9 March 2017

Trust in water

Water UK City Conference 2017

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Regulatory Keynote Speech

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Regulatory keynote speech

Good morning!

I am delighted to be here this year once again. When I was approached to speak, I was going to be abroad; it was only very recently that I realised that Water UK had changed the date so I was indeed able to be here!

It is exactly four years since my first speech as the Chair of Ofwat. I set out then my reflections on the regulation of the water sector and the performance of water companies. Since that time much has changed. Some for the better, to offer a fairer deal to customers. Some things haven't changed enough.

Today I want to reflect on our ongoing priority to modernise the sector and its regulation. I will reflect on changes over the last year. I will consider retail competition. I shall tell you why, as a hypothetical view, PR19 may offer very significant headroom either to improve the resilience of the service customers receive, or materially to cut their bills, or both.

Our current approach

But, first, to take stock of where we are. We've found a much more constructive engagement between economic regulator and the companies. There's a healthy mix of respect and of challenge between us. We don't win popularity contests in this role. I see that our job is holding companies to account on behalf of customers and the public interest. We hope our approach is complemented by investors also holding managements to account for performance to all stakeholders and I would see current conditions enhancing that alignment at PR19.

The effectiveness of Ofwat has been re-established under the executive leadership of Cathryn Ross and her team. Lines of communication with stakeholders are better, more honest and, for our part, more direct. Ultimately customers get a better deal when regulation works well; investors are more likely to find the predictability they crave if regulation is respected and progressive.

A good example of better working is the licence changes. Who would have guessed back in 2012, that in 2016 we would successfully navigate the licence changes

needed for the next periodic review without appeal and without fractious moments? Who also would have believed that we would signal our methodology a full year ahead of the AMP6 cycle? Or that the big tricky issues like indexation and RCV allocation would be clear this far ahead? I hope you would agree that this has built the credibility of Ofwat.

So far, so good. The ship has been steadied. We give companies more room to excel. We come down much harder on those who fail their customers or bring undue risk to customers or the public interest. We've become better attuned to the real world and more progressive in the way we signal changes and allow companies to decide for themselves how to adopt those changes. But of course, we will still enforce change where companies fail to respond.

I am asked: Is it all about competition?

We are seeing an increasing role for markets. But, we don't say competition in this context and the difference is not semantic. We are opening some markets to competition. In some cases these markets won't ever be truly competitive in the traditional sense - water resources or direct procurement may be cases in point. But we will try to make market forces work as well as we can, for example by reducing transaction costs, by making it easier to trade and by more transparent cost information. Companies - whether incumbents or new entrants - can then make better decisions for themselves.

Business Competition

A really big change, set in motion five years ago, comes in three weeks' time when the world's largest retail market for water will open for 1.2 million customers - businesses, public sector, third sector organisations. They will be able to choose who provides their services.

Getting ready for that has been a long term, herculean, effort. It has required collaboration and hard work all round.

I know for companies it's been a big effort and success is not yet guaranteed. There have been big system changes, changes in management structures. Colleagues led by Sarah Hendry at Defra, Ben Jeffs and MOSL, working with our team led by Adam Cooper, have done a great job in getting us to this point.

At the micro-level, companies have had to do a lot of housekeeping on customer data - to check whether customers comply with water regulations, verify their data

etc. Maybe it required more housekeeping than really should have been the case. It is important because retailers in competitive markets won't stand for being messed around by data or system inadequacies of previously monopoly incumbents.

Strategic Change

We're very interested in the diversity of strategic choice between companies. Three years ago I was met with disdain when I asked those running companies why they would want to keep competitive retail businesses, given low margins and the lack of opportunity to deploy large amounts of capital at regulated returns in a monopoly. Some could not contemplate a world in which they did not control an integrated system of source to tap and its corollary in wastewater.

Over the last year events have moved at a pace. Two big companies have divested their retail business; two others have formed a joint venture so as to minimise costs and get the benefits of volume that are required in a low margin business. Others are rumoured to be selling their businesses, WoCs are collaborating or outsourcing. It shows that if the incentives and opportunities are there, the sector does respond and we see a plurality of solutions.

We all speculate about the extent of change that will come and whether it will justify the cost of introducing competition. I hear there are large contracts already in the market; some will win business, some will lose. Volume is particularly critical in a low margin business as well as a step change downwards in administration costs.

