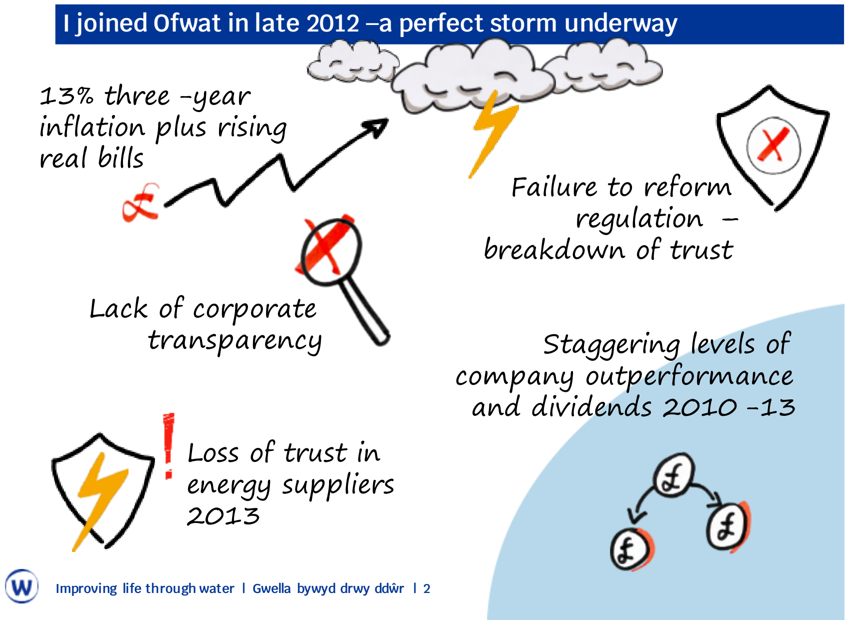
Speech

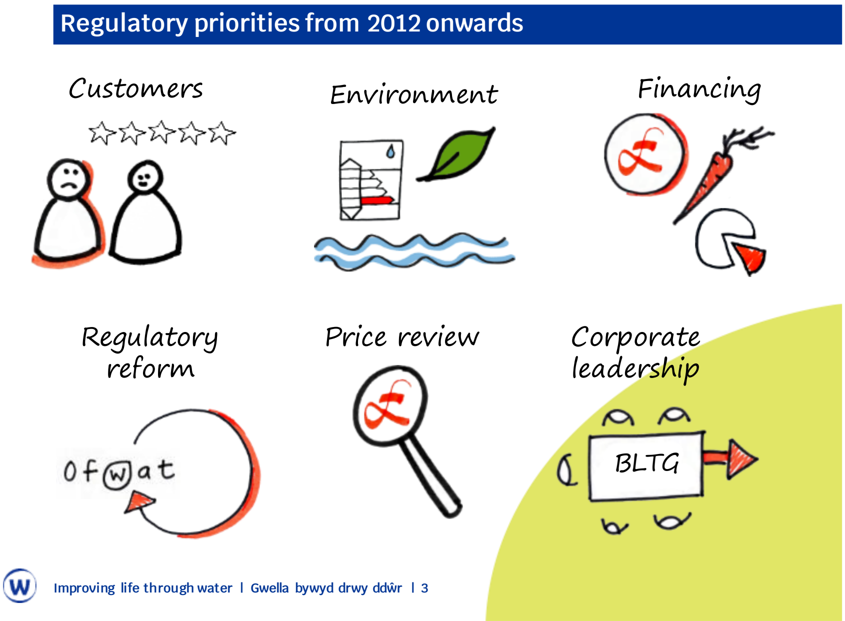
Given by Jonson Cox CBE, Chair
Westminster Energy, Environment, and Transport Forum – Priorities for water management
Tuesday 19 April 2022

Context and priorities for water companies in meeting the expectations of customers, infrastructure, resilience, and environmental performance

We all know the very large environmental priorities that water companies need to meet. My job as chair of the independent water regulator today is to set out the context for water companies to deliver what customers and society expect. I am delighted Anne is in chair today – she chaired my pre appointment hearing with the EFRA Select Committee nearly ten years ago.



