Water 2020: Wholesale markets and PR19

David Black, Water Industry Asset Management Conference, 10 May 2017

Good morning everyone.

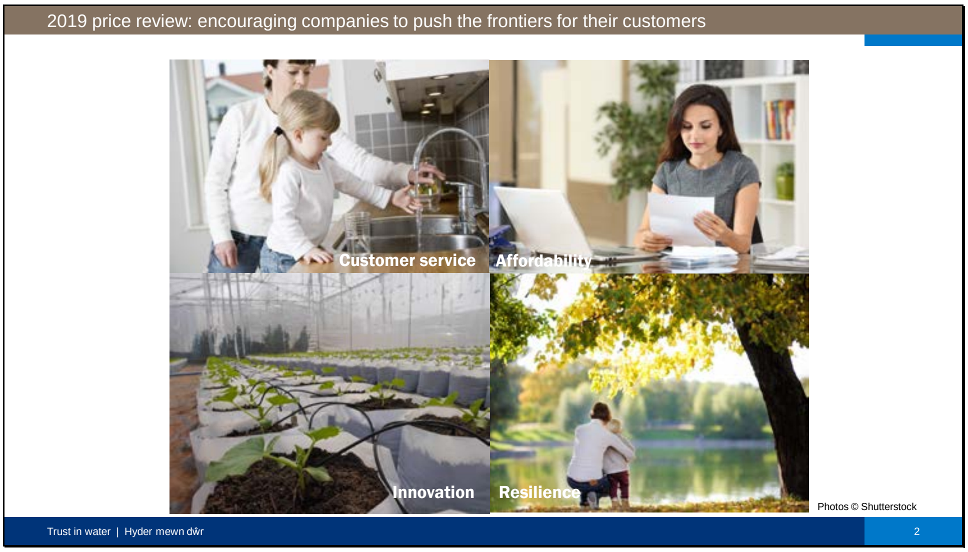
For those that do not know me, I am David Black, the Senior Director at Ofwat, the economic regulator of the water sector. I lead Ofwat's programme on future markets and PR19. Or 'Water 2020' as its more commonly known.

I want to say thank you for inviting me here to speak and for holding this event.

The central question for today is an extremely important one: 'How can water companies and the supply chain work together to go beyond traditional methods of innovation and collaboration?'

Innovation and collaboration (through strong relationships) are key themes of our trust in water strategy and how we want to see the sector develop.

Today I'll talk a little about how we're using the 2019 price review and future markets in the sector to encourage innovation.



Firstly, price setting. The 2014 price review was groundbreaking in many ways. But it won't surprise you to hear me say the sector needs to go much further to address the challenges it faces. And we know to do that you need to time to plan, to engage with customers and to innovate.

Although we will be consulting on our detailed methodology from 11 July, last year in our May Water 2020 policy document – more than three years before we make our final decisions on price controls − we set out key aspects of the policy framework that will govern the next review to give you the visibility and certainty you need. That includes:

- Strengthening our approach to customer engagement and outcomes. Companies should incorporate learning from their daily engagement with customers as well as a wider range of evidence such as pilots, rather than rely on traditional willingness to pay research. Co-creation and co-delivery recognises that customer lie at the centre of the water and wastewater value chains.

- PI/CPIH indexation of price/revenue controls and the RCV to maintain legitimacy of price controls in the medium as RPI becomes less accepted and less used measure of inflation.

- Retaining totex and outcomes approach.

- Encourage companies to focus on the longer term in the preparation of their business plans.

- Preparing for the introduction of wholesale markets – more on that shortly.

Retaining outcomes and totex was important for us in terms of encouraging innovation and collaboration.

Firstly outcomes, the purpose of outcomes was to focus companies on delivering what customers and wider society want – and give them the freedom to innovate, collaborate and make choices. Companies developed these outcomes by speaking with and listening to their customers – so it gives what is delivered legitimacy. It also helps to shift the balance of return away from financing to operating the business in customer interest.

It's early days in this AMP period 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.

But we also think companies can be more innovative and more ambitious. That is why late last year, we consulted on our approach to 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.

