Next steps for regulation and the outlook for 2020 Westminster Energy, Environment & Transport Forum Keynote Seminar

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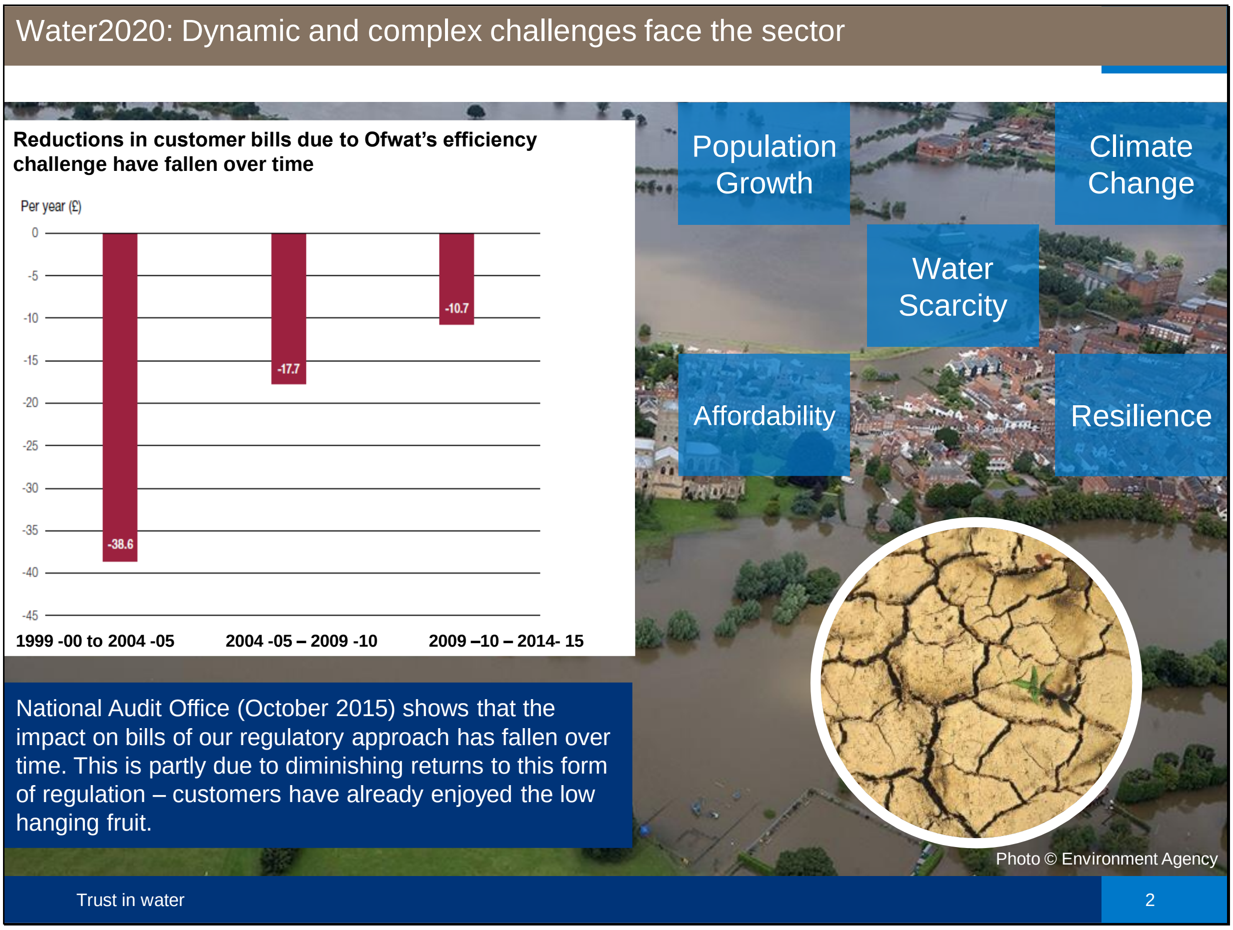
Introduction

Good morning everyone and thank you for inviting me here this morning today I'm going to talk to you about the next steps for markets and regulation as we look towards and beyond 2020.

