Go with the flow: does ESG matter when investing in water?

Water is, by its very nature, everywhere. Even in investor portfolios. But the sector is largely 'unquoted' – there are a dozen water companies supplying England and Wales, but only three of these are listed on the London Stock Exchange – the rest are generally privately owned through entities such as pension funds, sovereign wealth vehicles and private equity. However, this sector does have significant investment needs – and it regularly uses the bond market to help finance its infrastructure spending. The long-dated nature of the sector's assets means it is looking for long-dated lending – a perfect match for fixed income investors with long-term investment horizons.

If any sector was an obvious candidate for ESG (environmental, social and governance) analysis, it is water. However, the 'off the shelf' research that is easily available on listed companies doesn't exist for bond investors; it needs to be done in-house. This presents a number of questions – not least, what are the factors that matter, and how do we assess these?

While the water industry is highly regulated in the UK, opportunities to differentiate between firms and across capital structures do exist. To this end, in 2015 and 2018, we carried out comprehensive ESG analysis of the water sector, looking at a variety of measures impacting water companies. In 2019, we revisited our evaluation of the sector due to a number of developments, including criticism of overall company performance, the handing out of multi-million pound leakage-related fines by the regulator, and the increasing risk of nationalisation under a potential future Labour government.

Does it matter?

It is valid to ask whether ESG analysis matters. After all, for a bond investor, the risk of a borrower deteriorating after funds have been lent is what matters. Our view is that if you are not looking at ESG in assessing credit risk, you are not assessing credit risk properly, and are simply ignoring some of the risks that can cause borrowers to deteriorate.

In the case of the water sector, it is a mixture of short-term and long-term influences. In the short term, factors such as leakages matter because regulators fine companies that fail to address this. In the long term, ESG factors are part of the sector's social license to operate. Failures in this area could lead to fundamental changes to the regulatory framework – something that water companies have used to underpin lending to the sector.

In perhaps the most high profile recent example, Southern Water was hit with a record £126m fine, including £123m of customer redress, as a punishment for spills of wastewater from its sewage plants, as well as for deliberately misreporting leakage performance. As a result of the fines, Moody's and S&P downgraded their credit ratings for Southern. In addition, the Environment Agency is currently undertaking a criminal investigation into the case to determine whether permit breaches occurred at a number of sites and whether any damage was done to the natural environment. Southern also raised the incidents to the attention of the Serious Fraud Office, however no further investigation was undertaken by them.

How do we do this?

We looked at a selection of material ESG issues for each borrower with public debt outstanding. To ensure we targeted the most material issues, we used the Sustainability Accounting Standards Board's 'Materiality Map' for guidance, and supplemented with metrics that are more significant for the UK market. This led us to look at a number of areas:

- **Energy management**: the presence of energy recovery processes, the kind of energy being used, and the amount of sludge (treated residual sewage) that is transformed into valuable outputs on-site.
- **Scenario analysis**: companies now have to plan for alternative potential scenarios based on different patterns of rainfall which are likely to become more extreme as the impacts of climate change increase.
- **Water scarcity strategy**: we used the level of customer metering as a proxy for a water scarcity strategy as this is the most effective means to moderate usage. Fitting a water meter reduces usage by 10%-15%, a figure that rises to 17% when smart meters are fitted.

ROYAL LONDON
ASSET MANAGEMENT

- **Water stress**: an assessment to determine which regions are most at risk from water scarcity, and the severity of potential climate change impacts and water consumption demand.
- **Environmental performance**: the Environment Agency's 'Environmental Performance Assessment' is a basket of seven measures that assess how well a company protects the environment. Measures include the number of times there were unexpected contaminants released, whether companies are meeting their environmental permit conditions and whether sludge is disposed of safely.
- **Leakage**: leakage targets are set using the sustainable economic level of leakage. In practical terms, Ofwat requires water companies to fix leaks, as long as the cost of fixing the leak is less than the cost of not fixing the leak. Water companies maintain that leakage has been at economic levels since roughly 2000.
- **Access and affordability**: we looked at 'bad debts' in order to measure the extent to which water companies were successfully working with customers to ensure bills are paid.
- **Customer satisfaction**: water companies operate as regional monopolies, meaning there is limited pressure on companies from a competition perspective. However, customer satisfaction will have financial incentives in the next regulatory period, and as a result, has the ability to directly impact a company's financial performance and the credit quality.
- **Governance**: water companies operate within a highly regulated industry, dampening the transition of operating volatility to credit risk. However, this does not remove the benefits that bondholders derive from good corporate governance.

