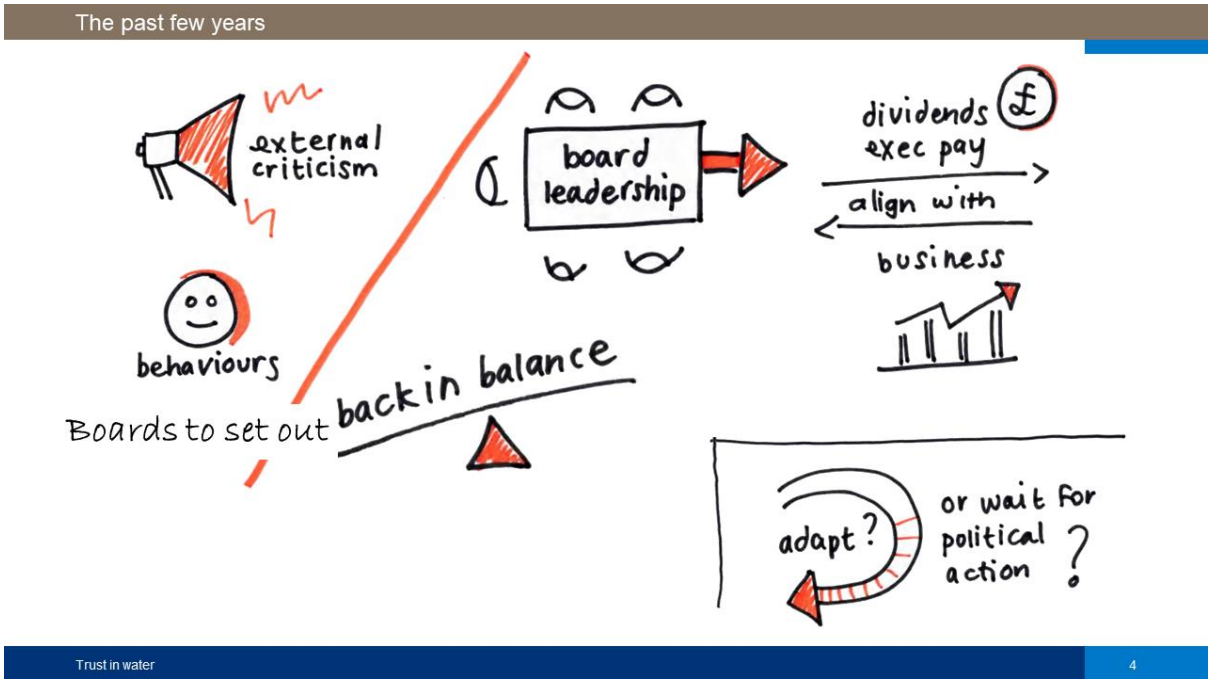


My question for today is 'what does trusted public service, under private ownership, look like and how is private capital rewarded?'

I'm not going to completely disregard history so let's first glimpse at how the last few years – not 1989 - has reset our compass.

The past few years

The last few years have been pretty tumultuous for the water sector. You may think we have been quite challenging but there is a need to change. If you go back to my first speech in 2013, I set out six principles for change.