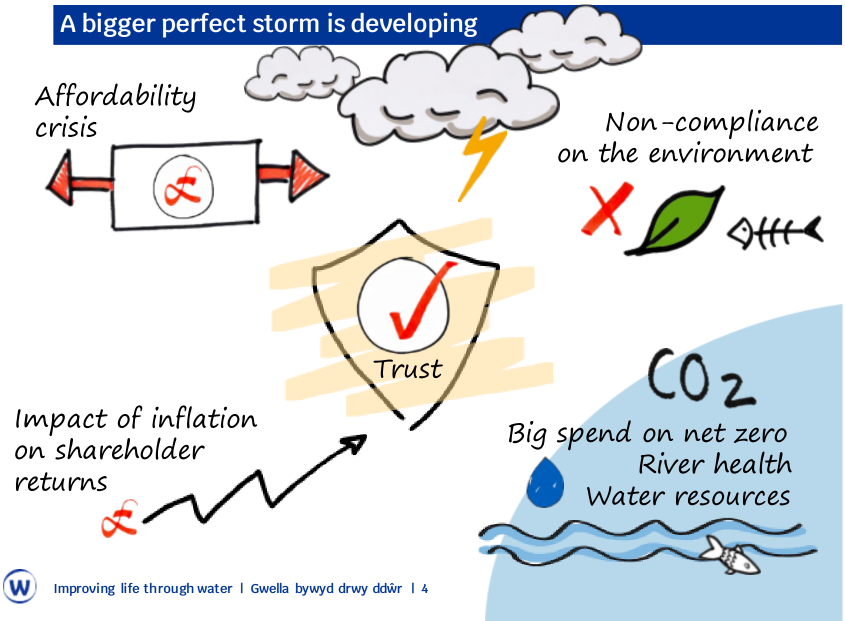
I joined Ofwat in late 2012. In a perfect storm of its kind. Big calls for post-recession infra spend. Inflation was running at cumulatively 15% over three years, staggering financial outperformance from a generous PR09 settlement, dividends running at a rate where some companies would repay their full equity value in 5 to 7 years (regulatory assumption more like 15 years) and there was a breakdown of trust between regulator and regulated.



I set out in 2013 six regulatory priorities. The good news was that we and the sector have been able to move performance forward. Initiatives like ODIs and PCs have shown what can be done on operating performance if incentives are there. Water resources are being tackled through RAPID and by our 15% target to cut leakage – half of the 2025 target delivered in one year. We have seen new equity coming into the sector since 2019, engagement in the design of the price review is better than it was 10 years ago, and board leadership is much improved.

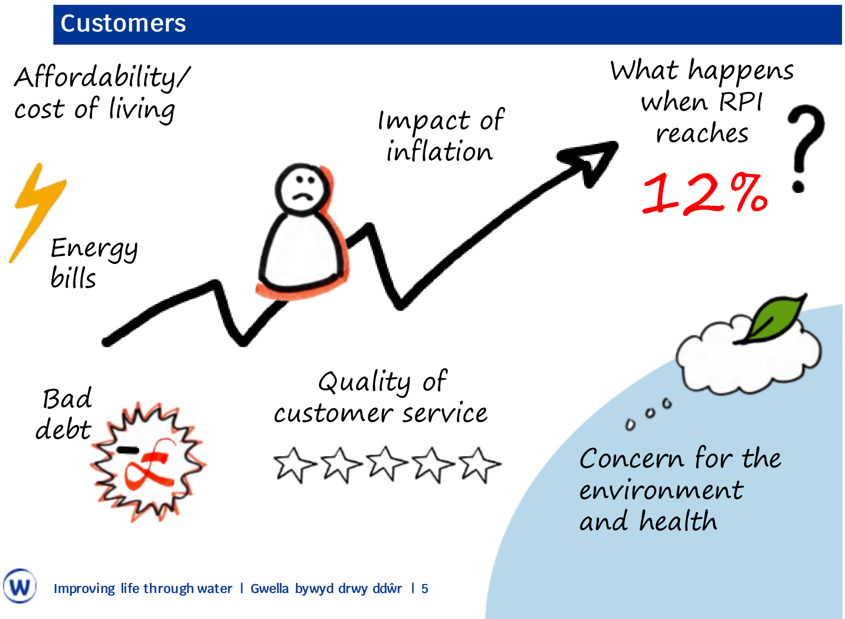
Overall, there has been good progress in getting the sector focussed back to its true job of operating the business, rather than thinking simply about RCV and financial assets.

