Speech

Given by David Black, Interim Chief Executive
Moody's Water Webinar
Wednesday 6th October 2021

Outlook for PR24 and beyond: Creating value for customers, communities, and the environment

1. Introduction

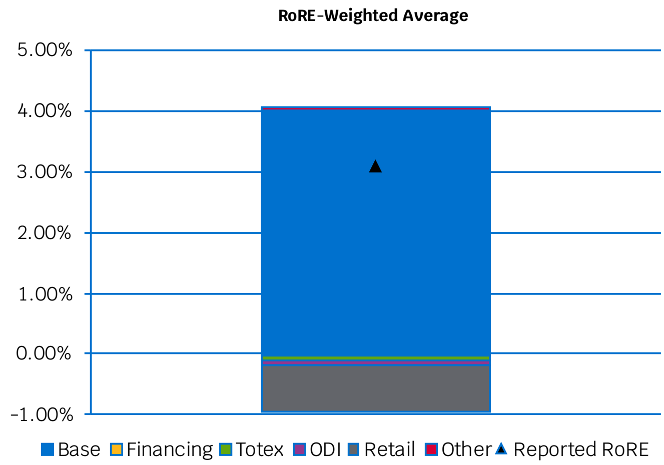
Hello, and thank you for hosting me today – I'm delighted to be able to speak to you today and look forward to discussion later. Today I'd broadly like to talk about three things

- Current sector performance, new investment, and financial resilience
- The challenges and opportunities that lie ahead and what this means for water companies and their investors
- And a look ahead to the future and PR24

2. The first year of the 2020-25 period: sector level returns for 2020/21

The first year of the 2020-25 period: sector level returns for 2020-21

Early view of returns from year one of the new AMP. Key drivers are underperformance on retail costs due to expected bad debts from Covid and low inflation reducing allowed financing costs.



		Weighted average
	Other	0.05%
	Retail	-0.75%
	ODI	-0.08%
	Totex	-0.08%
	Financing	-0.03%
	Base	4.02%
▲	Reported RoRE	3.12%

Data Source: Company APR 2020/21 and submissions, Table 1F Financial flows (Price Base -2017-18 CPIH Average)
Weighted Average by RCV – Regulatory capital values 2021 published 3 June 2021

Improving life through water I Gwella bywyd drwy ddŵr I 2

Before I look ahead, I thought it would be useful to reflect on where we are at the end of year one of new price review period.

It is fair to say these are extraordinary times. It now seems hard to believe that we set final determinations in late 2019 before we knew of Covid or the economic fallout that would follow.

Our 2020-25 price controls set stretching but achievable challenges for cost efficiency and outcomes. It also reset the allowed returns to much lower levels reflecting changes in financial markets. And increased the returns associated with operational performance – better linking returns to investors with performance for customers and the environment.

While there is more for all companies to do in order to deliver high quality services to customers, our early view is that we are seeing companies step up to the challenge. We also see some evidence that companies that made an early start in last AMP are performing well in first year.

