Uncharted waters: a forward look at managing change in the water sector

A speech by Jonson Cox, Chairman of the Water Services Regulation Authority (Ofwat)

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OFWAT

This is the speech as drafted. It may not exactly match the speech as delivered.

Foreword

Thank you very much for coming this afternoon. It's good to see so many familiar faces here. I'm joined by members of the Ofwat team, including Cathryn – just back from a speech to investors in Berlin in a similar vein to this.

I'll always remember my first meeting as Ofwat Chairman, a week before my formal start date in November 2012. I had spent the night before underground, on the night shift, at Daw Mill Colliery, in my role as then-Chairman responsible for restructuring UK Coal plc. That afternoon, I came to an Ofwat/industry meeting which showed that the water sector was at loggerheads. Many of you will remember that debacle – the section 13. Arriving as the new regulator, I was struck by the absence of trust between all involved, and how the dialogue between the parties appeared to have broken down – although Ofwat was legitimately trying to drive reform. I had come from stifling heat 800 metres underground to what could be called a boiling cauldron back in water.

The section 13 debacle showed how corrosive a breakdown of trust and confidence can be. I have no desire to revisit those arguments today. It could have been a much worse ending. There was fault on both sides without effective dialogue to help break the impasse. Ofwat was talking on a conceptual level, with little evidence of real thinking of how the concepts might be put into practice. Companies had reached for the 'contract' and their magic circle lawyers. The managements who led the issue spoke only about investor interests, with no mention of customers' perspective although their duties are to their companies and their stakeholders 'in the round'.

There was never going to be a meeting of minds. It took some settling. I personally led eight weeks of three-way intensive discussions and tough 'diplomacy'. As a result, we concluded with a reformed process for PR14, a path towards retail opening and regulatory reform, and a licence undertaking which ensured that there was an obligation on companies to work with Ofwat in a constructive and co-operative manner on the development of a new way of regulating.

That was nearly two and a half years ago. Since then, I have had the opportunity to think extensively about the role of a small, independent economic regulator, regulating a public service which is vital in every sense of the word and which is provided largely by monopoly suppliers.

Today

Today I'm going to share some of that reflection with you. I will take a brief look at a few of our achievements, what we've learnt from PR14 and the upcoming challenges. When I've worked in the past with financial stakeholders I've occasionally heard Ofwat described in a way that might imply our role was to simply set price limits every five years and to define some outputs. We, of course, do have statutory duties to customers to ensure that efficient companies are financeable. But I've come to appreciate that our role is rather broader.

A critical function we fulfil is not expressed explicitly in legislation. This is our duty to ensure that the sector delivers the promises of privatisation, that the best of private sector skills and experience will be brought to the delivery of essential public services; that a monopoly industry is kept on its toes; that it doesn't fall back to the public purse. Most importantly, that it retains the trust and confidence of those it serves – customers and all the other stakeholders, including environmental interests and investors.

March 2013 ‘Observations’

Let’s go back to my speech two years ago – ‘Observations on the regulation of the water sector’. The ideas I put forward then were met with a frosty response from some, yet there was no one in the sector who could materially question the legitimacy of what was said. Now, I’m gratified by the number of people who have come up to me and told me how timely and progressive those ideas really were in maintaining trust and confidence in our sector. Nevertheless, I hope that what I say today receives a rather warmer welcome.

In that speech, I set out six interlinked concepts about the future of the water and wastewater sector. My words probably were provocative and were intended to start a strategic debate about how we could move the industry forward and in a quicker way than a classic ‘strategic review’ would have achieved.

I started with customers, whose trust and confidence is the bedrock of a stable industry. Their support for their water providers was in danger of being damaged at a time of high inflation, falling real incomes and substantial outperformance for shareholders. We needed to take into account the fragile physical environment on which our industry depends, both for abstraction of water and for discharge of wastewater, and for which others depend for amenity and livelihoods. We needed a revised thinking about sharing pain and gain in the light of the shareholder returns we had seen in the early years of AMP 5. I indicated we would need a new approach to PR14 and a new approach to regulatory reform.

