Water 2013
Keynote opening address
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1. Introduction

Thank you and welcome.

We are about to enter a critical phase in this Price Review process. We are not counting in months we are now counting in days and hours until we will be receiving the company's business plans on the 2 December.

Today I am going to reinforce the messages I am not going to apologise that a lot of what you will hear me speak about today, you will have heard before. This is because this is so very important.

Bills will go down or companies will explain to their customers why.

Cost of capital will fall - when companies put forward their proposals for the cost of capital in their business; there is a real opportunity for this number to start with a 3.

With that in mind, what I am going to talk about today is the foundations that will underpin a successful business plan and these same foundations will ultimately underpin the success of the sector going beyond this price review.

2. Building blocks

This is a really unique opportunity for the sector to write a different future and do the very best that we can – for customers.

We have set a hard challenge for companies – and we don't underestimate how hard this has been.

Like with a Lego kit, a prescriptive set of instructions for companies to build their business plans in line with may have been the easier option and we would have resulted in a generic set of plans that look the same.

We didn't do this and we didn't do this very deliberately because it has meant that companies have the opportunity, for the first time ever, to build a business plan that is right for their customers – we think that the benefits are worth it.

This is a real change in the relationship between the companies and us – the regulator. And most importantly, the relationship that companies have with their customers.

3. Foundations

What is important however, is that these business plans are grounded upon solid foundations:

- customer engagement;
- affordability;
- statutory obligations;
- financeability; and
- board assurance.

A successful business plan will have provided robust evidence that these factors are being met. If a plan fails to meet any of these – we will not consider that plan to be "enhanced".

Customer engagement

You will have heard me talk a lot about engaging with customers through this price control process.

I think that we can all see the significant changes that have already happened in how companies are interacting with their customers. This is fantastic and it is a permanent change for the good of the sector going forward.

Part of the challenge for companies has been to find a way of communicating with customers so that they understand and accept the difficult choices there are to be made around infrastructure investment, planning for the future and protecting the environment.

The business plans along with the customer challenge group (CCG) reports will need to be supported by good quality evidence that customers support the proposals put forward. This means that where there are cost pressures, that customers understand what it is that they are paying for and why. Where there is the opportunity for scope –

to be flexible and responsive to customer needs – these choices are backed up by robust evidence that customers support those outcomes.

What this does not mean is to ask for instance “would you want a 2 or 4 or 6 per cent increase in bills”. We would not consider this to be good engagement.

Affordability

Customers are telling us and are telling you that they are struggling financially to pay their costs of living.

Along with the other utility bills, water bills are increasingly featuring in the wider affordability debate.

This isn’t surprising. In the last decade incomes have increased by around 14% but combined water and sewerage bills have increased by around 40%.

You heard me at the beginning of the speech and you will have heard me say before that in the business plans we are expecting companies to reduce their bills. Where a company is not reducing bills they will explain to their customers why.

There are real opportunities for companies to pass on efficiency savings and the benefits of the low cost of finance to their customers over the next five years.

At a conference earlier this year, I used the midpoint drawn from analyst reports of a 4.1% vanilla return to highlight what a large impact a 1% fall in the cost of capital could have on customer bills.

I could see at the time that companies could do better and I expect that companies will do better than that, given the opportunities presented by the current economic environment.

With nominal bond yields down around 1.2% since prices were set in 2009 and record low interest rates, I would like to think that in their business plans some – if not all – companies will go lower than that, there is a real opportunity, as I said before, for this number to start with a 3.

Efficiencies from setting separate controls for retail and wholesale along with other changes such as totex, water trading and the use of an average cost to serve control create the scope for bills to be reduced even further.

Companies should be responding to this by giving serious thought to how they are going to achieve lower bills for their customers in their business plans.

What would bad look like in this space? If bills don't go down and you don't explain to your customers why. Companies will lose the legitimacy of their customers and ultimately we will all lose the legitimacy of the sector.

Bills this year

I am also hoping that companies are responding in the more immediate term. You will all be aware of the letter from the Secretary of State to all water companies on 5 November.

In it he stated that he did not expect any of us would want to wait until the next price review before tackling bills.