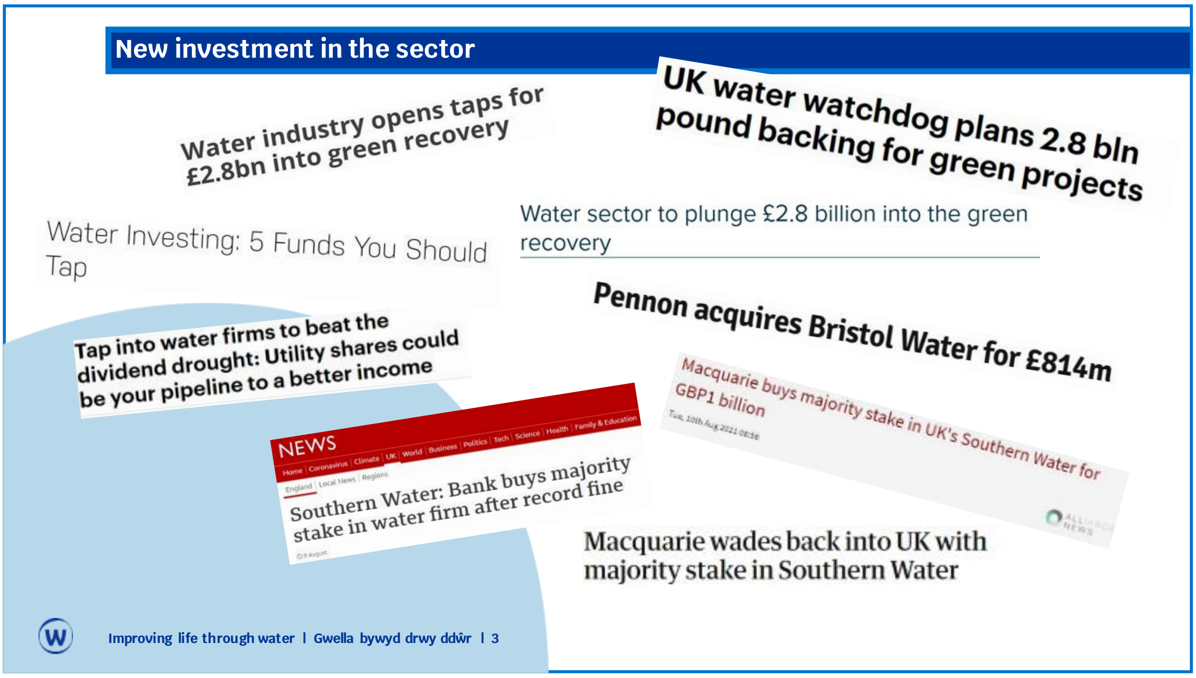
As set out on the slide, the sector as a whole underperformed against base returns on regulated equity of about 4%, with the key drivers of underperformance, the provision for expected bad debt on retail costs and lower inflation reducing the allowed cost of debt. There was very slight underperformance on wholesale totex and outcomes.

It's also becoming clear that the best performers in the sector can earn a premium from driving improvements to services valued by their customers and that poor performers pay a price for letting down their customers. I also think that it is interesting to see a number of companies investing more to improve performance and earn ODI returns – a real culture change in the sector.

Of course, it is very early days in a new price review period and much too early to draw definitive conclusions about the expected outcomes for the whole period, but I see reasons for optimism about companies' abilities to innovate and improve to meet future challenges.

We also set out our expectations that dividend policies should reflect performance delivered to customers. We have seen companies move to align their policies with those expectations. However, further action is required and for avoidance of doubt holding company finance arrangements are not an adequate justification for dividend payments.

3. New investment in the sector



The water sector is a great place to invest – with a strong track record since privatisation. It offers:

- Low risk returns
- Regulatory predictability
- Inflation indexation – of growing importance with increasing risks around inflation

In a world where ESG investing is becoming ever more important, the water sector offers huge opportunities for investors to participate in a sector which is delivering significant environmental and social value – and real opportunities for growth.

It's great to see the sector remains highly attractive to investors in the new price review period with the reset of returns.