We wished to be less intrusive but needed to know that we could rely on Boards to lead their companies in the interests of all stakeholders in this vital public service. If we were to devolve more scope and initiative to companies, we needed to see much higher standards of Board leadership and governance – which had slipped back in many companies from the requirements of the licenses and from public expectations of good Board leadership.

These six themes are all linked together in a cohesive whole. This “whole” requires the sector to step up; to understand its responsibility, the drivers of trust and confidence, and to take more responsibility for constructive dialogue and for delivery. This would enable us to be a more proportionate and targeted regulator.

Together, these six themes may have gone beyond the role of economic regulation as it has been narrowly understood. And indeed, there were a number who told me some of the ideas were not the purview of a regulator. Naturally, I beg to differ and I’m pleased to see that the ideas we have developed are gaining traction in other sectors and have helped maintain confidence in the water sector.

Achievements

Let's just reflect on some of our achievements since this time.

I was very worried in 2013 by the stark contrast between the economic lot of customers and the performance of the sector. Over the last two years we have changed attitudes towards what companies should do to maintain their customers' trust and in particular to address affordability for less well-off customers. We are interested particularly in initiatives on affordability which help reduce the mounting problem of bad debt, ultimately paid for by all customers. I have been personally impressed by the WaterShare scheme proposed by South West Water. Each company will choose its own approaches, but I thought this was a very useful template from a company who above all needed to regain the trust of its customers and seems determined to do just that.

Secondly, the resilience of water resources is receiving more attention in AMP 6. Companies allocated almost £700 million in their business plans to invest in resilience. For example, the programme committed by just three companies will mean that more than 500,000 customers will benefit from enhanced resilience protection. On the sharing of pain and gain by water companies, I'm pleased to see that PR14 has shown much more acceptance of this concept. We have now taken this further with the development of ODIs which set operating targets for providers and create material incentives and penalties for performance.

Thirdly, the dialogue that brought us out of the section 13 debacle identified the need for a new approach to the 2014 price review. And it's true that the early days of PR14 were dark. In May 2013, we found Ofwat was six months behind schedule, with no delivery plan and no CEO. But I'm delighted that after many sleepless nights by our teams, and under the strong leadership of Sonia Brown, we delivered a fair PR14 outcome.

And lastly, how could we give a licence to a vital public service which is part of the critical national infrastructure, without an understanding as to how the Board and its owners would behave? A regulator should not give companies more flexibility, and adopt a less intrusive approach, without itself being confident in the leadership and governance of company Boards.

Who would have imagined the extent to which we've been able to bring about an improvement in the quality of Board leadership? It helped to explain our approach by dividing our role into two parts: an economic regulation role where we set revenues to enable companies to finance their functions and keep a monopoly on its toes; the other is our role setting the licence terms under which this unique monopoly public service operates.

A very positive outcome is the number of Chairmen and Non-Executives who have told us that their own roles are more rewarding as a result of the emphasis we have put on Board leadership. I'm pleased to see the numbers of new, high-calibre Non-Executives joining our sector. This bodes well for companies taking ownership of their own business and customer relationships. Our Board leadership work may be food for thought for how other public services in private hands approach such challenges in the future.

I was also pleased to hear from Cathryn that investors at the Berlin conference this week complimented us on the approach to Board Leadership and Governance. I was perturbed to hear that some thought we should do the same for management incentives. We won't. It really is for owners to control management remuneration and demonstrate how their approach satisfies and aligns with the needs of all stakeholders in the company. We do provide useful tools in our delivery incentives and performance reports.

What have I learned following my March 2013 speech about independent regulation?

I am not a regulator by background although our Executive team is led by experienced regulators, from whom I have learnt a lot. We've achieved wider acceptance of our job in holding the industry to account. I hear companies talking in the language of legitimacy, of maintaining a vital public service and recognition of the importance that strong but fair independent economic regulation plays in creating confidence for investors, customers and all stakeholders.