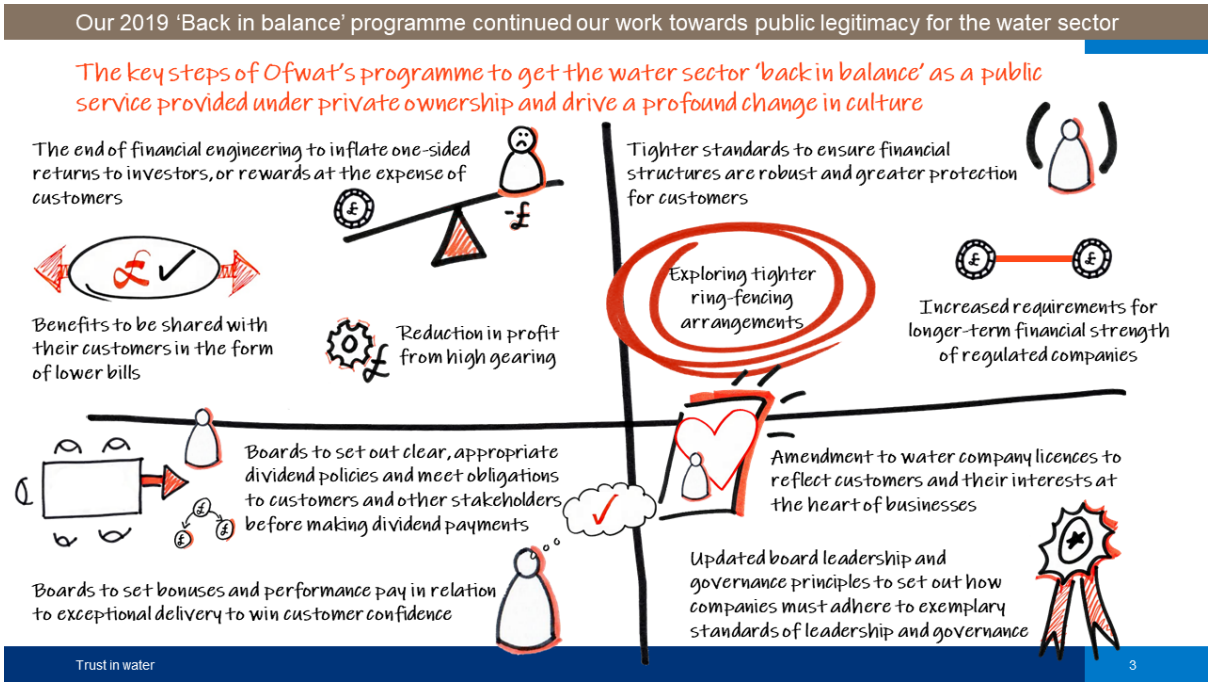


I couldn't foresee all that would come to pass to damage the legitimacy of the sector, but the themes are there. Nothing that we pushed for is less than customers and society were asking for. And by the way – you wouldn't believe this from the headlines - it hasn't been a bad time overall for shareholders. Collectively, annual average dividends for Amp6 are running at 9.6% pa of Regulated Equity and that's before investor return from growth in RCV.

We accept that it has been quite pace of change for investors; please think of the counterfactual if we hadn't driven this. The sector has struggled for public legitimacy. But so far, it's nothing compared to the loss of legitimacy and shareholder value in the electricity supply companies after the speech by the Leader of the Opposition in 2013, and then when the price caps were deemed necessary *by a market-orientated Conservative government.*

Back in balance

Ofwat has been the driving force for much of the agenda, including our Back in Balance programme: challenging high returns and dividends which were earned more by outperforming the cost of capital than by real service and efficiency improvements, the need for significant enforcement cases for unacceptable performance - with the largest penalty being nearly 7% of relevant turnover - and the loss of alignment with customers.



We have:

- Increased the element of return from strong operational performance
- Driven change by putting board leadership at the heart of how companies operate
- Set up sharing mechanisms which align high leverage with returns to customers as well as investors
- While some have argued for dividend caps, we have gone down the route of transparency : let the board explain how dividend policies align with the business' performance - and a similar principle on executive pay;
- And we have strengthened the ring fence around the appointed company, signalling a clear requirement to explain deviations

It is only fair to say some investors haven't all loved this. We carry out a regular survey of 450 investors. We will be publishing the results shortly. You would expect a drop off in support in the run up to FDs.

To give you a sneak preview, the results are interesting: on five fronts of how we regulate, scores for 'Strongly agree and Agree' continue outperform Disagree and Strongly Disagree' by two to one – it gives a great Net Promoter Score for Ofwat I think! Questions include alignment of investor interests with customers, being proportionate, choosing appropriate tools, and engagement with investors and credit rating agencies.

We took a small dip in the last year on perceived independence into the high 50s. Maybe this isn't surprising when we were being lobbied on the review, returns were falling and we were seeing practices which customers no longer accept.

I did note that listed equity consistently rates us much higher than institutional private capital. This appears to correlate with the overall assessment of better performance and regulatory standing achieved by listed companies.

