



Regulator's perspective: PR14 and beyond

Cathryn Ross, Chief Executive
11 November 2014

Regulator's perspective: PR14 and beyond – speech at Marketforce Water 2014 by Cathryn Ross, Chief Executive 11 November 2014

Thank you for inviting me to speak. It's great to be here.

I will talk about:

- the current price review – PR14;
- our new strategy and how the price review exemplifies many of the principles that our new strategy is built on;
- what our new strategy means for Ofwat; and
- more importantly, what it means for the sector

There will be some time for questions at the end.

2014 price review – delivering for customers

Across the sector £43 billion will be spent on improving services

A saving of at least 340 million litres a day by tackling leakage and promoting water efficiency

- An average 40% reduction in the time lost to supply interruptions

Cleaner water at more than 50 beaches

A target of 100% compliance on drinking water quality

A reduction of 1,200 incidences of internal sewer flooding by 2020

2014 price review – delivering for customers

We are fast approaching 12 December when we will publish our final determinations, which will set controls on what water companies can charge their customers in the period 2015-20.

There is still a lot of work to be done – decisions need to be made, models need to be run. And I cannot prejudice our final determinations.

But looking at our draft determinations, I am really pleased with what this programme has achieved.

The acid test of any review is what it delivers for customers. So let's look at that.

- **Lower bills.**
 - On average, a 5% reduction before adjusting for inflation.
- **Safe, reliable water supply and drainage.**
 - There is an average 40% reduction in the time lost to supply interruptions.
 - A target of 100% compliance on drinking water quality.
 - A reduction of 1,200 incidences of internal sewer flooding by 2020.
- **Stewardship of the environment.**
 - Cleaner water at more than 50 beaches.
- **Leakage.**
 - A saving of at least 340 million litres a day by tackling leakage and promoting water efficiency.

When I say that PR14 will see the companies deliver what customers want, how do I know?

PR14 has been the biggest ever programme of engagement in the sector.

Companies have engaged directly with over a quarter of a million of their customers.

Instead of companies building their business plans and then going out 'to get customer support', like they did at PR09, at PR14 business planning has started with the customer.

Every single company has achieved a step change in customer engagement from PR09.

2014 price review principles

Customer engagement

Outcomes

Risk and reward

Corporate governance
and culture matters



2014 price review principles

The acid test of any review is what it delivers for customers.

But at PR14 we have made some significant changes to the way we regulate.

These were based on a number of principles – principles that matter enormously to me. Because although I have only been at Ofwat as Chief Executive for just over a year, when I was at Ofwat previously – I left just over three years ago – I was largely responsible for putting these principles in place.

What are they?

- **Customer engagement** – already discussed.
- Focus on **outcomes** – the things that really matter to customers and society – rather than outputs.
- More **flexibility for companies to deliver** those outcomes in the most efficient way possible – getting rid of regulatory rigidities. The best example here is the total expenditure approach.
- A **balance of risk and reward** that genuinely aligns the interest of capital and company management with the interest of companies – so that investors can make a good return but **only** when they are delivering what customers want.
- **Corporate governance and culture matters.** This is something that our Chairman – having led companies himself – has placed particular emphasis on, and I agree. This has flowed through to our emphasis in PR14 on Board leadership, governance and transparency.

I know that there is the view by some that PR14 is a one-off correction – a bit like the 1999 review, perhaps – after which there will be a return to ‘easier’ times.

I want to make clear right now that this is not the case. In fact, PR14 and the principles it exemplifies are at the heart of our new strategy – a strategy that will take us through the next periodic review and set the agenda for the one after that.

I want to spend some time now outlining that strategy and saying a bit about what it will mean – for us and for the sector we regulate.

Vision for the sector

Trust and confidence
in a vital public service

An open and
collaborative process

Image © Dan Lavric

Vision for the sector

Our new strategy starts with our vision for the sector. This is critical as it provides the touchstone for everything we do.