Contrary to first impressions, I discovered that we could have dialogue and we could bring about change more informally than requiring licence changes for every step. This has been a profound change. None of the achievements I have just listed would have taken place without the constructive, collaborative and ongoing dialogue succeeding. It has taken many forms; the formal setting of a Board room, informal strategic discussions with some Chairmen, wading through chalk streams in Hampshire, seeing inspiring new inset appointments take shape and trudging through new sewers. The best conversations, wherever they take place are open, honest and straightforward, with a clear sense of purpose.

Importance of dialogue

The importance of dialogue stretches beyond the conversations with water companies. When I took up the role of Chairman I attended various focus groups around the country. One that sticks in my mind particularly was with a group of pensioners. I listened to their concerns about bills through the one-way viewing window and, as the focus group drew to a close and the participants were repeating their desire to speak to someone who could recognise their dissatisfaction, I was invited to go into the room and meet with them.

As we talked it was clear that the person they needed to talk to was the CEO of the water company, not the regulator. The starting point for dialogue and engagement should always be between a company and its customers. Only if that dialogue fails to deliver should the regulator step in.

The regulatory relationship should evolve progressively. So, it’s better to start with dialogue – provocative as it might need to be – than to resort to the “contract”. Incidentally, dialogue does not mean negotiation. I have learned that we needed to be clear-speaking and not intimidated by controversy. Conversely, it needs companies willing to engage and to debate subjects that might be difficult, and involve change, but which ultimately have some common sense or public legitimacy to them. It’s a tribute to all in the sector that we’ve been able to make achievements through dialogue.

I’ve also learned that it remains vital to offer companies the chance to differentiate. We can build on the good achievements of comparative competition, as we widen the goalposts and give companies the chance – and incentives – to differentiate and to show their customers and their peers that they can perform better and be rewarded for it. I look forward to seeing real outperformance in service delivery, and indeed superior equity returns for companies who really deliver exceptional levels of performance. Over- and under-performance will be transparently clear.

Naturally for all of that, the starting point is customers – a philosophy which was reflected in the way we approached the most recent price review.

In PR14 we were determined to create a more dynamic sector, more honesty (or you could say transparency) and more choices for water companies in the way they put forward their plans. The gap between “the best and the rest” should be and now is larger – a range of four hundred basis points (or 4%) on equity returns. Winners were not necessarily those who thought they were tipped to be enhanced – it’s a good sign of dynamism that few, if any, predicted the companies who got enhanced status.

The rules changed. If as a management team you played by the practices of the 2009 price review, you didn’t do very well. We achieved more focus on operating the business well. We’ve capped the ODIs this time at a range per annum of +/-2% RoRE – very significant in its own right. We may go further in future periods – or even in this period – if this creates the desired focus on operating the business well and with less reliance on outperfomance from simply gearing up the balance sheet.