I refer you to a speech I gave last week to water company boards on how the past might inform the future.



Today, a bigger perfect storm is developing. There are four elements converging.

I barely need to mention the impact of inflation and declining real incomes; that overall, company compliance with environmental objectives is far from acceptable; that we have major environmental challenges coming at us (net zero, river health and water resources);



and that inflation, while generating the cost-of-living crisis, is flattering shareholder returns, which in turn will call into question the legitimacy of the sector.

Let's think first about customers. Our service and performance report for the last year for the sector has some good news: the continuity of service during Covid; companies rising to our leakage challenge; some companies showing that targets for 2025 are achievable and for the first time, spending at or above the wholesale cost allowances, partly to deliver good outcomes.

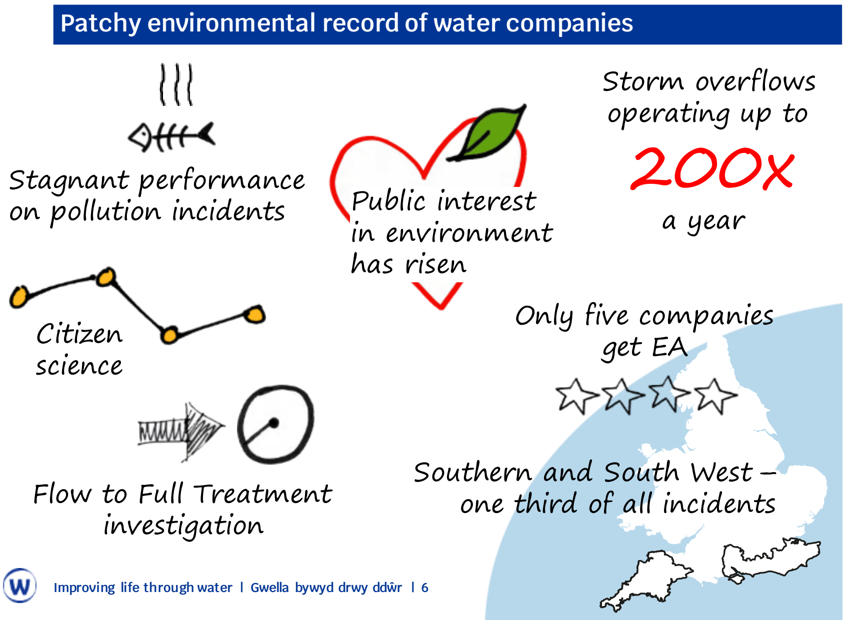
But it is not uniform. Three companies lead the sector operationally. A number of other companies lag behind the rest the sector, achieving only a small proportion of key outcomes.

It's not so much the impact of inflation on water bills that worries me - Ofwat struck a good balance in PR19 and prices remained affordable. What worries me is what's happening to energy bills – think about the price cap in October 2021, at £1200, and potentially reaching around £3000 in October 2022. This will plunge many households into fuel poverty. Add to that all the other inflationary pressures on customers.

We know that advice to households struggling to pay may include that the water company can't cut you off, so that can be the first bill that you don't pay – with limited immediate impunity.

