Cathryn Ross speaking notes
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Introduction

Good morning everyone. It's great to be here, and thank you to David and the Marketforce team for the invitation to speak.

I'm very conscious that what many of you will want to hear from me about is how the 2019 price review is shaping up. And I will say something about that…

… but if you will indulge me a little, in what is my last speech as Ofwat chief executive, I'd like to say more about where I think the sector is going beyond the next price review, and the challenges and opportunities that brings.

So let me start off with PR19.

As you know, we are publishing our methodology on 13 December. And I should take the opportunity to say thank you to everyone who responded to our July consultation document.

Given the process of co-creation we have been going through for a few years now, I don't think that much of what we put out in July was a surprise.

We have had a lot of support for the **four themes** we set out for PR19 – of great customer service, long term resilience, affordability for all, and innovation. And it has been great to see also the support for the level of ambition we set out in respect of each of those four themes. There is, I think, a genuine sense across the sector, that we are making real progress on all of those areas now and that we will see a genuine step change for customers in all of them in the next control period.

We have also seen some **great engagement**, helping us to take forward some of the detail of our methodology. We have had very useful input from companies but also more widely across the sector on the development of our **customer experience measure, CMeX, and the new developer experience measure, DMeX**. And there is a lot of work still underway, much of it under the auspices of WaterUK, developing consistent **metrics that we can use for common performance commitments**, and in particular developing new common performance measures on resilience on both the clean water and waste water sides. So thanks to everyone who has been involved on that.

Beyond this, probably the biggest issue we had responses to our July consultation on was the **balance of risk and return** across the review.

Most obviously, and predictably, this focussed on what we said about our approach to determining the **weighted average cost of capital** in the review.

We had already said, and repeated in July, that we envisage moving to index the cost of new debt in PR19, using an ex post true up mechanism in PR24 in relation to the sector wide **cost of new debt** across the period. But we also put out in July our expected approach to the **cost of equity**. Envisaging a shift toward away from basing what is after all supposed to be an estimate of the sector-wide cost of equity *over the next five year period* on history and regulatory precedent, and towards making greater use of market observations and future expectations. And we published a paper from PwC setting out a proposed approach. When we published our July consultation we further said that our view was that the PR19 WACC would likely begin with a two.

I think it is fair to say that some companies aren't fans of our proposed approach. We received a number of responses along the lines that we **couldn't possibly move away from an approach to the cost of capital heavily based on history and regulatory precedent** because… well … that would be … unprecedented.

I don't think I'm giving much away if I say that we weren't very impressed with those arguments. The fact of the matter is that if we have learned one thing from the last twenty years it is that the in the world of financing costs, **trying to predict the next five years simply by looking backwards is likely to result in getting it wrong**. And over the past twenty years, the direction of error has been consistently in favour of companies rather than customers. If, as Einstein said, the definition of madness is repeating the same thing and expecting to get a different result, I think we can look forward to an outbreak of sanity on this one.

We have also heard some thinly veiled threats from two or three companies that a significantly **lower WACC will result in levels of investment that are too low**, especially in relation to resilience. I'm sure the same points are being made – possibly more vehemently – to government.

Obviously, nobody – Ofwat included – wants to see companies under-spending on resilience. But let's just take a step back. What would what it actually take for the risk of under-spending on resilience (or indeed anything else) to crystalise?

Principally two things.

The first could be us setting a cost of capital in our PR19 determinations that doesn't reasonably remunerate risk. If we did that, it is true that companies would cut spending. But if you look at the analysts' commentary on our July document, we are not out of line with their estimates. After our City Briefing we saw analysts pretty comfortable with a real WACC of 2.1-2.8% and a cost of equity around 4% (compared to the range we put out of 3.8-4.5%). On the back of our document HSBC for example was giving broadly positive investor recommendations, RBC expected financial ratios to 'remain manageable', Macquarie called our cost of equity range 'realistic' and noted that water stocks were 'inexpensive' relative to other European utilities.

Companies might not make the kind of base returns they have been used to… but that doesn't amount to risk not being reasonably remunerated. Which seems to me pretty unlikely.

The second thing that could result in companies not spending enough on resilience is that the amount of money we allow them to recover from their customers is less than the amount they need to spend to do the stuff they need to do to deliver the resilience outcomes they promised their customers. Or, to put it another way, companies are inefficient. But **is the right way to get inefficient companies to spend what they need to spend on resilience to give them more of customers' money through a higher base return**? Feels deeply counter-intuitive to me. Better to challenge those companies to achieve upper quartile performance and put the risk of cost inefficiency on their investors. Another thing we have learned over the past twenty years or so is just how good companies are at mitigating downside risk when they are exposed to it, so I don't think this is something we – or indeed they – should be afraid of.

