



From the Chief Executive Officer, Susan Davy
Peninsula House, Rydon Lane, Exeter, EX2 7HR
T: 01392 443381 www.southwestwater.co.uk

12 February 2021

Public Value
Ofwat
21 Bloomsbury St
Bloomsbury
London WC1B 3HF

Sent by email: strategy@ofwat.gov.uk

Dear Amit

Ofwat's discussion paper on public value in the water industry

Thank you for providing us with the opportunity to respond to Ofwat's discussion paper on public value in the water industry. This is an area in which we have strong views and we agree that there is more scope for water companies, as responsible businesses, to have greater ambition, building on a proud heritage and history of public service.

To that end, we would be an advocate for Ofwat encouraging companies to do so, as part of the next price review process, in driving and enabling a step change in the industry, with targets and incentives aligned to imperative societal impacts and longer-term outcomes, firmly positioning the water industry as *the* industry with a strong social conscience, building a sustainable future for all, and ensuring legitimacy.

Additionally, we don't view the pursuit of wider public value, having unintended or adverse consequences, or necessitating a cautious approach. In our opinion, the risk of not doing so, has potentially far greater consequences. If events of the last 12 months have taught us anything, then societal impacts can and do provide the greatest catalysts for change. Scientific evidence told us for many years about the adverse impact on our climate, yet the biggest drivers for change have come from social movements on the ground. The pandemic has highlighted businesses doing the right thing for their employees and communities in the court of public opinion and Build Back Better will provide further opportunities to do so. Organisations everywhere are reassessing their priorities and purpose for the good of the planet, for people and for profit – in that order for the longer term, building agility and flexibility into their strategies, to be able to respond as things change. The water industry is no different.

For economic regulation to be successful, it will require a further evolution, but with a high degree of sophistication to avoid regulatory burden and to maintain transparency. There are already a number of recognised methodologies now being more widely used to measure a company's impact on society (Environmental, Social and Governance (ESG), Task Force on Climate-related Financial Disclosures (TCFD), Net Zero etc) that potentially could be used within the outcomes framework or recognised within the wider regulatory framework, where companies should be incentivised for providing better outcomes with wider societal benefits. There are also an



increasing number of case studies linking a focus on ESG with better overall performance, a lower risk profile and ultimately lower cost of capital, which would be welcomed across the sector.

In South West Water we have an established sustainability strategy which outlines our aims and objectives for Environmental, Social and Governance aspects of our business. We recognise the reputational and financial benefits of having strong ESG performance to improve our position in each of these areas.

But, we want to develop this further, taking into consideration how we can value our social purpose and expand our view of the impact on the environment outside of our existing frameworks. We are already developing our proactive framework which will consider not only our traditional approach to planning and benefits but recognise that natural and social capital should be considered in ambitious plans for the long-term. We have already begun to set our baseline for the measurement of our natural and social assets, as well as identifying how specific activities ('flows') can increase or indeed decrease our natural and social capital, as well identifying and measuring impacts which South West Water might have on other parties (i.e. land not owned by us). We believe that by 'valuing' such assets and flows and embedding these into our decision making and investment proposals will enhance our long-term benefits to the environment and communities.

We see that this approach is consistent with Ofwat's and our ambitions to enhance public value and our societal benefit as well and embed environmental investment and solutions for a truly sustainable future.

You've also asked for views as to what extent companies should focus on an enabling culture and in considering this response, we would advocate the importance of purpose.

Purpose is often defined (and as Purpose Union have done) – as to "why" a company or organisation exists. For us, Purpose helps shape our strategy and is not just seen as an important enabler of culture, it also drives transformational change, and sustainable financial value /performance.

At South West Water, this has been something we have been doing for some time now. Our reshaping of the Group with a focus on UK Water, together with the impact of the pandemic on society and communities has been a timely catalyst for us in reviewing our purpose, how it aligns to our strategy, as well as in considering the wider social contract we should have with customers, stakeholders and the communities we serve.

All water companies operate in the public interest, with a vital role in providing customers with safe, clean and reliable drinking water, with the added importance this has on health and hygiene – that's a given. However, we also believe we have a unique role to play societally, and environmentally. Our new purpose "Bringing water to life - supporting the lives of people and the places they love for generations to come" goes further. It's supported and underpinned by our core values, and our public interest commitments. It has led us and is enabling us to make better and bolder societal decisions – for example:

Affordability

Our toolkit of affordability measures looks much wider than just providing help with water bills. We proactively support customers to identify and claim additional income, improving the whole of the financial household situation, with associated social and economic benefits.