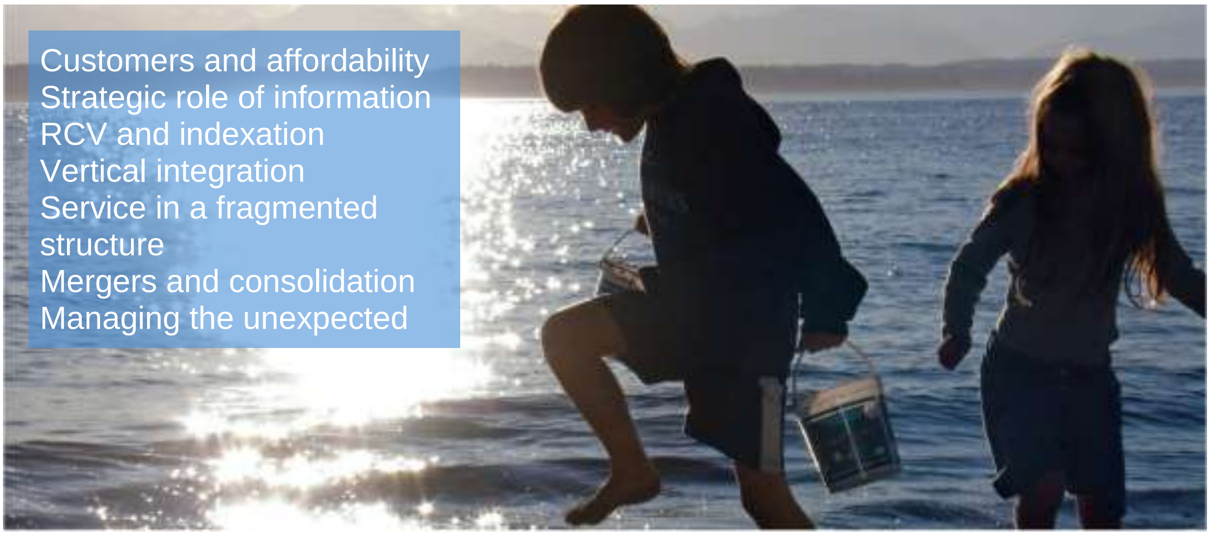
We continue as regulators to be under scrutiny about the level of leverage in utility sectors. If the risk profile of having more at risk on operation causes highly-leveraged companies modestly to de-gear, that would be a good thing. Our job is not to create the highest level of certainty for the industry; it's to put the risks where they are best managed and in doing so we create a very secure and stable investment.

We also look to managements to do an outstanding job. I was asked earlier this week by a journalist if extraordinary longevity and very modest turnover of managements in this sector says either that all are doing a great job, or that there has been complacency in applying the pressure of competitive markets? I imagine that Boards and owners will be asking themselves this question. We set a challenge for all management to reach the 2013 "upper quartile" standard for service and efficiency; in 2019 I imagine we will set a dynamic "upper quartile" challenge which will better emulate the reality of competitive markets.

We put much more emphasis on dialogue – dialogue between companies and customers and dialogue with the regulator. That created many fewer surprises. We signalled very clearly the direction and outcomes. Most Boards received their final determination on 12 December with a pretty accurate idea of what was going to be in it. We learnt the importance of dialogue directly with investors. The number of such conversations in PR09 could be counted on one hand (I am told). At the last count, we were at over 400 meetings with investors and a far more extensive range of conversations with companies.

A personal point for me – and perhaps for all my Board – is that we make very difficult judgements. We hope to get most of them right but will occasionally make a mistake. We work with far less information than the sector we regulate. I discovered that regulators have to be very brave – a small number of people, limited information and difficult judgements. I was pleased when difficult discussions were recognised as fair. In The Times, the day after our final determinations, Chief Business Commentator Alistair Osborne wrote: "Regulators are there to make unpopular decisions. Yet, on balance Mr Cox's pricing determination looks sensible." It was of course a team effort rather than a personal one.

Going forward: the future agenda



Reform isn't over. In fact, it's just beginning. No industry should be allowed to become complacent. Complacency is the enemy of innovation.

Customers and affordability

I don't need to say much more about customers, service and affordability. Companies need to develop or improve on their offerings to customers who find it hard to pay. There are plenty of incentives to do so, including maintaining customers' trust, their willingness to pay and indeed keeping bad debt down. I look forward to seeing significant differentiation in all services – a real frontier shift. My personal observation is that this sector has lagged behind the rest of the economy in enabling customers to have power and control over the service they receive and relevant performance data. They want real engagement. The frontier has moved radically elsewhere using all form of media at the time and in the way the customer wishes. The tolerance for service failures is much lower and the expectation of responsiveness and resolution is far higher. We've given companies freedom and the tools and we shall be monitoring that carefully.

