Speech

Keynote speech by Andrew Chesworth
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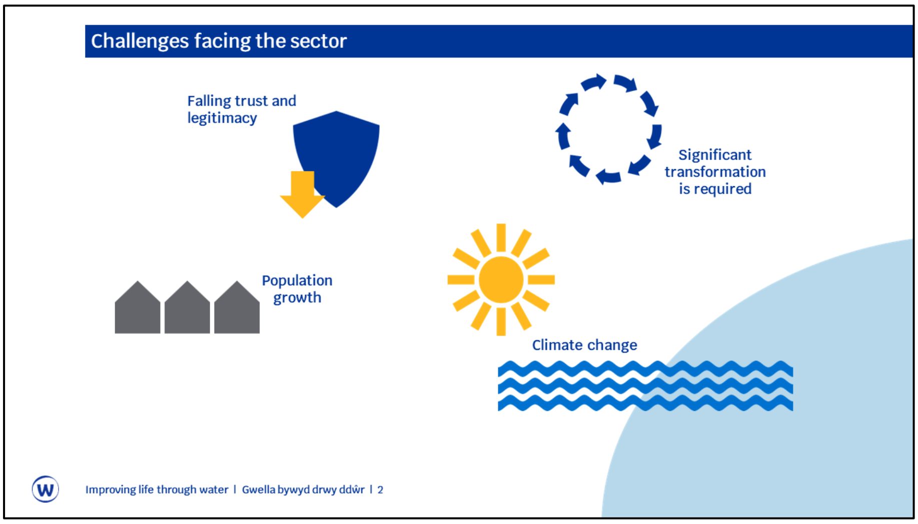
Challenges and opportunities for the UK's water sector

Introduction

Good afternoon. Thank you to Infralogic for inviting me along to speak to you all today.

I want to talk about some of the challenges faced by the water sector, about the opportunities for investors in the next regulatory period (and beyond) and about the next steps in the PR24 price review. This follows on from the submission of company business plans last week.

Challenges facing the sector

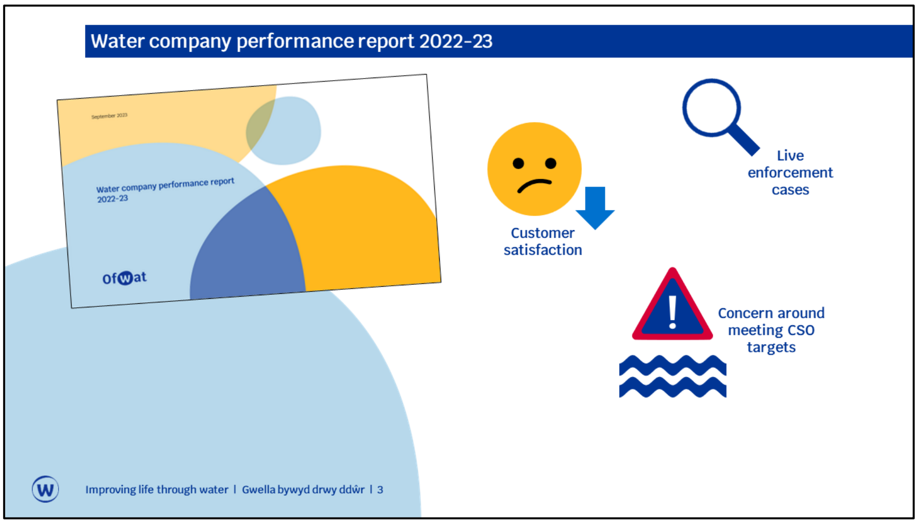


But first, I want to briefly discuss the challenges facing the sector. Right now there is significant public, media and political attention.

There is public concern and anger over sewage discharges and the poor state of rivers. There is concern over drought resilience in light of hosepipe bans in the last two summers and the supply outages due to hot weather. There is also concern over the weak financial position of some companies and concern over dividends and levels of exec pay which appear out of step with company performance.

All of these issues impact on the trust that customers and stakeholders place on their water suppliers.