But I am confident we will see innovation for customers in services, credit terms, bundling and billing administration, for example.

And this is just the beginning - whether it's by changing legislation or through economic incentives - we are giving companies choices at various points in the supply chain which will drive efficiency. This is symptomatic of the move from 'productive' efficiency (which may be harder to find in the future) to 'allocative' and 'dynamic' efficiencies.Residential Competition

You know that a year ago the Government asked us to look at the prospects of extending retail competition to residential customers after 2020. I was among many who wondered how competition would deliver value for residential customers. We could all see ***a priori*** that the real question of benefits was not whether there was significant savings to squeeze out of a retail gross margin of maybe 10% - maybe a quarter of that 10%?

The more challenging question was what competition might do for innovation, for improved service, for integration of household billing with other services and – probably most significantly – the effects a demanding retailer would have on incumbent monopolies that are the wholesaler. The latter is possibly a more effective source of change than an economic regulator and we heard of really good examples from new entrants in other sectors of public service.

The study opened my eyes to how slow water companies have been in looking for new ways to serve customers; how ineffectual they have been in tackling bad debt, how passive they have been, rather than restless to push the frontiers. One asks if steering the ship has been a steady cruise for those enjoying their monopoly position rather than the challenging voyage of the choppy seas that customers and competitive businesses face in their daily life.

We wait to hear the Government's decision on residential competition; I know some companies and investors have accepted that it may well happen in some form over the next decade.

The enhanced service benchmarks we learnt about help us right now. Even without competition, the results from our review will inform our views on frontier levels of service and innovation and the way we approach the setting of retail price limits in PR19. I would counsel companies to pay close attention to this. Please don't think that just resetting the SIM for monopoly services will hit the spot!

The Price Review of 2019

So, let's turn to what appears to be on most people's mind which is the price review of 2019. I remember that this time five years ago - early 2012 – I hadn't even been offered the role at Ofwat. We were in a heady world for utilities of high inflation, low cost of debt and out-of-this-world dividend payments. A world that didn't seem terribly fair to customers.

So here we are heading to the new price review. There are many decisions still to make and our Board will be consulting on its methodology in July. But it might be worth asking, how might it look to someone sitting at the Board of Ofwat thinking about this? I emphasise these are of course personal views at this stage and stated in a hypothetical sense.

But as the Chair of Ofwat it is worth sharing these hypotheticals with you even now. I perceive the potential for a very material level of headroom on prices which could be delivered for customer's benefit through service improvement, infrastructure

investment, system enhancement or price reduction. Let's take a tour of the factors that create headroom for us.

The world of customers.

It's challenging as ever. Inflation is rising; it's not clear that incomes will follow, and the economy faces some head winds. By 2019 we are likely to have left the European Union and who knows what opportunities or challenges that will bring. Last week the IFS warned of very weak increases in ordinary people's incomes over the next two years. Affordability will remain high on the agenda. It's ***not*** just about social tariffs for the least well off - important though that is.

Companies' experience of consulting on their social tariffs has shown that there is only a very small percentage – perhaps 1.5% - of the bill which most customers will pay to subsidise the least well-off; this underlines the importance of keeping prices down for all.

Our work in recent years on vulnerability has shown that over half of us at some stage in our lives are vulnerable and need extra help, be it in service or price, from our utility providers. That's very different from the way we all thought for several decades about vulnerable customers.

And customers are embracing innovation in the way they deal with their household providers to an unprecedented level.

Their expectations of how they are treated is changing rapidly as my mailbox shows. Above all, I take from this a world where customers expect clear evidence of value-for-money, expect suppliers to ease their pain and fear a challenging economic future.

Starting with customers is the first step in our PR19 journey.

Asset Health

Then our diligence will turn to companies' performance, including asset health performance and other outcome performance commitment measures. This is an asset intensive sector. Two thirds of all expenditure goes on asset maintenance and asset enhancement. Each price review has enabled more resilience; each price review sees some £25 billion spent on maintaining and improving assets. It's our job to make sure that money has been spent effectively and is delivering what customers have paid for.

I still get worried about attitudes towards this; only a few weeks ago Cathryn had to correct the impression given to a Local Authority by a large company that work to maintain their assets could not be done unless Ofwat funded it. To be clear: this is ***not*** the way the system works. First, it's customers not Ofwat that fund companies; secondly, it's the company's responsibility to maintain its assets. Talk about 'waving a red rag' to the regulator.