In May this year we published our regulatory framework for wholesale markets and the 2019 Price Review and we will shortly be publishing our emerging findings from our cost benefit analysis for the UK Government on opening the residential retail market to competition.

Now is a good time to be discussing the outlook for markets in the water sector.

Water 2020: Dynamic challenges face the sector



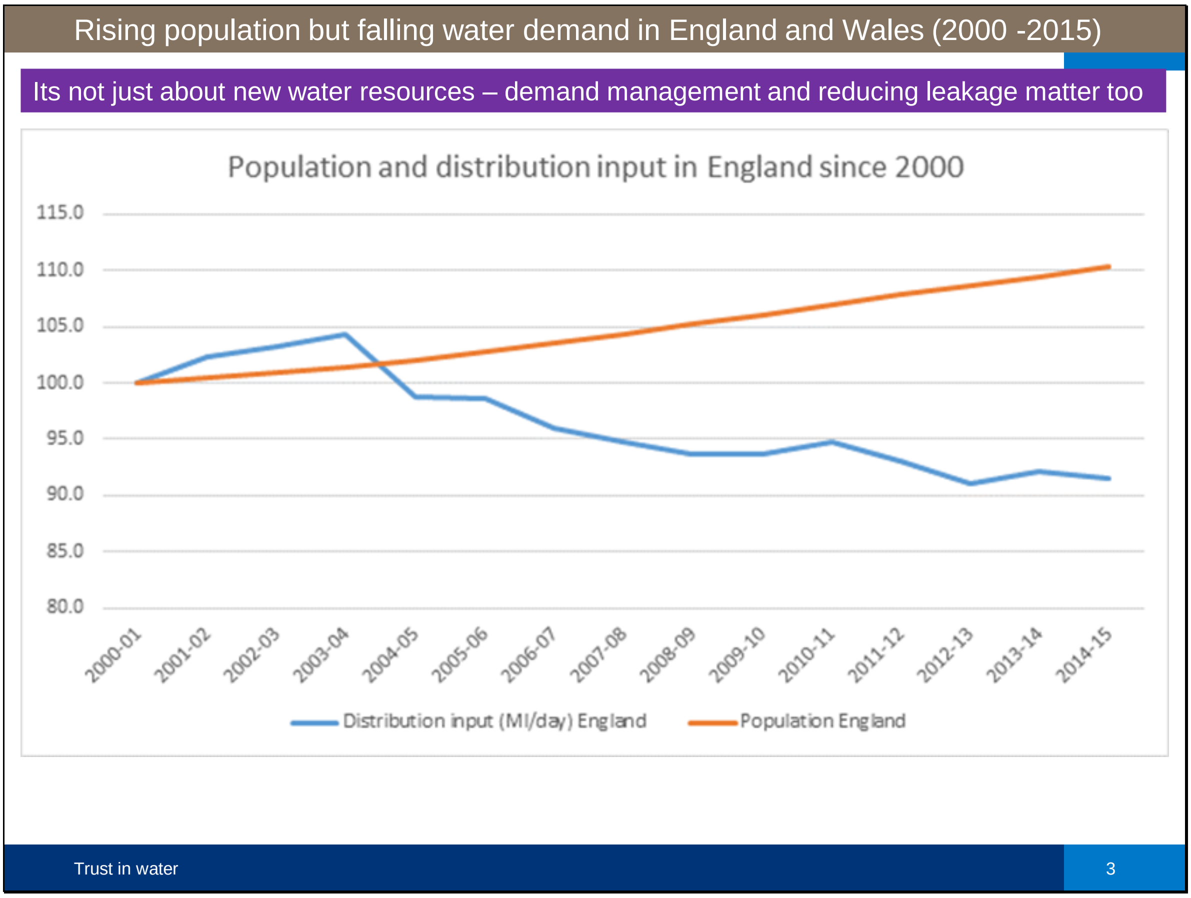
We consider that markets can play an important role in the way that we regulate and will enable the sector to address the long-term challenges it faces, some of which are set out on the slide behind me.