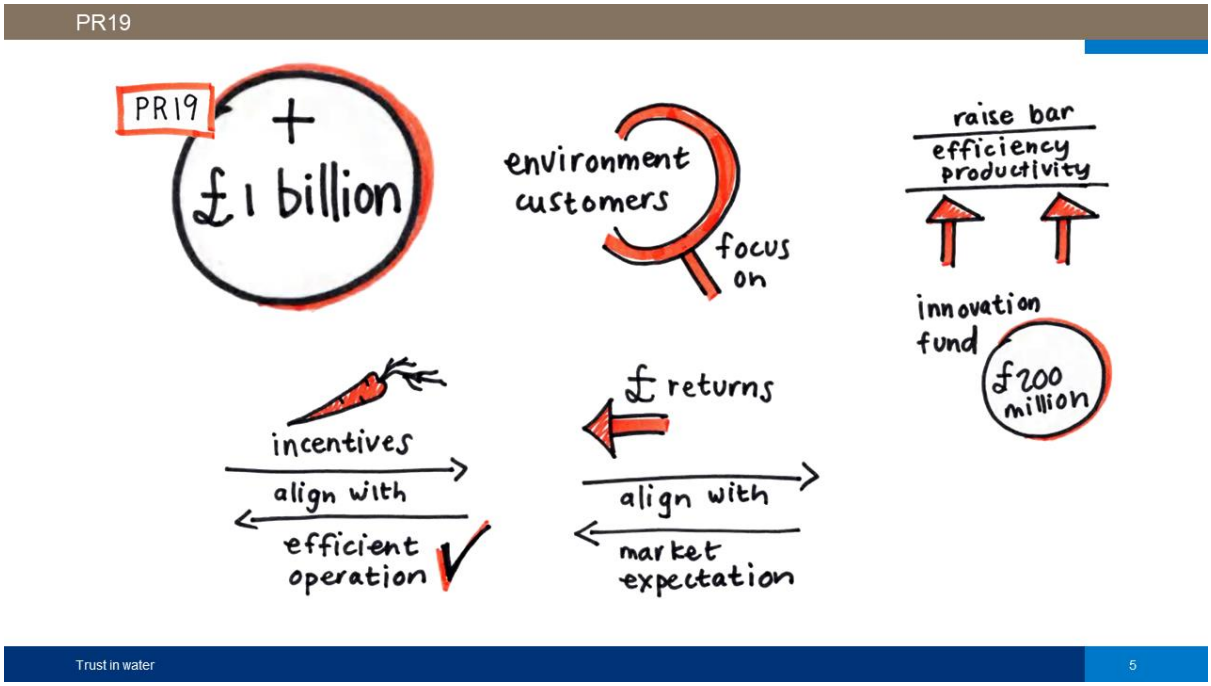
I can see the correlation but I'd like to hear from you the causation. Listed companies all delivered fast tracked plans. In the main, consortia-owned companies struggled with the price review, where they were miles adrift from our cost benchmarks and also where, with a few notable exceptions, operational performance has been weakest. Many were in significant scrutiny. Some of those companies now private used to enjoy 'top of the chart' performance, and have now slipped. What has caused that?

What should we read into all the appellant companies being owned by private equity interests, three of them consortia-owned?

The role PR19 played

Consistent with the above we had specific aims for PR19:

- The sector faces profound challenges. To meet these challenges requires a step change in company performance, customer service, efficiency and a more resilient and reliable supply of water, and an increased focus by companies on delivering public value. PR19 is the single most significant regulatory lever in driving this step change in the industry.
- The main stretch is on outcomes - companies are getting more funding than previously, including more money for the environment and resilience. In fact for a few companies we have given them more money than they asked for.
- Money is for delivering for customers and the environment and not financial engineering. Companies with a similar structure to our notional structure are financeable and even some highly-geared companies are too
- We introduced a new form of competition in DPCs
- We expect exemplary corporate behaviour. Look back at AMP 5 when some companies bid strongly for resilience. A generous PR09 achieved only massive dividends – up to 24% per annum of regulated equity flowing straight out of the sector. We need more alignment in the system



