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## Water Market Reform 2016, Monday 4 July 2016

### Keynote opening address: Water and wastewater markets: short-term challenges, long-term evolution

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#### Introduction

Good morning everyone.

Well. We live in **interesting times**...

**Brexit.** Who knew?

Not the markets, that's for sure. Not many of the opinion pollsters. Not many of the bookies. I suspect not that many of the politicians. But we live in a democracy, our government was elected with a promise to hold a referendum, that has happened, and the British people overall have made their choice to come out of the European Union. There has been a cottage industry in post referendum analysis. And I won't go through it all here (we have a conference to participate in...). But the one thing that **we can all agree is certain is uncertainty, at least in the near term.**

I want to use the opportunity this speech provides to share some reflections on the events of the past few weeks and what they mean for the water and wastewater services sector. I want to talk a bit about the **immediate impact** on the sector and on our regulation of it, but I also want to talk about the **longer term direction of the sector** as well – and as I do that I will give you a sneak preview of some of the findings coming out of our work on **residential competition in England.**

But returning to Brexit, one can think about its implications in respect of our politics, our legal framework and our economy. So let's just consider each of those in turn and what they mean for the water sector.

## Our politics

No denying the uncertainties there. A **change in the leadership** of the Conservative party, a change in prime minister and quite likely in cabinet ministers. **Changes in the shadow cabinet** too. High political drama, fascinating debate. But when you look at the implications for the water sector, I'm not sure that there are many that are new to us.

As I said, we live in a democracy. Democracies are **dynamic, changeable** things. But we have a sector that benefits from independent economic regulation. Precisely to provide the sort of **predictability and stability** that closer government involvement could never bring. If nothing else, the events of the last few weeks should serve to bring home to all of us just what a valuable thing that independence is, that ability we have to get on with the job. Valuable for companies so that they can **plan over the long term**. Valuable for investors who can make their decisions based on **long-term expectations** about what the sector holds. And valuable for customers who benefit from **lower and more stable prices** as a result.

It is true that Government policy has an impact on the sector, but two points on that. First, that was always true and I don't see the drivers for policy change being noticeably different today than they were a few weeks ago. And second, let's not forget that we only recently saw the enactment of the **Water Act, in 2014**, and the delivery of the **Wales Water Strategy**, which paves the way for reforms that will keep us busy for several years – we were not 'due' a new policy framework.

## So what about our legal framework?

As you know, a lot of the legal framework in the UK is either directly applicable European legislation or UK legislation with its origins in the EU. No immediate uncertainty there, as we are still members of the EU for the time being. But what happens then? We know that one areas of our legislation that links back closely to EU law and policy is **environmental protection**. On one level what happens there clearly depends on the settlement we negotiate. But most of that EU law has been **transposed** into UK law. So it depends too on the appetite of the UK government to row back on environmental regulation that forms part of UK law, but which has its origins in the EU. But right now, and until any change is agreed and implemented, the companies' obligations are what they are.

It is also important to remember that water companies' contribution to the environment does not only reflect compliance requirements. **Customers and society value the environment**, and they expect water companies to play their

part in its stewardship. This is reflected in the performance commitments the companies have made to their customers. And it will remain important for water companies to deliver against those commitments and deliver for the environment over the long term.

And from the perspective of the economic regulatory regime, again the **sector looks stable**. Unlike telecoms or energy or transport where there have been many 'single market' initiatives from the EU, water – by dint of physics – has not lent itself to those. The economic regulatory regime in water does not track back to EU law or policy. There is no European Single Market in water. There is no Europe-wide market architecture. No EU rules on access pricing. Or capacity allocation. The obligations of water and wastewater service providers are not set out in European directives. I do not see a need for the economic regulatory regime in water to change as a result of Brexit.

## Let's talk about the economy

Right now we can see a certain amount of **turbulence** as markets respond to the decision, and a lot of **speculation** about how the macro economy will be affected. A few points on this.

First, let's not forget the fundamentals of the water sector. The fact that the companies in the sector provide a **vital public service**, using assets that are by and large well known, well understood and not going anywhere, within a regulatory regime that is **predictable and transparent**. Fundamentals that have long meant the sector is seen as a safe port in a storm by investors. None of those fundamentals have changed.

Second, from the perspective of companies and investors, some of the emerging scenarios actually look **favourable**. I'm not in the business of speculating on macroeconomics, but there is talk, for example from the Bank of England about **higher inflation** and there is also discussion about the prospect for **lower interest rates** driven by concerns over lower economic growth. Especially taken together these things could lead to **financial outperformance** for water companies.

Thirdly, I want to talk about the effect on customers. Again, that depends on a combination of what happens in the macro economy and on government policy, for example on austerity and wealth distribution. And again, I am not in the business of speculating. But if we follow through one scenario that is being discussed at the moment – high inflation, low interest rates, lower growth – there could be a

**significant impact on customers.** One in which the cost of living rises at a faster rate than household incomes. A scenario in which more customers than at present are struggling to pay their water bills – and we know that right now around 20% report themselves as struggling. And potentially also a scenario in which more customers are finding themselves in **circumstances of vulnerability**.

