Speech

Given by David Black, Chief Executive
Infrastructure Investor Forum: Europe 2022
Thursday 12 May 2022

PR24: Our expectations for companies and investors

Good morning. Thank you for welcoming me to the Forum, a real privilege to be here.

Let me begin by making a fundamental observation - that the water sector has been an attractive place to invest and will remain so for responsible, long-term investors. While I have not worked in an investment business, it seems to me that in a world seeking ESG investment opportunities the water sector in England and Wales has some major advantages - low risk, gold standard regulatory regime, inflation protected returns in businesses that have real scope to create value – for customers, the environment, society, and shareholders. I will be interested to understand how you and your institutions see these opportunities and how they compare with and fit into your wider portfolios of investments.

As a regulator, I aim to set the regulatory framework to encourage the sector to maximise the value it creates for customers and the environment.

I use the term value not cost – value is the benefits that customers perceive from the service not what they pay for it. Maximising the value created by water companies enables them to better serve customers, protect the environment and enable investors to enjoy reasonable returns. Value for customers means better service and affordable bills, value for the environment includes cleaner rivers and seas. If we maximise the value or cake if you prefer, we can then decide how the value should be appropriated in a way that is beneficial, fair and is supported by stakeholders and public.

In reality the sector and its investors do not command public confidence – in fact we face challenging times. with high levels of public dismay at the environmental performance of the companies. And we need to address these concerns at the same time that customers face a cost-of-living crisis.

I am optimistic that companies can raise to the challenge. It requires investment that will pay off over the long term, innovation and new business models, and tighter operational performance, including better utilisation of the assets for which customers have paid.

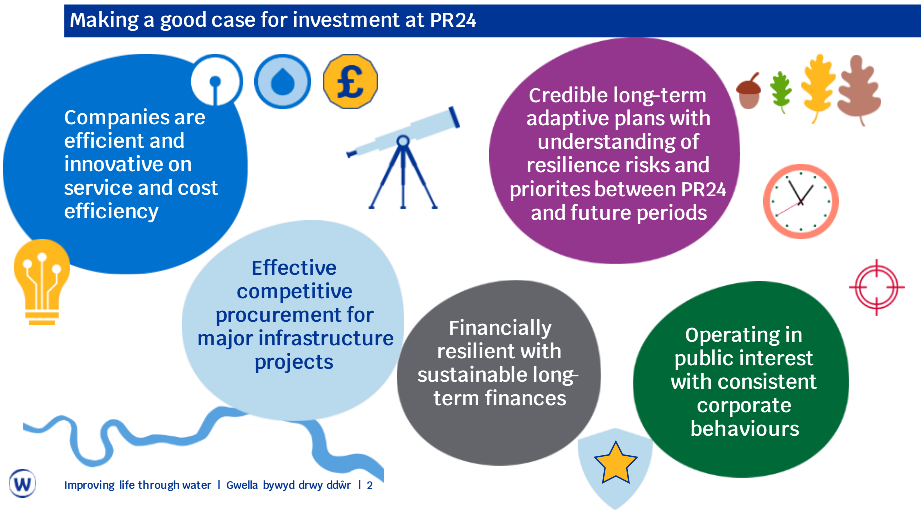
This is unlikely to happen without action to improve and maintain the credibility of the sector and its legitimacy in the eyes of customers, stakeholders, and the public.

I now want to set out our expectations of companies at PR24 and discuss what they mean for investors and the positioning of the sector.

Companies may be making cases for increased investment to address environmental and resilience challenges. I want to be clear that we do not start from a pre-determined view as to whether customer bills should go up or down. In real terms, water bills are up over 60% since privatisation and much more taking account of inflation, although they have fallen before taking account of inflation in the last two price reviews.

In order to support case for investment at PR24, Ofwat will be looking for:

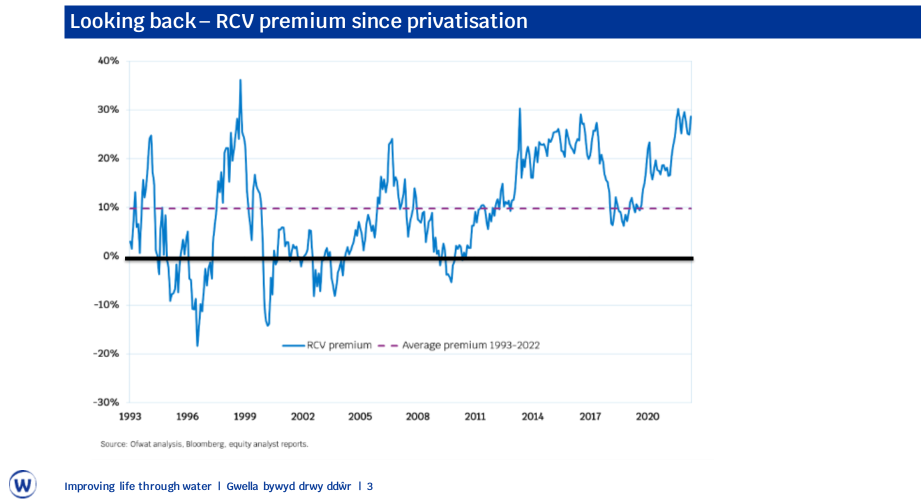
- Companies that are efficient and innovative – driving the frontier forward on service and cost efficiency.
- Effective use of competitive procurement for major infrastructure projects
- Companies have credible long term adaptive plans with clear understanding of risks to resilience and priorities for their investment between PR24 and future periods
- Companies are financially resilient and are financed for the long term
- Companies that demonstrate they are operating in the public interest and that their corporate behaviours are consistent with serving the interests of customers and the public.



Investors have enjoyed attractive low risk returns from the sector

The water sector has strong investment fundamentals

- Low demand risk as water an essential service provided by regional monopolies meaning that investors are protected against the economic cycle
- Inflation protection of returns and the RCV – something of huge value in the current environment.
- Gold standard regulatory regime with high degree of regulatory predictability and transparency
- Significant growth opportunities



Investors have enjoyed attractive returns over the period since privatisation, with the chart showing a premium to the value of the regulatory capital value (RCV) of listed water companies for most of the period since privatisation with significant increase in recent years, despite falling allowed returns at recent price reviews. These values are also reflected in the premium paid in private transactions, with a recent example being the acquisition of Bristol Water by Pennon, at a 44% premium to RCV.

There has been a significant increase in investment since privatisation, with the level of the RCV increasing roughly four-fold, reflecting significant investment to enhance service as well as maintain the existing asset base. And while the sector can point to a number of achievements and improvements in service and the environment, there is clearly significant work still to do.

Looking ahead the sector faces a number of challenges:

- The environment – the controversy over sewer discharges into rivers highlights that only 14% of rivers achieve good ecological status. While the water sector is only one of the causes for rivers not being at good ecological status, the excessive use of storm overflows has raised issues around whether companies can be trusted by customers to do what is right.
- Improving resilience – the impacts of climate change will accentuate need to improve drought resilience and to ensure wastewater systems can handle heavier rainfalls. Droughts will happen – the only question is when and how severe. And how well companies are prepared.
- Transition to net zero will require the sector to reduce greenhouse gas emissions, with English water companies committing to net zero on operational emissions by 2030.
- Getting the basics right – customer service expectations are rising. In too many cases, we still see elementary failings in companies getting the basics right. There were over 100,000 customer complaints about poor service from water companies last year and this number is rising not falling. Our recent research with CCW on customer experience with sewer flooding found that all companies were treating customers poorly.
- Affordability – general inflation and the escalation of energy bills is resulting in the largest fall in real disposable incomes ever recorded - and energy bills are expected to increase further by 30% to 50% in October.

These are the challenges companies will be seeking to address in their PR24 business plans. We will set out our draft methodology for PR24 in July, however, we have published a number of consultations already which indicate our expectations of companies.

We seek to align interests of companies and their investors with the best interests of customers by ensuring strong incentives on operational performance as part of our outcome-based regimes. Where companies go above and beyond their performance commitment levels, they earn higher returns, where they fall short, returns are reduced.

I want to touch on five key areas that can help companies to successful outcome at PR24 and role investors can play.

Companies are efficient and innovative – driving the fronter forward on service and cost efficiency.

Improving efficiency and productivity is a core expectation for privatised water companies. However, the low hanging fruit of reducing operational costs following privatisation is long gone. In order to improve service and operational performance, companies must innovate and find new ways to deliver to unlock value.

At PR19, we set companies performance improvements such as 40% reduction in supply interruptions and sewer flooding over the PR19 period, based on historical rates of improvements.

Improving environmental outcomes is an area ripe for innovation and improvement. The historical approach has been detailed prescriptive plans set by environmental regulators. We worked with the Environment Agency to reform the approach for PR24. Taking outcomes and catchment-based approaches can help prevent problems such as excess rainwater entering sewers rather than relying on end of pipe solutions.