More recent changes we all face. The vote to leave the European Union on 23 June has placed us in unchartered territory. Inevitably Brexit brings with it significant political and financial uncertainty, but the water sector is comparatively stable. From an investment perspective it is seen as a defensive share, it's a safe place in a storm, and the framework of independent economic regulation provides a measure of stability and insulation from the heightened political risks.

Brexit will not change some of the fundamental challenges that the sector faces and it remains important to take steps to help the sector to evolve to address these challenges.

I'm sure many of you will be familiar with the complex challenges that are set out on the slide behind me, including dealing with population growth, climate change and addressing water scarcity. Rising population and climate change will undoubtedly bring future, as well as current issues, not the least in terms of water scarcity and dealing with extreme weather events, both of which raise questions about stability and resilience of this vital public service.

Population growth vs distribution input in England and Wales



I do want to pause for a moment on the supply and demand and balance point, it’s important to realise that supply side solutions such as new capacity are only part of the answer in the sector. This graph shows water consumption in the networks of water companies in England and Wales over the last 15 years, and you will note that it has been reducing over this time despite a rising population, so a 10% increase in population and a 10% reduction in demand. This trend is also true even in areas of high growth, for example South East England has seen a 7% reduction over the same time period and an even greater rate of population growth.

Why has this happened? Well this is partly down to the good work done by the sector in terms of successful leakage reduction and demand management, and these figures are especially relevant for the South East of England where it’s predicted that most population growth will come in the future. There are already pressures on water stressed parts of the country and as a result we’ve seen an increased emphasis on water meter reading and leakage reduction. More efficient water appliances in new and existing homes and helping customers to make smart choices to reduce consumption have all helped.

However, as we know, the past is not necessarily a good guide to the future, the reduction in water demand in the face of a rising population is an impressive achievement and it does highlight the role demand management and leakage reduction can play, alongside other measures to address supply and demand imbalances such as new capacity and water transfers.

It is also important to acknowledge that we are going to face a continuing challenge around affordability in the sector, and that it is just not possible to build our way out of the long-term challenges and to spend hard pressed customer's money to address every potential supply side need. We continue to see that affordability will play a key role in the sector, unpaid charges or bad debts have risen by 17% over the last 4 years and that's ultimately a cost borne by all customers.

Furthermore, at the 2014 Price Review there was a large reduction in the allowed cost of capital from 5.1% to 3.7%, or around 140 basis points compared to the 2009 Price Review. Well I'm not going to forecast the cost of capital for the 2019 Price Review, however it's unlikely we will see such a large reduction again andf the headroom that provided for improvements in service and resilience and for customer bills to fall in the 2014 Price Review.

