Towards the 2019 price review – Ofwat's views for wastewater

David Black at Wastewater 2018 Conference, 30 January 2018

Introduction

Good morning everyone. Thank you very much for the invitation to speak here today.

The theme of this morning's session: *"How regulation is impacting wastewater investment"* is very relevant as we head into the 2019 price review. So its great to be at this event and very timely as we have just published our final methodology for the price review.

The Wastewater sector is often the unsung hero of utilities, I was reminded recently when reading Robert Gordon's account of the risk and fall of economic growth in the US, of the central role of public sewers in major improvements in public health, environment and life expectancy as well as quality of life from the construction of sewer networks in the US context. Major 19th investment in infrastructure enabled similar benefits in the UK. More recently, since privatization in 1989, the regulatory framework has enabled over £150 billion investment in water and wastewater sector to maintain and enhance services.

I would also say that continued investment is important, but it also true that investment is cost to customers and that more investment is not necessarily better. Investment is a means to an end – enabling services to customers today and tomorrow. Inefficient investment raises costs and prices without delivering wider benefits. It is important to keep this in view – and in our case as an economic regulator, part of the 2019 price review will be assessing the efficiency of company's total expenditure and how this cost is recovered from customers over current and future review periods.

While the programme of work that I lead is very much focused on looking to the future of the water sector, it's probably worth, for a minute or two, reflecting on the year that's just past.

2017, I think it's fair to say, was one of the most eventful for the water sector since privatisation back in 1989.

In April, we saw the opening up of the world's largest water retail market for businesses customers and we're now seeing an average of 10,000 supply points switching or renegotiating with their existing supplier each month.

Over the summer months, we began to see the very legitimacy of the sector called into question, with some openly calling for the re-nationalisation of the water sector. And of course, just last month the we released our early view of the PR19 cost of capitalof 2.4% – the lowest ever for a regulated utility.

Added to this, we've had the political uncertainties thrown up by the triggering of Article 50 in the Brexit process and of course the hung Parliament back in June.

In the midst of all this uncertainty however, Ofwat's course remains unchanged. Our principal focus is on maintaining trust and confidence in the water and wastewater sector and ensuring that providers are focused firmly on delivering the outcomes their customers want.

2019 Price Review

I'll now turn to something which I'm sure is front of mind for many in this room - our forthcoming price review.

Our price review is centered on four key themes, resilience in the round, innovation, affordability and great customer service.

We are looking for companies to demonstrate to us that their plan is delivering for their customers in line with these themes. Ambitious and innovative companies that do this and so don't require us to step in on behalf of customers will be recognized with exceptional or fast track status, earning reputational and financial benefits and an early draft determination.

We will assess all company plans in the first stage of our price review process – the initial assessment of business plans. We have set out the nine test areas that we will examine including customer engagement, outcomes, cost efficiency, innovation and resilience, among other areas.

PR19: Long-term planning and resilience

Those of you who are familiar our PR19 methodology, will have noticed one particular phrase which is often repeated and that is "long-term."

It is absolutely vital for the wastewater sector to have a long-term focus. This means looking not just at the next price control period (2020-25), but at least 25 years and potentially further.

The Water Act 2014 gave Ofwat a statutory duty to "further the resilience objective".

We think of resilience in the round ie resilience to operational financial and corporate risks. Operational resilience means that a company's systems and services, can cope with - and recover from - whatever challenges come its way.

I'm sure you don't need me to tell you about the increasing external stresses which will face the wastewater sector in the years ahead. Climate change, with the potential for drier summers, wetter winters and more irregular rainfall is putting pressure on our wastewater systems and a growing population will result in ever greater demand on networks and treatment systems.

In the face of these challenges, it is therefore crucial to plan for the long-term to ensure that if and when an incident occurs, companies are prepared for it and so minimise the impact on themselves and their customers.

When, later this year, as part of our price review, we assess company business plans, we will be looking carefully at how companies are planning for the long-term and assessing both their understanding of risks to resilience and how effectively risks are mitigated and managed.

The wastewater sector sometimes feels like the poor cousin of the water sector in terms of long term planning – the water sector has the well-established water resource management planning process. There has been progress in developing drainage wastewater management plan framework for the sector and we will be looking for companies have approached long term planning in their business plans and how they applied principles of Ofwat and EA's drainage strategy framework.

PR19: Customer engagement and Outcomes

Building on our approach to the 2014 price review, a focus on customers and outcomes will be at the heart of PR19.

Understanding what customers want will require ever closer and deeper engagement with customers. This is not just about drawing on market research such as willingness to pay studies, but about utilizing insights from company contacts with their customers and wider evidence of customer priorities. And all of this be assured by company Customer Challenge Groups (CCGs).

