
The future of water regulation

Utility Week Live: Keynote Conference

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- Domestic competition in 2020 – potential challenges and opportunities
- Maintaining investor confidence in the sector
- Maintaining customer confidence in the sector
- Cross sector opportunities

Introduction

Good morning everyone. Thank you to Utility Week for inviting me.

For anyone who follows water, you'll have noticed it's **an exciting time** for the sector. Indeed 'embracing transformation' could be said to sum up the sector right now!

I want to use this opportunity to talk here firstly about the **drivers of that transformation**, and then to talk about **what we are doing as the regulator to** inform, enable and incentivise a transformation that really delivers benefits for customers, society and indeed investors. And I also want to talk about **what others are doing**, how people are working together to deliver something great for customers and society, which after all why all this matters...

Our changing world

Quickly to recap, a lot of you will be familiar with the complex challenges the water sector are facing and which go to the very heart of what our sector does.

Our **population is growing**. It is projected to rise by 20% in the next 20 years with much of that will be concentrated in the already water-stressed South East and London, where we have today less water per head of population than Malawi or Morocco.

We are seeing **demographic changes** too with an increase in single occupancy households, which use more water per head than multiple occupancy households.

Then there is the added pressure of **climate change**, which is bringing more severe weather events – more drought, more flooding, less drizzle. More places and times where we don't have enough water. More places and times where we have far too much where we really don't want it.

And, both as customers and citizens, we have **higher expectations** not only of **what** we get in terms of levels of service but also **how** we are engaged with by our service providers and how we **feel** about that.

I'm confident that just as rising expectations are here to stay, so **affordability** will remain a **huge issue for at a decade at least...** And what that means is that spending our way out of these challenges of population growth, climate change and rising expectations simply isn't an option any more.

The only way the sector is going to square this circle is by doing **more with less**. The problem our transformation in the water sector is trying to solve is really clear. It is about becoming more efficient.

And that isn't just about doing the same things the sector has always done in the ways they have always been done, while taking 10 percent out of the cost base. This about **the tough stuff**. Finding new and better ways of doing things, allocating those scarce resources we have - including customers' money, investors' capital and our natural capital - to those uses we value most.

And that isn't just a transformation for the sector. It is a transformation for the regulator too.

I think Einstein defined insanity as doing the same thing over and over again and expecting different results. The same thing applies to regulation. Just **cranking the handle on the old regulatory model is not going to deliver transformational efficiencies**. In fact it isn't even going to deliver the same efficiencies we have been used to - our efficiency challenge as part of the price review back in 1999 delivered £39 off the average bill. In 2009 it was £11. In 2014 it was £10.

To get the step change in efficiency we need, we need to regulate differently.

Which is what we are doing...

What we're doing to deliver against these challenges

I have talked before about the fact that Ofwat has a **new regulatory model**. It sees us moving away from a model that was rather administrative, one size fits all and intrusive, towards one that is more framework-based, more proportionate and targeted and more pro-market. And that is crucially accompanied by our increased emphasis on regulatory reporting, market monitoring and assurance. So that as we enable markets to develop, we can know whether they are working well and delivering for customers and society.

Essentially this is about Ofwat becoming a **pro-market regulator**. Not in the sense of saying 'competition is the answer now what's the question'... But we do see markets - as places where buyers meet sellers and where transactions take place - as key to informing, enabling and incentivising that transformational efficiency the sector needs. Because **markets create options, they enable choices, and those choices reveal information**. About what companies should make or buy, and about how they should do this, and from whom. And those transactions reveal information to others who may not even yet be part of the water sector, about value they could add, opportunities they could realise....

We have had our strategy in place, with that new regulatory model for 18 months now. And you can really see a lot of our work aligning around it.

Water 2020/ PR19

We set out some key planks of our thinking back in December in our Water 2020 consultation document. And just a quick plug - our decision document will be out on 25 May.... Back in December, we were explicit about seeing **scope for markets to add value in three areas**.