On the wider point about risk and return one aspect of the responses to our July consultation that I was pleased to see was a much deeper appreciation of what we are doing to **rebalance returns across the review** as a whole to better align the interests of companies and investors with those of customers. To ensure that companies make money by doing stuff that benefits customers.

With that in mind, it has been good to see companies really engaging on the **potential for returns through totex outperformance and ODIs**.

And it has also been good to see companies realising that, although PR19 will be a tough review, there are **genuine opportunities for outperformance**, especially where they act now to get ahead of the game. I spoke at a water sector conference organised by Moodys last month and was really pleased to hear that message coming across from Liv Garfield of Severn Trent, Liz Barber of Yorkshire and Susan Davy from Pennon.

It has been good too to see the level of enthusiasm across the sector about the theme of **innovation**. I genuinely do think that there is a sense of confidence, and openness to change and new ways of doing things across the sector right now that is really exciting. I know a lot of Ofwat people have attended innovation events (and one innovation festival!) run by companies in the last year. And I've really enjoyed hearing about how companies are pulling in new ideas and fresh thinking from some pretty diverse places!

At the risk of looping back on risk and reward, we have had some quite thoughtful consultation responses querying whether in July we quite got the right balance between **rewarding innovative business plans** through **upfront returns** (such as that 20 basis point uplift on the cost of equity we had suggested) versus access to more powerful **rewards for delivery** through totex sharing factors and ODIs. And there are things in there for us to think about.

But even now I know that we will see some very exciting ideas coming through in the business plans, in terms of product and service innovation but also new ways of delivering those products and services.

All of which tees me up nicely to talk about **where I think things might go beyond PR19**.

Shaping the future of the industry

I know a lot of people in the water sector right now are feeling as though there's a lot going on. They aren't wrong. The pace of change in the sector right now is greater than certainly at any point since privatisation. If anything, I think that pace of change is going to pick up post PR19. Indeed, I've been saying to our people at Ofwat that I think the difference between PR19 and PR24 will be greater than the difference between PR19 and PR14.

Why is this?

Bill Gates said back in 1996 that **'"We always overestimate the change that will occur in the next two years, and underestimate the change that will occur in the next ten".**

If you want to test that statement for a minute, just step back 10 years. Famously, Steve Jobs had just launched the iPhone. Most of us were still glued to our Blackberries… Facebook had just become a thing. In the world before Twitter the tech-savvy young things were all Instant Messaging. 67% of households in the UK had internet access (rather than 93% in 2016) and 23% of people had never used the internet (compared to 4% today) [ONS]. If you were buying a new car, it probably wasn't going to come with a satnav, let alone a 4G enabled touch screen infotainment system. Most people still got their news from newspapers and broadcasters like BBC and ITV, there was no Huffington Post, no Buzzfeed, no bloggers or vloggers. The concept of the internet of things didn't even exist.

So what? None of this stuff is directly connected to the water sector… why does it matter?

Well, **it matters because it is the world that that customers live in**.

Now, I could look at lots of different drivers of change in the water sector – everything from climate change, through to changes in geopolitics and global capital markets. But – and I'm sticking my neck out here – my prediction is that the **biggest drivers for change in the sector between now and 2024 will relate to customers**. In particular as a result of iterations between changes in technology that enable new products and services to be offered, and the changes they drive in expectations and the choices that customers make.

When I first arrived at Ofwat, in my first role, in 2008, one of things you used to hear around the sector a lot was 'we all know customers want – they want to turn on the tap and get a reliable supply of wholesome water, and they want to flush the loo and know the waste will be taken away'. Yes, of course. I think we now know that lots of other things matter to customers too – the wider quality of their experience, how easy it is to pay their bill, get a meter, report a problem and get things fixed, how often you dig up the road outside the house. And we also have an appreciation of the fact that customers are not all the same – they have different preferences and priorities. We have, thankfully, moved on.

But that old mantra did have some quite profound insight underlying it. About the **value that people attach to peace of mind**. About the **value people attach to their time**.

Specifically being able to choose to spend their time on things they want to do, rather than things they feel they have to do. And being able to do what they want to do, when they want to do it, as quickly and as easily as possible.