Over the past year I have spent a lot of time talking to the companies we regulate, to customer representatives, to non-governmental organisations (NGOs), to government and others. We have held and participated in a wide range of workshops, roundtables, debates and good old-fashioned conversations.

Our vision for the sector has emerged from that open and collaborative process.

And our vision is simple: trust and confidence.

Everyone should have trust and confidence in the provision of these vital public services.

- Trust and confidence in the quality of our drinking water.
- Trust and confidence in the resilience of services – that they will be value for money and affordable.
- Trust and confidence in customer service and in fair dealing.
- Trust and confidence in the stewardship of the environment.
- More generally, trust and confidence that decisions taken today won't impoverish future generations.

We want to see 'trust in water'.

Trust and confidence



Trust and confidence

Trust and confidence is built around two main components: outcomes and strong, effective relationships. Or to put it another way – it ain't **just** what you do, it is **also** the way that you do it.

Let's talk about outcomes first. It is clearly important that companies deliver in line with the expectations of customers and society more widely.

But it is also important to recognise that those expectations have evolved – and will continue to evolve – over time.

So the wrong thing to do here – no matter how tempting – would be for us to write down a list of the expectations of customers and society and regulate to that. I know that some people would like to see us to do that – for some people that is what 'strong' regulators do.

But it would not be right and would not in fact best serve customers.

Rather, we need to put in place a framework that encourages companies to take responsibility for what they deliver – for understanding what customers and society expect, recognising that different people have different priorities and that priorities change over time, and to deliver on that.

You can see that this is what we have done, for example, in PR14 – where companies have proposed an astonishing 399 outcomes **and** incentive frameworks that will see them rewarded for doing more of what customers want and penalised where they fall short.

But there is more to trust and confidence than outcomes. Relationships matter too.

Service providers in the water and wastewater sector need to recognise that they occupy a privileged position as providers of a vital public service – and one in which right now very few customers have a choice of provider.

How those companies treat those around them matters immensely.

Those relationships need to be open, honest, transparent and fair.

The most obviously important relationship here is between service providers and their customers. And I have talked about how important we think it is that the companies own those relationships.

But other relationships also matter, especially when you take account of the importance of the sector for the environment, for the economy and for wider society. This includes relationships within the sector, for example, with the supply chain and with others in catchments, relationships with NGOs, with government central, national and local.

When service providers put themselves in that wider context and think about doing the right thing across all those relationships you do see some different behaviour.

For example, this year companies opted to give back £700 million to customers by not taking their full price control settlement. Actions like that really serve to strengthen those relationships and boost the sector's legitimacy and I commend that.

So... outcomes matter. But relationships matter too.

How do we achieve trust and confidence – Ofwat's role

Be focused on outcomes

Understand and nurture relationships



How do we achieve trust and confidence – Ofwat's role

So, what does all this mean for Ofwat? What sort of regulator do we want to be? How will we best help to move the sector closer to the vision I have just set out?

Our vision for Ofwat is to be respected, stretching and leading edge.

In terms of how we do our job we will do the following.

- We will be focused on outcomes –we will not be going back to regulating to outputs.
- We will understand and nurture relationships too – we will not insert ourselves in the relationship between companies and customers, for example, but will set frameworks that encourage and reward companies who step up and take real ownership of those relationships.
- We will look for and place great weight on the assurance we receive from those we regulate as to whether and how they are doing the right thing. And we will take a risk-based approach to that assurance – where companies have ‘form’ they may find this quite burdensome. But where companies can convince us that they really have stepped up are really delivering and building those strong relationships, they will see us take a less intrusive approach.
- We will be supportive and encouraging of success. Where companies outperform, this is good for companies and for investors and it will also benefit customers – including society and the environment.
- Where we are not satisfied by the assurance we receive we will step in to protect customers, to provide that critical safety net.

Overall, we will challenge the companies – management and investors – to step up, to take responsibility for delivery, for challenging themselves constantly to improve for their customers, and for managing the complex set of relationships they own.

