

PRESS RELEASE

13 June 2017 : IMMEDIATE RELEASE

ENVIRONMENTAL RATING AGENCY



Water Industry Risks Briefing 2017

**A Review of the Environmental, Regulatory and Financial Risks
of the Water Industry of England**



Photo credit: Environment Agency : Sewage foam collects around boats at Bourne End Marina on the Thames Path

Disclaimer

'This press release and the associated report represent the opinion of The Environmental Rating Agency Limited (ERA) and are for information purposes only. They are not intended to be investment advice. This press release and report reflect our best understanding of the evidence heard in court and available in the public domain. The ERA will correct any factual errors brought to our attention by the water industry or other parties.'

Copyright Environmental Rating Agency Ltd © 2017

Is the Water Industry the next Too Big To Fail?

A fundamental challenge for the British government is how to fund, structure and regulate essential public services.

Privatising essential public utilities, such as the water industry, took place in the 1980's when they needed massive investment, allowing the resulting private companies to self-regulate their activities as much as possible.

Investors were then able to innovate and maximise their returns, with the government focusing on regulating environmental protection, the quality of service and agreeing prices, profits and investment plans with the privatised water companies.

The Environmental Rating Agency's latest report entitled "*Water Industry Risks Briefing 2017: A Review of the Environmental, Regulatory and Financial Risks of the Water Industry of England*" investigates the risks that have developed in the nine major water and sewerage companies in England, that are regional monopolies, over the past thirty years and identifies a number of operational, regulatory and financial issues that should be of serious concern to investors, regulators and the public.

When the water industry was privatised in 1989 it was largely debt free and the companies had corporate structures and finances that were relatively simple to understand. Today, sophisticated international investors including private equity firms, sovereign funds and pension funds have created complicated corporate structures and loaded these companies with £40 billion - £50 billion of complex debt.

“£40 billion - £50 billion of complex debt threatens the water industry with insolvency”

This accumulation of debt and complexity leaves these businesses vulnerable to unexpected changes in interest rates or inflation and could make liabilities unaffordable without constant access to new debt and result in insolvencies under reasonable worst-case scenarios.

Given that water companies provide essential clean water and water treatment services to millions of people on a daily basis, we explore whether stricter regulation of environmental and financial risks needs to be introduced.

The water industry struggled to compete for funding when it was owned by the state, and much of the private sectors investment has taken the form of debt, so the issues raised in this report are not simply about the ownership model but also the financing and regulatory models that are best suited to protecting the public interest, offering value for money and protecting the environment.

Thames Water Prosecution: Aylesbury Crown Court

In March of this year Thames Water was convicted of discharging 4.2 billion litres of untreated and partially treated sewage into the River Thames and its tributaries at Aylesbury, Little Marlow, Didcot, Henley, Littlemore and Arborfield.

This prosecution was important as the Judge took into account Thames Water's turnover and ability to pay when calculating the fine for the environmental offences it had committed and this could have implications for all industries that pollute the environment.

The evidence heard in court is used as a case study and has uncovered serious deficiencies in the environmental data and self-reporting of pollution incidents relied upon by regulators, investors and the public. In particular, the judge mentioned a technique known as "flow clipping" which involves manipulating the environmental data collected by water companies.

"... the constant use of flow clipping to protect the treatment process, so that, despite the regular and prolonged discharge of untreated sewage to the River Thames via the storm outfalls, all samples taken at the final effluent outfall complied with the permit. This was deliberately done and gave a false impression of the sewage treatment works' performance and undermined the operator's self-monitoring process."¹ His Honour Judge Francis Sheridan

As an example, Aylesbury Sewage Treatment was operated in ways that only allowed it to fully treat half the sewage it was designed to treat whilst simultaneously releasing hundreds of millions of litres of untreated and partially treated sewage into the local river via unlicensed and unmonitored discharge points.

"Regulators need direct access to independent environmental performance data"

The environmental data collected by water companies is used by Ofwat to determine how much money water bills need to go up or down, the operating profits that companies can make and how much money they need to invest in maintaining or upgrading sewage treatment works and their related systems so very important.

Deep dive into the water companies

We (Environmental Rating Agency), as part of this investigation, did a thorough analysis of the regulatory and financial performance of the nine major water and sewerage companies in England in an effort to understand the relationships between good and bad environmental performance and corporate performance.

This research includes a combination of Freedom of Information requests for industry-wide environmental performance assessments undertaken by the

Environment Agency each year, summaries of court cases, fines and cautions per company, as well as some of the site maps and other evidence put before the court.

The annual company accounts for the major water service companies and their parent companies were also examined and used to compile the financial data included in this report.

Court transcripts were obtained with the permission of HH Judge Francis Sheridan that covered His Honour's findings and rulings, and sentencing remarks at Aylesbury Crown Court and these have been quoted where relevant.

Ratings, Indicators and Risks Profiles

In attempting to give clarity to much of the murky waters uncovered in this report, ERA has identified nine fundamental indicators of risk to help make a comparative analysis and by rating companies on a 20 point grading scale based on the best to worst performance recorded within each indicator.

This unified method for assessing different types of material risk has made it possible to identify 3 distinct risk profiles in the 9 major water and sewage companies in England, namely (i) high corporate performance across all indicators, including low exposure to financial risks, (ii) high to moderate corporate performance across most indicators, but high financial risks in terms of leverage (gearing) and (iii) poor environmental and regulatory corporate performance, but low financial risks.

“The Environmental Rating Agency’s risk profiles offer a unique assessment of water industry risks”

This method of rating offers a unique assessment of the risks inside the water industry that should be of relevance to investors, regulators and the public.

The future of the industry

One thing seems clear, things can't remain as they are in this industry (based on this investigation), so what next for our most fundamentally important utility? Could regulation of the privatised industry be adapted to take into account many risks covered by this report, and what likelihood a future nationalisation of the water industry (either as a result of an outright purchase by a future government or unplanned insolvencies). What lessons have been learnt from past conflicts of interest and to what extent could decision makers benefit from the use of independent environmental data and independent regulation?

It is possible that a new combination of public private partnership will enable the public and private sector to play to their respective strengths with fewer conflicts of interest and more sustainable economics and financing.

It is not clear that the public interest is protected by the accumulation of such large and complex debts inside essential public services, especially where unplanned insolvencies could result in the debts of these “too big to fail utilities” being transferred back to the public sector with little warning or choice.

Investors, regulators and the public could benefit if crucial environmental monitoring and the reporting of pollution incidents were both undertaken by bodies that were totally independent of the companies being assessed, and the roles and responsibilities of the regulator and the regulated were more clearly and impartially separated.

Regulators could then focus on ensuring full compliance by water companies based on complete and reliable information. Regulated water companies could focus on providing value for money to customers and managing the risks and returns to investors by improving the real-world operations and basic finances of their core businesses rather than relying on complex financing engineering to boost performance.

You can download the full report here:

www.environmentalratingagency.com

CONTACT DETAILS

Contact the Environmental Rating Agency to find out more:

Email : info@environmentalratingagency.com

Tel : +44 (0)7789 854737

Environmental Rating Agency

The Environmental Rating Agency (ERA) provides unique and independent ratings of corporate environmental risk and performance for investors.

The ERA rates companies using scientific metrics, benchmarks and insights to help investors to make better informed investment decisions.

We see the reliance on corporate self-reporting and voluntary disclosures as an endemic failure in the financial system.

Our mission is to change the way investors invest, to revolutionise how the environmental risks in businesses are analysed and to give life on Earth a business model.