After all, what is that **Amazon** sells us?

Stuff? Yes. Amazon does sell some stuff.

But what Amazon sells better than pretty much anyone else, is stuff it knows you want before you even knew you wanted it. Stuff you can buy at 2am. Stuff you can get delivered the next day. Stuff you know you are getting a good deal on because it has searched the entire universe for you can put you in touch with whoever has the best price. All with one click. On the smartphone you didn't have 10 years ago.

I do understand that buying stuff is generally something we like to spend our time doing. And thinking about water and waste water services isn't. But my point here is that there exists right now both what economists call a 'pent-up demand' for peace of mind and convenience, and the technology that is enabling the provision of services to satisfy that demand.

Which to my mind means the **water sector, indeed all utilities, are ripe for a revolution**.

Imagine a world in which you don't even know who your supplier of water and waste water services is, or who supplies your energy, or broadband, or maybe even your home insurance and emergency cover. Because you have a contract with an intermediary who takes care of all that for you. You gave them some information about what mattered to you – price, maybe speed of response if there's a problem, maybe the environment – and they guarantee you that at any moment in time you will be supplied on the deal that best suits those needs. You don't pay them for this, but you have given them access to data about how you run your home and said, because you trust them, that they can use for things they think reflect your interests. You may well have given them the ability to turn some bits of your home infrastructure on and off to manage demand and reduce costs, because this will enable you to get a better deal.

I don't think there is anything really stopping that world from existing today, at least for some people.

Maybe some of you think that the **absence of household competition** is a barrier. But I really don't think it is. Those intermediaries don't necessarily have to be able to choose water retailers to offer a bundled service.

Maybe some people would need **better broadband** than they currently have… but that is coming, and in any case, data compression techniques are improving pretty rapidly.

I do understand that this sort of service aggregation and optimisation isn't easy. And that one of the biggest barriers is the availability, quality and formatting of the data it requires. But I reckon we will see significant moves in this direction before we hit PR24, which means it is something we all need to start thinking about very soon, if we haven't already.

Because, while the **opportunity is huge**, this world does bring some big **challenges, for companies and for regulators** too.

An obvious challenge for all of us is that of **data**. Whose is it? Who has access to it? In return for what? How is it kept safe? And if we are trying to enable markets for these new services to emerge, do we need to start now tackling some of those issues around data quality and formatting? If data – not only at customer interfaces but also potentially about network management - becomes as important an asset for service providers as, say, pipes and wires, how does that affect the economics of these sectors? And should that change the way we regulate them?

Another challenge, we all face is posed by increasingly differentiated service. One person's more tailored, more personalised offer is another person's price or service discrimination. Are we going to enter a new world of data poverty? In which the customers who get the best deals are those whose data are help generate value for intermediaries, while other customers with less valuable data find themselves in second class? Is it OK to differentiate price and service according to factors that the customer can't change?

A further challenge, again for all of us, is **increasing intermediation**. We have been encouraging water companies to engage more with their customers, and to move beyond that into customer participation. That's relatively straightforward in a world of vertically integrated end-to-end monopoly. But how does this work when there's an intermediary? How do we make sure that those back up the value chain don't lose that public service ethos than comes from a deep connection with customers? How do wholesale service providers keep focussed on delivering what customers want? What happens when there is a problem with the service? All challenges that can be addressed, but that require some serious forethought.

And across all of this there is a very specific **challenge to regulators to stop thinking in our silos** about water bill payers, energy bill payers, telecoms bill payers, insurance customers and start thinking about 'home services' customers. Or better still human beings, with busy lives and competing demands on their money and time.

But for all the challenges, the opportunity is huge. The **opportunity to satisfy that 'pent-up' demand for peace of mind and convenience**. That opportunity to use data and a more engaging interface really to build customers into the value chain, influence demand and manage networks and resources smarter.

So, how to draw this together?

I'm conscious that many of you will be in throes of business planning right now. So if I wanted to leave you with two thoughts it would be these.

First, **in your business planning for PR19 be ambitious**. In terms of what you can deliver for customers, but also in terms of your thinking on how best to deliver that. Your curiosity about new and better ways of doing things.

And second, if you can bear it, **start thinking now about the world beyond PR19**. About how different the world could look in 2024 or 2029. About how to navigate those challenges, which you don't have to do on your own – there are people across the sector, in other sectors and in the regulator you can work with.

And above all, **how to seize those opportunities to deliver more of what customers of what matters**, what really matters, to customers.

Thank you.