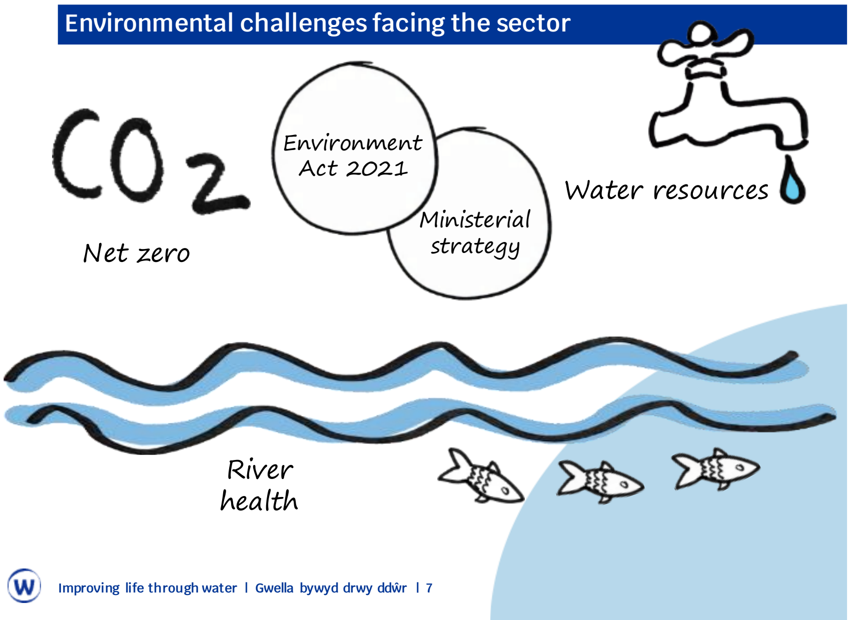
As an aside, I had just taken over running a water company in the late 90s when the sector lost the right to disconnect for non-payment - and it was straightforwardly and simply a political reaction to a big supply incident in another part of the country and an industry that had lost legitimacy.

And that brings us to the increased public concern for the environment and health that we have seen increase so rapidly during the pandemic and the strong public concern that water companies are not in compliance.



The companies that follow me today may not like me describing the sector's environmental record as patchy. Let's look at this evidence, we have:

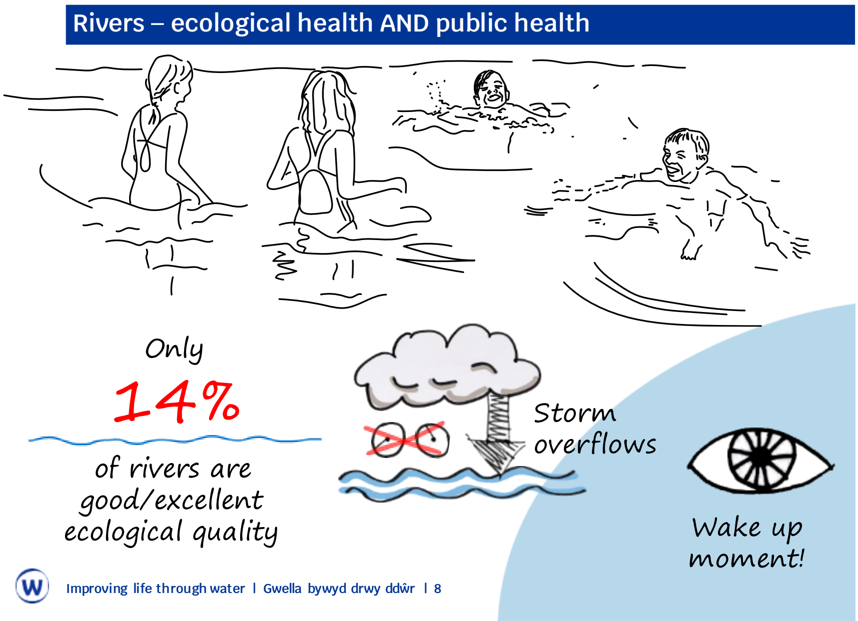
- a stagnant performance on pollution incidents.
- the impact of storm overflows - some of which are said to operate up to 200 times a year (and the clue to what they should do is in the word "storm").
- only five English wastewater companies got a four-star rating from the Environment Agency in a sector that should be the gold standard for environmental compliance.
- two companies cause one third of all pollution incidents.
- the remarkable rise of "Citizen Science" which in my mind highlights what can be achieved with transparency and open data in holding the sector to account.
- Ofwat's Flow to Full Treatment Investigation – We expect companies to use all available information including flow meters, monitors and operational checks to ensure they are in FFT compliance. we have found potential non-compliance right across the sector, less than acceptable plans to rectify the problem urgently from some companies, and complacency in the way some companies initially responded to our investigation.