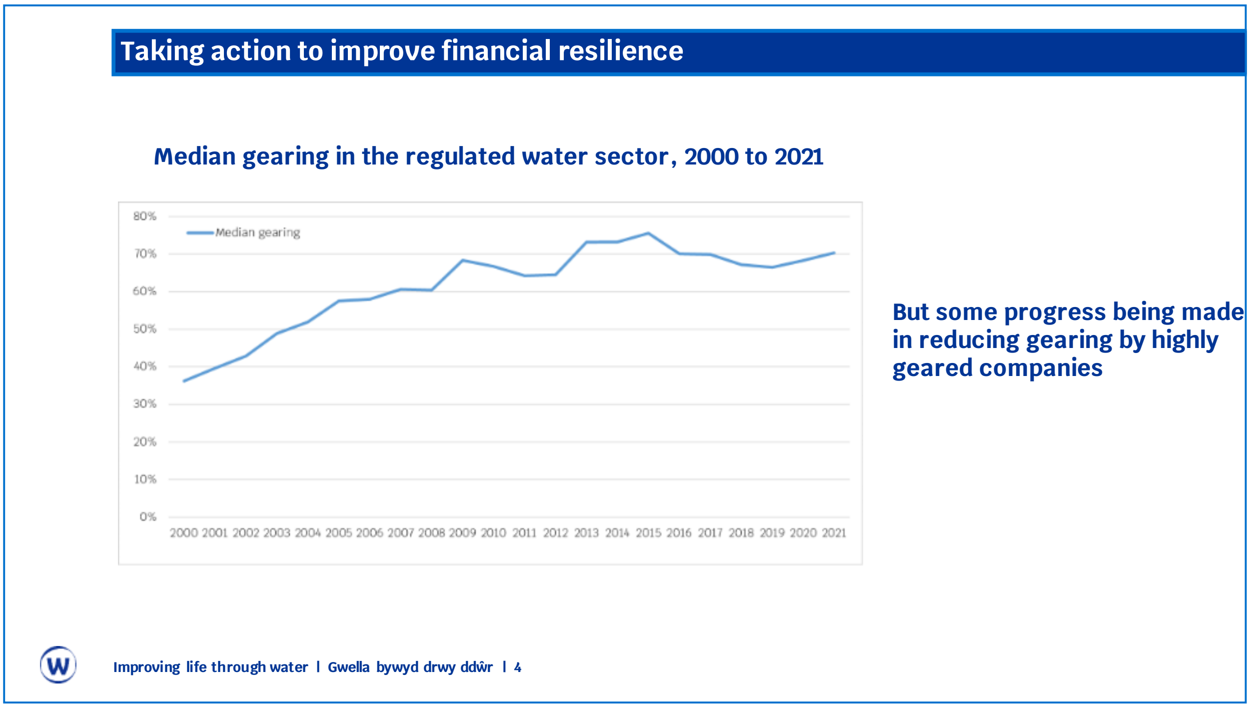
Earlier this year we announced almost £800m of new investment for five companies as part of the green recovery package, along with advancing almost £2bn of statutory WINEP schemes, taking the total investment brought forward to over £2.7bn. As part of funding its green recovery package, Severn Trent raised £250m of new equity.

We are seeing companies raise debt finance including green bonds at attractive rates. And on listed markets, water shares trade at a significant premium to their RCV. We also see significant early investor interest in opportunities to invest in direct procurement schemes.

We have also seen new investment in Southern Water. Southern's performance, as recognised by the company itself, has not been good enough. It has a challenging transformation plan that requires significant new investment by shareholders. Despite the challenges facing the company, there was strong investor appetite to invest in Southern. But investors have to drive the right performance.

The existing shareholders in Southern saw their shareholding significantly diluted, reflecting that persistent poor performance will not just dampen returns but lead to loss of equity value. I think it's right that the regime should only reward those investors who are committed to the long-term success of companies and who hold management to account for delivery for customers and the environment.

4. Taking action to improve financial resilience



Financial resilience – we live in uncertain times, underlined not just by the pandemic, but wider political, technological, economic and social uncertainty and speed of change.

Water companies are providers of essential infrastructure, they must provide services to customers over the long term and under all circumstances. To do so, companies must be financially resilient now, and in the long term –resilient to events and circumstances that are unexpected

Financial resilience is important for investors; it matters for customers and it affects company behaviour.

- The regulatory model rests on the assumption that when things go wrong, companies have the financial resilience to turn around poor performance and the ability to absorb penalties arising from their failings. The record £90million fine we saw this summer as a result of the Environment Agency's prosecution of Southern Water make it clear that these consequences can be financially significant, even for large companies.
- Inadequate financial resilience may lead management to focus on short term cashflows, kicking the can down the road, rather than investing to transform service to customers over the long term.

For some time, we have signalled need for companies to maintain and improve financial resilience and our concern with complex risky structures and equity withdrawal from companies. We have taken number of steps to promote financial resilience:

- enhanced reporting and monitoring regime,
- requirements placed on companies to set out how they will maintain financial resilience in PR19 business plans,
- Long Term Viability Statements in APRs
- updated ring-fence licence arrangements,
- engaging with companies with weaker financial resilience and pushing for changes where this is required.