Secondly, total expenditure or totex. We got companies to plan their services and be rewarded for differing the right things –rather than just end of pipe solutions. To encourage things like catchment management approaches to stop pollution at its source. The companies who are successful with adopting totex approach will shift the efficiency frontier forward on costs, and this in turn will drive our view of the efficient level of costs for PR19, benefits customers of all companies and not just the customers of the efficient company.
A good example of the progress we have seen here is catchment management. Catchment management involves more operational expenditure (opex) than traditional capital expenditure (capex) solutions.

By removing the perceived capex bias the introduction of totex at PR14 has removed a regulatory barrier to catchment management.

At PR09 companies proposed £60m expenditure on catchment management schemes in their business plans. At PR14 this had increased to £206m.

Over the coming months we will consult on, and then finalise, the methodology for the price review. As we do that, and for the rest of the price review, we will have four themes at the front of our minds.

- First, customer service. We want to see a real improvement in the service customers receive. Water companies are far too comfortable providing the same customer services in the same way they always have. The retail residential review revealed that customer service has been too slow to evolve and lagged behind other sectors and residential behind business retail. That has to change.

- Second, resilience - and by that we mean resilience in the round. More on that at the end.

- Third, we want affordable bills. That means bills that offer value for money, are clear, fair and as low as they can be while ensuring there is the right amount of investment for the future.

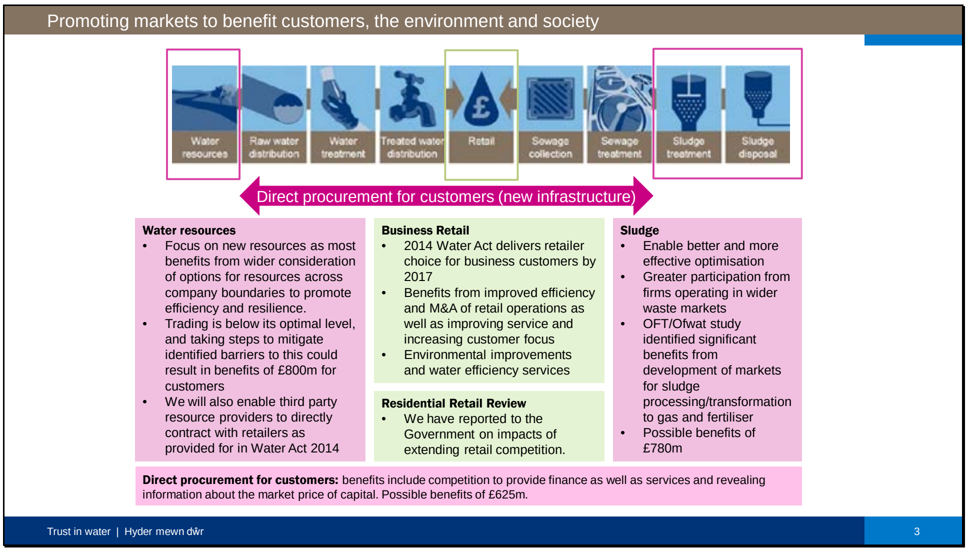
- Finally, innovation. Not to say that there aren't pockets of good practice or that the sector hasn't come a long way. But the lack of innovation by water companies compared in other sectors– in service, technology, new offers, working practice – is really striking. Companies have been too passive and happy with the status quo, rather than testing themselves to improve and innovate. Customers deserve better.

Clearly, in addition to specific incentives, we'll be looking at the overall incentives to encourage companies to produce high quality plans in all aspects of their business, including management of their assets.

It won't surprise you to learn we're also retaining a form of risk-based review for businesses plans. This will be recognise and reward companies that submit business plans that are right first time ie do not require intervention by Ofwat to protect customer interest.

But to encourage that step change in innovation and ambition for customers, this time we're considering recognising an exceptional plan that breaks known frontiers and so shifts the boundaries of what is possible for all companies and customers.

This is not just about a good plan, our assessment will take account of performance in the 2015-20 period and returns will be aligned to the delivery of the plan. And I would suggest that a company that wants to do this will need to collaborate with its supply chain very effectively.



As mentioned, price setting isn't the only area we have looked at.

We have looked across value chain to see where we could introduce markets – either direct choice for customers or other forms – to encourage innovation and get better outcomes for customers and wider society.

