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# Understanding best practice in UK water



## Overview

Water companies are an essential part of the UK's infrastructure. At Royal London Asset Management we are a long-term investor in the sector, with a history of research and engagement with UK water utility companies dating back to 2016.

In 2022, we wanted to build on our engagement program to focus on water management and adaptation to climate physical risk. We want water companies to have comprehensive water and biodiversity management plans, climate adaptation plans, and to consider social issues. This is because climate change is disrupting the water cycle, producing extreme weather events, and increasing the risk of water scarcity and water pollution events.<sup>1</sup>

In collaboration with our Sterling Credit team, the Responsible Investment team sent letters to 11 of our largest water holdings: we received a response from all 11 companies and met with 10 in the first phase of this engagement. The goal of this phase was to engage for information to better understand each company's approach to resilience, biodiversity, and a just transition,<sup>2</sup> in addition to identifying best practice.

Although net zero<sup>3</sup> is not the focus of this engagement, it is worth noting that the UK water sector is the first to provide a sector-wide commitment to deliver a net zero water supply for customers by 2030. According to Water UK, it is estimated that reaching net zero two decades ahead of the UK

Government's legally binding target of 2050<sup>4</sup> could save 10 million tonnes of greenhouse gas emissions.

## Why is it important to engage as bondholders in the sector?

Water companies continue to be subject to considerable public scrutiny, as evidenced by the negative media attention following the recent departure of Thames Water's CEO, Sarah Bentley, raising questions about the financial resilience of the water sector. From an ESG perspective, the latest news flow on Thames Water has again highlighted the disappointing pollution and leakage performance of recent years. Significant scrutiny of the sector is appropriate given the clear environmental challenges faced and we believe our role as long-term lenders remains critical to help water companies achieve more sustainable operations. The significant need for investments – to be balanced with the affordability needs of customers – make the role of long-term stable funding more important than ever.

As a consequence, and with the sector being an important area of debt finance, our active engagement with issuers is vital, as direct interactions allow us to look more objectively beyond the headlines and immediate financial impact of fines, to ensure appropriate stakeholder understanding of important social and environmental issues. We believe these issues, in isolation, remain unlikely to materially impact the sector's creditworthiness given the regulated nature of returns. However, as consumer finances

become strained and the political landscape volatile, it is more important than ever that public utilities' demonstrate their 'license to operate'. As long-term stewards of our clients' investments, and major investors in UK utilities, we will continue to scrutinise and challenge our borrowers on this basis.

## Engagement Programme: Phase 1

Phase 1 was used to gain both a better understanding of best practice in the UK water sector and this regulated industry. When we met with the 10 companies, we were able to ask four main questions, as listed below, with the opportunity to ask for greater detail.

### Question 1: What action have you taken to adapt to more extreme weather scenarios, particularly how you have improved your resilience to drought and floods?

The companies we met have consistently listed climate change and population growth as the largest challenges facing the sector. Many are concerned about the supply of water in the UK and have considered working together by using interconnectors to allow for the distribution of water from those with a stronger supply to water stressed areas, such as the one connecting the River Severn to the River Thames.

Managing of the water supply through investments in new assets and upgrading current assets, is critical in adapting to climate change risks.<sup>5</sup> We have observed that companies demonstrating best practices are those who are able to maintain strong asset health; for

<sup>1</sup> MCIP ([mccip.org.uk](https://mccip.org.uk))

<sup>2</sup> The concept of the just transition is to ensure that social issues are considered when moving to a low carbon economy.

<sup>3</sup> To achieve the long-term temperature goal set out in the Paris Agreement, a global peaking of greenhouse gas emissions must occur followed by rapid reductions thereafter. This is to achieve a balance between anthropogenic emissions by sources and removals by sinks of greenhouse gases (net zero emissions). You can learn more about what we are doing in our [Net Zero Engagement Report](#)

<sup>4</sup> [Water UK – Net Zero 2030 Routemap](#)

<sup>5</sup> <https://www.gov.uk/government/news/over-5-billion-of-action-set-out-in-latest-plans-to-protect-englands-waters>

example, leaders in the sector are focused on reducing leakages, which resulted in some companies being able to avoid hose pipe bans in 2022.

According to Ofwat, England and Wales have been able to keep leakage consistently lower than Scotland and Northern Ireland over the past three years. In the most recent figures, England's leakage measured 51 litres per person per day compared to Scotland and Northern Ireland being more than 80 litres. Comparing this to the wider EU, the UK does perform better on leakage against many countries but is behind those such as the Netherlands, France, and Switzerland<sup>6</sup> showing that the UK can and needs to continue improving.

