

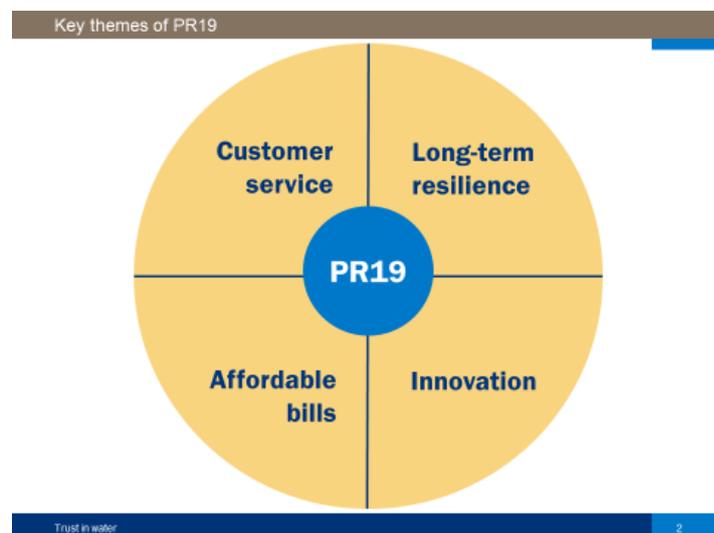
## Preparing for PR19: What are companies expecting for PR19?

### Speech by John Russell, Utility Week Live, 23 May 2017

Good morning. Today I'll be concentrating on the upcoming price review, PR19 and what Ofwat will be expecting from companies.

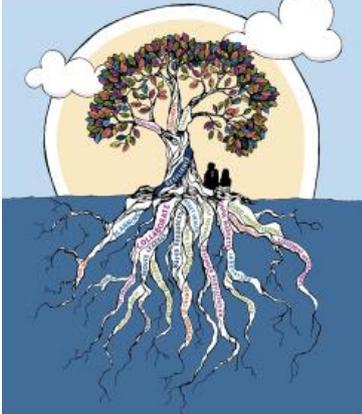
Last year we set out our approach to PR19 and beyond. We want to build on some of the step changes we put in place for PR14 – by that I mean the focus on customer engagement and the move we made to an outcomes and totex approach.

We promised that we would provide clarity on our expectations for PR19 early. On July 11 we will be publishing our methodology consultation for PR19 - six months ahead now of where we were at this point for PR14.



So looking forward I would like to reflect on each of the four themes of PR19 – affordability, resilience, innovation and customer service.

Resilience in the round for the long term



**Our initial assessment of business plans** will consider their resilience

New common **performance commitments** for resilience and new asset health performance commitment

Looking beyond the five-year regulatory period with performance commitments relating specifically to resilience for the next 10 to 15 years

Good to see **progress on wastewater planning** - Drainage Strategy Framework and 21<sup>st</sup> Century Drainage Board.

More **integrated thinking** across wastewater and water needed

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## Resilience

First I'll talk about resilience which I imagine is fresh in everyone's minds with recent coverage of drought risk in parts of the country. Also, if you didn't see our recent resilience campaign, I'd urge you to get online and start following us on Twitter.

First of all, this issue is not new to Ofwat. Even before we were given a statutory duty to forward resilience in the sector in 2014 we took a very broad view on resilience. It's not just keeping the taps running. We consider '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.

The picture behind me illustrates the point we're trying to make here. Each part of the tree is critical to its success or failure. As our Chief Executive Cathryn Ross explained recently, the leaves cannot work without the branches. The branches cannot work without the trunk. The trunk cannot work without the roots. The whole system must work together.

An accusation we've been hearing is that Ofwat is 'anti-infrastructure'. This is not true. We are, however, pro-strong business planning, and we are looking for companies to use all the tools in their toolkit to achieve better resilience outcomes.

If building new infrastructure is necessary to ensure the resilience and continuation of water and waste water services then that's fair enough. However, we know there is no such thing as zero risk, we need to think smarter about resilience - we can't just build our way into a more resilient sector.