Companies delivered their best estimate of efficient expenditure, and for that sum they contract to deliver stable and resilient asset serviceability. In hindsight we saw significant increase in expenditure in PR14 on enhancement and indeed resilience – which helps explain why prices only fell by 1% per annum despite the largest ever reduction in the cost of capital. So, as we go into PR19, we need to see as a baseline that existing assets are resilient and have been maintained in accordance with licence obligations.

Efficiency

The next stop on our journey would be **efficiency**. We changed the playing field markedly last time by the introduction of TOTEX to see what additional productive efficiencies could be found by creating a "cash pot" as opposed to separate OPEX and CAPEX lines.

The underspend in 2015/16 would have excited me about the potential efficiencies we were seeing, if I were not inclined to put more weight on this being late spending more than large efficiency (I have to say it doesn't speak well of the business planning process by companies that they take money ahead of needing it and seem unable to phase expenditure in accordance with their business plan – something we shall be more watchful about going forwards).

The Totex approach has shown great effect in the energy sector. We have great expectations for Totex; smarter approaches, such as catchment management, enable large capex-heavy costs to be avoided and postponed, benefiting customers. We will take account of actual and projected evidence of efficiency gains from AMP 6 at PR19, using and projecting the limited data available by 2018. If you want scare yourself silly, look at the Totex efficiency achieved by NGC.

We'll also be taking a careful look from the real world of competitive businesses. Following the recent devaluation of sterling, we're seeing major UK companies bearing down once again in radical ways on costs and productivity in the face of import price pressures. We'll want to see how managements of network water utilities, not exposed to competitive markets, deliver a comparable productivity improvement.

We've signalled market opportunities to enhance the scope for dynamic efficiencies. We will open up the market for bio-resources which is up to 10% of the value chain of a water and waste water company. Maybe this element of the value chain is better thought of as an energy business, rather than as a disposal problem. Bio- resources may well be a stand-alone commercial energy business in its own right.

I am conscious that our separate price controls will bring some increase in complexity but it's on the route to less intrusive regulation.

It will put a sharper emphasis on companies' efficiency at different points in the value chain. Incidentally, this may well lead to further steps of companies divesting areas they don't see as core to their business, while they concentrate on their regulated monopoly networks.

Innovation

We'll also be considering and forming a view on the scope for **innovation** in this sector. As much as any management in the sector, I could tell you of many innovations that have been made. But I wonder how truthful those claims really are, especially when the supply chain to the water industry repeatedly tells us that the UK water industry is one of the slowest adopters of new approaches in the world.

Financing

And the last point in our journey around the inputs to the price review would be **FINANCING** which is always close to the heart of this conference. We're in an extraordinary world of "lower for longer". Government debt is now raised at a negative rate in real terms; the allowances we made for new debt in 2014 continue a 30 year habit of over-estimating the cost of debt.

So we are considering indexation for new debt and that our estimate of the efficient cost of existing debt takes account of outperformance by the sector as well as evidence of market benchmarks.

It won't be lost on this audience that the cost of equity for stable mature well-regulated infrastructure assets has fallen markedly. Listed water companies are currently trading at around a 25% premium implying a ***nominal*** cost of equity of under 7%. We have seen institutional transactions at premia well above those observed in the market for the listed stocks. These transactions tell us that investors are willing to accept a cost of equity even below these levels.

Lower returns for incoming investors will increase their focus on the potential return for operating and performance on service and efficiency. This is complementary to our focus on companies striving for the frontier, and creates more alignment of interest, if investors play their part in holding companies to frontier performance!

A company was recently bemoaning to me embedded debt raised at 3.6% real terms. I had to say to them that this approximates to the nominal equity returns at which pension funds and infrastructure buyers are bidding for low-risk infrastructure these days – rates which are half those sought a decade ago. I believe Moody's recently discussed a wholesale WACC of around 2.5% for PR19. I need hardly point you to the WACC we achieved on TTT through competitive bidding

So where do we go with this? In my hypothetical tour of PR19, a step change in efficiency, segregation of the value chain, opening up of markets, innovation and record low financing costs all creates significant **headroom.**

Headroom

We could be looking at the potential for a material reduction in prices to customers. At a time when customers are hard-pressed and economic markets are not strong, that may be very attractive to customers. We shall expect to see companies consulting their customers for their views on such opportunities.