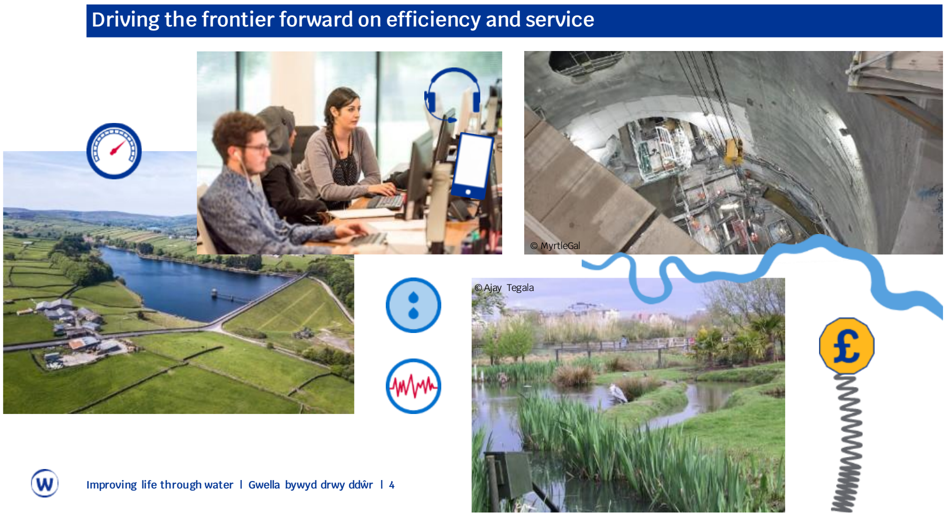
For example, as part of the green recovery, Severn Trent are investing £80m in Mansfield with co-funding from the local council to install large scale Sustainable Drainage Systems to prevent water entering the sewers. SuDs include rain gardens, permeable paving, planters, and swales, with more than 20,000 of them to be installed across Mansfield. They work by diverting surface water away from sewers, slowing it down and helping our drains to cope.

Nature-based solutions such as the use of reed beds to treat water also provide low carbon and biodiversity benefits.

Smart networks and systems offer huge scope to get more from existing assets and prevent problems before they adversely impact on customers and the environment.

Working with customers to adjust behaviour could reduce sewer blockages and demand for water. The average person uses 152 litres of water a day with consumption rising rather than falling in recent years. We need to see a large-scale consumer behavioural shift to reduce water use to 110 litres per day by 2050 to meet Government targets and to protect precious water supplies.

So, the question for investors is how far along are companies on the innovation and change curve? Companies that already lag behind on their current performance will face an even bigger challenge at PR24.



Effective use of competitive procurement for major infrastructure projects

A new opportunity for investors to enter the sector is competitive procurement for large infrastructure projects. This enables competition to provide finance and construct new infrastructure. A great example is the £4.6 billion Thames Tideway Tunnel which will improve the capacity of London's sewerage system and reduce the number polluting discharges that spill into the River Thames by over 90%. United Utilities will shortly begin procurement for the Haweswater Aqueduct Project, a 110km pipeline between the Lakes district and Manchester.

RAPID (our alliance with EA and DWI) is working with water companies to develop 18 strategic water resources solutions, including reservoirs, water transfers and recycling schemes to provide options to improve drought resilience at PR24. These are also likely to be procured by competitive procurement processes.

Companies have credible long term adaptive plans with clear understanding of risks to resilience and priorities for their investment between PR24 and future periods

A key focus for PR24 is on the long term. Water companies need to look well beyond the 5-year price review period and anticipate and prepare for long term challenges in an uncertain world. They need to have a clear Long Term Delivery Strategy which employs adaptive planning techniques, identifies no regrets investment, and develops options to meet future challenges.

The regulatory regime already provides strong commitment to future cost recovery by the RCV, we will look at how we can better reflect the expected benefit to customers and the environment in future periods from new investment at PR24.

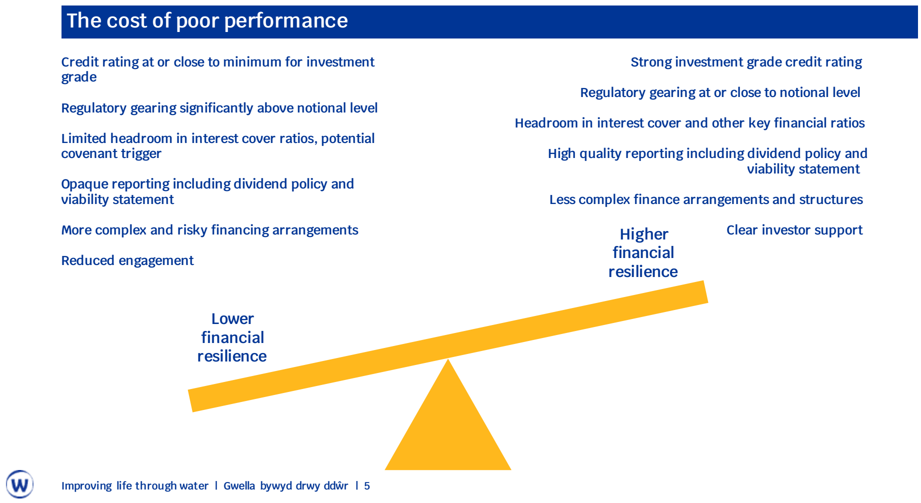
Companies are financially resilient and are financed for the long term