If they get it right, we will support any outperformance they earn. And they can expect additional flexibility within our regulatory framework and a less intrusive approach.

Companies who don't get it right will be subject to more intrusive assurance processes, and more burdensome regulation.

And we will be transparent about what we are doing and why – which will make it clear who isn't getting it right, but will also give them an opportunity to learn.

So what does that mean for our priorities over the next few years?

- Promoting **better information** that shows how the sector is doing:
 - to help us understand who is best placed to do what, and when; but also
 - to help others play their part. We expect, for example, our new financial monitoring framework to prompt some powerful conversations between investors and company managers.
- We will be **implementing the Water Act reforms**.
 - Part of this will focus on non-household retail market opening (which we are already supporting through PR14 and our work with Open Water).
 - But crucially, this will also involve doing more to reveal transactions and costs and cost drivers within the wholesale part of the value chain (where after all 90% of the costs sit) – this will enable us to regulate more effectively, will enable markets to work better, and will reveal better information for use by managers and investors.
 - Of course, this raises questions about how we allocate costs, and the RCV. I know that this could make a lot of people nervous so I want to promise you three things on this.
 - We will be very clear about what we are trying to achieve – and I can say now that we see scope for significant efficiency gains, specifically allocative and dynamic efficiency gains – in the wholesale part of the value chain.
 - We will approach discussions with an open mind, and we will listen to what we hear.
 - We will have closed down the more sensitive issues in this area in 12 months' time.
- **Casework**.
 - We will focus more on strategic cases – the sector's new alternative dispute resolution scheme supports this, and we are also looking at whether we can make more use of arbitration to push this further.
 - As we get towards market opening, we expect more strategic cases.

- And we are going to be more proactive in ensuring that the messages from our casework get through to those who need to know – so they can change their behaviour pre-emptively.
- In the context of market opening, this includes making sure that companies are aware of their responsibilities under competition law.

I fully recognise that our new strategy implies further evolution in our regulatory tool kit. And that will bring challenges for us – in terms of our own capability and resourcing – which is why I have put in place an ambitious **transformation programme** to support it. This is ensuring that the changes we are making in terms of what we do are fully supported by how we work – and who we are in terms of the mix of skills, experience, knowledge, values and behaviours of our people.

What does it mean for the sector?

The sector and other stakeholders stepping up



What does it mean for the sector?

But I still think the bigger challenge here lies with the sector – with the need for companies to really understand their responsibilities as providers of vital public services, both in terms of the outcomes they deliver and, more so, the relationships they own.

We have seen some good examples of companies rising to challenges in PR14 working collectively with stakeholders. Here are some examples.

- Companies have included innovative approaches through catchment management to deliver the best outcomes for customers, including the environment. I heard last week about some of the work that South West Water is doing with the Western Rivers Trust, and many of you will be familiar with Wessex's work on catchment management and United Utilities' SCAMP programme.
- Affinity Water is proposing to reduce leakage by 14% over the control period to help meet demand in its areas without degrading local chalk streams.

But there is a lot more to do – building on the sorts of examples I have outlined here, in terms of really thinking through the customer lens, thinking about the outcomes they want to see and really thinking creatively about how those outcomes are delivered. And the sector needs to be thinking outside the envelope of the traditional vertically integrated water company – making better use of new technologies, seeing the customer more as part of the solution.

As I have said – our vision for the sector is not one that is our unique property. It has emerged from an open and collaborative process. Trust and confidence in provision of a vital public service: it is a vision that really resonates.

And that is good – indeed, it is essential.

Because this isn't a vision we – Ofwat – can deliver alone.

It requires the sector, and other stakeholders, really to step up – to own the vision and take responsibility for doing their part to deliver it.

Seeing what is being achieved through PR14, and seeing how we can build on the principles exemplified by PR14, I am confident we can get there. And I look forward to working with you to do that.

Questions?



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