Results

Our analysis found a significant variation between companies ESG scores, although with 55% of factors assessed being rated as poor, severe or medium, we consider the overall ESG performance of the sector as weak. However, this weak performance needs to be viewed in the context of the underpinning of the regulatory framework, which significantly dampens the impact of most measures from a lenders perspective in the short and medium term. In this light, the ESG factor that we deem to have the most direct link to short-term company performance is leakage, as financial implications associated with leakage fines directly impact performance through the regulatory framework.

Leakage

Since privatisation, water companies have spent approximately £150bn on improving services overall and are continuing to invest. However, there is criticism that based on current leakage targets, many leaks will not be fixed as it is not economic for water companies to repair. Clearly as water stress and scarcity becomes worse, the wastage of water from leaks will become more impactful and water companies will have to invest further to reduce these. This is particularly the case for water companies that are located in regions experiencing severe water stress. Therefore, as the impacts of climate change become more extreme, the correlation between metering, leakage and water stress will likely intensify.

Governance

Some bonds are issued outside the operating company entity, and are therefore not covered in the Ofwat regulatory protection, making good governance more of a concern. But following the increase in leakage and pressure from the opposition Labour Party over re-nationalisation, there is increasing focus on the influence of shareholders on the balance between paying dividends and maintaining a sustainable network, making strong governance even more vital. Companies are regularly criticised for paying too much to shareholders while performance is worsening.

To understand the impact of governance, we reviewed a number of governance factors for each company and compared them against what we consider to be good practice, referencing the UK Governance Code as appropriate. As illustrated in the table opposite, there appears to be a trend in the factors between governance and overall company performance. No companies that have good governance practices feature amongst the worst environmental performers.

How does RLAM use this?

This ESG analysis has been integrated into our existing credit analysis of the sector. For example, we look at credit spread and gearing with the Class A part of the capital structure (illustrated in graph opposite). This gives a simple valuation perspective on which bonds are attractive – generally speaking higher gearing translates into a higher spread available. But with our ESG ratings we can see where we believe the market is pricing risk incorrectly – for instance offering high spreads on companies that we believe have better ESG credentials, and this is indeed the case for South East Water.

Conclusion

We believe that sound ESG management leads to less volatility and marginally higher profitability, stronger long-term climate resilience and greater social performance. In the short term, upcoming changes to the regulatory framework this year will make these factors more relevant, as a higher proportion of company revenue will come from operational performance incentives.