Others will talk about the challenges facing the sector. I have four on this slide. The requirements of:

- Net zero - where I applaud the industry's self-imposed target of halving operational emissions by 2030 (we only have 7 ½ years to go) and if I look at Government targets the sector may need to be at 75% reduction of all emissions by 2035
- The Environment Act 2021 and recent ministerial strategy on storm overflows
- The need for cross-company water resources. The RAPID partnership formed by Ofwat, the Drinking Water Inspectorate, and Environment Agency already have 18 cross company schemes under active development.

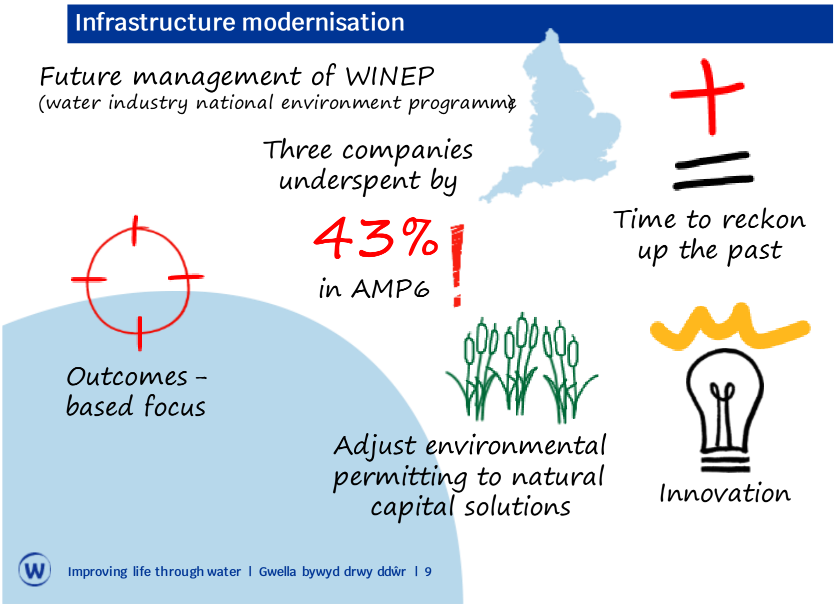
- The issue of river health referred to above



I want to pause on river health. Shockingly, only 14% of rivers in England are of good/excellent environmental quality – that really is a wakeup call on performance of the last 30 years.

We have one designated inland bathing water area, with another on the way; France has 500. I know full well that on environmental criteria, the large majority of pollution is caused in broadly equal measure by water companies and by agriculture, with residual amounts caused by road run-off and other causes.

But those who were at my meeting with water company board members last week will have heard the concerns around public health and rivers. The public health point of view is that children always have and always will play in rivers; that we've seen an explosion of use of rivers for public recreation; that people using rivers will be at risk of ingesting faecal coliforms coming from storm overflows and normal discharges from wastewater treatment works. That this just isn't acceptable in the 21st century.

