
Realising the potential of markets in water: maximising benefits for customers

Speech by David Black, Water Market Reform, 27 June 2017

Good morning.

It's great to be here today and thank you for inviting me.

I am talk this morning about realising the potential of markets in water to maximise benefits for customers

I suspect today, many of you will focus on the business retail market. I would like to broadly sketch how we see markets continuing to develop and evolve in this sector.

Using markets to deliver better outcomes for customers and wider society

Markets benefit customers and wider society by encouraging innovation and efficiency. They avoid having the regulator second guess what is efficient and long arguments about cost models or contests between engineering or economic consultants.

It is worth being clear that by markets, I don't just mean competition. Markets are just places where people buy and sell. In some cases such as the business retail market, there will be multiple buyers and sellers, in other cases there aren't. We see benefits from a whole range of markets in the water sector, opening the potential to move beyond monopoly water companies to provide service, revealing information about cost and improving diversity and resilience of service providers.

I see promoting markets as pragmatic way to improve outcomes for customers. There will be more relevant in some parts of the water and wastewater value chain than others and the approach to markets will vary depending on the context. We don't see our role as forcing markets onto the sector, but about unlocking opportunities for markets to add value. We will still be in business of setting price

controls for monopoly services for some to come, even with the development and evolution of markets that I talk about today.

Using markets to deliver better outcomes for customers and wider society

On the slide is snapshot of markets, I will discuss today.



Retail – business retail market in England has been opened and we reviewed scope for extending competition to residential for the UK Government last year.

We also see potential for markets to enable and encourage value creation within the wholesale part of the value chain too. In our decision document on future markets in May last year, we confirmed we would promote markets for:

- Water resources
- Bioresources
- Direct procurement for customers

Not on the slide, we have existing markets for new developments requiring connection to water and wastewater networks:

- self-lay – where third party contractors chosen by a customer install pipework instead of the local company; and
- new appointments – where one company replaces another for a given area

And we're currently examining how to make both those markets work better for customers.

Colm Gibson, Head of Economic Regulation, Thames Water talking about NAVs later today.

Business retail market: creates opportunities and challenges

On 1 April we opened the largest water retail market in the world, with 1.2 million business, charity and public sector customers able to choose their water and wastewater service retailer.

Business retail market: creates opportunities and challenges



More than 22.5k supply point switches
61% sewerage switches = consolidation to one retailer

Switching across all customer segments
Larger users more active

25 licensees - incumbent and new entrant
7 in progress

6 largest retailers have 88% share
But range of business models emerging

Trust in water

We fully recognise and appreciate the extensive hard work and constructive approach taken by the sector to achieve it

Worth reflecting on the last 2-3 years worth of effort. Because shows the sector is able to change. I remember five years ago, some saying it couldn't happen...

We now have 25 licensed retailers in the market (and more on the way), with a variety of different retail offers, ranging from competing on price, to competing on value-added services such as water efficiency or multi-utility bundling.

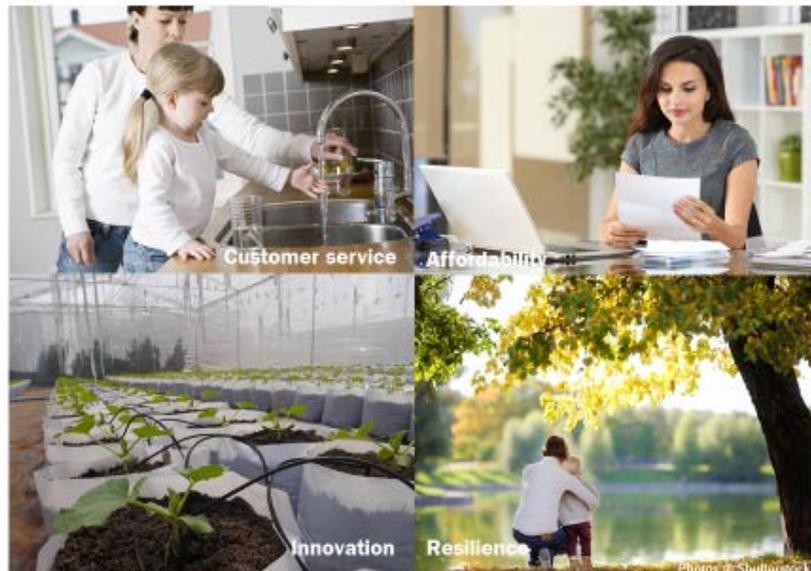
And we're starting to see new players in the water sector (both as companies and their staff), bringing insights, experiences and most importantly constructive challenge from other sectors.