Water company performance



Our Water Company Performance Report, published last month showed several companies falling short of the stretching performance commitments agreed at PR19 across a range of measures. There was an increase in the number of companies categorised as 'lagging' compared with the prior year, and our draft decision on company performance against the outcome delivery incentives set at PR19 found that companies will have to return £114 million to customers for under-performance.

Our report showed customer satisfaction to have fallen for the second year on a row. It showed fewer than half of the companies were meeting performance targets on reducing pollution incidents and fewer than half of companies met their performance commitment on leakage.

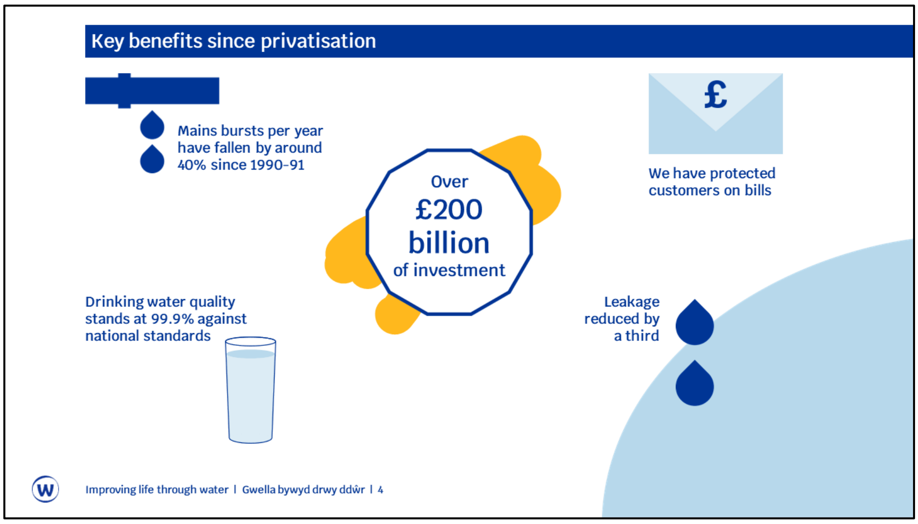
There is significant concern about companies meeting public expectations about combined sewer overflows. The sector has been slow to address these issues – and with 300,000 discharges from 15,000 overflows last year - there is clearly more to be done to address public expectations.

Earlier this year, the Environment Agency reported on the environmental performance of the sector – it was notable that over half of the serious pollution incidents in 2022 were driven by the performance of just two companies.

Concerns are also highlighted by the fact that we have the largest number of live enforcement cases we have ever had which cover potential failures at sewage treatment works that may have led to sewage discharges – and cases regarding the accuracy of performance information reported to us by South West Water and Welsh Water.

All stakeholders should expect the water companies to meet their legal obligations – where we find a company to be in breach of its obligations that we enforce, we will not hesitate to use our enforcement powers where appropriate to do so. And we are ramping up our enforcement capabilities.

Key benefits



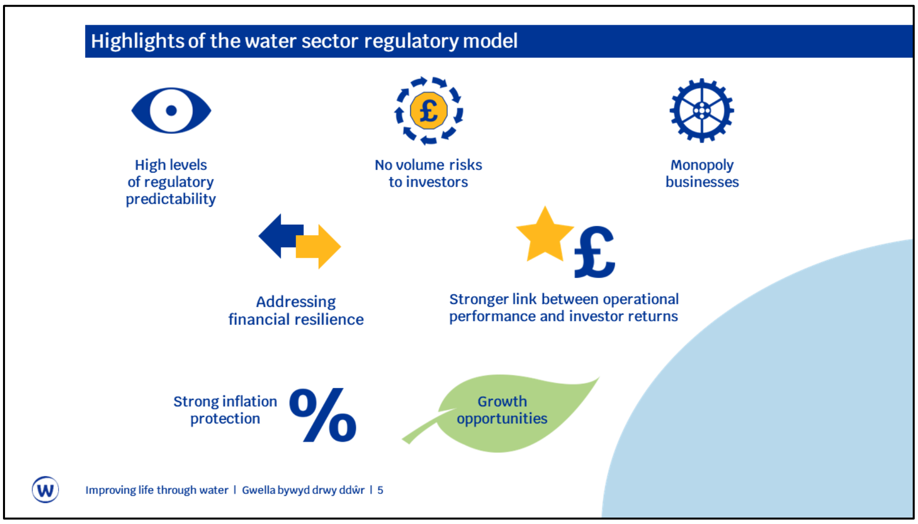
There are, however, some areas where there is reason to be positive.