Our position is clear - resilience does not always have to mean spending heavy capex – but where it needs to, we would hope that companies are engaging with their customers and having honest and open conversations about the options and impacts.

So we expect companies to provide us with the complete picture in their plans - assets and performance, the risks and opportunities for innovation, applying rigorous processes and analysis and clear governance.

We are building resilience into our PR19 methodology. We will have a strong focus on considering if plans are resilient and focused on the long term - ie beyond the current 5 year regulatory period.

We will continue to build on PR14, with our approach to outcomes and we will expect companies, to include in their business plans, a set of performance commitments relating specifically to resilience for the next 10 to 15 years, as well as a new asset health performance commitment.

At the moment Ofwat is also doing a lot of work looking at asset health. We've completed a report looking at the asset health of the sector which will tell us more about what operational resilience might be needed in the future. We aim to publish this soon.

We are seeing positive work taking place in the industry at the moment with the development of the latest round of 25 year Water Resource Management Plans and development of common Resilience metrics by the industry group established following recommendations from Ofwat's independent resilience task and finish group.

It is really good to see water companies adopting innovation in the way they are delivering their WRMP's. A key example is the use of Robust Decision Models (RDM) to help them make long term best value decision under the uncertainties of climate change and population growth.

Another example is The Water Resources in the South East Group, an alliance of companies and stakeholders who are working together on planning which will enable better value options across company boundaries.

The sector is working together to develop resilience metrics, the first time we have seen this happen and a great foundation for being able to provide long term value for customers.

These activities show that there is real engagement happening, but that we expect things to go further and wider than before. For example we want to see evidence that companies have considered cross-boundary resilience solutions such as water transfers and catchment area management rather than just answers in their own

patch and we want to see groups like WRSE and WRE doing more to lead this thinking.

So often, wastewater, as the unsexy part of the resilience debate, finds itself relegated when it comes to discussing these issues. But this is an essential part of considering “resilience in the round”. The 21 Century Drainage project, which includes all water companies and is considering if the sector’s approach to drainage is fit for the future is helpful, but it is yet to deliver. We want to see more integrated thinking about the management of water resources and wastewater together for PR19.

Great customer service

**TAPPED IN**  
From passive customer to active participant  
Organised by Ofwat

Raising the bar for **customer engagement and participation** – **Tapped in**

Stretching, transparent and powerful common and bespoke **performance commitments**

**Beyond SIM – new customer experience incentive** – benchmarking beyond the water sector and focusing on customer experience rather just customer service

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## Great customer service

The next theme I want to discuss is customer service which follows quite neatly on from resilience

The difference between the water sector and other utilities is that customers sit in the centre of the value chain. By that I mean they not only drive the demand for water, they are an integral part of what goes *into* our system too. They are not passive users of the vital services that water companies provide,

Recently Ofwat held a 'Tapped In' event which was attended by water companies and senior stakeholders from across the sector. It was an opportunity to discuss how the sector can encourage customers to recognise the fact they play an active part in the water and waste water value chain. Customer participation is about putting customers where they belong – at the centre of everything.

Customers are key to PR19 and we expect companies to raise the bar with active customer participation rather than passive engagement.

That's because when customers are truly 'tapped in' - that's when you can unlock benefits for customers and companies and improve the current and future sustainability of water.

Encouraging customers to recognise themselves as active users in the chain will help the sector to understand what customers want, and to act on their wishes, improve customer service and build trust and confidence. Their actions, such as reducing water consumption can help to increase resilience very directly.

Companies have a part to play too in educating their customers to encourage action and behaviour change. Wet wipes flushed down toilets, fat poured down sinks, these are the kind of unwanted additions to our networks that end up costing water companies serious money in asset maintenance.

Working with customers to enable and encourage water efficiency will give companies headroom when it comes to current and future resilience of the sector. It might take a generation or more but we need to start getting customers used to the idea that water is a valuable and finite resource. This may need a much more intensive and long-term engagement with customers, rather than periodic, sporadic campaigns during periods of drought.

During PR14, not only did we focus on customer engagement, 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.