Information

This touches on a critical future role for us, our strategic role in the provision of information. Our old style of collecting information – disbanded with the demise of the June return – was voluminous data, mostly impenetrable and little of which was used. Having gone to collecting very little, we now see a different approach. We believe we have a strategic role in making sure companies provide accurate and useful information for us and for all customers and stakeholders. We see a suite of data that enables third parties easily to see how the company is performing compared to its commitments and be able to compare and contrast across the different monopoly suppliers around the country. This is not just an information request for us to be able to do our next price review; it's also to enable all those third parties who depend on the industry to see how companies are performing. PR19 will enable us to select enhanced companies based on a proven five-year track record.

RCV and indexation

I'd like to move onto a difficult issue which we flagged in our strategy: RCV and indexation. The regulatory capital value was a concept introduced to help the regulator determine the value of assets on which to base the return. It's become very important to the investors in the industry. At the time of privatisation it was also fundamental to investors that assets and revenues (assets as measured by RCV) were indexed to the inflation measure of the day – Retail Price Index.

Indexation – together with the regulated return – has been fundamental to the influx of pension fund money into the sector, enabling funds to match their liabilities. We don't at this stage debate the concept of indexation for wholesale assets.

It's clear that we cannot continue to avoid the question of retail price inflation or indeed which parts of the supply chain should be indexed. We are called on to address this issue as a matter of urgency by many parties. For example, in a consultation the Institute of Fiscal Studies claimed that RPI is "no longer fit for purpose" and called on regulators to address this. Pensions, benefits and incomes (if you're lucky) go up with CPI at best.

Our industry is index-linked to RPI, which systematically over-counts inflation by up to 100 basis points above CPI. We recognise and are fully aware of the quantum of RPI index-linked debt. Financial markets are nothing if not adaptable, but we realise that change may take some time, innovation and potentially 'grand-fathering' of some elements. It's one of those areas where we are looking for a grown-up and constructive debate as to how we move forward.

Vertical integration

When I arrived in this sector just over two years ago, there were howls of protest at the thought that we might dismantle the vertical integration of the sector that has prevailed for twenty-five years. I respect the pride of management in controlling a supply chain from source to tap and sink to treated river discharge. The logic of vertical integration no longer works. The money invested in this sector seeks the asset base. The capital intensive nature is largely confined to the network and treatment businesses. It’s very clear now, that the argument which was decried by managements two years ago, of retail separation is catching on in water companies.

Why would an investor who’s interested in deploying large amounts of capital in a monopoly business, subject to reliable economic regulation, wish to invest in a retail business with between 1 and 2.5% margins, a capital base limited to IT systems and a business responsible for managing very large amounts of bad debt? There are others who may be better than doing that than the investors who are attracted to the networks, and the management who have had their careers wholly running a monopoly service.

I started off more sceptical about the separation of upstream activities. It has become clear to me that if a country, with a growing population and a diminishing availability of water due to climate change, is successfully to tackle its upstream challenges, we have to allow the innovation that results from having a choice of sources. The Water Act 2014 has created the opportunity to start to discuss the separation at the retail end and we are very interested as companies come forward – and they are doing so already – with ideas about separation.

Service in a fragmented industry

There’s a further point on service which we’re going to have to think very carefully as we introduce choice or standalone retailers for all business customers – from the corner shop to the much larger – and retail and potentially upstream separation. Other networks have fragmented before water – for good reasons of giving customers choice and of exposing where costs really lie in a monopoly supplier. But competition and contestability is often frustrating to customers when something goes wrong.

If competition between retailers takes place on only one or two factors – for example, price and ease of switching – retailers are only incentivised to act in the best interests of their customers in relation to the things that drive competition. But customers are concerned about network issues. If a frustrated customer is left trying to engage with a monopoly network that only picks up the issues from the retailer three weeks after they occur – as recently happened to me in a sector I had better not name – that customer is not going to feel trust and confidence. We and companies need to think about how customers will be directed to get the quickest possible resolution in an area where different corporate entities will provide different parts of the service. As we break up the supply chain we mustn't lose customer confidence to deal with wholesalers and networks as well as retailers.