## So what does all this amount to?

I don't have a crystal ball. But there is a scenario, one that is being raised by, among others, the Bank of England, that foresees **higher inflation, lower interest rates and lower growth**. And I want to point out now that that scenario could pose a **very significant challenge** for the water sector. A challenge of customer legitimacy. Because it is a scenario in which water companies could remain a very attractive investment proposition, water companies and their investors could enjoy substantial financial outperformance, at precisely the same time as their customers become poorer and find it harder to pay their bills.

There are undoubtedly a lot of people engaged in scenario planning exercises right now. And I would encourage water companies to plan now for that scenario. And to think about what they would do to avoid a **potentially significant impact on customer legitimacy, on trust and confidence**.

And I would also encourage water companies not to take their foot off the gas in their **pursuit of efficiencies** that benefit customers. If companies do find themselves doing well as a result of higher inflation and lower financing costs, they need to ensure that there is no let up in their search for totex efficiencies, for better ways of using resources, for new and better ways of doing things.

Why? Partly because delivering those efficiencies, efficiencies which directly benefit customers, will help enormously with that **customer legitimacy challenge**. And partly because all of those things I have been saying for a while about PR19 are no less true today than they were three weeks ago. It is going to be a price review where we see the efficiency frontier shifting substantially, where we are looking at what we should do to move our benchmark from upper quartile to closer to the frontier or something more forward looking, and whether we should look again at the glide path we give companies to get the benchmark. It is also going to be a review for which we look again at the balance of incentives as between performance on totex, financing costs and outcome delivery, with a view to getting the best alignment we can between the interests of companies and their investors and those of customers.

To be completely clear, I should also say that I see no reason at all to change the wider policy framework for our regulation and specifically for PR19 that we published back in May. We remain of the view that markets have great potential to inform, enable and incentivise companies to achieve new **frontiers in efficiency**. Especially through better use of resources and innovation. And especially when coupled with **effective, proportionate, targeted regulation** that supports the development of those markets and provides a framework to enable their benefits to be shared with customers.

Indeed our strategy with its shared vision for the sector of **trust and confidence** in water and waste water services isn't changing. Our regulatory model, bringing with it a move away from reliance on a one size fits all, intrusive, administrative regulator-focused approach, towards an approach that is more framework based, more pro-market, with more proportionate and targeted regulation and greater focus on customers, coupled with a greater emphasis on regulatory reporting, market monitoring and assurance, that hasn't changed either. And our work across our portfolio continues, very much as we had planned it.

And that includes our work, the work we were asked to do by the UK Government, looking at the costs and benefits of **competition for residential customers in England**. We still plan to report to Government on this in early September, and we still plan to publish our emerging findings next week.

If you will forgive a shameless plug, our Director leading the review, Giles Stevens, is speaking later in this conference on that topic. I won't steel his thunder, but I think you will find that presentation and our work very interesting. We are finding customers to be very interested in the idea of being able to **choose their supplier** – indeed somewhat unclear why they can't now. We are finding some scepticism about whether on the basis of current business models the price savings on offer would be sufficient to get customers excited. But importantly we are also finding significant potential for **new business models** to emerge, which have the potential both to increase scope for price savings, to reduce switching costs and to engage customers on issues such as water efficiency.

These are all very much emerging findings at this stage, and as I have said consistently our work will not result in our recommending any decision to government, but interesting nonetheless and we would like to hear from you about whether we are looking at the right costs and benefits in the right way.

## So let me come to a conclusion

I'm not denying the significance of the events of the last few weeks. But, as far as regulated water and wastewater markets are concerned, the **fundamentals remain** very much as they were and are sound. The independent economic regulatory regime insulates the sector as it has done since privatisation from the effects of political turbulence. And in any case the Brexit decision itself doesn't prompt great changes to the legal and policy framework for the sector. Our work continues as planned. And in line with all of this, in line with the **Water for Life policy framework and the Water Act 2014**, in line with the Welsh Government's **Wales Water Strategy** and in line with our **Water 2020 policy framework**, I don't see significant changes in the way I would expect the sector to evolve over the longer term.

The challenge I do see in all of this for the water sector is that of **maintaining customer legitimacy**. Not a new challenge – a perennial challenge for the sector. And if we have a higher inflation, lower interest rates, lower growth scenario, one that could look a lot like the challenge the sector faced at the end of the last control period.

It is imperative that the sector **meets that challenge**.

The good news is that we know companies **can do this**. By keeping that connection with customers, focusing on delivering against their expectations and recognising their circumstances. By planning ahead and focusing on the long term. By constantly challenging themselves to achieve new frontiers in efficiency.

Ultimately by doing the **right thing**. And being able to demonstrate that to customers and society.

Success will require board leadership, enlightened investors, focused company management and – as always – the good offices of a passionate and engaged workforce.

With all of these things in place, the sector is **well-placed** to come through the next few years building on those sound fundamentals with greater legitimacy. With trust and confidence in the vital public services it provides enhanced. And I very much hope that it does.

Thank you.