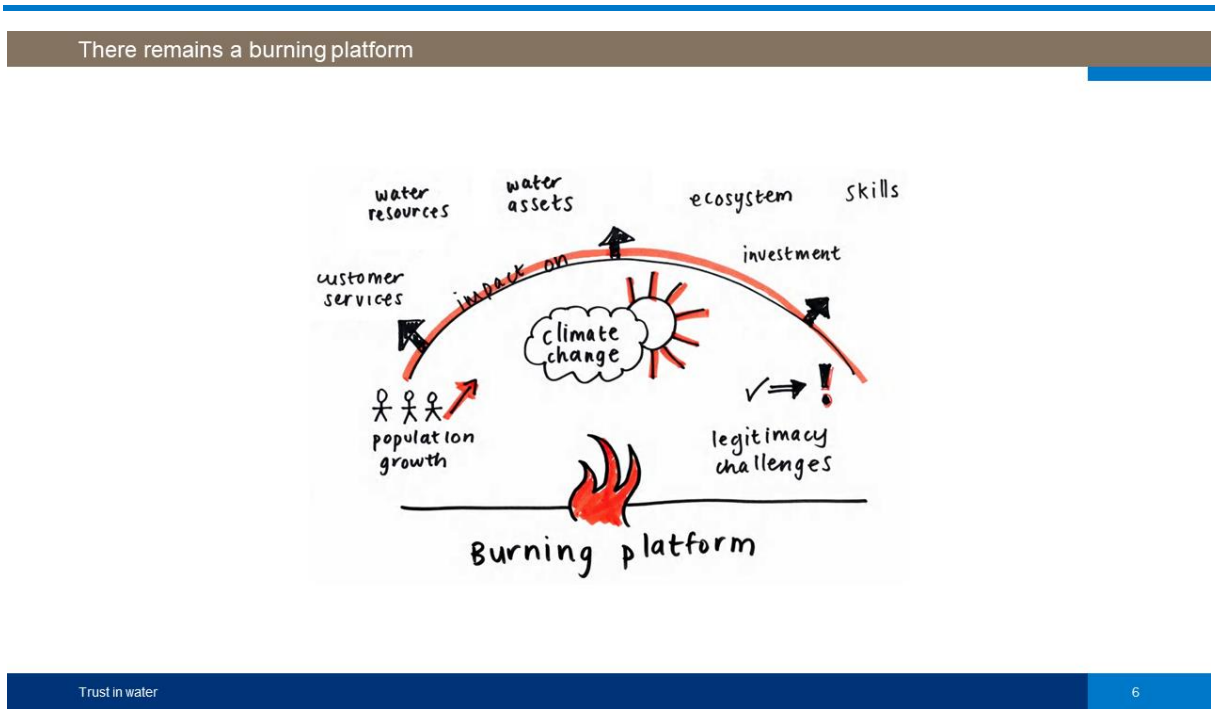
What have we delivered?

PR19 allows massive investment – funding of £51bn including £1bn on items above that requested by companies. It puts even more emphasis on ODIs and performance commitments. So if a company does well by customers and the environment, its shareholders do well, too. This puts more focus on the environment, on helping those in vulnerable circumstances, and on improving resilience. And it does all of this while bringing bills down by £50.

In AMP5 we reward companies for performance and corporate responsibility is vital to trust

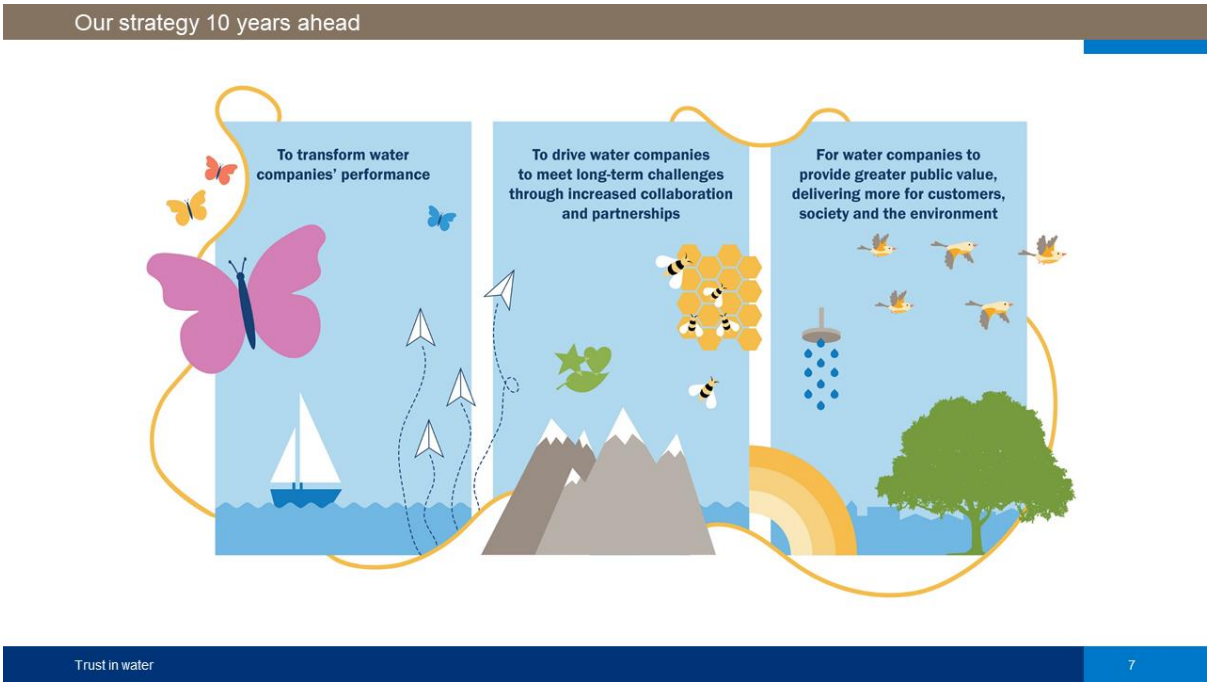
I hear it said it's been the toughest review yet. But, thirteen of the seventeen companies have stepped up to the challenge and are cracking on with it. The option to refer to the CMA provides an important check and balance. But I hope that even those four companies going to the CMA will be pushing to improve their performance for customers from the outset of this AMP.