Over £200bn has been invested since privatisation. Leakage is down by over 1/3, the UK rates in top 6 countries in the world for drinking water quality and there has been a significant reduction in mains bursts since privatisation and a 60% reduction in serious pollution incidents since 2011 (with two companies reporting zero serious pollution incidents in 2022).

We have seen a 27% improvement in sewer flooding performance since 2019-20, with opportunities for companies to meet and potentially surpass performance targets by the end of the period.

And to help address the problem of spills from combined sewer overflows, the £4.6bn Thames Tideway super sewer is due to start the commissioning process next year, such that sewage overflows will be diverted away from the River Thames – with final commissioning and acceptance completed in 2026-27.

Financing



One of the key problems we have seen with the sector is companies that have focused too much on financing and outperforming by the use of complex and highly geared financial structures. This has been accompanied with too little attention on operational performance and the levels of service provided to customers and the environment. This was one of the motivations that led to the shift in our focus to better align investor returns to the levels of performance delivered for customers and the environment – under the outcome delivery incentive regime.

In 2021, we gained new powers to amend company licences and we have used these to strengthen the ringfencing licence conditions. We made three key changes:

- First - the regulatory ringfence had already required water companies to maintain one credit rating – we amended this for companies to maintain two credit ratings.
- Second - we strengthened the licence to require companies to link dividend policies and dividends paid to performance delivered for customers and the environment and
- Third, we increased the protections that require companies to restrict dividends where company credit ratings are too low (previously this applied where a credit rating was at the minimum of the investment grade and on negative watch, this has been amended to one notch above the minimum of investment grade and on negative watch from 1 April 2025).

The licence amendments align with, and are designed to support, the objectives of responsible, long-term investors in this sector.

And while we have some concerns about company financial structures, we are now seeing improvements. We took action to encourage a change of ownership of Southern Water – their new owners are injecting around £1.5bn into the business and its holding companies – with around 60% of that to financing a much-needed performance turnaround at the regulated company. Other companies have also raised fresh equity in recent years (including Thames, Portsmouth and SES Water) to strengthen their balance sheets.

However, some companies still need to take action to strengthen their levels of financial resilience – and Thames Water remains a company that needs to deliver both a turnaround in operational performance and improve its financial resilience.

In total, we have seen around £3.6 billion of fresh equity injected, or committed to be injected into the sector, since 2021.

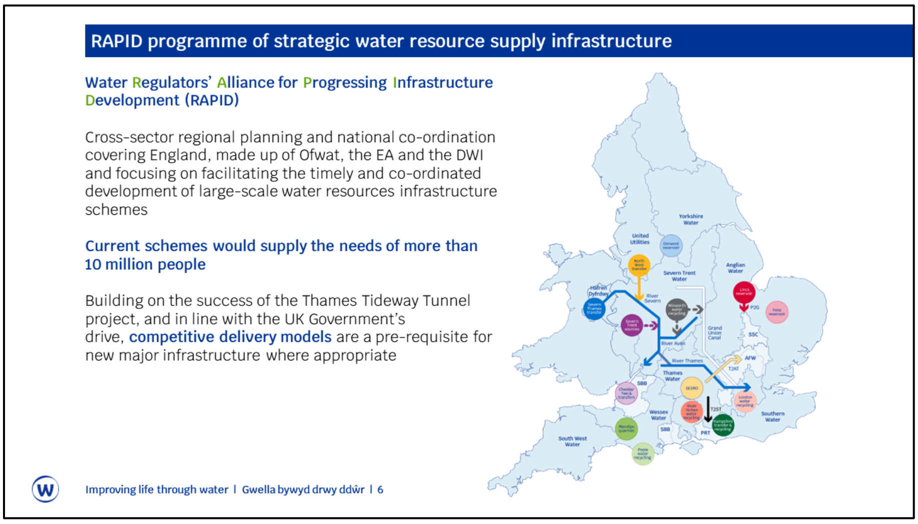
The recent £1 billion equity raised by Severn Trent to finance its AMP8 investment programme demonstrates a vote of confidence in the company and the regime. This should I expect reflect many of the benefits of the regime to investors that are highlighted in the slide.