Now of course price reductions are not the only use of that headroom. There may very well be further investment in infrastructure required to deliver an ever more resilient sector. Spending on resilience in this sector is nothing new. Each price review has brought improvement in the sector's resilience. We recognise that there may be considerable expenditure for "hard" infrastructure for new water transfer schemes, for flooding resilience, for service continuity.

I am told some think Ofwat is "anti-infrastructure". When I came into this role we were faced with the biggest single infrastructure project in the history of the water industry: the Thames Tideway. I was lobbied left right and centre for more sustainable, less capital intensive schemes. Some of these had good arguments but we decided that there was a clear case for the delivery of the £4.2bn infrastructure project to meet EU directives and avoid fines. It was for Ofwat to focus on how to deliver this and obtain value for money for customers- which we have done.

Resilience

Let me say a little about how we see 'resilience' unfolding in PR19.

We take a holistic view of resilience “in the round”, following the Cabinet Office’s guidance and interpretation of resilience. We expect all aspects of company’s service to its customers to show an appropriate level of resilience – whether it be water supply, prevention of waste water flooding into homes, corporate structures or the reputation and standing of a company with its customers. A resilient sector is one that is able to navigate its way through operating, technical, financial and affordability challenges in a smooth and predictable way.

In that context it’s worth looking at water in the east and south of England. We are very conscious of growth in population, expectations by customers of resilient supplies and the need for appropriate supply headroom. There are a number of answers to this. These include demand management through metering and water efficiency, further work on leakage, greater trading of available resource between companies and lastly investment in new resources. No option is ruled out as of today.

My Board recently had the opportunity of hearing a presentation about the report from Water UK on water resilience. We welcome the long-term thinking inherent in this report and the effort that has been put into it by many parties. We recognise that there will be requests to fund more infrastructure, such as, for example, inter-company transfer schemes.

We came to the view that it is a useful report which we need to see developed and challenged to understand better what is required for PR19 and PR24 at regional and company level. We believed it would benefit from a stronger analysis of the opportunities from demand side, leakage and smarter management of networks and resources. We noted it assumes a high marginal cost for some companies, up to £25 per customer in contrast to the £4 quoted, and these figures exclude much of the investment in further resilience already embedded in the long term plan, which is part of ‘business as usual’.

We look for more consideration of what the resource position might be if the 12 companies in the south and east of England were subject to an independent system operator who was able to determine how water be shared across companies. (For the avoidance of doubt I am not proposing at this stage we should set up a statutory system/operator, but we are looking at and interested to see what a system operator would do if they had the powers to force an efficient allocation of water).

We questioned if there had been sufficient focus on the continuing potential for metering and here we found good news. It has been explained to us that Anglian Water had not yet had to tap further inter-company trading and by driving down even further on leakage than we did in my day, now accommodates 26% more customers

than in 1990 with declining levels of ‘water into supply’. That speaks of great potential and we’d like to see more of this recognised in plans.

Conclusion

So let me bring all this together. We see significant opportunities to create a material level of headroom in the pricing of water, with material choices for companies as between further investment, service improvement, and well-earned price reductions to customers.

We have four key themes in the price review and these are:

- Outstanding service to customers showing real innovation, high reliability and responsiveness.
- A strong recognition of customers’ views on affordability particularly given the conditions – if the same in 2019 as they are today – offer the scope for material price reductions if that’s what customers want.
- Resilience in the round; resilience of the infrastructure, of corporate structures, the resilience of the relationship with customers, operational resilience and asset resilience – all this underpinned by companies operating at the frontier of efficiency
- And lastly a step change in innovation.

And these may be delivered in a process where “enhanced” will be the new normal and there could indeed be an exceptional reward for the one company that breaks all known frontiers.

Now, what you’ve heard from me is a set of personal views as to where, given conditions today, one might see Ofwat take the price review. But we’ve got a long way to go. We have intensive Board meetings every single month considering the price review and we will be progressively publishing our position on it. That position may modify as we think further about the issues and it may modify as circumstances evolve. But I hope that gives you something to help your planning over the next 12 months.