Whatever the outcome of these appeals I do not see a world where things go back to how they were in the past. Despite claims that it's been tough, listed companies have seen a significant boost to their shareholder value: Tuesday [4 March] – even after last week's sell off SVT was still up 9% from FDs and up 18% relative to the market. Premia to RAV look as high as ever.



Our strategy 10 years ahead

And that move takes us, at Ofwat, into our new strategy, which we shared at the end of last year. “Time to act, together” is Ofwat’s strategy for 2020 and beyond. The title highlights the need for joint action.



We identified three strategic goals:

- The route to business success is through achieving and sustaining operational excellence – and that route alone.
- Risks arising from climate change and population growth need urgent attention.
- And society expects companies to do more than focus on profits but on providing wider public value.

Operational excellence

I have covered this in relation to PR19 Stretching performance targets and efficient totex allowances are combined with a WACC reflecting market rates and a requirement to share the benefits of high gearing.

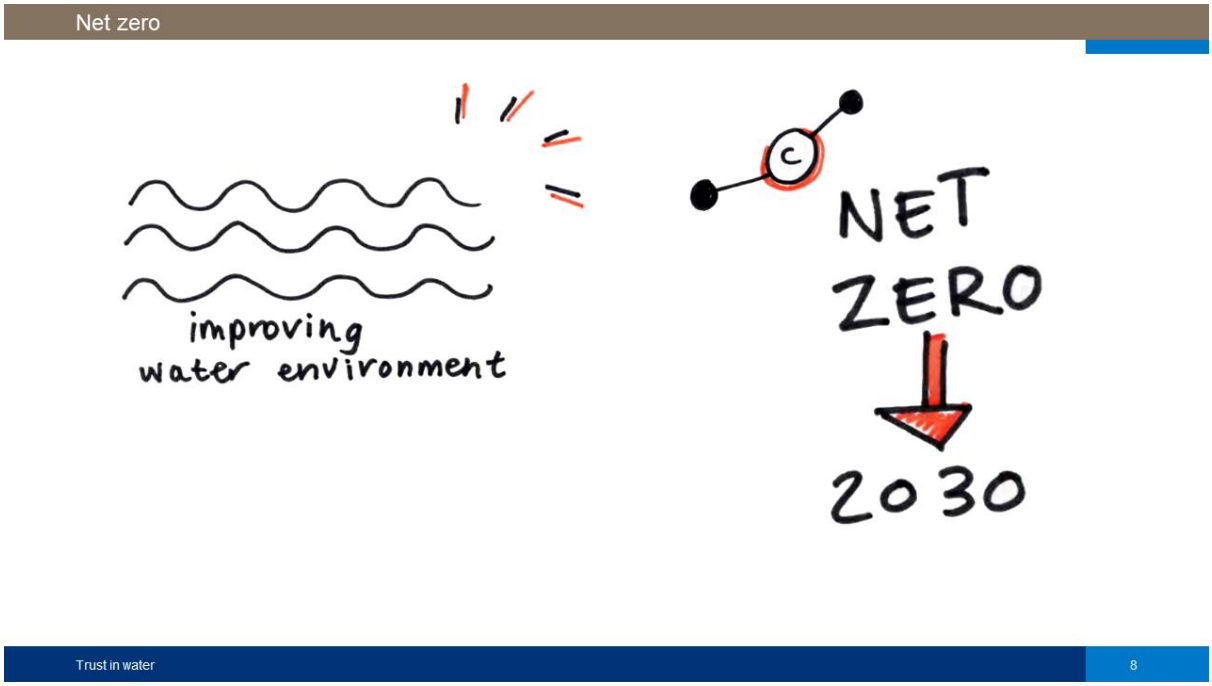
Alongside expectations on executive performance pay, dividend policies, tightening the ring-fence and signalling the end of Regcos lending to their shareholders – these arrangements make it abundantly clear that business success will, from now on, be based on building and sustaining operational excellence: short cuts to success are not available.