We are already seeing an improvement in performance of leading companies as a result of this approach which will result in a step change in efficiency.

We will build on this for PR19. We want performance commitments to be more transparent, stretching and powerful so customers get more for their money and drive further improvements in service.

We have also consulted on stronger outcome delivery incentives (ODIs) to better align investors and company managements' incentives with those of customers towards a greater emphasis on service delivery.

We are also developing a replacement for the SIM which looks at the full experience of a wider range of customers.

We are considering benchmarking customer service against other sectors. My colleague, Jon Ashley, will be talking about the SIM later today.

It's clear the water sector faces a customer service challenge in that the benchmarks for good customer service won't necessarily be set in the water sector.

For instance, in January, the Institute of Customer Service published its yearly UK Customer Satisfaction Index. The top three companies in terms of customer satisfaction this year are Amazon, ASOS and John Lewis.

There were no water companies in the top 50.

We know that customers don't compare the service they receive from their water company with the services provided by other water companies. They compare the services they received with companies like Amazon, ASOS and John Lewis.

While they are different companies with different value propositions, they don't just win on price, they also score on the way they've adapted their services to fit their customer's lifestyles.

But we believe that water companies can be up there competing with these types of companies on customer engagement and service.

Innovation



**Promotion of markets** in water resources and bioresources and direct procurement for customers for new infrastructure

**Customer participation**

**Initial assessment of business plans** with incentives for exceptionally high quality, ambitious and innovative business plans – recognise and reward companies that shift frontier on service and cost efficiency

Simply **reducing operating costs will not be sufficient** for PR19 and the future

## Innovation

Now I'd like to turn to innovation which is becoming an increasing focus for Ofwat.

Many people think the water sector is not particularly innovative – according to a recent survey, water companies spend around 0.5 percent of their turnover on innovation, compared with upward of 5 percent in the unregulated engineering and technology sectors.

The good news though is that our approach to totex and outcomes during PR14 has removed barriers to innovation.

For instance, we saw all companies put plans for Sustainable Drainage Systems, or SUDs, in place. Anglian Water plan to have 25% of sewerage capacity schemes incorporating SUDs and Welsh Water have announced 162 sustainable drainage plans, covering 12% of population.

For PR19, we will incentivise companies to push further regarding innovation by recognising and rewarding exceptionally ambitious and innovative business plans that shift the frontier on service and cost efficiency. The sector needs to create more value for customers and through PR19 companies will be able to share in the value created.

We are also considering how outcomes delivery incentives can be designed to reward innovation in service.

We think that whereas there's been radical change with innovation and technology-led advances in service in other competitive sectors. Until now, water has been left behind.

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

There's nothing like that yet in water, but more efficient water appliances, metering and SMART technology in homes is deepening customer control over the amount of water they use, which in turn can further resilience and bring the bills down.

But innovation doesn't just have to be technology. It can also be customer service, customer engagement and using customer data effectively to target services and reduce demand. Currently there are only three water companies offering a smartphone app for customers to manage their account

We're also closely monitoring and learning from the business retail market which opened 1 April. It's early days yet but we believe that we will see the market drive down prices, improve water efficiency, encourage innovation and improve customer service.

Customer expectations have changed with regards to how they'd like to be engaged with.

Social media has provided customers with a voice regarding the service they receive and is a very basic example of companies using innovation to engage with their customers.

We are also seeing companies taking steps to make better use of data in order to tailor their services and better use of technology in order to communicate with customers. Next month we will be publishing a report on how we expect to see companies using customer data.

And we think introducing markets in parts of the value chain, such as water resources and bio resources, can help drive innovation to make step changes required, increase efficiency and resilience.

Until now the sector has relied upon reducing operating costs to make changes but this will not be sufficient for PR19 and the future. That is because for PR19 we expect companies to deliver affordable bills for all. Combined with the challenge of better resilience, asset health and customer service, the sector will need to find efficiency above business as usual - this will require innovation and doing more for less.

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#### Affordability

We consider there are **three main aspects of affordability**:



That brings me neatly to our final theme ... **Affordability**

Affordability is the ability of a customer to pay for his or her water bill. There is no “bright line” between affordable and unaffordable bills, it depends on household incomes, size of water bill and customer circumstances.