Markets help reveal information and to discover new ways of delivering services. It is becoming increasingly important for companies not just to understand their own costs, but to better understand the costs of buying in their requirements from third parties.

The business market for retail customers was opened last month. That market now means 1.2 million businesses, charities and public sector organisations can renegotiate, switch retailer or self-supply delivering £200 million of next benefits to the economy and the environment. For example, more tailored water efficiency services to help customers cut their consumption and reduce their bills.

We plan to develop markets in water resources and bioresources (also known as sludge) and direct procurement for customers of large discrete infrastructure.

Water resource markets will help make better use of scarce water resources and better signal where new resources are required. Looking further ahead, the opening of the business retail is a key enabler for the provisions of the Water Act 2014, which allow for competitive retailers to procure water resources direct from third parties, providing additional stimulus for efficiency and resilience.

Bioresource markets recognise that conversion of sludge into energy and fertiliser is just not about minimising cost but about maximising value. The focus on bioresources is increasingly revealing that companies had thought relatively little value about how to optimise their processes within company boundaries and much less across company boundaries.

We're also looking at the potential of direct procurement. Direct procurement for customers unlocks power of competition and markets to reveal innovation and market cost of financing for larger infrastructure projects. It helps to remove perception that ambition to grow RCV is behind appetite for new investment.

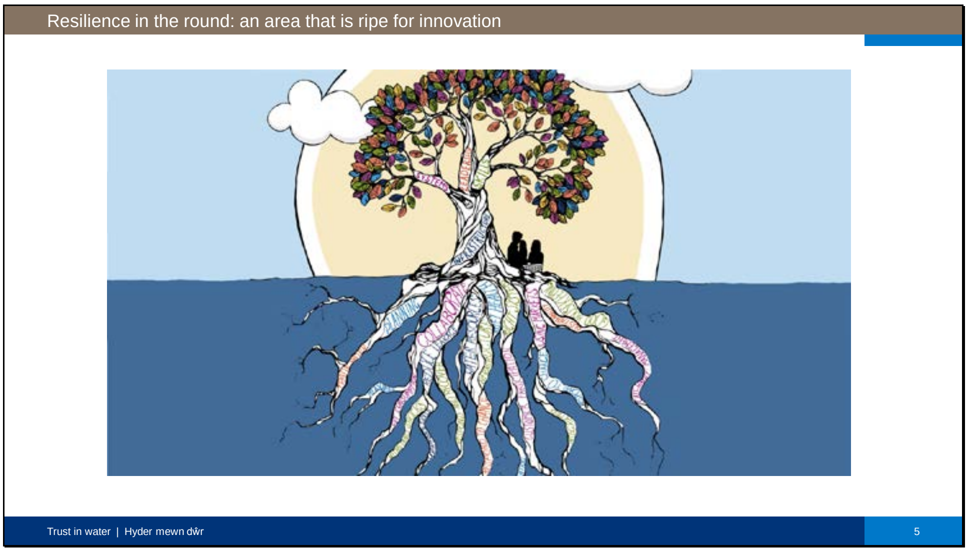
The way in which we are promoting the use of markets in the wholesale part of the value chain - for water resources and bioresources - should give companies a broader set of options about how their services are provided.

But companies can also use a broader set of options themselves to meet the challenges they face.

We think companies can use market testing – the tendering for specific elements of projects, often the design and/or building of new infrastructure – to seek out efficiencies or innovative ways of doing things.

Alternatively companies can use markets in quite different and innovative ways. Just one example I'm heard about and been impressed by recently.

- Wessex Water's nutrient trading platform allows farmers to bid into a reverse auction to reduce nutrients from their land entering local water catchments. The reverse auction is not the new bit, but the customer-facing trading platform is.



Finally, I thought that would highlight an area that is ripe for innovation: both how we think about it but also how we do it. Resilience.

Resilience will be a key theme of our next price review and its importance will be reflected in our methodology.

We will continue with an outcomes led approach in PR19, aspects of resilience were reflected in a range of performance commitments in PR14 such as supply interruptions and pollution incidents. We have working with the sector and stakeholders to develop a set of metrics to better measure resilience in PR19 and we expect companies to include in their business plans outcome performance commitments relating to resilience and asset health.
And we have also been clear that a good business plan will be one that builds in our resilience principles.