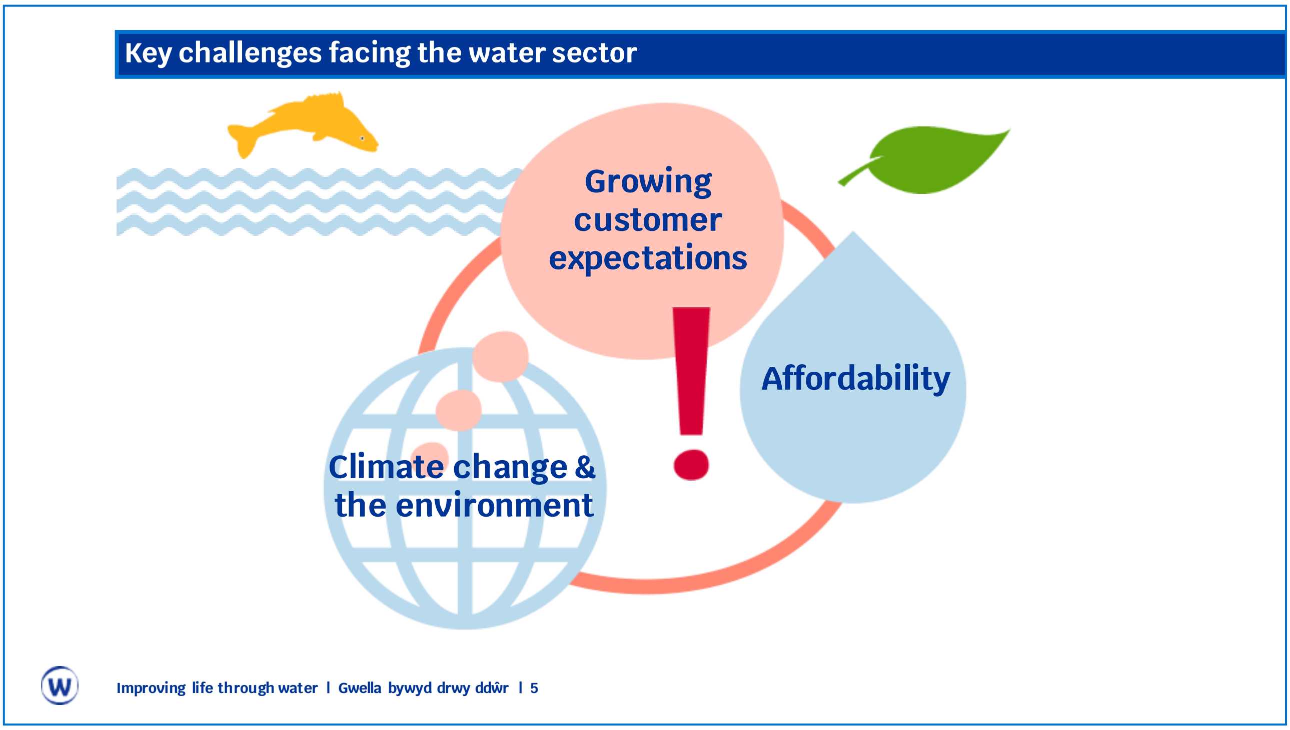
And as set out in the slide, gearing has remained relatively stable over the last five year at around 70%, after doubling between 2000 and 2015. I am pleased that a number of companies have taken steps to simplify their structures and strengthen their balance sheets. But significant concerns remain:

- It cannot be right that some companies flirt with credit ratings that are at the minimum of investment grade – we have always set clear expectation that companies should maintain headroom above this level. What's more customers fund a notional structure with a comfortable equity buffer.
- The use of derivatives to solve short term cash flow issues – but these have the effect of pushing financial resilience problems into the future. This also devalues company financing covenants, which companies have vigorously argued are designed to ensure the companies remain resilient.

Complex, opaque, financial structures call into question companies' commitments to serving the public interest. Why are these structures necessary and whose interest do they reflect? We expect companies to be open and transparent about their financing arrangements – including arrangements about debt structure and dividend policies. We are considering our approach to financial resilience and will publish a discussion document later this year.