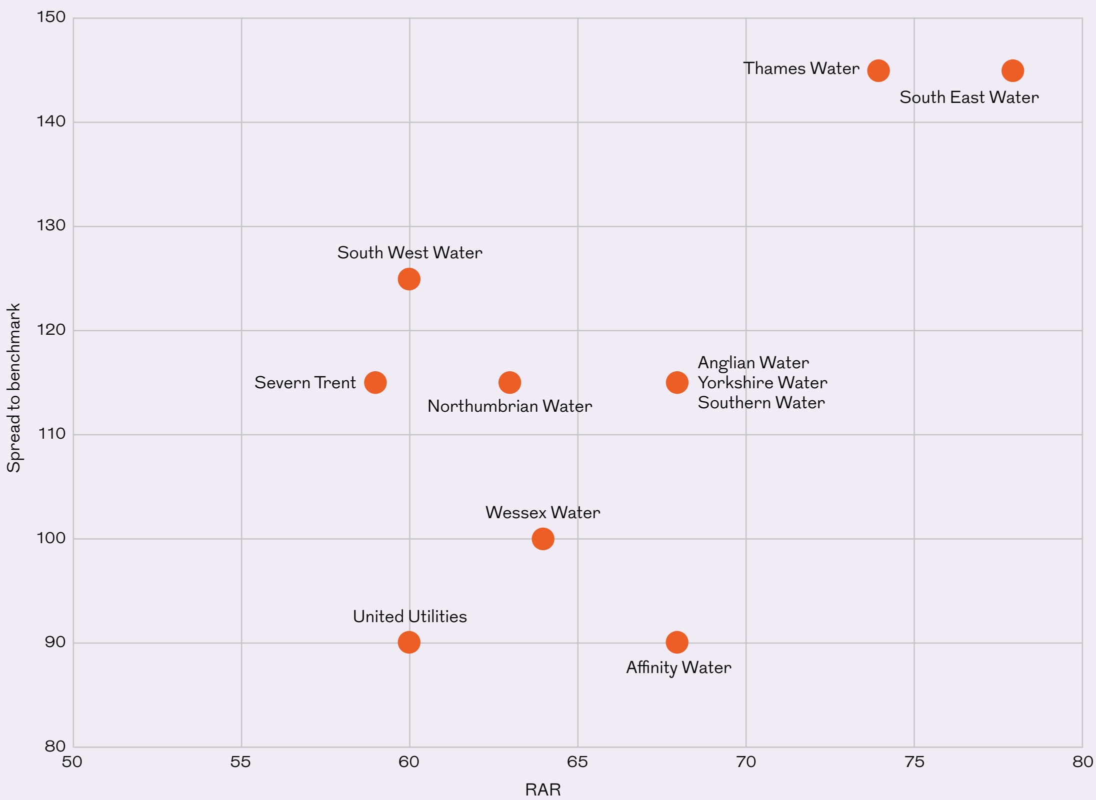
More importantly from a long-term investor perspective, ESG management is essential to ensuring companies maintain their social license to operate and build positive customer perception. Governance and metering appear to be indicators of a company's overall ESG performance and therefore are good leading indicators of general ESG performance. Effective ESG management can also bolster a water company's social licence to operate, something that should be a priority to all the water companies in the UK in the face of potential nationalisation.

RLAM internal rating matrix

Borrower	Access and affordability	Energy use	Leakage	Metering	Water stress management	Customer satisfaction	Governance	ESG score	2018 ESG score
Company A	Good	Good	Good	Poor	Medium	Good	Good	5	3
Company B	Good	Good	Good	Good	Severe	Medium	Average	4	5
Company C	Good	Good	Good	Good	Severe	Medium	Average	4	4
Company D	Good	Good	Good	Good	Medium	Medium	Poor	4	4
Company E	Good	Good	Medium	Good	Medium	Good	Poor	4	5
Company F	Good	Good	Good	Poor	Medium	Good	Poor	4	3
Company G	Good	Good	Medium	Poor	Medium	Medium	Good	3	3
Company H	Poor	Good	Medium	Poor	Medium	Good	Good	3	2
Company I	Good	Good	Medium	Good	Severe	Poor	Poor	3	3
Company J	Good	Poor	Good	Poor	Severe	Poor	Average	2	4
Company K	Poor	Good	Poor	Poor	Severe	Poor	Poor	1	1
Company L	Poor	Poor	Medium	Poor	Medium	Medium	Poor	0	2

Source: RLAM internal research, as at June 2019.
Companies have been anonymised as ratings are subjective.

Risk and return in the water sector



Source: RLAM. Spread and RAR (regulated asset ratio) based on figures available 30 June 2019

Contact us

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

Royal London Asset Management

55 Gracechurch Street, London EC3V 0RL

020 7506 6500

communications@rlam.co.uk

www.rlam.co.uk

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

The views expressed are the author's own and do not constitute investment advice.

All information is correct at June 2019 unless otherwise stated.

Ref: AL RLAM PD 0037

18 61

63529 11 2019