Resilience is not just keeping the taps running or toilets flushing – although that is one very important aspect

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. We call this resilience in the round.

A resilient sector is one that is able to navigate its way through operational, financial and corporate challenges in a smooth and predictable way.

- **Financial resilience**: We have a duty to ensure that efficient water companies can finance their functions. Decisions on capital structure are a matter for companies and their investors, and investors bear the risk associated with those decisions. But it is important that we protect customers from any fall out from that risk crystallising. This is why we have the special administration process and keep an eye on things we consider to be the risk factors to financial resilience through our annual financial stability report.

- **Corporate resilience:** This is the idea that a service provider's ability to predict, respond to and recover from shocks in the services it provides is in part a function of its information, systems and process as a company. We have been very active on this in the last few years. Board leadership transparency and governance principles. NED events. NED pre-appointment discussions. We also now look systematically at the quality of the information we see from companies, and rate it's quality, and the assurance on the company's systems and processes it provides through our company monitoring framework.

- Finally, **operational resilience**. This is partly about networks, and the assets that water companies own and control. This is at the center of running a water and wastewater business. But we don't take it for granted and we are conducting a targeted review of asset health right now. Operational resilience is also more broadly about the wider physical stuff on which the supply of water and waste water services depends. Which includes ecosystems, as well as traditional water company owned and controlled assets.

As I've touched on, the way in which we are promoting the use of markets in the wholesale part of the value chain - for water resources and bioresorces - should also help improve resilience by giving companies a broader set of options about how their services are provided.

Also about managing the impact of operational risk on customers - not just about preventing every bad thing happening, but getting better at predicting what bad things will happen, and getting better at helping customers manage the impact on them.

Also brings in customers in a different way too. Recognising that in this sector they are literally in the middle of the value chain - not passive recipients of services but active participants in that value chain. So that their actions, for example by reducing water consumption, can help to increase resilience very directly. Our recently commissioned report on customer participation challenges companies to do more and provides some examples from other sectors about where it has been done.

I just want to make a few warnings on resilience before I finish.

We have heard quite a bit – mainly through the back channels - that companies think Ofwat is somehow 'anti-infrastructure'. I just want to be 100% clear now that this is not true. We are however, against poor business planning.

We expect companies - monopoly companies spending customers' money - to be clear about the outcomes they are trying to deliver for their customers, about where the risks to the delivery of those outcomes lie, and to include cost-effective risk mitigation in their plans.

If cost-effective risk mitigation includes building new kit, fine with us.

But we have very little sympathy for any company who - listening to the current debate - sprinkles the word 'resilience' liberally throughout their plan, comes up with some spurious willingness to pay research, and seeks to land the customer with a substantial bill. We will also take a dim view of companies seeking funding for things they should already have delivered in previous review periods (no double counting).

We also expect companies to set their five year business plans in much longer context. The five year price review period is no excuse for not taking a long term approach. We expect to see companies think about both the outcomes they are delivering and risks and costs they are managing in the long term, in the context of 25-year water resource management plans or the joint 50 year water resource strategy. It could include, for example, some indicative, non-binding performance commitments 10-15 years in the future. We will assess this longer-term context as part of our assessment of business plans.

Which brings me to another warning - incremental improvements in resilience do not mean bills going up.

There are two parts of this myth that need busting.

The first is that resilience always costs. It doesn't. For example, the outcomes and totex approach we are taking now is enabling and encouraging more catchment management, because it is a more totex efficient way of delivering the outcomes customers want. And it is very often more resilient.

The second is that the idea that incremental resilience means bills have to go up assumes that there are no cost reductions that could offset any net impact on bills.

We don’t buy it.

Given our notional gearing, the importance of embedded debt costs and what has happened to the cost of debt in the last few years, the cost capital may well be lower at the next review. And the totex efficiency frontier is certainly shifting. All of which creates headroom which opens up choices about how that headroom is allocated - back to customers through lower bills, to the environment, or potentially through incremental improvements in resilience. Or all of the above...

Leaving plenty of space for innovation and the need for intensive collaboration. Both between companies and their supply chain – and (most of all) between companies and their customers.

Thank you.