He also referenced the fact that the lower cost of capital than that estimated at the last price review has led to higher than expected profits and noted that he supported our Chaiman Jonson Cox's letter where companies were asked to consider whether you would implement the full price rises you were granted at the last price review.

Some companies are already hearing these messages

Financeability

Now, like with all the other areas the onus is firmly on water companies to demonstrate that their business plans are both financeable as well as affordable, and that the right balance has been struck between rewarding investors and serving their customers.

Companies will need to be able to demonstrate that their activities are financeable under a range of scenarios. In performing our assessment we will also assess whether individual controls are financeable in their own right.

The role of Ofwat is not to provide risk-free investments. However we are committed to the framework that has seen over £116 billion invested since privatisation. We are therefore looking to companies to ensure a fair balance of rewards to customers and investors, based on risks being allocated appropriately between them.

A bad outcome in this space would be a sector that cannot attract investment.

Statutory obligations

It will be no surprise to hear that companies must meet their mandatory statutory requirements. If they do not set out how they will successfully meet their statutory obligations their plan will not be successful until they do so.

This is not just our statutory requirements but also environmental obligations and obligations about water quality

What this means is that a high quality plan will include a high level of assurance that the outcomes and performance commitments will result in compliance with its mandatory statutory obligations.

This does not mean that the only business plans that will be classed as enhanced are those with “gold plated” environmental improvement programmes.

Companies should deliver the most cost-effective solutions and where they are proposing environmental improvements over and above their mandatory obligations, robust evidence of customer support is critical.

Where companies do not adequately demonstrate that they will meet their future statutory obligations we will intervene; until such time that they can and will.

Board Assurance

As we have moved away from a more prescriptive approach to regulation.

We expect each company’s Board – the whole Board – to take responsibility for signing off its business plan.

What this means is that we expect each Board to give us a statement, in its own words, stating how it considers that all the elements add up to a business plan that is high quality. The statement will explain how the Board has held the management team to account and how it has challenged and tested the proposals within the plan.

In this vein - past performance also matters. Take SIM scores for example. For those companies that are at the bottom end of the SIM table, they clearly have much more work to do in order to deliver a good outcome for customers than those that are already scoring highly.

What bad would look like would be for a company to provide a list of Board meetings and agendas.

4. Built upon strong foundations

It is a challenge and I don’t underestimate how hard pulling all of this together into a robust coherent plan and obtaining customer support for that plan is.

I believe that some companies will achieve this.

For these companies that are enhanced this will mean that their plans are excellent and so there will be no reason to intervene.

So what is the prize?

- A lighter touch procedure which will save costs and give them an early start on implementing their plan – put simply if a company is enhanced, we will get out of its way.
- This early start provides clear opportunities in terms of getting going with engaging along the supply chain.
- Reputational benefits – an enhancement of the reputation of these firms.
- Higher performance incentive rewards – companies will have access to ‘enhanced menus’, providing them with the potential for further rewards when they outperform.

5. Rebuild

We recognise that this is a new process and some companies will not achieve enhanced status.

In that instance we will ask that company to take parts or all of its business plan apart and start again.

Some plans – standard plans – will need revision to part of the plan prior to the draft determination to deal with the issues we highlight.

Other plans that have more systemic failure will need to be resubmitted in their entirety. This will be where the foundations we have talked about do not hold the plan together and it has failed to deliver for its customers.

We will work throughout 2014 with those companies who need to resubmit to ensure they can also produce a good plan by December 2014.

However, it will be the company who rebuilds the plan – with our support. This is because we think this is really important that ownership of the plans are with company Boards, rather than having the regulator re-work the poor elements in the plan.

6. Successful price review

Wherever a plan comes out following the risk-based review – whether it gets on with it as an enhanced company or requires significant reworking through the resubmission process – we will end up with all companies providing the best service possible to its customers at the best price.

It is within the companies control to avoid the pain associated with significant regulatory intervention and enjoy the benefits associated with being enhanced.

Companies – don't allow your plan to topple because the foundations were not established.

What we are doing here together is really different and it is really special. If we are successful we will end up with a sector which will have earned the legitimacy resulting from the trust of customers and a stable sector for investment.

Personally I find that hugely exciting

And to end – in case you have not heard it clearly enough already listen well – customers' bills will go down or the company will explain to its customers why