But as the saying goes: the hard work starts now.

2019 price review: shifting frontiers and supporting markets

Now, I want to speak about PR19 – that's not just because I am spending a lot of time on this at the moment, with our methodology going out for consultation in two weeks time. Rather, it is because, I am keen to emphasise that we are expecting and welcome business retailers involvement in the review.

2019 price review: shifting frontiers and supporting markets



Trust in water

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PR19 will set price limits for wholesale water and wastewater services, or more precisely, it will set revenue controls for water network plus and water resources and for wastewater network plus and bioresources from April 2020, our new wholesale controls. To explain - the wholesale water control is to be replaced by water network plus for network and treatment services and a separate water resources control. The wholesale wastewater control will be replaced by wastewater network plus covering sewage transport and treatment and bioresource covering sludge processing and transport. This will mean that the charges that you face from wholesalers will change from 2020 too.

PR19 will set revenue allowances as well service expectations for wholesale network plus and resource controls for period 2020-25, a key cost for retailers. This will be the first price review where we have independent retailers, so we are keen to enable retailers to participate. We will be publishing our draft methodology on 11 July and a final methodology in December this year. Company business plans are due on 3 September 2018.

Our four key themes for PR19 are:

- customer service – Business retailers still depend on wholesale services, so great customer service for business customers will depend on the quality of service of wholesalers too. For the residential market, we will be looking at how we can draw on lessons from the business market in setting expectations for the residential market.
- long term resilience in the round – operational, corporate, financial. A resilient sector is one that is able to navigate its way through operational, financial and corporate challenges. It also means tackling issues that could compromise resilience – like leakage, wasting water and bad debt. The sector faces challenges from climate change, population growth, water scarcity and affordability pressures, so understanding, mitigating risk will be central as well as ability to respond and recover from events.
- Affordability - we see three key dimensions to affordability at PR19:
 - Overall affordability – this means low and value for money bills for everyone.
 - Long-term affordability – low and value for money bills for everyone over the long term
 - Affordability for those struggling to pay their bills – effective and efficient assistance to help customers most in need
- Final theme is innovation – and this is an enabler for the other three themes. Innovation is about new ways of doing things – implementing improvements in services or ways of delivering services that benefit customers. This is a sector that seems better at testing new ideas than rolling them out.

Residential retail: reviewed costs and benefits

Last year, at the UK Government's request, we carried out a review into the costs and benefits to residential customers in England of competition for retail water services,

Our review found a market could:

- deliver net benefits worth almost £3billion over 30 years; and

- lead to innovation, improved customer service, new offers – including bundling of products such as energy and telecoms with water, and the provision of value added services.

But we also found that there would likely be:

- a limited reduction in bills;
- significant set-up and ongoing costs;
- as in the business customer market, a need to ensure through our regulation that public health and safety is maintained and customer protection measures are in place to ensure all customers are treated fairly; and
- an ongoing need for appropriate assistance for vulnerable customers and those struggling to pay their bills.

In consulting on its statement setting out its strategic priorities for economic regulation in water before the recent election, the UK government said “Further work needs to be done both to ensure that these benefits can be realised, and to understand and mitigate any impacts on vulnerable customers. It is also important that we learn the lessons from the opening of the business market. Ofwat should work with the government to build the evidence base further, in order to enable the government to fully understand the case for extending competition to households.”