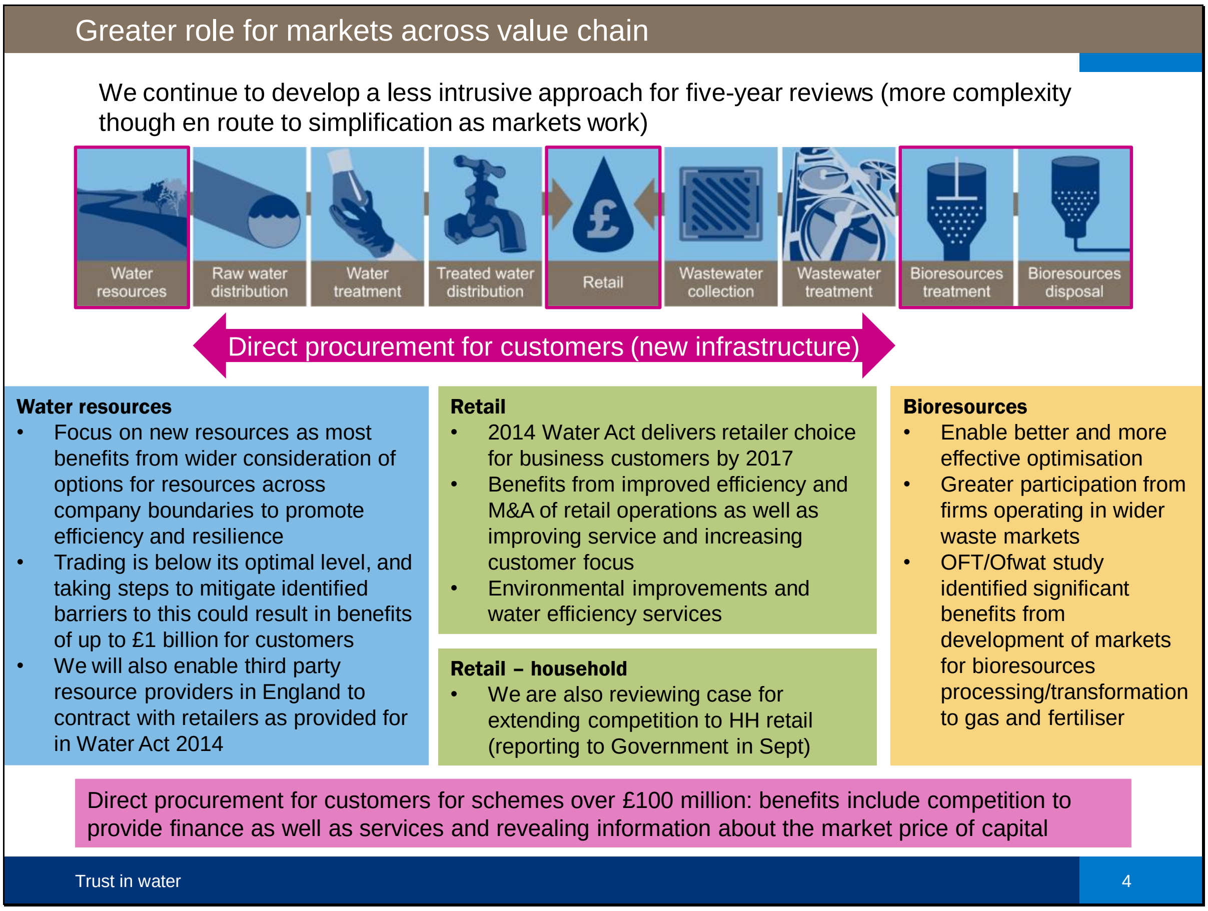
One other point to highlight from that earlier slide was that the reduction in customer bills from the improvements and sector efficiency has fallen over successive Price Reviews. Going all the way back to 1999 it was worth £39 off customer bills, in 2009 this was just £11.

The challenge of delivering more for less is going to have to come the hard way. We see two important frontiers in efficiency, the first is through continuing to focus on customers and customer engagement. Companies will need to focus their scarce resources to deliver the outcomes that matter most to customers. To do this companies will need to know and understand their customer needs better than ever before.

The second driver we see is getting dynamic efficiency benefits through innovation. We think that some of the changes we introduced in the 2014 Price Review, such as a total expenditure approach, the outcomes approach, and the greater focus on customers will help enable innovation in the sector.

We also think that markets can play a greater role in the sector.

