Cathryn Ross speaking notes from British Water Annual Lunch

14 June 2017

Thanks for having me today. When Chris offered me the opportunity to speak with you at this event, I was delighted. Because I'm conscious that you while you represent an enormous and important part of the water sector, and one on which the provision of the vital public services we all rely on depends, you are a group of people we at Ofwat talk with relatively little. So thank you for the opportunity.

Chris mentioned in his introduction the fact that we are in turbulent times right now. In that context I make no apologies for talking about a topic that is very much ‘business as usual’ - our next price review, which is coming up in 2019. If there is one thing that the turbulence in the political world reminds us it is about the value on having an independent economic regulator, able to provide clarity and predictability to a sector that provides vital public services, on which we all depend.

I'm going to start by saying a few words on process, so that everyone understands where we are. But I will quickly move on to talk about the substance - the four key themes on which we really see PR19 making a difference.

A bit of process

Right now we are approaching a major landmark en route to the next price review, which is the publication of our Methodology for consultation in July 2017.

We will be publishing our final methodology in December 2017. This is almost a year earlier than in PR14. Which is important because it allows companies more time for business planning.

Alongside that we will give some guidance on where we think the cost of capital will be for the review. Which again enables more effective company business planning.

And it also reflects one of the lessons we learned from PR14... in PR14 we expected companies to include aggressively low costs of capital in their business plans in a bid to gain 'enhanced status' and be fast tracked. But in reality that was too much to expect them to do - we were always going to set the WACC on a sector wide basis so it was a bit pointless anyway- companies were not going to have better information that we did. And the fact that they estimated a WACC that was far too high, meant that the cost base on which they did their customer engagement was inflated and - even if the rest of it was good - it was less effective than it could have been. So we are doing things differently for PR19.

So already you can see that there is earlier certainty for companies approaching PR19 that at PR14. And we are very much hoping that benefits the supply chain, because it enables earlier conversations with you about how you can help shape and deliver plans. And ultimately enables a better deal for customers, because plans are more challenging on efficiency, and more confident about what can be delivered.

The four themes

So, moving on from process to substance…

There are four themes that will run through PR19. And the supply chain has an important contribution to make to each of them.

The first is **great customer service.**

I know the companies have made great strides here over the years. And recently I think SIM - for all its flaws - has really driven a focus on and improvements in customer service. But we really want to see companies in this sector going way beyond getting the basics right and really delivering against the expectations of customers in the 21st century.

Which doesn't mean thinking like a water company. It means thinking like a customer. And not just thinking like someone paying a water bill. But thinking about the real people the companies serve. People will busy lives, with competing demands on their cash, with multiple affiliations to different communities. And thinking about how in everything a water company does it can make life better, easier for those people.

So I'm not just talking about reducing complaints, or getting it right first time in resolving issues, which of course do matter. I'm talking about different services, different ways of accessing those services, plurality in channels of communication, more personalised, more targeted. And I'm talking about getting a lot smarter in how companies learn about what customers want and how they want it. There is so much more companies could be doing to collect information about their customers. You have to be careful here clearly. This isn't some miraculous source of secondary revenue streams. This data is customers'. They expect it to be used wisely. And if they are going to share it they expect to benefit directly from doing so. But there is massive potential here to deliver better service and build trust. And I'm sure a lot of the thinking on how to do this is already there in the supply chain.

The second of our themes is **resilience**. This is probably the word that will most dominate the next review. And rightly because it is one of the things that matters most to customers. We all depend on the vital public services the sector produces. We rightly expect them to be reliable. And we expect to have confidence that they will continue to be provided into the future.

You may already have heard that we take a broad view of resilience. If you look from the customer perspective, what matters is all those risks to the reliability and long term resilience of water and waste water services. And those risks are many and various. Which is why we refer to 'resilience in the round'.

This most obviously includes **operational resilience**.

Which includes the resilience of the assets that the water companies own and control. We have taken an interest in this for many years - first in respect of 'serviceability' and more recently 'asset health'. And this stays a strong interest for us, albeit that some of the recent incidents in the sector - notably the Thames pollution fine - have reminded us that we need to focus as much on how the assets are operated as we do on their condition. And elsewhere - for example through the work we are doing on our targeted review - we have developed an interest in the information, systems and processes that companies use for asset management planning too.

But even operational resilience goes beyond company assets.

Ecosystems are part of operational resilience too - as we depend as much on them to supply clean water and absorb waste water as we do on pipes and treatment works.

And customers and communities are part of operational resilience too. Customers are themselves part of the value chain. Their behaviour and decisions have a huge impact on how much water we need to supply and how much waste water treatment is needed. And incident response and recover and excellent communications are all critical to mitigating the impact of service disruption, which is important for operational resilience too.

But when we talk about resilience in the round we aren't only talking about operational resilience. There are other features of a service provider that determine its ability to anticipate, understand, manage and recover from disruption.

Financial resilience matters enormously. Companies are investors are free to make decisions about how their company is financed, for example about the balance between debt and equity, and different financial instruments. But they are on risk for this. And we have been raising questions in the last few years about whether this risk has always been properly understood, and whether companies' capital structures really enable them to manage and withstand the risk in the most effective way. Less directly relevant to the supply chain, perhaps but very important for us.

Corporate resilience matters too. Here we a referred to the quality of a companies' information, systems, processes, governance and decision-making. All of which is critically important to its ability to understand and manage the risks it faces in providing vital public services. And again it is an area we have been doing a lot of work on in recent years - establishing our 'company monitoring framework' that assess the quality of company assurance to us, and our principles of board leadership transparency and governance.