I know that there is a panel discussion later about residential retail competition – and Sebastian from Defra will be speaking later on the UK Government priorities.

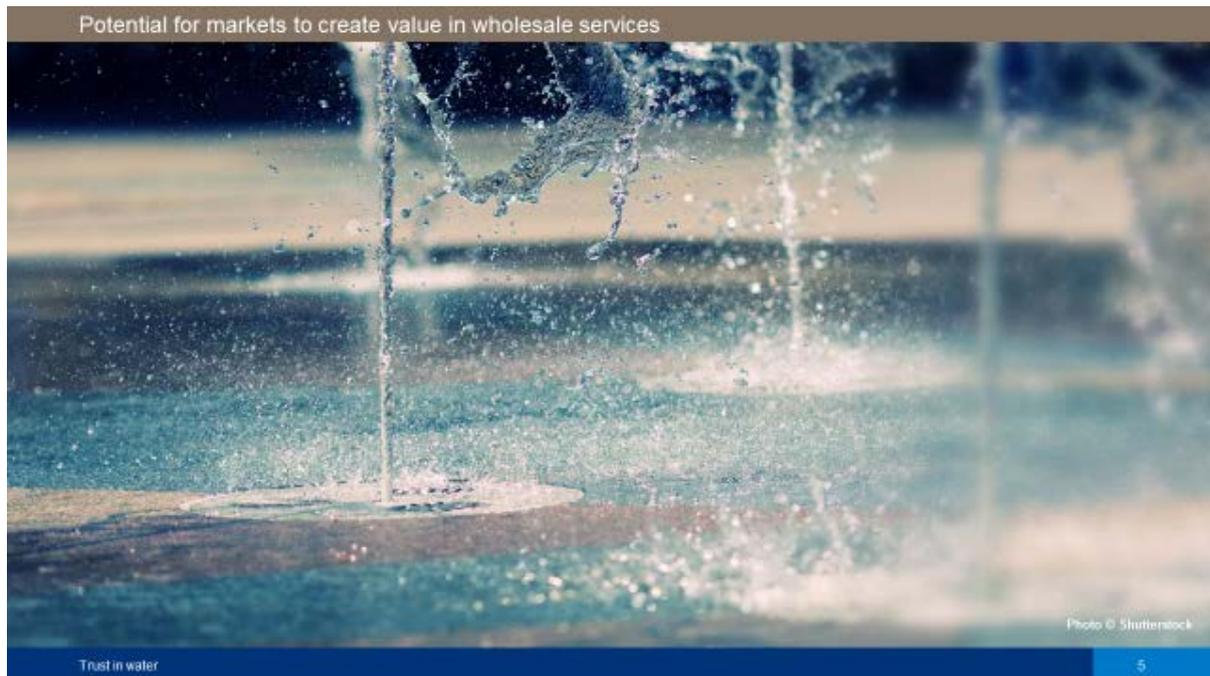
Potential for markets to create value in wholesale services

As I mentioned earlier, we also see potential for markets to enable and encourage value creation within the wholesale part of the value chain too

We don't see wholesale markets being characterised by vigorous head to head competition.

But we do see a lot of scope for markets to provide a wider set of options and choices about how water and wastewater services are provided.

And we see them revealing valuable information about where scope for greater efficiency lies.



Water resources:

Water trading is below its optimal level,

With climate change, population growth and the pressures on the water supply we have at certain places and at certain times, we still have the same 5pc of our total public water supply being traded across boundaries - the same 5pc we had at privatisation.

This means that water services are more expensive and less resilient than they ought to be.

We are expecting incumbent companies to look hard at options for water trading, as part of their development of water resource management plans for PR19. This includes looking at their ability to source water from third parties and to export surpluses to adjacent areas.

In order to promote water resource markets, we are requiring publication of information by incumbent companies to help potential suppliers identify opportunities.