The 2024 price review represents a fresh opportunity for the sector to address its challenges and transform its performance and reputation.

PR24 will deliver a step up in investment. The figures I state are from our initial look of company plans, but the company business plans include around £96bn of expenditure, including £40bn of enhancement spend. This is a significant increase on previous price reviews with proposed enhancement spend about three times the level set at PR19.

This expenditure remains subject to our check and efficiency challenge – but based on business plans would lead to an average RCV increase across the sector, in real terms of around 30% across five years, compared with only 6% at PR19. That is a major step up compared with PR19 and will need new equity – as well as debt - to fund the significant increase in investment.

Opportunities for investors



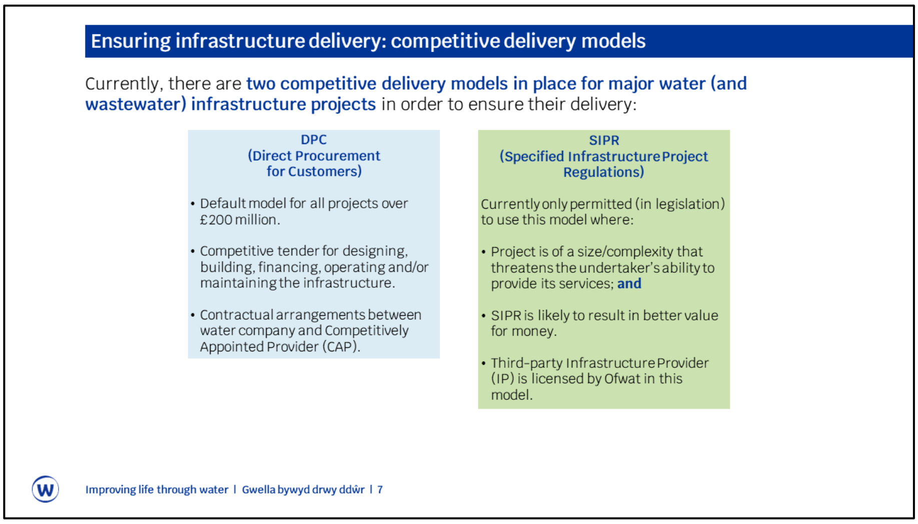
The challenges facing the sector will mean that companies will need to find new ways of responding to meet their obligations and the expectations placed on them.

But these challenges also provide significant opportunities for investors – to invest in new delivery models and to earn enhanced returns where companies deliver transformational levels of service for customers.

The Regulators Alliance for Progressing Infrastructure Development (RAPID) is a cross-regulator initiative bringing together Ofwat, the EA and the DWI with the aim of supporting regional co-ordination of water resource planning.

It has been in place since 2019 to investigate a number of schemes to support the development of large-scale water resources infrastructure schemes.

Competitive delivery models



There are two key delivery models:

- The 'Specified Infrastructure Projects Regulations' regime – this is suited to the delivery of very large infrastructure schemes that would otherwise be of the size or complexity that threatens an undertakers' ability to provide services to its customers – the Thames Tideway super sewer was delivered using this model.
- And the DPC regime, where our PR24 methodology set out that DPC will apply - by default - to projects with a whole life cost over £200 million.