To meet the challenges of the future, companies will need to be financed on a sound long term basis, with structures that are able to finance new investment. They also require good levels of resilience to handle operational performance risks in a regulatory regime with strong and increasing levels of returns linked to good operational performance.

The importance of sufficient financial resilience has been underlined by the experience of Southern and Thames, who have incurred packages of penalties worth about a quarter of a billion over recent years.

In the case of Southern Water, the penalties for poor operational performance and financing decisions resulted in need for injection of £1bn of equity in the business, with the existing owners losing much of the value of their equity investment in the company. A salutary lesson for investors on the importance of good operational performance for returns and their investment value.

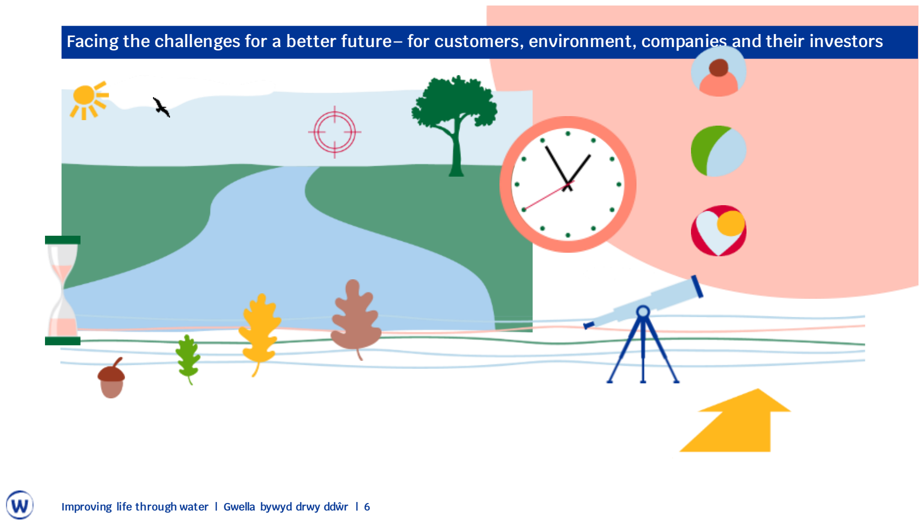
We remain concerned about poor financial resilience of several water companies struggling with high gearing and risky structures. Last year, we set out a discussion paper with proposals to raise the investment grade requirements for cash lock up and strengthen the requirements on companies to align dividends to operational performance. We will further consult on our proposals over summer.



Companies that demonstrate they are operating in the public interest and that their corporate behaviours are consistent with serving the interests of customers and the public

Water companies exist to provide essential clean water and wastewater services with significant potential impacts on communities, the environment and public health. Customers and the public expect companies to do the right thing. Public scrutiny of the sector may be occasional and judged on a limited number of actions – but when the sector is at the centre of attention it needs to clearly demonstrate that it is acting in the public interest.

It is not what the sector says it is doing or even external accreditation of its virtue, but ultimately the way that companies act that matters. This includes company dividend policies and executive pay. Customers need to be confident that water bills are going to be used to fund environmental improvements and better service and not be siphoned off for the benefit of management or investors.



Water companies face challenging times with strong expectations to improve their environmental performance along with helping customers who face a sharp fall in real incomes. Addressing the environmental challenges will require substantial investment – but that's the easy part. It'll also require the large-scale deployment of innovative solutions, strong operational performance and much greater engagement with customers and catchment partners.

As a regulator, we value the contributions that long term responsible investors can make to the sector, we are expecting investors to help drive high performance companies and responsible long stewardship of assets and the environment. And I also want to be clear we don't welcome short term investors focused on cash returns or those seeking to make gains from risky financing structures. The sector provides significant growth opportunities in a low-risk regulatory environment – and in return seeks responsible investors who can help add value to the sector.

Thank you