We will require each incumbent company to publish a bid assessment framework setting out its policies and processes for assessing bids from third party providers of water resources and leakage/demand management services.

We will introduce separate binding price controls for water resources and network plus.

The Water Act 2014 provides for markets to be opened up across the value chain. While the provisions have yet to be enabled, the Act provides for business retailers to choose their water resource provider. So if you are a water retailer and wanted to choose your water supplier, this is possible under the Act.

The market will take some work to develop and approval from Secretary of State to enable, so we are not expecting opening before 2022 at earliest, but it is certainly worth thinking about in the longer term. We will release a discussion paper on the options for developing the market in September.

The market model would involve a water resource provider and an independent retailer to enter into arrangement for supply of water. The water resource provider would pay for access to incumbent's treatment and distribution network to supply customers, although there is also scope for new entrant to supply treatment services. The access charge will be regulated and will also include a compensation payment, where third party is providing water resources in area that is high cost for appointee to provide.

We set out in our May Water 2020 document last year, we want to align value, so that entry is attractive in areas where water is scarcest and so highest cost for appointed incumbents to supply.

So this opens a new avenue to promote water trading and improve resilience and efficiency. It may also force incumbents to look harder at opportunities for trading that previously have not been exploited.

Bioresources:

We see a scope for markets in bioresource treatment, transportation and disposal. The nature of the service provided and the cost functions differ, so the design of the market looks different from water resource markets.

The development of anaerobic digestion technologies enabling sludge to be transformed to gas or electricity is turning bioresources from cost at the end of wastewater value chain to value generator. Other technologies such as drying are also developing meaning that it is more economic to transport longer distances and capture energy value. Adjacent sectors such as other organic waste processors use the same technology and there may well be economies of scale in processing on a single site.

For bioresources, we want incumbent appointees to think of themselves as buyers as well as service providers. In some cases, it makes sense for incumbents to provide bioresource processing and disposal for other appointees or other organic waste providers, in other cases, it will be more efficient to take advantage of spare capacity elsewhere or enter into long term arrangements to process with other providers.

In order to promote market development, we are:

- making market information available to help providers identify scope for trades with incumbent appointees..
- set a separate binding price control for sludge activities in the 2019 price review (PR19).

We will set an average revenue control to regulate sludge, which will reflect the volume of sludge produced by WaSCs.

What we are not doing with this market is allowing retailers to contract with their preferred sludge providers. We are not ruling out this model, but it would face additional barriers to operationalise due to localised nature of sewage treatment works and it is not clear at this point that this approach would add value. So consistent with our wider approach we will monitor how market evolves and new opportunities emerge.

Direct procurement for customers: Options for tender models

We also see scope for encouraging the greater use of markets in the financing and provision of new assets by third parties ('direct procurement'), which will help to reduce the costs of major infrastructure improvements.

This approach draws on our experience with Thames Tideway, which used a competitive procurement process to provide a £4bn sewer under London. The successful tender had a

2.497% - cost of capital of the competitively procured Thames Tideway tunnel, the lowest to date in the UK water sector. This reduced potential customer bill increase from around £70 to £25.