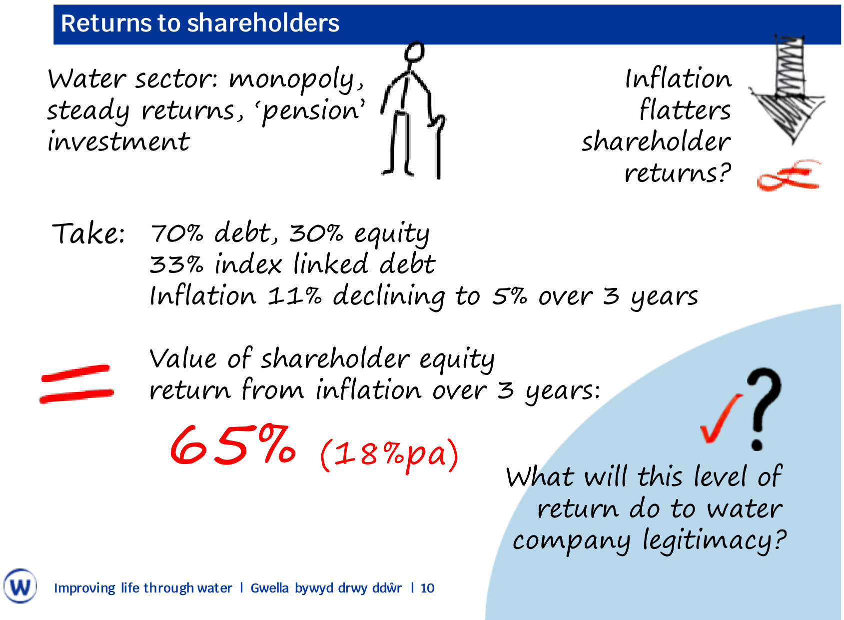


I am worried about infrastructure in general. There are great examples of where Ofwat has funded and companies have implemented major upgrades to infrastructure. There remain instances of inadequately maintained or resilient infrastructure in the sector, 30 years on from privatisation. I have seen examples of this recently so it's fresh in my mind. In one case, we gave the company more than it asked for and pioneer gated payments. I am very glad we did.

But for today I want to focus on WINEP – the programme of environmental improvement scoped and defined by the EA and funded by Ofwat. We need improvement here. In our extensive CMA hearings last year, a published figure was that the three wastewater companies had underspent their AMP 6 WINEP collectively by 43%. That beggar's belief.

I don't give the number to pick on the appellant companies – others might be as bad. And before following speakers criticise me for using this shocking number, I have several times asked Water UK what number would be more representative of sector performance. They and their members have not answered me on this – but assure me that current performance in AMP7 will be much better. I do hope so.

We do need innovation in WINEP: we need well performing, trusted companies to be able to adopt a much greater outcomes-based approach; we need to think about adjusting environmental permitting to reflect the very different characteristics of commissioning natural capital solutions rather than conventional process-based solutions; we need to ensure that all WINEP commitments are delivered with value for money.



I've been quite shocked by taking a very simplistic look at what high levels of inflation are going to do to returns to shareholders in the water industry. Companies are going to have to think about this as they push for large investment and increasing bills, while maintaining customer support. We know the sector has a monopoly, offers steady index-linked returns and dividends as a secure pension fund investment. Companies are valued by their asset base, RCV, and inflation flatters the equity value.

For this slide, I've taken from a very simplified model one of my colleagues developed, three simple assumptions: 70 Debt/30 equity structure, 33% indexed linked debt and composite RPI/CPIH inflation this November, at 11% declining to 5% over three years.

In that simplified view, the 3-year return on starting shareholder equity is 65% – a compound annual return of 18%.

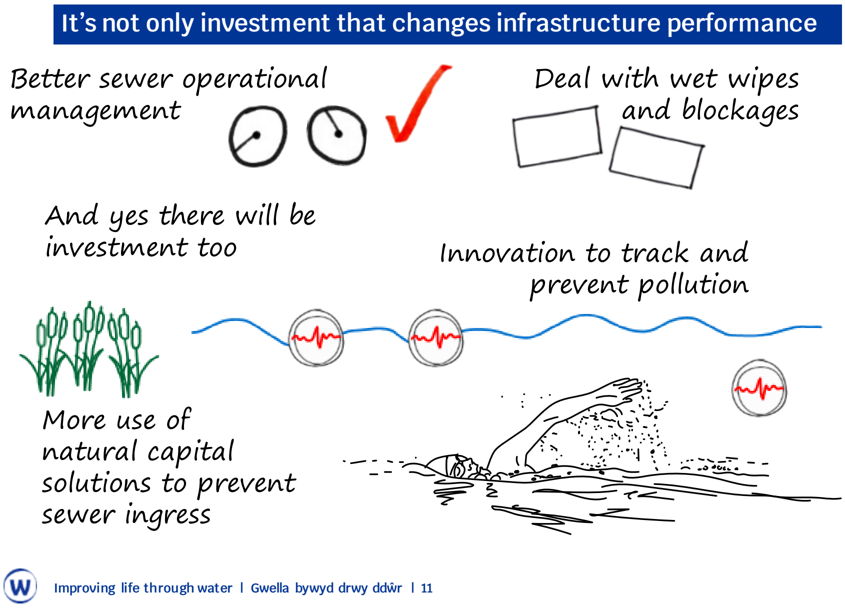
Just as we have "Citizen Science", I'm sure we will have "Citizen Finance".

