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## Financing water efficiency

### Speech by David Black at Annual Waterwise Water 2017 Efficiency Conference

8 March 2017

#### Introduction

**[Slide 1: Title slide]**

Good afternoon everyone.

Firstly, I want to say thank you to Waterwise for holding this event on such an important event and inviting me to speak here. Water efficiency is a vital issue for the water sector and for customers and for Ofwat.

Congratulations to Nicci on her new role, while very sorry to see her leave Ofwat and lose her hugely valuable help across our work programmes, I am delighted that she has returned to Waterwise and am sure she will be huge success.

The title of my presentation is financing water efficiency – but I have taken liberty and expanded scope to cover how we step up on water efficiency for PR19 and beyond. Firstly, I discuss the opening of the retail business market in England and the retail residential review and what this means for water efficiency. Then I will set out key themes for PR19 and role of water efficiency.

The opening of the retail business market in three weeks creates new opportunities for retailers to work with customers to save water and reduce wastewater. As the wholesale charge is 90% of the bill faced by customers, retailers who can help customers reduce demand can share these savings with customers. The opening of the retail market has important implications for the wholesale supply chain as retailers will engage with wholesalers to better serve their customers.

**[Slide 2: Customers at the heart: image of a large tap on left hand side of panel and smiling people/customers on right hand side]**

For too long, the sector has focused on supply points or a tap rather than customers.

For the industry, customer's numbers are not really the number of customers but number of supply points, customer identities are not names but locations. Companies have understood too little about their customers, their wants and needs and individual preferences.

Poor understanding of customers is also reflected in high levels of bad debts, if you don't know your customer, then it may be difficult to get them to pay for their service. Understanding what customers want and how to best meet this need is key to better water efficiency and better sector.

So one point I want you all to take away is that opening markets and economic regulation is not just about a better retail service, it is about a better understanding of what customers want and finding better means of delivering what customers want including improving water efficiency and leakage.

We have already seen the benefits from innovation in the competitive market in Scotland such as examples of better leak detection, closer monitoring and water efficiency audits that have saved customers thousands. In England, companies offer Active Water Management Programme which monitors their customers' water consumption for irregularities, advises how usage can be reduced and can highlight leaks.

Why should this kind of technology not be available to residential customers?

Our residential retail review was something of a wakeup call, retailing has not evolved in the same way as in competitive markets, with customer service stuck in a pre-digital age. It identified considerable opportunity for a competitive retail domestic market to work to improve water efficiency and reduce leakage. We await the outcome of the Government's decision on opening the market, but in any case, we are conscious of the need for the retail service to step up.

## **Wholesale markets**

Last year in our May Water 2020 policy document, we set out key aspects of the policy framework that will govern the next review. This includes where we want to see markets develop in the sector.

As you will know, we have proposed development of markets in water resources and bioresources (also known as sludge) and direct procurement for customers of large discrete infrastructure.

We think these markets will increase resilience, create value and drive efficiencies through the value chain which directly benefit customers. This will improve legitimacy in the sector.

Markets will also drive resilience by ensuring we drive the value within the resources which are being utilised. Unproductive resources need to be mobilised certainly before we start developing lots of new resources. Markets can help liberate that potential.

## Looking ahead to PR19

We've identified four key themes for PR19; resilience, innovation, customer service and affordability.

Today I want to look at how we are considering water efficiency in each of these contexts as we look towards the next price review.

But first, I think some quick context is in order to explain where we've come from and where our approach to PR19 is going before moving onto the PR19 themes.

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[SLIDE 3: Outcomes: Affinity Water]

### First of all...outcomes

In PR14 we incentivised companies, with rewards and penalties, to focus on the delivery of **outcomes** that matter to customers both now and in the long-term.

During that price review, one example was Affinity Water's consultation with its customers over its acute water resource challenges and options for how it could address them.

This engagement led to stretching performance commitments of a 14% reduction in leakage and a 7% reduction in average water use which will involve changing investment and operating activities and working with customers to change their water use behaviours.

Its early days but already we are seeing an improvement in performance from leading companies as a result of this new framework which will shift the efficiency frontier forward for PR19.

We have consulted on our outcomes approach in outcomes for PR19. We want performance commitments to be more transparent, stretching and powerful so customers get more for their money and we drive further improvements in service.

We are also proposing that there will be a common performance commitment or commitments on resilience and we are currently working with the sector on what those measures might be.

We have proposed ten common performance commitments to be used as standard at PR19, which include internal customer property sewer flooding, wastewater pollution incidents and sewer collapses.

### Totex

For PR19 we are continuing with the totex approach we introduced at PR14. This

removed the perceived bias between capex and opex, allows companies more flexibility and enables them to manage future uncertainty around their investment programme.

The companies who are successful with this will shift the frontier forward on costs, and this in turn will drive our view of the efficient level of costs for PR19.

## Next risk and return

Another key component of the way we regulate is the efficient allocation of risk and aligning interests of investors, company management and customers by how we set allowed returns.

In PR14 we adjusted balance of risk and return to focus more of the returns on performance and less on outperforming financing assumptions. We have already signalled that we see need to take this further in PR19. We need boards and management teams focused on the business and its our role as a regulator to ensure the incentive framework is aligned to this.

Our initial assessment of business plans in PR19 – replacing the risk based review process in PR14 will be assessing ambition and innovation in business plans. We recognise that a good business plan is not just a great plan, but one that see real change in value for customers – better and more resilient service and lower costs.

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Now I want to move onto the focus of today's speech, resilience, water efficiency and why this matters for PR19.

## Resilience

Resilience is not a new focus for Ofwat.

Even before we were given our new primary duty under the Water Act 2014 to further the resilience objective, we considered it “in the round” – social, environmental and economic.