Catchment approaches

We are industry leading in catchment management through our upstream thinking programme, working with partners across our region, in practical land management, alleviating pressure on the rivers and our treatment works, securing a sustainable future for the environment.

Pioneers of a new relationship with customers

We believe there's no better way to respond to public sentiment than building a deeper relationship with customers through our pioneering Watershare+ scheme, which gives customers a say and a stake. 1 in 16 households in our region are shareholders as well as customers, heralding a new era in customer ownership. Sharing our success with customers is now firmly at the heart of what we do. Put simply, if we deliver, customers directly benefit.

Sustainable financing framework

Investors (both equity and debt) are increasingly integrating ESG into their investment criteria and research shows that companies that focus on material sustainability concerns outperform their peers by almost 5% (based on total shareholder returns). This further links to debt financing and was the driver for South West Water (and Pennon) for launching the first Sustainable Financing Framework in the UK back in 2018.

Since then we have raised over £385m (70%) of South West Water's debt under this framework. These are either linked directly to the company's green projects such as the innovative new Mayflower Water Treatment Works or specifically links the amount of interest we pay to specific environmental outcomes such as bathing water quality and our overall performance against ODIs. This approach demonstrates our commitment to environmentally and socially sustainable outcomes as well as delivering efficient financing increasing the availability of funds.

Paying our Fair Share

We see that paying our fair share of tax is one of the many ways we contribute to our communities and we were one of the first Water Companies to achieve the Fair Tax Mark in 2018. We have a robust and transparent tax strategy and we know that through our customer engagement that customers expect us to be acting ethically as part of being a responsible company delivering public value.

Net Zero

We are determined to achieve Net Zero by 2030. We will take every step we can to do our bit for the greater good and in a sustainable way. Our customers have told us that climate change is a top priority and are fully supportive of actions we can take to reduce our carbon footprint. Net Zero has not been mandated nor any steer provided within the regulatory mechanism during this regulatory period to glidepath to this goal.

Given our geographical positioning and work in our regional catchments, we have a unique opportunity to build natural carbon sequestration through our moorland work and reverse carbon emissions – a key differentiator for us and the South West.

Social mobility

Much has already been said around the water industries involvement in signing up to the social mobility pledge and the role of business generally in advancing social mobility. We were one of the first larger water companies, and the first in our region to sign up to the government's kickstart scheme – offering 50 placements to socially disadvantaged 16-24-year olds on universal credit. What's unique about our scheme however, is that we are also personally funding an additional £500 bonus payment for those completing their placements. To our knowledge, we are the only

company to be doing so. However, given the South West has some of the highest furlough rates in the country, we think it's incumbent on us to do more.

The same applies to addressing racial and gender inequality. All companies have a requirement to disclose gender pay gaps. We go beyond that, publicly talking about what we are doing to promote an inclusive working environment that stretches beyond gender, race and social mobility. We were the first water company to sign up to the Change the Race ratio – indicating our ambition and role as a responsible business to address a social inequality around race that stretches way beyond our region and demographic makeup.

To that end, public value must be a key focus of PR24. We believe that Ofwat should ensure that public value is embedded within the price review process and guides decisions on future determinations.

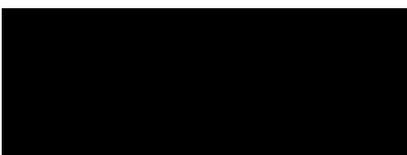
PR19 provided some scope for companies to include natural, social and human capital areas within performance commitments, namely bespoke and predominantly reputational in nature covering areas such as vulnerable customers, bio-diversity and long-term resilience. However, there are no comparative measures looking at wider society aspects and therefore we believe PR24 should go further to incentivise company's delivery of public value.

The PR24 process should deliver a regulatory framework focused on supporting the water industry meeting its long-term goals. At its heart, PR24 must aim to encourage and support investment that will address the environmental and sustainability challenges facing the sector.

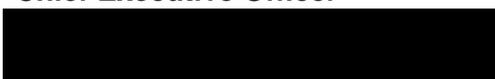
In conclusion, we have strong views on public value and great ambition in this area, having already started our journey. We would wish to see the regulatory framework continue to evolve to enable and incentivise companies to continue to embrace public value.

We have included specific responses to your questions in Appendix 1, but please do not hesitate to contact me to discuss any aspect of our response, we would welcome further engagement on this important area with you.