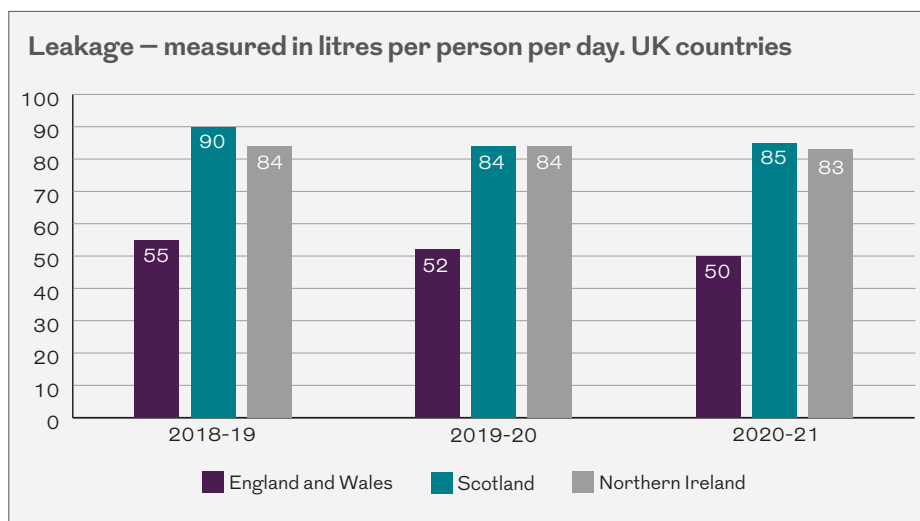
Flood management is also critical in the adaptation of extreme weather scenarios, examples of best practice include flood plain reconnection, restoring meanders in rivers to reduce the strength of flow, and going above and beyond in improving resilience in communities (as seen below).

## Question 2: Have you considered how the effects of climate change and your management plans to improve resilience impact on:

### a. The biodiversity in the catchment area you operate in

Six out of the 11 companies have biodiversity as one of their outcome delivery incentives (ODIs).<sup>7</sup>

Royal London Asset Management has no single definition of best practice for biodiversity due to the wide scope of solutions. However, we are encouraged by actions that demonstrate biodiversity as an important consideration for water



Source: [Ofwat](#)

utilities, such as collaborating and working on community projects and farmers or introducing a biodiversity net benefit rule on new sites.

One company employed several techniques to improve biodiversity such as hiring 20 farmers to educate other farmers in the community on the importance of biodiversity, as well as employing river rangers, using customer education programmes and investing in planting trees. Recognising the importance of collaborating with other stakeholders in addressing

biodiversity as well as other issues, some companies work with farmers to better improve biodiversity and the quality of the rivers because of the pesticide and phosphorus used in agriculture can run off into the rivers.

### b. The increasing pollution levels in open waterways

Climate change acts as an amplifier to pollution events for the water sector. This is because droughts can lead to the ground becoming too dry to absorb rainwater quickly,

**Example of best practice:** One company has estimated that 60% of their customer base are at risk of flash flooding due to living in areas dominated by impermeable surfaces such as concrete. As a result, the company has launched a project that is the first flood management system of its size in Europe. These include replacing surfaces in car parks, walkways and other hard surfaces with permeable paving which will allow the water to soak through as opposed to remaining static on top; swales which allows for water storage away from paths and roads; rain gardens and basins.

**Example of best practice:** To manage water supply and drought risks, the company was able to explain how every five years they are planning to add 150 million litres back into supply, by focusing on reduction of leakages and maximising the current water treatment works.

<sup>6</sup> [Leakage in the water industry - Ofwat](#)

<sup>7</sup> Outcome delivery incentives (ODIs) aim to align the interests of companies and their investors with those of customers. ODIs are the financial consequences to companies of underperformance or outperformance relative to their performance commitment levels (PCLs). They act as an incentive for companies to deliver their committed levels of performance, returning funding to customers for foregone benefits if they deliver less than is expected. Companies that go beyond and deliver greater benefits than expected to customers and the environment can receive outperformance payments ([Appendix-8-Outcome-delivery-incentives.pdf \(ofwat.gov.uk\)](#))

thus, resulting in surface flooding and often overwhelming the current infrastructure. Pollution events are exacerbated by blockages in the system.

Companies have demonstrated best practice through the innovative use of technology and artificial intelligence (AI) to combat pollution incidents by being able to monitor the flow of water in real time or to predict blockages. Many companies find that the main cause of blockages is due to wet wipes and items not meant to be flushed being entered into the system. To reduce pollution incidents, best practice is where companies have an internal response team that can clear these sewer blockages before turning into pollution events. In addition, effective targeted campaigns to educate customers and working with distributors of wet wipes, such as supermarkets, to ensure packaging is clearer on what is flushable. The focus is to invest in their current systems than pay the significant fines associated with pollution events.