We will continue to work closely with companies and their investors where we have concerns with financial resilience to address issues with specific companies.

5. Key challenges facing the water sector



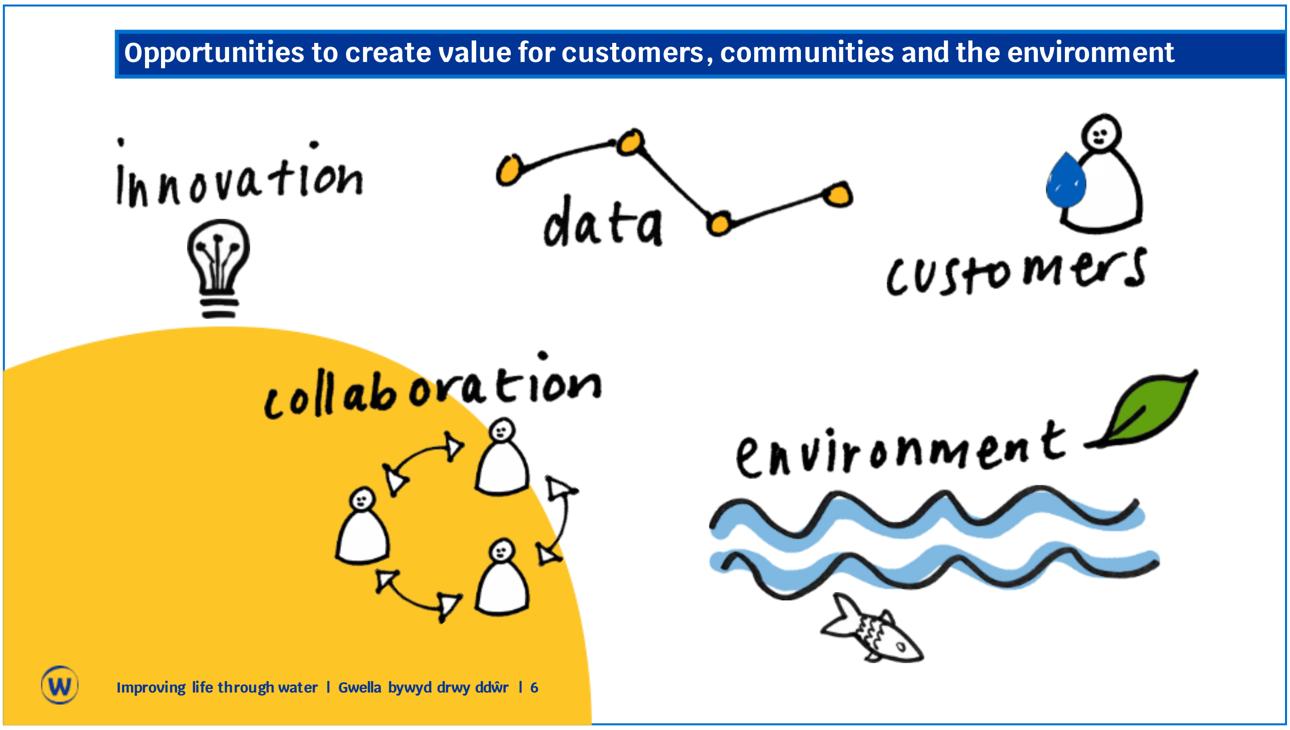
So, what do the main challenges look like for the sector in the coming years. Firstly, the impact of climate change on water and wastewater services and the challenge of transition to net zero. The last decade has seen the wettest winter on record and the warmest year on record. Just last month, we saw flash floods rushing into Tube stations in London and cars sinking underwater in the Black Country.

While many companies have significantly reduced carbon emissions over the last decade, the tough part of the transition to net zero remains. Reducing emissions from wastewater processes requires step change in approach. The sector's ambition for operational carbon emissions by 2030 is welcome, but the challenge of reducing emissions on new capital programmes also need to be addressed.