Mergers and consolidation

I want to say something about mergers and consolidation. It's the time in the five-year regulatory cycle when there is speculation and some attempts to reframe the sector. Comparative regulation has been very powerful but is also a constraint. Comparators are not useful if they don't lead to setting new frontiers every five years. The old model was to seek a share of productive efficiency for the company in putting two water or two water and wastewater companies together. Those approaches have now run their time and would not get support from us today.

We're not out to encourage consolidation – indeed de-consolidation could be viable – but we recognise that we and the CMA may receive proposals to do so. In the event that we do, we would expect to see more than telling us that putting two water companies together is more efficient. If efficiency was so closely linked to scale we'd be able to predict accurately the league table of efficiency. The reality is that we have very efficient companies at the small end and some efficient companies at the top end of the scale. (Portsmouth Water is 1/100th the size of Thames yet gives many in the sector a run for their money on efficiency.)

We're interested in different ideas. Why do water companies need to be water and wastewater companies? Would there be more efficiencies available by two companies putting their water businesses and their wastewater businesses together as two separate entities? A merger of this form might be simpler. What do we gain if two companies put their wholesale business together in one corporate entity and their retail business together in another corporate entity?

All of this offers opportunities for companies to come forward. The CMA's test still relates to Ofwat's ability to make comparisons so we will continue to play an important role in any merger process. The Water Act 2014 brings changes that enable the CMA to accept undertakings in lieu of a full enquiry. We would be looking for a level of innovation.

Managing the unexpected

Lastly, managing the unexpected. There will be unexpected challenges in AMP 6. There were unexpected challenges in AMP 5. We confronted what we regarded as excessive shareholder returns at a time of real hardship for customers. That led to difficult, and at times confrontational, dialogue. It would be a fallacy to pretend that any of us setting a five-year deal can forecast every outcome. It’s equally important that we do not create uncertainty in the regulatory framework by continual change especially within an AMP period. The overriding principle for us is the maintenance of trust and confidence in the sector. If we see unexpected events which challenge the trust and legitimacy of the sector in a material way we will continue to raise that with the industry and we look to companies to come to the table constructively and fairly, just as we will.

All of that puts more weight on dialogue; to have a constructive and progressive approach – not lobbying – and two-way dialogue, we need a joint understanding and commitment that we tackle relevant issues in a timely way so as to maintain trust and confidence. We learn from seeing how companies, investors and customers respond to our challenges. We have made Ofwat a much more open place for all third parties, not only for companies but particularly for their investors. There need to be some ground rules for this dialogue. Dialogue that works best is dialogue that is honest, open and straightforward, with a clear sense of purpose. It can take place formally, or informally. But above all, there must be mutual respect between the parties – the need for trust and confidence extends to companies’ relationships with the regulator and vice versa, as well as with customers.

Conclusion

So to conclude, the last two years have established a lot. Not just about how to run a price review or to set licence conditions, but also about the role of an independent regulator. While the regulator has formal duties, our real role is much broader and helps to deliver the implicit promises made to customers when the sector was privatised 25 years ago. To ensure trust and confidence within the sector we encourage and facilitate honest and open dialogue which welcomes new ideas and approaches and looks to open up competition and opportunities across the sector. We have a role in focusing on the whole rather than individual parts of the sector; and ensuring they work well together for customers.

As The Times said regarding my appointment; “There is nothing poachers hate more than a gamekeeper who knows where the pheasants are buried”. It’s true in that sense that I became a ‘poacher turned gamekeeper’ when I took on this role at the behest of colleagues in the sector. As a ‘gamekeeper’ I will always ensure that the regulator stands ready to step in when companies fail to protect their customers as they should. At a recent launch of our strategy, a respected analyst asked the audience if they preferred independent or government regulation across the industries in which they invest around the world. The answer was clear.

But in truth I feel neither poacher nor gamekeeper. This is an industry I am passionate about, to which I have a lifelong commitment. And to me, it doesn’t matter on which side of the table I sit, that commitment will always be the same.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.

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