Creating markets to meet the challenges we face



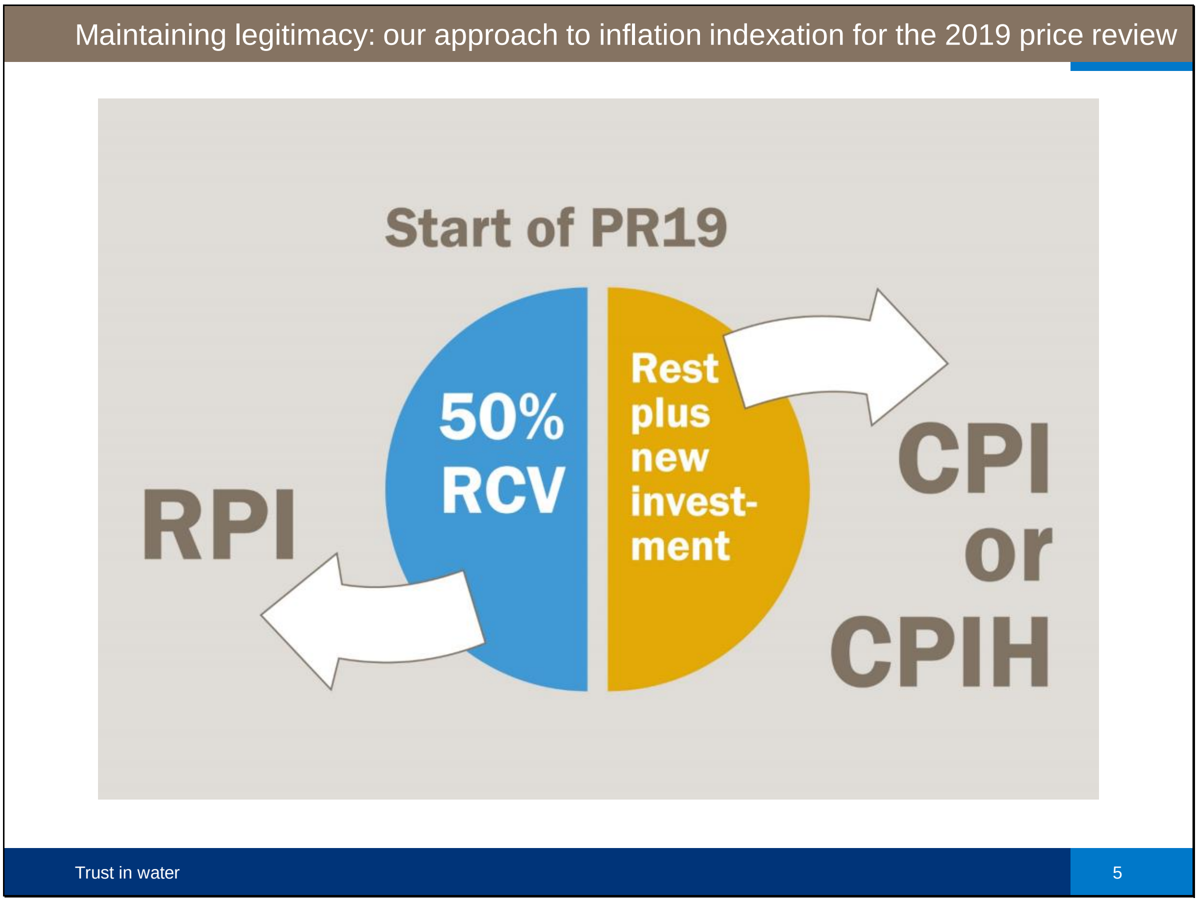
Now I would like to talk a little bit about the ability of wholesale markets to play a part in innovation and change in the sector. We think markets are helpful for informing, enabling and incentivising the sector and also to stave off the risk of declining legitimacy in eyes of customers. In May we published our most recent document confirming how we intend to move this forward, and I'm just going to touch on some of the headlines on this slide.

We think there is a potential to create value from use of markets for water resources and for bio resources (a product formerly known as, sludge). In water resources we want to enable and incentivise companies to choose the most efficient new water resources and this may include demand management, it may also include resources from outside the company area. We estimate benefits from more water trading of around £800 million. In terms of bio resources, we think that markets will enable companies, either existing waste water companies, or potentially new waste companies, or existing organic waste companies, to enter the market, to take advantage of the developments of technology and economies of scale to turn waste into energy.