Secondly, the growing customer expectations around the service companies deliver and how they look after our environment. Every day brings a new story about the state of our rivers. Just 14% of rivers in England are rated as good ecological status. Research is telling us that customers don't just want to hear from water companies when their bill is due, their expectations around service and the role their water company plays in their community, is increasing.

At the same time, Covid-19 has really laid bare the importance of supporting customers who are vulnerable or struggling to pay. Being able to afford life's essentials is becoming more of a problem for millions of people. Over a third of water customers say their finances got worse over the first year of the pandemic. A quarter expect them to get worse in the following year.

6. Opportunities to create value for customer, communities, and the environment



But there are opportunities as well. And this means opportunities for investors too. Water companies have huge potential to create environmental value whether it is the abstraction and management of water flows on rivers or the creation of renewable energy and clean water in their water recycling businesses. Although companies are active in these areas, it feels like we are at the very beginning of realising these opportunities.

The wider political and regulatory landscape is also changing – the exit from the EU and the development of environmental land management schemes (or ELMs) to replace the common agricultural policy, the proposed reforms to the Water Industry National Environmental Programme to a more outcomes based approach and the development of carbon markets all point towards realising catchment based solutions, with water companies well placed to create value.

Catchment based approaches offer huge efficiency and value gains over conventional water treatment solutions. Yet these options remain at the margins. In order for the sector to make transition to net zero and address the challenges of improving rivers, this approach must become mainstream.

Data and artificial intelligence are another value creator for the sector. The rapid development of technology and low-cost sensors enables smarter management of networks and asset health. On the customer side, data will become much more important as smart meters are rolled out and much more intelligent engagement with customers such leakage detection and water efficiency advice.

So, what are we doing to help?

The outcomes approach and ODIs are driving innovation by companies to reduce sewer blockages, pollution incidents and leakage. It's been great to see potential and ambition on my recent company visits.

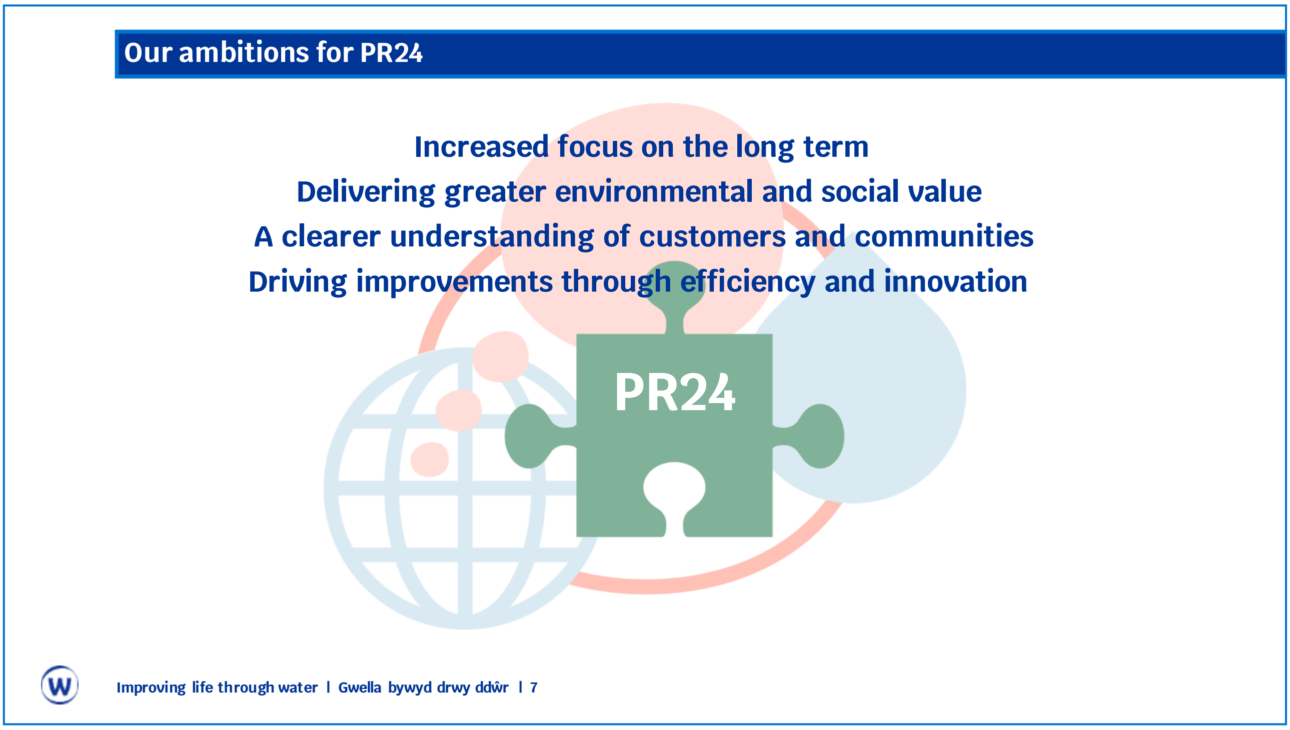
We are promoting the next generation of innovation by our £200m innovation fund, of which the second round of winners was announced last week. The winners include cutting-edge innovations to address challenges facing communities and vulnerable customers – such as preventing leakages and reducing bills – as well as improving the health of our rivers and waterways, and drastically reducing CO_2 emissions.