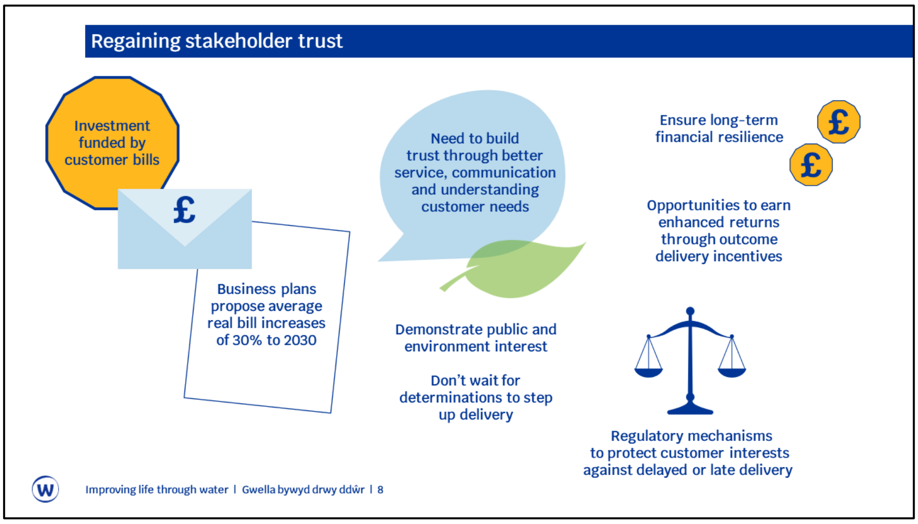
Through RAPID and our regulatory approaches we are supporting the delivery of a number of large projects including, currently we are supporting:

- The Havant Thicket Storage reservoir – which will be built in the Portsmouth Water area to support the water resource position of Southern Water.
- The Haweswater Aqueduct (HARP) scheme, which will provide long term resilience to supplies of water in the North West by renewing the Haweswater aqueduct.
- The Cwm Taf scheme that is designed to address water quality at three water treatment works.
- Southern Water's 'Water for Life' scheme that will use recycled water to supplement water levels at the Havant Thicket reservoir.

In addition, business plans have put forward 25 schemes for delivery under either the DPC or SIPR routes with a combined capital cost of around £15bn over AMP8-AMP10.

All of these schemes will provide significant opportunities for new investors to invest in this sector.

Regaining stakeholder trust



Of course all of this investment – and the efficient costs of companies meeting their obligations – are ultimately funded by customer bills. The investment programmes referenced in company business plans are underpinned by proposed average real bill increases of around 30% over the five years to 2030.

For customers to support such material bill increases, it is crucial that companies build trustworthy relationships with customers through better service, communication and understanding customer needs.

Companies will need to demonstrate that they are operating in the public interest and that their corporate behaviours, levels of executive pay and financing choices are consistent with serving the interests of customers and the environment. They will need to demonstrate they are financially resilient and have finance in place that allows them to deliver for the long term.

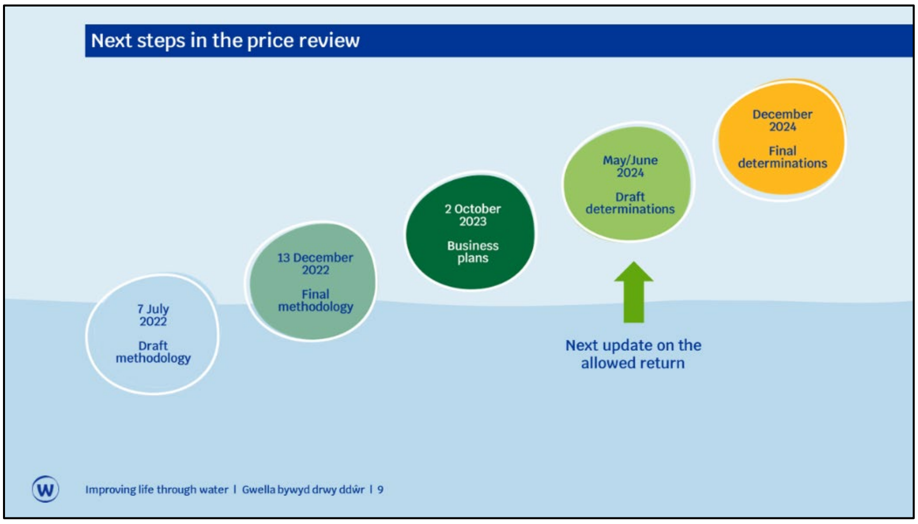
Given the scale of increase in investment in the next period, companies should not be waiting for our determinations to set about delivery in the next period – we expect them to be able to demonstrate the actions they are taking now to ensure they deliver– and where they do not deliver, we will ensure that appropriate regulatory mechanisms are in place to protect customer interests against delayed or late delivery – using mechanisms such as our Price Control Deliverables.   These allow us track delivery of investment and return funding to customers if appropriate.