Climate Change and Population Growth

The need for urgent action to address the risks from trends in population growth and climate change is the second new norm. With this winter's storms and floods in Wales, Midlands and the North, and fires in Australia, the impact is all around us. It is clear that climate change is already having a serious impact on peoples' livelihoods and on natural habitat around the world.

Net zero

Water companies did respond last year with a commitment to cut their operating carbon footprint to zero. I'm pleased to see impressive 2030 'net zero' ambition here. It's welcome, it's ambitious and we have less than ten years to go. I'd like to see evidence of planned delivery – a lot will need to be delivered in the coming five years. This will need meaningful investor support and funding in AMP7, and processes and technology will need to change. I welcome, as progress, Severn Trent's ambitious announcement yesterday.



It's not just carbon emissions that should concern us. Growing population combined with changing weather patterns is causing real damage to the natural world. We are falling woefully short of our ambitions to restore our beautiful rivers to a healthy state, despite billions of capital investment by customers. Beyond meeting the targets in PR19, an effective long term strategy is critical if we are to avoid the condition of our rivers overtaking leakage as a source of public outrage

The legitimacy of the sector is still questioned. Even following a convincing Conservative win, questions are still being asked about the appropriateness of private ownership in water and other sectors. At the root of this disquiet is the question whether more has been taken out of these businesses for shareholders than has been received by customers in terms of service and efficiency improvements.

Journalists continue to question the scale of dividend payments – including those used to service loans to shareholders. To find our way out of this – and to create the stability which investors also desire – we must ensure that business success is inextricably linked to delivery for customers and the environment too.

Public purpose

The third norm is relevant to all types of business across the developed world. It's an increasing expectation that companies should be driven by public purpose, not short term profit maximisation.

Last year we saw some of the largest companies in America, members of The Business Roundtable, pledge to place the needs of stakeholders alongside those of their shareholders, US markets are now moving from ‘establishing’ this idea to it being institutionalised by the SEC. This side of the Atlantic there has been much debate about the move to “reinvent” capitalism. From the business paper of record – the FT – we see calls to rethink capitalism and for companies to re-evaluate whose interests they serve. Survey after survey shows public trust in business has waned.

But good news: of all business sectors, I can’t think of any better than water companies to deliver for society and the environment, and more than they do at present. If you like, to add net positive public value after accounting for bill increases and any other detrimental impacts of your business on society and the environment.

We see this agenda not just as an opportunity to secure the legitimacy of the industry but also to bring tangible business benefits. Our ambition – which I think is realistic - is to see the industry become a beacon of responsible capitalism.

So, the business of business is changing. The notion of a company’s sole purpose being to make money for their owners is gone. Forces are coming together to push companies to adopt a purpose that is to deliver for ‘people and planet’. Where returns are derived from delivery and trust.