We will shortly consult on our approach to open data to set how we can help the sector shift towards an open data approach and enable greater use of citizen science. There are real opportunities to be had here and we’re excited to see what improvements can be generated across the sector.

We are working closely with the EA and companies on the reform of the WINEP programme and the storm overflows taskforce. A shift to an outcome-based approach will better enable nature-based solutions and a whole system approach. RAPID, our collaboration with EA and DWI on developing major new water resources makes great progress, with 15 schemes across England and Wales, being developed, with intent to have range of schemes ready to go at PR24.

And new investment opportunities in strategic water infrastructure will not be limited to water companies. Building on the success with Thames Tideway, we have three DPC schemes being developed and further to come at PR24.

7. Our ambitions for PR24



It is still early days in the development of PR24, we have set out a consultation document and thanks to all who have engaged and responded on this. There are four key points about our approach to PR24.

First, we want an increased focus on the long term. Five-year price reviews should be staging posts in a long-term trajectory for water companies. They will need to set out long-term strategies, how they will work towards them and how they reflect customer and community preferences

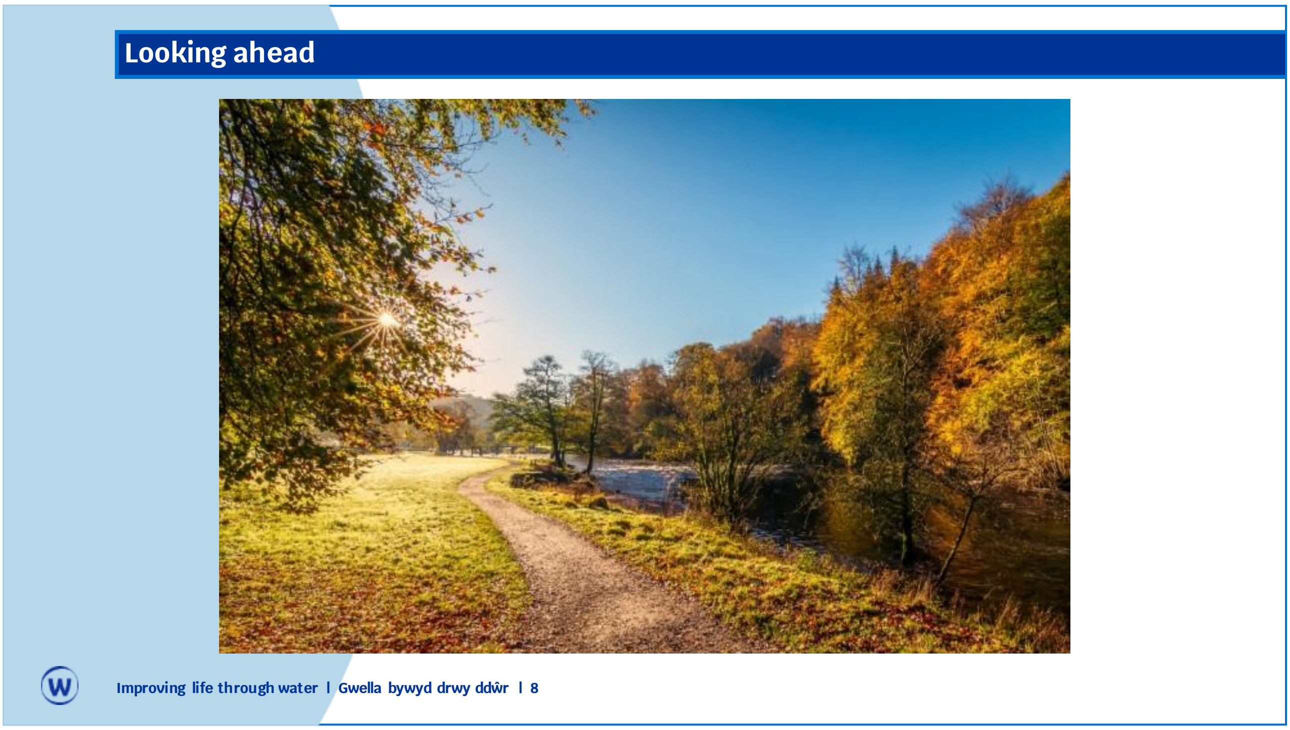
Second, companies can deliver greater environmental and social value. That means choosing nature-based over conventional solutions where they're the best option. It means helping companies realise the potential of working with third parties and optimising how schemes are delivered to meet wider environmental outcomes like net zero.