There will be opportunities for companies to earn enhanced returns from the range of outcome delivery incentives that will be included in the price review – we have refined the ODIs for PR24 – which focus on measures which are important for customers, asset health and the environment – and there will be enhanced rewards available where performance commitments deliver the greatest benefits to customers and the environment (e.g. leakage and PCC – doubling incentive rates to push companies on performance).

PR24 provides an opportunity for us to look again at the calibration of the price determination package, to ensure there is a reasonable balance of risk and return. In carrying out this calibration we will consider evidence of cost and service performance in AMP7 to date.

We will consider what this means for the level of stretch in our determination, such that an investor in an efficient company has a reasonable prospect of earning the base allowed return set out in our determination.

Allowed returns



Finally, I want to turn to the timeline for our determinations and the allowed return.

The allowed return is an area that generates many pages in consultancy reports offering alternative views on the same underlying data that is available to investors and regulators.

As a step forward for PR24 we provided the detail in our final methodology that underpinned our calculations of the early view allowed return on capital and which would allow companies, investors and other parties to understand, and if necessary, update our calculations. Our methodology aligned with the guidance on cost of capital estimation that was set out by the UK Regulators Network in its guidance document that was prepared collaboratively by regulators, which drew in the expertise of the CMA and was peer reviewed.

We will next update our calculations for our draft determinations in May/June 2024 with final determinations following in December. Our decisions will take account of new information since we set our early view (which used data to the end of September 2022).

And relevant to this assessment and the overall level of investor returns, I want to flag two points, that highlight the importance of inflation on the realised returns for investors:

- Firstly, outturn inflation is a component of the investor's return. Outturn inflation has been higher than the Bank of England target, averaged over a 20 year period, and where inflation is projected to be high, or outturn inflation is above the level applied by a regulator in its determination, then this can drive benefits to equity investors.
- Secondly, despite disappointing operational performance, and typically reporting higher costs than allowed in our PR19 determinations, eight of the 17 companies have reported higher dividend yields on average for the first three years of this price control than we set out as guidance at PR19, and this comes on top an annual sector RCV growth of c.7% across the period – and a reduction in average gearing across of the sector from 71% in 2020 to 66% as at 31 March 2023.

Just to repeat that – despite operational performance, half of the sector has paid dividends that exceeded the guidance level stated in our PR19 determination (4%), which has come alongside compound RCV growth of 7%.

Conclusion

PR24 represents both a huge opportunity and challenge for the sector. It offers the regulator the opportunity to consider and ensure the price determination package is appropriately calibrated.

There is opportunity for the sector if companies visibly accept the responsibility for making transformational change to their service, and for investors to generate enhanced returns where transformational change is delivered.

A step change in investment is required and this will have to be both debt and equity financed. We will welcome and would like to see responsible investors, whose interests are aligned with the long-term objectives of the sector, to see the sector as attractive.

We will continue to push for more from companies using our full range of powers to accelerate and amplify the sector's impact to what customers expect and what is beneficial for wider society.

Thank you.