In terms of our role in promoting these outcomes we have proposed to develop information platforms to better enable third party provision of services, and to set separate binding price controls to enable and incentivise companies to pursue the best solutions. This will help maximise the benefit for customers, the environment and also for companies themselves. We also propose to set pricing rules known as access prices, to incentivise the provision of new water resources to provide the greatest possible benefit in areas with demand supply imbalances.

A third market area is something we call direct procurement for customers, this is about learning from the experience with Thames Tideway Tunnel, which shows the benefits of having third parties bidding to provide both finance and delivery of new infrastructure. Together we think that these three changes (in water resources, bio-resources and direct procurement) will enable more innovation, better optimising across company boundaries and use of efficient third party providers to address the long-term challenges facing the sector around resilience, future services and also improving the environment by turning waste into energy.

Maintaining legitimacy



Moving onto the way that we index our future price controls. Traditionally we have indexed wholesale price controls to the retail price index or RPI. However, we are aware that RPI is no longer an official statistic, its robustness has been called into question and its use by both Government, other regulators and across the economy generally is diminishing. RPI is also more volatile than other commonly used measures of inflation, risking more uncertainty for customer bills. We propose to index company revenues to CPI or CPIH and we will make a decision on which of those indices in 2017.

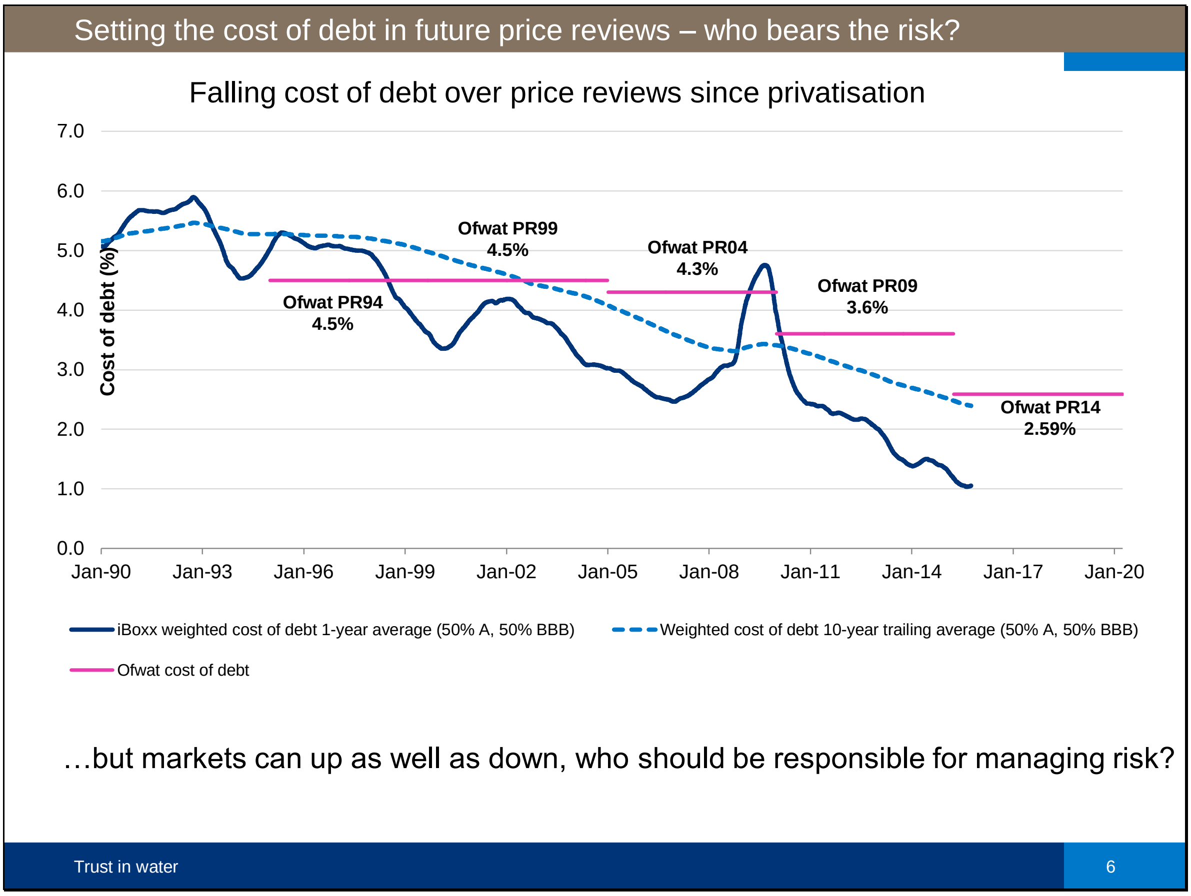
We will also propose to transition the index of the regulatory capital value, the asset base of the companies if you like, or the value associated with that, and in recognition of the importance of the long-term financing of this sector this will be a gradual process where we will start with 50% of the RCV that will remain linked to RPI in April 2020, with the remainder of the RCV being linked to CPI or CPIH.