Based on their understanding of customer priorities, water and wastewater companies develop their outcome performance commitments.

In order to better enable customers to understand and challenge company performance, we have established a 14 common performance commitments for all water and wastewater companies. Wastewater commitments will centre on areas such as: property sewer flooding, wastewater pollution incidents and wastewater asset health measures and new risk based resilience metric.

We are also setting out our expectations for how companies set stretching outcome performance commitments such as expected upper quartile performance levels for the common performance commitments. Companies that don't deliver their performance commitments will face penalties reflecting the lost value to customers from failing to deliver. Companies that deliver beyond the expected performance levels can earn outperformance payments – but only where the customers value the improved performance. Outperformance payments help incentivise companies to go beyond stretching service levels and help set the benchmark for all companies in future price reviews. We are also requiring companies to set indicative performance commitments for the period beyond PR19 to 2035 to reinforce focus a longer term approach.

Costs and efficiency

Another key focus as we head into PR19 is efficiency. The introduction of totex and outcomes in the 2014 price review was intended to enable a step change in efficiency – companies have much greater freedom to decide the best way of delivering outcomes for customers. Totex is simply the aggregation of capital and operating expenditure and avoids an artificial distinction between capital and operating cost.

The need to boast productivity in the sector is highlighted by the recent Frontier Economics study for Water UK. The study identified significant productivity growth since privatisation – around 2.1%, but that the pace of productivity growth had flattened off in the last 10 years. While the report notes, this might be in part due to difficulty to measure quality adjustments, the fall in productivity is also consistent with Ofwat evidence of lower cost efficiency improvements in recent reviews.

I want to be clear that we expect a step change in efficiency to be reflected in business plans in PR19. We see good early evidence of efficiency gains under totex regime in first two years of this price review period – and this is not at the expense of quality either, with evidence to suggest that most efficient companies are also doing well on their outcomes performance.

It is also worth noting, that in contrast to some earlier price reviews, a company's cost allowance will not be derived from its own business plan. Prior to PR14, companies had some incentives to pad their business plan with additional costs to make delivery of the price review easier. However, in PR19, we will be using econometric benchmarking to derive efficient baselines based on industry wide evidence, using efficiency benchmark of upper quartile or higher. We are also setting a cost sharing incentive, which means that companies that submit plans more efficient than our baselines will be rewarded with more attractive cost sharing rates, while those that submit less attractive plans will have less attractive rates. This means there real incentives for companies to sharpen their pencils and submit stretching plans.

One long running issue in the sector has the issue of cyclicality of spending over price review period, with issue of start/stop of spending over price review meaning supply chain is faced with feast and famine, reducing efficiency of procurement. The graphic illustrates the rise and fall of spending over the price review cycle in earlier review, but a noticeably improvement in the run up to PR14. However, there is also some evidence of delays in capital spending in early years of PR14 period, with underspends in 2015/16 and 2016/17. The move to totex and outcomes should help to smooth spending as it decouples link between cost allowance and specific projects. We also introduced provision for transitional expenditure in PR14, which allows companies to bring forward spending from PR14 into 2014/15, which meant that companies need not delay starting new projects until the next price review. We are also allowing provisions for transitional expenditure for PR19. We consider that outcomes/totex framework and transitional expenditure should enable companies to manage pattern of spending over price review period. Failure to do so is likely to raise question about efficiency within companies.

Risk and return

A key component of our approach to risk is the efficient allocation of that risk to ensure that those best placed to manage risk, bear it. This ensures that risks are allocated to companies and their investors where they are best placed to manage them, not their customers.

As I mentioned at the beginning of my speech, our early view of the Weighted Average Cost of Capital (WACC) for companies for PR19 is 2.4% at the appointee level and 2.3% for wholesale network plus and bioresources controls. This is the lowest to date for the water sector - and indeed any utility.

This reflects the lower costs of financing, both accessing debt and equity markets. The lower cost of capital is part of a package of returns which puts increased focus on operational performance from outcome delivery incentives and totex cost sharing and less focus on financing. We want company boards to focus on improving operational performance – service and efficiency rather than just running a clever treasury. The increased importance of operational performance will help align investor and company interests with their customers. It also likely to help companies enhance their legitimacy in the eyes of their customers.

PR19: Innovation

Innovation, as I previously mentioned, is one of the four themes of our price review.

We can see how technology and changing consumer expectations are transforming industries all around us from entertainment to transport.

Just think for a moment – who, ten years ago, had heard of the "Gig Economy", TV streaming services like Netflix or ride-hailing apps like Uber?