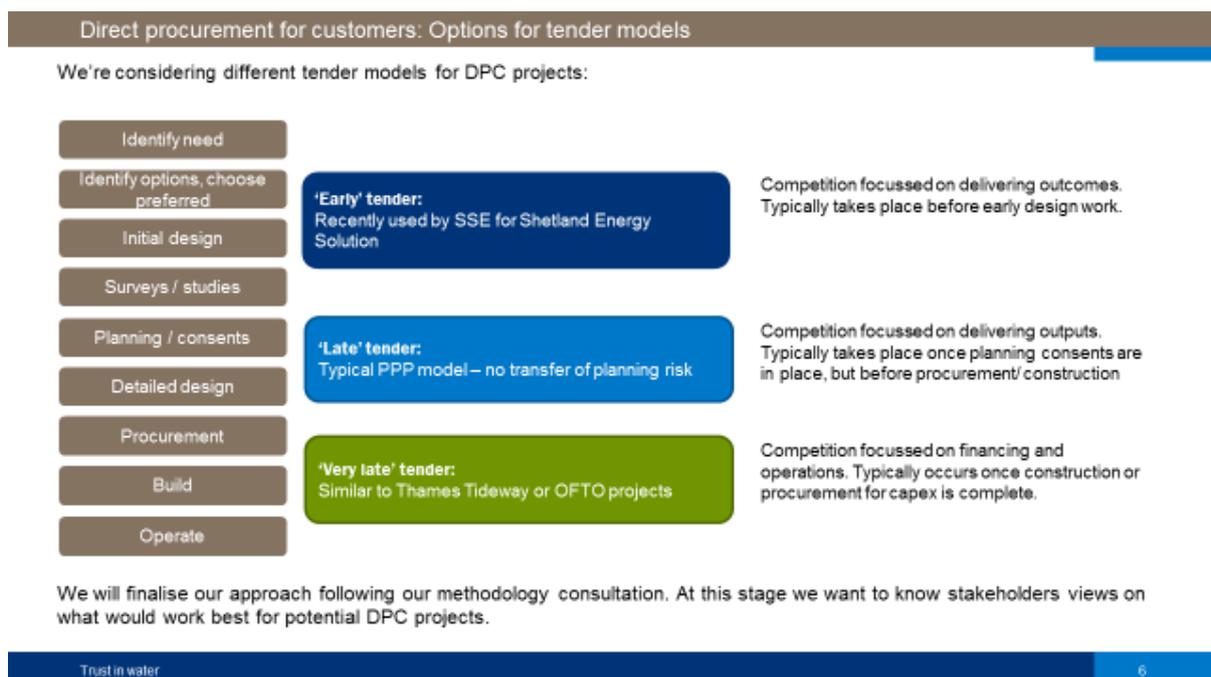
The benefits include competition to provide finance as well as services and revealing information about the market price of capital.

The DPC model is appropriate for contexts where direct competition between providers in the market is not possible, as it is a monopoly service, but competition between potential providers is possible.

There are a number of options for implementing a DPC approach – this depends on how broadly the problem that the DPC is addressing is framed. This can vary from

Early – where problem is specified and competition is focused on delivery an outcome such as improving supply/demand balance by 10ML a day. Potential providers could then develop options such as demand side, new supply capacity or water transfer schemes

Late – where proposed solution is specified and planning consent has been obtained and the focus of tender is detailed



Very late – where asset has been built and focus is on financing.

The benefits of early stage procurement is that it allows market testing of various solutions and enables scope for innovation or new solutions to emerge that have not been developed by the incumbent. The disadvantage is that tender process is more complex and requires transfer of planning permission risk.

The late and very late options reduces complexity of tender process and focus competition on financing costs, however, they also reduce scope for innovation.

At this point, we see merit in considering all options – quite possible that different approaches may maximise value better in different circumstances.

For PR19, we will set our expectations for companies to use direct procurement for customers for suitable high-value projects through our assessment of business plans at PR19.

We will set a guideline value of £100 million whole-life totex as the boundary above which direct procurement for customers should be considered for suitable projects.

Summary

So you can see markets do play a role today in the sector and this role will grow in the future, as water resource and bioresource markets and direct procurement for customers develops. The markets themselves will come in different shapes and flavours, depending on the nature of the services been provided.

And just to be completely clear - new markets doesn't mean that significant elements of the value chain won't remain as regulated monopolies or even that regulation will be removed where markets are operating. But they will impact on the way we regulate and enable better informed and targeted regulation.

Customers will benefit in variety of ways ranging from choice of provider and service and price competition in the business retail market and greater innovation, resilience and efficiency in wholesale markets.

Huge progress has been made in recent years to bring new markets to the sector, but I feel we are only scratching the surface - I look forward to the continued evolution of markets in the sectors and the progress to come.