Water trading: to enable companies to see and choose the most efficiency incremental new water resources. Not stranding existing assets - I emphasise - but making sure that the most efficient new sources of water, which could include re-use or demand management, or sources from beyond the company boundary are visible and chosen.

Sludge treatment and disposal: to enable companies to understand whether other providers of treatment and disposal services can better extract value from sludge than they can. These providers might be other water companies. They might be other firms who generate renewable energy from bio waste. These markets are already emerging, but so far regulation has hindered their development. Here we see

scope for the services provided right now by the companies to become contestable. Because technology in this part of the value chain is moving fast. And because asset lives are typically pretty short - 15 years rather than say 200 for water resources.

Direct procurement for customers: this is about learning the lessons from the experience of the Thames Tideway Tunnel, which shows the potential for companies to procure new kit on behalf of customers, so that customers benefit. In this way we see **scope for new models**, with companies potentially choosing third party solutions that include designing, building, owning and potentially also operating new infrastructure.

We are making **changes to the way we regulate to enable all of this to happen**. Separate **price controls** for water resources and for sludge treatment and disposal, to reveal costs, improve companies' focus on these activities, and also to enable us to challenge efficiency in these areas specifically. We are also looking at what we need to do in terms of **information and trading platforms**.

But even beyond this, we are building on our work at PR14 to **use regulatory processes to drive markets**, by creating places where buyers can meet sellers, and, even where there isn't choice in the market, preferences can be revealed. This is exactly what we are doing with our continued focus on **outcomes driven by customer engagement**. It is perfectly possible see this as pro-market regulation.

Retail market opening

Elsewhere we, together with Defra, MOSL and of course companies, are working hard to introduce **competition and choice in the market for retail services to business customers in England**, with the market opening in **April 2017**.

This will reveal information about customer preferences and provide incentives for providers to respond to those and to **drive down retail costs**. I'm expecting customers' bills to come down in some cases. But I'm also expecting improvements in **customer service and account management**. And in provision of **water efficiency services**.

And I'm expecting all of this not only to benefit business customers but to reveal new frontiers in customer service and retail cost efficiency for the part of the market that isn't competitive, for the **residential part of the market and for the bulk of business customers in Wales**. Which will help us when we set price controls there in PR19.

Of course we have been asked by the UK Government to look at the costs and benefits of **extending retail competition in England** to the residential part of the market. Our emerging findings will come out on this in July and our final findings in September. After which Government will decide how it wants to proceed.

The market for corporate control

And in all of this we are not ignoring the **importance of the market for corporate control**. As information is revealed, as it becomes clearer what companies need to do to reach a tougher efficiency benchmark, it is logical for investors to look across the value chain, and decide what activities they wish to specialise in, and which they would prefer not to do. They will wish to respond to this perhaps by contracting with others, or perhaps by exiting some parts of the value chain and consolidating in others. We are open to this.

I have said before and I will say again that **I don't have some industry structure, some blueprint I am working towards**. But I do think it is important that investors are able to respond to all of these transformational elements I have spoken about. Our more nuanced approach to regulation facilitates this, as does our work to bring in wider comparators and market information.

So... You can see that in terms of our strategy, we are well on the way from that administrative, prescriptive, one size fits all model towards someone more framework-based, more proportionate and targeted and more pro-market.

There is more to come.

Other developments in line with our model

We still have work to ensure that our **Casework** programme will be able to deal with the demands of casework in vibrant, dynamic markets, where for example retailers will want things from wholesalers that none of us have yet heard of...

And we still have a lot of work to do in developing our regime on **regulatory reporting, market monitoring and assurance** to ensure that we understand not only what companies are delivering for customers and society today but the resilience of those outcomes over the long term, and the risks to that. And we need to develop our market monitoring so that as we roll out markets we know whether they are working and where interventions may be needed. A lot to come on this!