Third, customers and communities are at the heart of the company activities and the price review. We want to make customer input more meaningful, so it can be better reflected in our determinations. We think this can be achieved through a more targeted, collaborative approach to capturing customer views, to complement companies' own engagement. For the avoidance of doubt, this is not a one sized fits all approach, but ensuring there is robust evidence to support differentiation and tailoring of incentives across companies.

And fourth, companies must step up their productivity, increase innovation and improve efficiency: whether embracing data, using markets, or taking in learnings from across the industry. And when we talk about improving efficiency, we're thinking of creating the space to do more for customers and the environment, as well as operational improvements inside a company.

This is underlined by the likelihood that for many companies the challenge to improve environmental outcomes and transition to net zero could increase costs. While the benefits in the last two price reviews of significant reductions in allowed returns is likely to fade. It is still too early in my view to forecast the allowed return at PR24, although I am aware that Stefanie will shortly set out a range of scenarios. But it seems most unlikely that the 180bps reduction in real RPI terms at PR19 could be replicated and the transition to CPIH indexation will put upward pressure on allowed returns. All of this may mean that at least some customers face bill increases in real term, before any allowance for high inflation, add further to customer pain.

8. Looking ahead



And so, what does this all add up to? What does it mean for investors?

Firstly, there are real opportunities for growth and value creation along with a very attractive environment for investors with inflation indexation and high regulatory certainty. But in order to succeed, companies need to meet and exceed the rising expectations of customers and society.

Secondly, the affordability and acceptability of business plans and the impact on customers who may also be facing rising energy and transport costs will become much more important at PR24. This underlines the importance of companies driving real improvements in value for customers and the environment.

It will also raise the importance of public perceptions of companies and their ability to demonstrate they are acting in the public interest. And this also means that public trust influencers such as dividend policies and executive remuneration are likely to become more rather than less important over the next few years.

As at PR19, companies that seize the initiative, taking early steps to unlock and create greater value for customers, communities and the environment, that anticipate risk and bolster their operational and financial resilience and can demonstrate that their financial structures, dividend policies and executive remuneration are aligned to customers' interest will flourish. And companies that are insular and lag behind in facing these challenges are likely to find the going tough and their investors too.

The sector can take pride in its response to Covid, it faces a future rich in opportunity, but also challenge. We look forward to playing our part in creating a regulatory environment which recognises and rewards companies to take advantage of the opportunities and address the challenges.