The environment facing customers is challenging. Further upward pressure on prices looks inevitable as inflation continues to rise in and the subsequent squeeze on customers could deepen affordability issues. At the same time, financing costs are at a record low.

We think that PR19 may offer very real headroom either to improve the resilience of the service customers receive, or materially to cut their bills, or both.

However, we've said before and I'll say again, there is no trade-off between affordability and resilience. If a company is efficient they can achieve both and that's what we'll be expecting in PR19.

Nearly one quarter of households in England and Wales are experiencing affordability problems.

This issue therefore will remain high on the agenda, but, in PR19 our approach will not only be about – those who struggle to pay their bills - important though that is.

Instead, our approach, which we will consult on in July, will include three elements:

First of all, we expect companies to deliver affordable bills for all.

Secondly, that should mean affordable for all over the long term

And finally want to incentivise companies to support those struggling to pay their bills.

There are great opportunities to improve the overall affordability of bills in PR19. The potential for a lower cost of capital and improved efficiency reflecting the introduction of the totex and outcomes should create scope for lower bills.

We want to see companies keeping prices down for all customers and demonstrating the overall affordability of their plans and providing clear evidence of value for money.

Companies will also need to consider the profile of their bills as well as their level, as sharp movements in bills can affect affordability for customers if they are not expecting them.

For long-term affordability we want to see companies demonstrating that their bills provide value for money beyond the end of the next price control period. Customers, CCGs and we will want to see companies being fair to future generations, and not moving costs unduly into subsequent price control periods.

We want to see companies addressing affordability for those who struggle to pay their bills, providing support through approaches that are accessible, effective and efficient.

All 17 water companies have now put in place social tariffs following customer engagement and the number of customers accessing those tariffs is increasing.

However, we know it's not all about social tariffs –they cover only a half per cent of the total customer base. Companies need to consider how they are addressing affordability for those who are struggling to pay their bill more widely. We will be reviewing companies' approaches at PR19.

We are currently developing tests to measure these three aspects of affordability as part of our assessment of companies' business plans. We will also be looking for evidence that companies have self-challenged the level of bad debt included in their business plans.

We do think there's real scope for companies to be more cost efficient at PR19 which will enable companies to set low bills for all their customers as well as improving resilience and the standard of service customers receive.

Customer vulnerability will also remain a key focus of our work. We are proposing to include vulnerability as an explicit part of the price review for the first time in PR19.

We are considering the use of metrics to measure progress in relation to both affordability and vulnerability and will also be consulting on incentives to encourage companies to improve their approaches to reducing bad debt in July.

Summary



The four themes of PR19

1. Resilience in the round over the long term,
2. Customer service to match the best in other sectors.
3. Finding new and innovative ways to deliver more for less
4. Affordable bills over the long term for all, including those who are struggling to pay or are in vulnerable situations

Each price review should build on successes of the past while driving the efficiency frontier forward for the long-term

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## Conclusion

So let me bring all this together.

PR19 is part of a journey. It builds on the successes of PR14. Through company ownership, customer engagement and greater use of markets we think the sector can deliver for customers.

And we're raising the bar on what we expect from companies. In PR19 "enhanced" will be the new normal.

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

- A focus on resilience in the round for the long term,
- A real push forward regarding on customer service. We want the sector to look outside itself and compete with other sectors regarding experience for customers.
- Finding new and innovative ways to deliver more for less
- And finally, affordable bills over the long term for all, including those who are struggling to pay or are in vulnerable situations.

While these are the key messages I'd like you leave with today, there's one more point I'd like to make. The world will not stop at 2019. Every price review is a journey and every price review looks back to the last one, while simultaneously anticipating the next one.

We have looked back to those step changes we put in place during PR14 and we're building on those.

But each of our themes will offer long term benefits for customers and we want the sector look ahead, to 2024, 2029, 2034 and beyond. That's how we're really going to drive forward the efficiency frontier and ensure resilient, reliable services for customers.

Thank you.