Not directly relevant to you in the supply chain. But I think it will - and should - have an impact. As we put more emphasis on the quality of company decision-making, the quality of information, systems and processes, this may well change how they work with you. They may be looking to work more closely with you not only to deliver outputs, but to improve the quality of the information systems and processes. And - in a world where alliancing agreements of varying sorts are widespread and many companies rely on you to deliver some of their core obligations - they should certainly be looking to make sure that they have clear lines of accountability right the way through all their activity.

So that covers two of our key themes- customer service and resilience. Let's talk about the third. **Affordability**. And it is worth being clear here that what we are talking about here is affordability for all - not only for those customers who need specific assistance. Concentrating concerns about affordability on that smaller group risks tipping more people into a position of struggling to pay their bills.

We think there is scope at the next review to really improve affordability for everyone. Because we think there is really substantial scope for costs to come down. In part this is about financing costs. Since our last review in 2014 debt costs have fallen further and we will shortly be publishing a piece of work on cost of equity that shows reductions too. But in part it is about real efficiencies. Many of you will be closer to this than I am, but we really do see those companies that have really embraced totex really pushing that efficiency frontier.

All of this reduction in costs creates scope at the sector level for us to see that step change in customer service, improvements in resilience and bill reductions. And we expect companies' customer engagement to reveal customers priorities for how they would like to see the headroom creates by those cost reductions best used.

Last, but by no means least, I'd like to talk about our fourth theme. **Innovation.** This sector gets a lot of stick for being slow on innovation. And I don't think it is entirely true. But I do think that innovation is difficult - it requires a different mindset, one that embraces disruptive change, and it requires investment in a way that doesn't generate the sort of 'guaranteed returns' the sector was used to (in inverted commas because I think that was what the sector thought it had rather than actually had). And I just don't think the sector came under sufficient pressure to cause it to embrace this difficult stuff. It was too easy to carry on doing things the way they had always been done. And I don't think we helped. Partly I don't think we made it tough enough to create that impetus to do things differently. And partly I think the way we regulated, with a bias to capex, holding to account for outputs, and a desire to see evidence that companies knew what would work and what it would cost… all compounded the effect.

But that has really changed. Our regulatory approach has changed - the move to outcomes and totex is key here. And we have also been clear with companies about the wider variety of evidence we are open to in business plans - including evidence of things that have been tried and haven't worked.

I know a lot of people have said that the five year price control periods are a barrier to innovation. Well, we still have those… but frankly I just don't accept that this is in any real way a barrier to innovation or long term thinking more broadly. Because water companies hold their licences in perpetuity. Those companies will face the obligations they face for decades to come. The physical geography they operate with and in is well known and unaffected by price control periods. Financial markets similarly. So the only thing that changes every five years is the amount of revenue they are allowed to recover from their customers and the incentive framework around their performance. That sounds significant…. but in reality any thinking company can take its revenues in the last period apply a decent efficiency challenge and probably reach a pretty good idea of revenues it is very very likely to be able to recover in the next period. This certainly gives them sufficient certainty to get on with the vast majority of what would be sensible and to plan over whatever length of period they think is appropriate.

So, to the extent that there were some regulatory barriers to innovation, I think they have now gone.

But I think the real driver that will mean we see more innovation going forward is that companies simply cannot do things in the way they always have and continue to deliver those vital public services we all depend on at a price we can all afford.

There are big pressures on the sector from things like climate change, and population change. But there are also massive opportunities from new technology. And simply from learning from what is done in other countries, where they have maybe faced some of those pressures for longer than we have here. I was talking to someone from Israel recently about what is happening there on waste water metering and water re-use for example.

And there are also pressures for change from customers, who expectations, based on their experience in other sectors, are rising. Customers these days expect a great service and a hassle free experience. But more than that they expect a more personalised service, better information, more control. And competition for customers is still pretty limited in the sector. But the sector does and should care deeply about its legitimacy. And that legitimacy depends on meeting those expectations. So this is a very real driver for innovation.

And this is something where the supply chain has huge role to play. I'm quite sure that a lot, probably most, of the innovations that water customers will benefit from over the next couple of decades won't come from the water companies themselves but from the supply chain. And not only from the tier one contractors, but from smaller more specialist firms too.

I know in the past one of the biggest issues has been matching those with the ideas and the innovations with those who might need what they can do. And it is great to see the progress being made on this front by technology exchanges. They really are something I would encourage everyone to plug in to. Something else I'd like to see more of is companies, including water companies, who are trying to solve the same problems coming together to pool their thinking and perhaps also their funding.

So… to sum up…

I have said repeatedly that **PR19 will be a tough review for companies**. And so it will be - more stretching outcomes, lower financing costs, a tougher efficiency challenge, and indeed a higher bar on the quality of business plans.

But I also see it as a review with massive opportunities. Through greater customer participation, through new technology, through better use of markets, I think the sector has more scope to do amazing things for its customers and really push the boundaries than it has ever had. But more than any of this, the thing that makes me really optimistic about the future of the sector - optimistic in a way that frankly I didn't feel say 8 or so years ago - is the mindset I can see now. A much more confident, outward looking, curious approach that is really up for embracing the challenges the sector faces and seizing the opportunities they bring.

And the supply chain is a big part of this - a big part of this sector delivers for its customers and of that culture change. So I am hoping you share that optimism too.