Yet each of these innovations have now transformed the customer experience, not to mention customer expectations. The customer of the twenty-first century expects the same quality of service for everything they pay for, including their utility providers.

Next week, Ofwat will kick off a digital campaign to help encourage water and wastewater companies not only keep pace with the rapid change going on all around them, but to fully embrace innovation and the opportunities it brings.

The change we've seen in recent years are likely to gather pace in the years ahead. This is why we are making innovation central to PR19.

We see innovation as essential to enabling the sector to deliver more of what matters for its customers – it enables the sector to step up operational performance and be more cost efficient. While technology is part of innovation, I would not like to leave impression that innovation is just about more tech. At its most basic level, innovation is about new ways of delivering, requiring openness to change and willingness to take risk. It also means focusing on the customer – for example the way customers interact with the wastewater system impacts on service performance and cost, such as, the disposal of fats, oils and grease.

The development of catchment management approaches over the last decade has been an innovation that has delivered value for customers and the environment. Wessex Water have developed Entrade, a market platform for procuring catchment management, which is a further innovation, with evidence that it reduces cost by 30% relative to conventional catchment management approaches and over 90% against conventional wastewater treatment. A word of warning too – there is tendency to think of catchment management as innovation – it was in PR09 and perhaps in PR14, but it is now an established technique, so difficult to see deployment of catchment management, as worthy as it may be, as an innovation at PR19.

In our initial assessment of business plans we will be looking for evidence of innovation and an innovative culture in companies.

We see new markets as opening up scope for further innovation and efficiency gains. I will highlight two areas.

Direct procurement for customers (DPCs)

DPCs are where companies procure both financing and delivery of major new infrastructure assets. We say major as there are costs associated with running this kind of procurement, so have suggested a guideline value of £100 million of whole life totex as basis for determining appropriate scale of project. DPCs require a shift in mindset for wastewater companies from provider to procurer of best value solution on behalf of customers. We see two key benefits from DPCs – firstly in terms of competition for financing costs and secondly in terms of greater scope for innovation and competition in the delivery of these projects. Competition for financing costs means greater assurance that customers get the best possible deal and avoids dependence on the regulator estimating appropriate cost of capital, which previous reviews, suggests is challenging. The scope for innovation arises from being able to package together financing, design, operations and allowing supply chain to greater scope to propose solutions. There are a range of options for DPCs – from "early" to "late", in the jargon, reflecting the openness to alternative solutions in the procurement. Early stage DPCs would allow more scope for bidders to take responsibility for design of solution, which increases scope for innovation, but also increases risk borne by bidders and may increase cost to customers. It likely that different models will be appropriate to different contexts. We are leaving choice of the appropriate option for wastewater company to propose in their business plans.

It is also worth noting that option short of DPCs such as market testing also provide scope for demonstrating efficiency in areas where DPCs are not feasible and it is encouraging to see this approach at centre of some companies approach to PR19.

Bioresource markets

I won't spend too much on bioresource markets, as I know my colleague, Alison Fergusson is covering this in a parallel session. Bioresource markets are all about maximizing the opportunities from anaerobic digestion of sludge to convert to energy and fertilizer. It is not a natural monopoly as other aspects of wastewater collection are and opening to wider market allows companies to take advantage of opportunities for treatment both in nearby wastewater companies as well as beyond the sector. And in turn this will enable regulatory model to adapt beyond PR19 to better reflect commercial opportunities and innovation. Similar to DPCs, the bioresource market is about the wastewater company acting as an efficient procurer on behalf of customers. We will be looking for companies to demonstrate their approach to efficient procurement of bioresources in their business plans.

Conclusion

The theme of this session is about the impact of regulation on investment. In summary I see PR19 as enabling and incentivizing companies to:

- Consider resilience in the round – understanding, identifying and mitigating and managing risks to resilience and planning for the longer term
- Focus on the customer – development of business plan should be framed around strong understanding of customer priorities and this should be reflected in outcome performance commitments and associated delivery incentives
- Consider both capital and operating cost solutions to deliver outcomes – no longer should the sector be biased to expensive capex heavy schemes when these will not deliver best for customers
- Take advantage of new markets and new approaches to unleash innovation.

The 2019 price review is real opportunity for companies to step up in terms of innovation, outcomes and efficiency for customers. Ambitious companies that succeed in doing so, have opportunity to be recognized with exceptional or fast tract status in PR19, providing early certainty and additional returns. However, for companies that fail to do so, will find PR19 very challenging indeed, with lowest WACC ever, tough cost efficiency challenge and stretching performance commitments.

Thank you once again for the opportunity to speak here today. I look forward to Q&A later in the session.