**Question 3: How are you working with the regulator to ensure you can meet the needs of your physical climate adaptation whilst also keeping costs reasonable for your customers?**

At Royal London Asset Management we want to see a just transition where companies transition to a greener future, but no one is left behind. As we have seen above, higher investment in innovative solutions to manage physical climate risk is required, however, as investors, we want companies to manage this risk without significantly increasing the cost to its customers.

In the UK, water companies are not allowed to shut off the water supply, meaning it is important to be creative

in ways to minimise bad debts through various affordability schemes.

Leaders would often work with the local authority and other utilities to help identify vulnerable customers.

We consider best practices those of companies that have a strong support for vulnerable customers to make their bills affordable. This is especially important in the current climate where according to Ofwat “half of water bill payers reported they have struggled to pay one or more household bills fairly frequently over the past year”. Of those who struggle, “17% struggled to pay water bills”.<sup>10</sup>

**Question 4: Your views on your 2021 EPA rating and what you are intending to do to improve or retain your rating going forward?**

The Environmental Performance Assessment (EPA) rating has seen a change in methodology from the 2020 to the 2021 scores (the latest scores) resulting in a large quantity of downgrades in the sector.

The overall decrease in stars assigned went down by 9 (2021:25, 2020:34). After meeting the companies, many welcomed the increased level of scrutiny, but also noted the misleading

**Example of best practice:** One company is the biggest corporate landowner in the UK, where a large portion is classified as Sites of Special Scientific Interest (SSSI).<sup>8</sup> They have been regenerating and rejuvenating the peatlands and the ecosystems that they support through rewetting resulting in an increase in the peatlands resilience to wildfires. The company has also pledged to commit to the new legislation requiring a biodiversity net gain of 10%.<sup>9</sup> The purpose of achieving biodiversity net gain means that natural habitats will be extended or improved as part of a development or project.

Another company has an in-house team of conservation scientists that work on their own land holdings who complete environment and biodiversity screening of new capital projects such as a new facility or pipeline. Within these screens the team of scientists will assess the impacts on grassland, protected land and trees, especially in SSSI. The company also collaborates with wildlife trusts, and lead projects on specific habitats and species to manage the biodiversity risk.

**Example of best practice:** One company is investing £3 million a month to tackle storm overflows and targeting 25% reduction of storm overflow discharges by 2025. The storm overflow issues they are facing is due to how the storm overflow systems were designed in the past; as a result, the company will be completing sewage treatment upgrades at 42 water recycling centres to increase capacity; in addition to 13 improvement projects from part of their priority programme.

One other company is investing £100 million a year on their sewage network, to improve their systems, reduce sewer flooding and pollutions, and installing more monitoring capability. The company hopes that 100% of sites have monitors by the end of 2022, where they can apply alarms linked to information inflows to enable faster diagnosis and response.

<sup>8</sup> SSSI are the finest sites for wildlife and natural features in England, supporting many characteristic, rare and endangered species, habitats, and natural features. Any pollution event that occurs at one of these sites is classed as a serious pollution event

<sup>9</sup> Consultation on Biodiversity Net Gain Regulations and Implementation January 2022.pdf (defra.gov.uk)

<sup>10</sup> Cost-of-living-report-Final.pdf (ofwat.gov.uk)

nature of a red score. This is because the scoring does not distinguish between a company that requires minor improvements to another who may face significant issues. Some companies are looking to improve their EPA scores using new technology whilst others have considered a year-on-year target of reducing pollution events. Leaders in this sector have set stretching targets.

## Next Phase

We met the objectives of the first phase of the engagement by identifying best practices in the UK water sector. As a result, we gained further clarity on the challenges water utility companies faced. However, we are concerned about the continued negative media attention facing the industry and recognise that the water sector must continue investing in their asset health to manage pollution incidents.

**Example of best practice:** One company is currently helping 100,000 customers and has a suite of approaches to help them financially. The company spoke of how they can give up to 85% reductions in tariff discounts on bills.

Water is relatively low cost compared to other utilities. However, given the current cost of living crisis, another company has tried to educate its customers by explaining that reducing water usage can reduce energy costs. This is because the more water is used, for example in showers or baths, the more energy is required to heat that water. According to the Energy Saving Trust, heating water accounts for 12% of a typical gas-heated household's energy bill<sup>11</sup> so taking shorter showers can add up to large savings.

It also highlights the importance of investors and active stewardship to improve laggards and push leaders further to encourage better practices in the industry.

From these learnings of our first phase, we are collaborating with selected clients to initiate the next step of the engagement with a focus

on change. We will be exploring further issues facing the industry. We will develop a set of investor expectations to drive positive outcomes in the water sector to tackle adaptation to climate change physical risks, biodiversity risks, affordability, and other salient issues.



<sup>11</sup> Advice to help you save water at home - Energy Saving Trust

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For more information about our range of products and services, please contact us.

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