And although I have talked a lot about what we are doing, it isn't just us on this transformation journey. We have been really upfront in saying that **we couldn't delivery our strategy alone.**

The sector stepping up

Not only does our vision of trust and confidence in water and waste water services rely on others, our regulatory model does too. It crucially relies on those in the **sector stepping up**, taking advantage of the flexibility they now have, using the information available to them and really embracing the responsibility they have as providers of vital public services.

And it is great to see this happening.... You can see the changes in the sector already.

We saw companies really embracing the transformation **we started in PR14**. Really running with customer engagement, feeling their way with outcomes, and trying out totex.

I have spent quite a bit of time with companies over the last few months and it is great to see some of them really building on this. I have to say it has been amazing to hear how some companies have reorganised their businesses to really focus on **outcomes and their ODIs**, and to take full advantage of **totex**, including in their **alliancing arrangements with the supply chain**, which do much more to unleash the potential in the supply chain to develop and implement new solutions. I'm expecting all of this to deliver a **new frontier in efficiency for PR19**.

Many of you will know all the hard work going on to get ready for **retail market opening in England**. Not only in the retail part of the value chain, but wholesale too. And it has been great to see some companies making big **strategic choices** about whether and how they want to play in this space, with the creation of Water Plus by UU and SVT and Portsmouth deal to exit to Castle Water.

And many of you will also know all the work that is going on within companies on **50 year water resource planning**, which will really help the to take advantage of those water resource markets I was talking about earlier.

Government support

It is also worth noting too that all of this is happening against the backdrop of a supportive government policy regime too. Not only in respect of retail market opening in England, where the UK government is obviously very much involved, but I'm also thinking about the **support of DEFRA and the EA and Welsh Government and NRW for the long term, wider look at water resource management planning**. I'm thinking about **payments for ecosystems services** in Wales. I'm thinking about **abstraction reform** in England.

Relationships - the critical success factor

I have talked about a lot of different elements of the transformation that is going on across the water sector, I want to finish by bringing in one more.

And that is the transformation in **relationships** across the sector. Relationships between companies and customers, relationships with government, relationships between the various regulators and between us as the economic regulator, the companies and their investors.

We have **come a long way**.

In some ways I think s13 trauma we went through when we tried to achieve the infamous '**enabling licence modifications**' back in 2013 were a wake-up call for all of us. And I'm very proud of the genuinely constructive, co-creative process we've followed to come up with our Water 2020 proposals. And those who have contributed all their hard working and thinking across the sector should be proud of that too.

I'm also really pleased with the **quality of the conversations we have been having with investors** too - which have come a long way even in the last few months. We have gone from I have to say quite a lot do suspicion about our commitment to transition from RPI to CPI on a NPV neutral basis to a genuinely constructive conversation about how we should make that happen.

And of course it isn't just the relationships that we as the regulator hold that are so important in delivering this transformation. The **relationships held by and across the sector are critical** too.

I have talked already about the relationship between **companies and their customers**. Which is critical if customers are to maintain confidence in these vital public services through a period of change.

And I have talked too about what I see as a really positive change in **relationships between companies and the supply chain** in the context of outcomes and totex.

But I think it is also worth stressing the importance of those companies we regulate **developing new relationships**. As the boundaries of the traditional water company become more porous, as the outcomes customers and society want depend on more complex systems, relationships across **catchments** and with **communities** become more and more important.

And it is also great to see - as I do - the water companies increasingly looking to develop **relationships across sectors**. To bring in the learning for example from the **energy** industry where there are quite a few experiences we can learn from in what we're doing. And to look across sectors for best practice in **retail**, for example through the bodies like the Institute of Customer Service.

And I have to say that of all the elements of transformation I have talked about it is these deeper, broader more mature relationships that gives me the greatest hope that **we will - all - succeed not only in 'embracing transformation' but delivering that transformation** really effectively. On a scale and at the pace that is needed to ensure the sector maintains and builds on trust and confidence in water and waste water services.