Yours sincerely



Susan Davy
Chief Executive Officer



APPENDIX 1 – Response to specific questions

Scope and Ambition

a) What factors – outside regulation – impact on water companies’ ability to deliver ‘optimal’ public value outcomes when delivering their core services? What are the constraints to meeting ambitions in this area?

b) What are the risks in the pursuit of greater public value; and what could companies, and/or Ofwat, do to mitigate these risks?

c) In pursuit of better public value outcomes, to what extent should companies focus on an enabling culture that drives public value holistically; versus a more discrete, targeted approach?

To truly deliver optimal public value, there needs to be broader recognition of the importance of working in partnership with a wider range of stakeholders, all empowered to develop and deliver regional priorities with easier access to investment.

To operate successfully, we are highly dependent on the natural environment, local relationships, our extensive network infrastructure, the skill and dedication of our people, and our sources of finance. Only by maintaining and effectively combining these can we ensure that our customers will have sufficient clean water and that wastewater can be effectively dealt with, now and in the future. There are greater constraints within the regulatory framework that need to be unlocked for companies to meet ambitions in this area and these are discussed in the following section.

Incentives and barriers

d) How does the regulatory framework contribute to, or limit, companies’ ability to deliver better public value outcomes?

e) What role, if any, should the price review play in encouraging or incentivising companies’ delivery of public value?

PR19 provided some scope for companies to include natural, social and human capital areas within performance commitments, namely bespoke and predominantly reputational in nature covering areas such as vulnerable customers, bio-diversity and long-term resilience. The use of financial incentives to encourage the delivery of social goods at an efficient cost is at the heart of RPI-X incentives. Since privatisation, Ofwat has used financial incentives to drive extensive efficiencies in the sector and improvements in quality.

In more recent price controls, the introduction of ODIs has generated strong incentives for companies to deliver a number of outcomes through bespoke and common performance commitments. However, while existing common and bespoke performance commitments do capture a wide range of outcomes with a public value dimensions—such as preservation of water supply through the leakage ODI. Therefore, beyond the extent to which companies’ existing ODIs overlap with the broader delivery of public value, Ofwat’s framework neither rewards companies that go out of their way to deliver public value, nor penalises companies that neglect public value concerns.

Not only does the regulatory framework limits financial incentives for companies to deliver public value, it may not provide sufficient funding to companies that aim to deliver public value despite the

absence of incentives. Total expenditure is largely determined through a combination of top-down and bottom-up benchmarking between companies, generally based on historical cost data. To some extent, this approach will provide a baseline of funding to deliver public value—as Ofwat states, companies have an extensive history of public service. However, it could also risk underfunding companies through a number of drivers, which may need to be considered.

In determining the role of the price review to encourage and incentivise the delivery of public value, Ofwat should consider how it can use benchmarking and efficiency analysis within its core building blocks approach to incentivise the sector to go above and beyond the historical levels of public goods delivery.

Ofwat should seek to develop a regulatory framework that rewards companies that are leaders in the industry in delivering new public value outputs at an efficient cost, and uses the benchmarks set by these companies to challenge the sector. It may be that Ofwat's current understanding that future delivery of public goods can come without future costs is legitimate. Ofwat could consider using the existing incentive regime for companies to reveal this through their behaviour.

Understanding impact

f) What are the markers of progress on public value, both in the context of enabling culture and outcomes?

A marker of progress and an enabler would be the evolution of the framework, one that recognises the monetary benefits of public value. As stated in our main response we are seeking to develop a proactive framework which will consider not only our traditional approach to planning and benefits but recognise that natural and social capital should be considered in ambitious plans for the long-term. We are also seeking to recognise and value the wider benefits that are associated with delivering Net Zero activities particularly around natural carbon sequestration.

We would also advocate the importance of purpose as an enabler particularly when ensuring the right culture and values exist within a responsible business. We also believe that if purpose is widened to include strategy and not just seen as an important enabler of culture – then by definition – it does and can become more tangible, measurable, as well as a catalyst for transformation change, and sustainable financial value/performance.

g) What role, if any, should Ofwat have in monitoring progress? How else can we, customers and other stakeholders be assured that genuine and meaningful progress continues to be made?

h) Is there anything else Ofwat should be considering in order to meet our objectives on public value?

We are in a unique position that with customer ownership and an independent WaterShare+ Advisory Panel holding us to account over delivery of our business plan. This means our stakeholders can be assured that genuine and meaningful progress continues to be made in delivering wider societal benefits but not at the detriment of the core services.

Companies should be able to tell its own story around how it's delivering additional public value through its purpose. Each company's narrative will be different and should relate to what matters most to its customers. We believe that we must be accountable to the people we serve.