Companies should think about how they will present and justify this level of return simply from inflation, in the context of their legitimacy with hard-pressed customers. I'm sure many much more financially qualified than me in the audience will take on the detail of the assumptions but I believe the stark simple point stands.

And if we are to ramp up the level of investment, we need companies that were taken private, and in doing so geared up their capital structures, to rebuild appropriate financial resilience.

We need a reality check by companies who push back on the relatively modest proposals on financial resilience we published recently, following our intervention on Southern, which Moody's characterised as a shadow special administration and brought £1bn into the Southern Group. Customers would think financial resilience unarguable (e.g., that licences should reflect that bonus payments should take account of performance or that no monopoly water company should be flirting with junk credit status).

The public mood in the middle of a cost of living crisis is not positive on the behaviour of privately run utilities. Companies refusing to commit to accept reasonable financial resilience standards for a public service provider should review their position. To object just adds fuel to the fire.



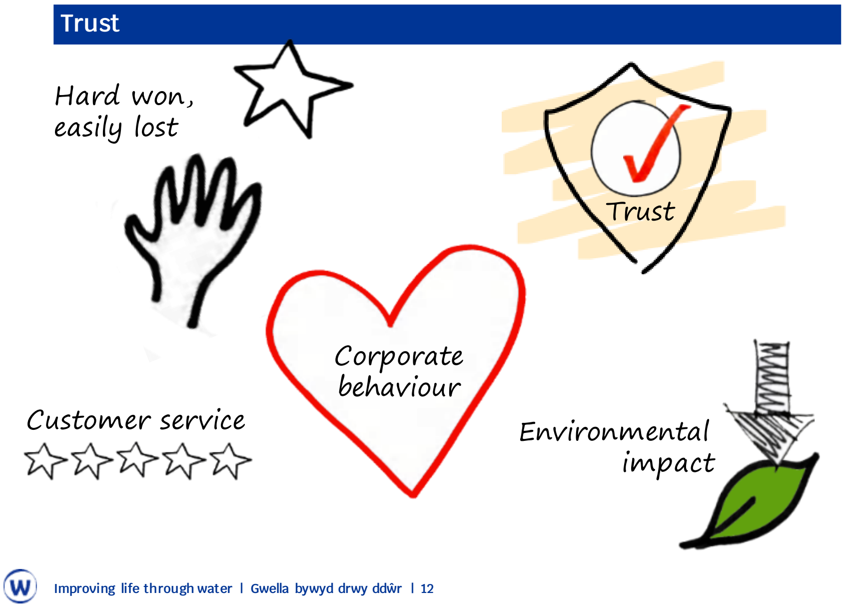
I also want to say it's not only investment. Take the example of the public harm from faecal coliforms in rivers.

Part of this is reducing use of storm overflows. Are sewers not the least well managed of all the utility infrastructure networks, in terms of intelligent management? Blockages themselves cause overflows. We know we have the serious problem of wet wipes and fats and oils congealing to form blockages - and yet we still do not have a co-ordinated and effective campaign from the water sector to get manufacturers to make wet wipes biodegradable and have one common national-scale approach from the water sector to change customer behaviour. If it were my call, I'd change the trade association from a more inward-looking lobby group to a public focussed national voice on helping customers change behaviour.

We have the opportunity of innovation. I saw an exciting innovation at Wessex, whereby use of upstream monitoring in the catchment, the real-time hazard to bathing at a particular spot on the river could be predicted with 92% certainty – I thought that was pretty good. We should see more of that.

An awful lot of the excess flows to sewers are created by ingress that should never be getting in the sewer in the first place. We should see more use of natural capital solutions to slow the rate of run-off, from highways or from other built-up areas in sewers

And yes, there will be investment too.



To finish, I comeback to a mantra I have talked about many times: trust is required, and once it is gone, companies are on thin ice.

To earn that trust, companies must deliver outstanding service, demonstrate impeccable corporate behaviour, show they are acting responsibly financially, and care for our environment. But more than that: they must do these things willingly, proactively, enthusiastically. Getting dragged there by regulators, politicians or the press isn't enough. To have the trust of the public they serve, they must lead from the front.