We believe resilience is about all the systems and services that customers rely on - not only about capital-intensive solutions.

And to start, let's consider for a moment our external environment: firstly, some of the “known unknowns”

We know we face challenges of climate change, water scarcity and population growth which go to the very heart of what our sector does.

The impact may be drier summers and wetter winters, heavier and more irregular rainfall which could put more pressure on wastewater systems.

Population growth of between 6 to 12 million by 2040 and 12 to 32 million by 2065 will increase demand and is likely to meet more paved areas and more run off to contend with.

And yet we are continuing to see discussion around large infrastructure projects as the means of achieving resilience.

We're not ruling out that this as an approach, it may indeed be appropriate in some cases, but we do think it is important that companies consider a full range of options, both **demand** and **supply** and **within and beyond** their boundaries. Solutions that can adapt and flex as we learn more about the future challenge and the potential of better demand management and smarter network management have inherent value.

This is something economists refer to as real option value: this recognises the irreversibility of sunk investment and the ongoing uncertainty of the economic and the social environment and impact of climate change. Real option value recognises the benefit from delaying a decision to build a substantial new asset such as a reservoir and learning more about potential for other more flexible measures to address issue first.

#### **[Slide 4: Rising population but falling water demand in England (2000 -2015)]**

To highlight this point, the graph behind me shows us that distribution input, or the total amount of water input into the network (Reducing distribution input means reducing leakage and/or per capita consumption), in England has fallen by 10% over the last 15 years. This is despite growing population. Put yourself in shoes of water companies planning demand 15 years ago, they too faced pressure of strong population growth and climate change. This shows the answer can be to focus on demand side rather than supply.

We should celebrate that the sector has been successful regarding falling consumption. We've been really pleased to see the sector upping its game on demand management, working with Waterwise, who have shown great thought leadership and acted as a delivery catalyst for change in this space over the last decade.

It is impressive to see water demand falling, even as population growth and demands for other forms of infrastructure have increased.

Our early thinking about using a measure of distribution input as a common performance commitment for PR19, reflects that it is total water demand that matters. Not one particular component such as leakage or per capital consumption, which emphasises the importance of an integrated approach.

## **Innovation**

#### **[Slide 5 – Innovative approaches to resilience]**

Resilience is concerned with tolerance to risk and risk management, and we can see society's tolerance towards risk is changing.

We only have to look at the recent spate of bursts in London to see what distress these can cause for customers and the political and social attention such instances can attract.

We expect companies to be adopting new technology to manage their networks, thinking about how they interact with customers, how they use customer data effectively to target services and reduce demand.

Innovation is not new to the sector for instance, development of catchment management approach by range of companies and Wessex Water have developed a trading platform to work with farmers on options for upstream catchment management.

However, historically our regulation has penalised losers when new approaches have failed - which may have curbed appetite for innovation.

Now our outcomes-focused approach will reward winners, incentivising innovation. But its important to remember that innovation is not just about clever new technology, it is about changing how we deliver services.

As meter penetration becomes more widespread, particularly in SE, the easy benefits for water efficiency from rolling out meters will have been enjoyed – it will be important for companies to innovate and really think hard about how to best influence behaviour of customers to reduce demand.

Likewise on leakage management, many companies are at or below SELL – but what if new technology opens up dramatic new possibilities for reducing leakage? SELL should not be a static concept. Innovation and new ideas for demand management and reducing leakage have potential to avoid some of the heavy costs and inflexibility with infrastructure heavy options.

In the energy sector products such as Hive empower customers to control their lights and turn on their heating remotely. Boiler IQ offered by British Gas can automatically monitor your boiler for faults.

We think innovation at in retail, networks and resources should drive resilience. We will also hold an event in March designed to highlight how customer participation and co-creation can work

There is no more water, from the beginning of the value chain to the end, we are simply moving around what already exists.

If we want to create more water, we have to reduce the amount of demand on it to start with.

It might take a generation but we need to start getting customers used to the idea that

Not only is this fundamental to the long-term resilience of water supplies and the environment ... it also helps to keep the bills down.

And this is especially crucial because, while we need to ensure that services are resilient for the long-term, another theme of PR19 is going to be affordability.

## **Affordability**

### **{Slide 6 – Affordability}**

More resilience and ensuring people can afford their bills.

It's up to all of us as to how we make this work.

Our 2015 report on affordability showed that risk of not being able to pay your bill increases significantly where households spend more than 3% of their income on their water bill – 24% of households across England and Wales.

That increases to 32% if you take Wales alone.

A separate but related issue is addressing needs of customers in vulnerable circumstances. There will obviously be some particular groups of customers that need special attention, it means that vulnerability needs to be integrated into a company's plans to deliver great customer service overall.

The forecast increase in inflation and slower growth towards the end of this regulatory period is likely to exacerbate cost of living issues for many customers. It is also true that we are expecting an efficiency dividend from outcomes and totex approach and development of wholesale markets.

We expecting companies to challenge themselves hard to become more efficient, business as usual should not be assumed to mean flat costs. In the wider corporate environment and indeed in Government, we have seen dramatic cost reductions. We expect to see companies reflecting this in their business plans. Efficiency gains mean more scope for companies to reduce bills and deliver more resilient and better services. It also means rethinking business as usual and highlights importance of innovation, customer engagement and demand management.

## **Conclusion**

So to conclude.

Companies have made a good start but there's so much more to do.

As we ask the sector to build on this with a real step change in the scale and ambition of their water efficiency plans, we're keen to see more of this smart ways to co-create

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and work with customers, new ways of doing things and working with third parties to deliver for customers.

We think water companies should be thinking about and working on water efficiency, not only through the water efficiency practitioners in their supply/demand teams, but at Board level, and perhaps most importantly, through the customer lens.