
Innovation and efficiency workshop – speech from David Black

We have had a number of workshops in the lead up to PR19, covering areas such as customer participation and resilience. In many ways, I see today's workshop as one of the most important for PR19.

The issue of innovation and productivity growth is at the heart of the current debate on the legitimacy of the sector. Innovation and productivity gains are the means for shifting out the frontier of what is possible to deliver to customers.

When we started on the Water 2020 journey, we talked about value creation (or how we grow the pie) and value allocation (how the pie is sliced between customers, investors and other stakeholders) - and that we saw the 2019 price review having a major role in both value creation and allocation.

The debate around the sector in recent months has often focused on value allocation, in particular around whether equity investors are benefiting at the expense of customers. There will always be a debate about sharing benefits in the sector – it is entirely reasonable for stakeholders to raise these issues. But the debate must be sharper if it is just about value allocation - ie no discussion about how interests of companies, supply chain and investors can be better aligned to increase the value created by the sector.

I think the 2019 price review can play an important role in both value creation and allocation.

The move to a totex and outcomes framework in PR14 was a fundamental shift in the regulatory regime. The move to an outcomes framework provides companies with significantly more flexibility to make sure they are delivering the right schemes to meet customer needs and to innovate. Prior to PR14, companies were held to deliver outputs (particular schemes) or even individual elements of those schemes (for example, due to logging up process). The move to outcomes provides companies with considerable flexibility on how the final outcomes are delivered so that they can deliver these in the most efficient way and where opportunities arise to go further than anticipated in business plans to provide customers with better outcomes. When built on the foundation of customer engagement and participation, there is huge power to deliver better for customers.

Before totex, Ofwat looked at operating and capital expenditure separately. While there were relatively strong incentives to deliver schemes and operate efficiently,

there was less incentive to swap operating expenditure for capex or to bear down on capital expenditure as this was added directly to the RCV.

Combining operating and capital expenditure into totex places water companies more in line with those of an ordinary business where there is an incentive to bear down on costs across the board.

The combination of focus on customer, outcomes and totex means huge scope for productivity gains in the sector.

The recent Frontier economics report for Water UK highlighted the strong productivity gains in the sector since privatisation. It also highlighted the slow down in productivity growth over the last decade. This is consistent with Ofwat data on outcomes and cost efficiency, which has showed that in a number of cases, the rate of improvement in outcomes has tailed off and cost efficiency gains have slowed.

The workshop today highlights some great examples of companies using this flexibility to innovate, do things differently and improve efficiency and outcomes. It is also clear that there is a lot that companies can learn from each other and that the totex and outcomes framework can deliver even more in the next control period than the current period.

I encourage you to engage positively in the discussion. There will be opportunities to comment now and provide feedback later on. We also encourage companies to take the findings of this work into account when developing their business plans.

Perhaps in a more conventional environment, companies would have favoured “holding back” on potential gains in their business plan. However, in the current environment, I think companies have a strong interest in demonstrating that they can stretch to deliver and that the business plan reflects company aspirations to deliver more, deliver better and deliver more efficiently. I also note that the initial assessment of business plans, including the assessment of innovation, outcome stretch and preferential cost sharing rates for more efficient plans all support building the gains into the plan.

Mat and Tim have worked hard to develop a super workshop today. We are going to hear from companies about some practical examples of how they turned the new framework into action and from consultants Acqua and KPMG about the scope for benefits in PR19.