I want to give a quick update on the progress towards introducing markets for retail business and residential customers.

So as you know we are moving towards opening of the retail market to competition for 1.2 million business customers in April 2017 and we are continuing to work hard with Defra, MOSL and of course the companies and their preparation for this event. Opening this market will enable business customers to choose the service provider, but will also reveal new information about the best possible customer service, and retail cost efficiency, for parts of the market that currently aren't open to competition.

We have also been asked by the UK Government to look at the costs and benefits of extending retail competition in England to residential customers. I cannot say much about this at this point in time, we are due to publish our emerging findings in a few weeks, after that we will have a very short period of consultation before finalising our research for the Government in September and it will be then be for the Government to decide how to take this work further forward.

Cost of debt



There is one other area I would like to touch on in terms of our further work, which has significant implications for customer bills which is around how we set the cost of debt at future Price Reviews.

You will see from the slide that we have had a steadily falling cost of debt for much of the period since privatisation and indeed since the PR 99, and over that time we, as a regulator, have tended to overstate the cost of debt for much of the period. Our historic and current approach has been to set the cost of debt, allocating the risks of changes in the cost of debt to companies rather than customers. This means if the cost of debt falls faster than anticipated, companies benefit, whereas if the cost of debt increases then companies bear this cost.

We will be looking at a range of options to ensure that the cost of debt is set on an appropriate basis in the future, including an assessment of options for increasing the pass through to customers of cost and benefits associated with market movements and borrowings.

We acknowledge that the cost of debt is difficult to forecast accurately. This matters as even a 0.5% movement in the cost of debt can have around a 2% impact on average bills. It is important to customers that we look carefully at this issue and ensure that the overall balance of risk and reward built into the price control is right to ensure that companies are incentivised to deliver the services that customers want.

Looking forward to PR19, in the 2014 Price Review we made some major changes to how we set price controls, such as the total expenditure approach, the outcome delivery incentives, and the focus on customer engagement. In PR19 we will continue to build on this approach and we will expect companies to build on their work on customer engagement to put customers at the centre of their businesses and not just the centre of their business plans that they submit to Ofwat. We will also look at plans to see how they look beyond the 5 year regulatory period to ensure that they are providing resilient services both now and in the longer term.

I also note that as companies respond to the cost and service challenges that were set in PR14, we will see improvements in their performance over time. Hence we look forward to seeing the sets of upcoming company results for the first year of this new price control shortly.

As the performance frontier shifts due to the incentives in company performance during this period it will reveal new information which can be used to set even more stretching targets on behalf of customers at PR19. This means that if companies are not exceeding and delivering on their targets during this period, they will be very ill placed to deal with the challenges that we will face in PR19.

In terms of next steps, I've talked about our direction of travel towards 2020, about the challenges the sector faces and how the sector will need to achieve more for less. I've also explained how we think markets can play a role alongside how we regulate to enable the sector to continue to evolve and adapt to meet the challenges that face us.

I think even in an environment of heightened uncertainty it is important for the sector to continue to evolve to be in a better shape to address the challenges it faces now and in the longer term.

Thank you.