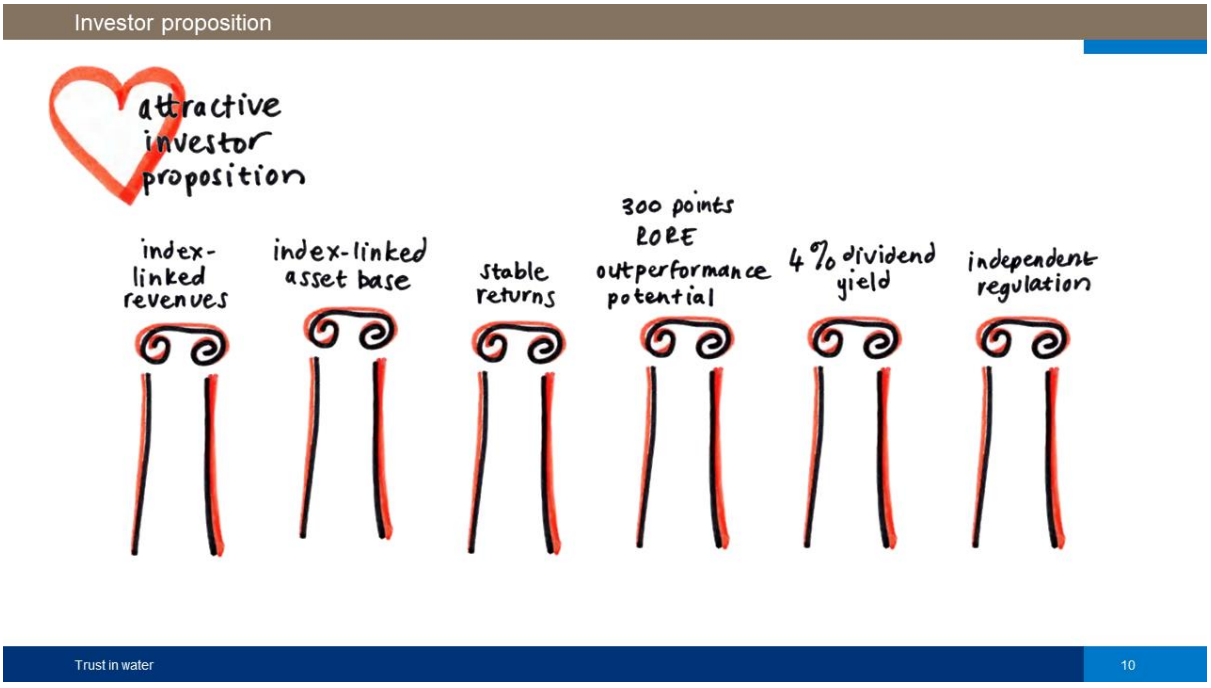
Investor proposition

Our job is to protect customers and to do so requires a sustainable fair investor proposition. Our strategy recognises this. We intend to focus on using our full suite of regulatory tools, including incentives.

So what does this mean for you as the investor community? I am particularly thinking of those investing equity in the water sector.

First, I can't deny that future base returns are likely to be lower than historic returns but that won't be a surprise. As I said earlier, average dividends in five year period AMP6 are running at 9.6%pa – it'll take some stonking outperformance for customers to match that. But as today's conference title says: 'Capital is abundant', and with that returns have come down.

Please remember the strength of the investor proposition.



It remains hugely attractive for long-term responsible investment, currently built on six pillars:

- Guaranteed, index linked revenues
- Index linked asset base
- Predictable returns and a stable regime
- Significant potential for outperformance of up to 300 basis points on RORE
- The opportunity of a dividend yield of 4% on notional structure

- And all of this underpinned by a transparent, independent system of regulation, with a reset every five years.

As the dust settles on the review, despite appeals, the reaction of public listed markets shows the attraction of this proposition.

M&A

At this time in the cycle the prospect of corporate M&A activity is always raised. We heard of investors who wanted to sell before the review and couldn't, given the nationalisation threat; we hear of new capital wanting to come in.

We welcome responsible long term capital. Our door is open to pre-acquisition discussions with incoming investors. Consistent with the public utility point, we expect simple capital structures not too far removed from the notional. As our guidance says, we look askance at approaches such as the Regulated Company lending money to its parent via inter-company loans to finance acquisition: regulated companies are not lending banks

And by the way a warning on premia to RAV that I have given in previous years. Companies will be able to earn a decent return on their RAV. But it shouldn't be assumed that they will be able to earn a decent return on RAV plus a 30% premium.

Management matters: equipping companies with effective management, who deliver for customers and all stakeholders, and supporting and challenging them is a core job of boards and investors. Board leadership matters too: We need diverse and challenging boards as our recent principles say.

So in conclusion...

As we step into a new decade, this is the task before us: face into and shape a positive future for the sector. Don't forget that lack of public trust fuelled the nationalisation issue. Engage with the concerns and challenges before us. Become a sector renowned for modernity, progress and net zero.

Shape the change that is coming. In particular around climate change and net zero. Business will be required to lead on climate crisis. Yes, you need to find the right story to tell. But it must be authentic and backed up by the right actions.

Shape a positive, progressive future