

## David Black speech: Next steps for the PR19 regulatory framework

### Future prospects for the water market and development towards PR19, Westminster Energy, Environment and Transport Forum, 14 June 2018

Hello everyone. It is a pleasure to be here this morning. I am going to talk about next steps for the PR19 regulatory framework.

Water sector faces challenges

20% population rise over 20 years – much of it in drier areas

Risk of too much water being taken from rivers, causing environmental damage

Up to 20% predicted reduction in summer rainfall and increase in winter rainfall by 2050

210,000 new households per year, many in the South East and East of England

One in five customers do not feel their bill is affordable, despite 5% drop in bills in real terms by 2020

Trust in water | Hyder mewn dŵr

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We all know the sector faces significant challenges:

- Population growth
- Climate change
- Water scarcity and rising environmental expectations
- And rising expectations of customer services

- Affordability concerns in a time of flat real wages
- Diminishing efficiency gains from the old regulatory model during period between 2005 -15.

We have also seen some more immediate challenges to the sector:

- Calls to move the sector back to a public ownership model;
- Significant concern following supply interruptions in certain parts of the country following the freeze/thaw incidents in late February and early March; and
- The challenge laid down to the sector by the UK Government (and Ofwat) to improve financial resilience and legitimacy.

To address the challenges it faces, the sector needs to find ways to do more for customers and the environment, while at the same time reducing cost. Delivering more of what matters.



That is why our methodology for the price review (which we published last year) is centered on four key themes, resilience in the round, innovation, affordability and great customer service.

We are looking for each company to demonstrate to us that their business plan – which they must submit to us by 3 September – is delivering for their customers in line with these themes.

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.

Ambitious and innovative companies that do this and so don't require us to step in on behalf of customers will be recognised, earning reputational and financial benefits and an early draft determination.

I will now discuss each of the main themes and some of what we're expecting.

### **PR19: Affordable bills for all**

Water and wastewater services are a vital public service and they need to be affordable, for all. Improving affordability also means effective and efficient support for those struggling to pay their water bill. Customers have faced challenging times and it is vital that water bills are affordable.

Our total expenditure and outcomes approach, alongside anticipated lower financing costs, means that customers could get lower bills over the next five years, despite upwards cost pressures.

We have identified scope for bill reductions from cost of capital reduction (£15-£25) and improved efficiency challenge (£15-£20), suggesting potential cumulative savings of £30-£45 or up to 10% of bills despite upwards cost pressures. To be clear, each company faces its own specific circumstances and it is up to companies to engage with customers and propose an appropriate balance between enhanced services and improving affordability. One size does not fit all.

One final point here. There has been a long running issue in the sector has the issue of cyclical 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 move to totex and outcomes approach helps to smooth spending as it decouples link between cost allowance and specific projects. We are also allowing provisions for transitional expenditure for PR19 (as we did at PR14), which means that companies need not delay starting new projects until the next price review.

## **PR19: Great customer service**

Customers' expectations of service are set by their experience they receive from other service providers – like their bank or their broadband provider. Companies need to aim for new standards of customer service in the sector comparable with other sectors of the economy. These expectations extend beyond the customers that contact their companies, to all customers, particularly those who are vulnerable.

Understanding what customers want will require 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 to be assured by company Customer Challenge Groups (CCGs).

Based on their understanding of customer priorities, water and wastewater companies develop their service promises to customers (outcome performance commitments). These will be underpinned by incentives (outcome performance incentives). We have set out our expectations for how companies set stretching outcome 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, ensuring a more dynamic sector.

We are also requiring companies to set indicative performance commitments for the period beyond PR19 to 2035 to reinforce focus on a longer term approach.

## **PR19: Long-term planning and resilience in the round**

Bills aren't the only thing that matter to customers. We look at resilience in the round, which includes operational, financial and corporate resilience. Customers need reliable, resilient services in the short and long term. Operational resilience requires understanding and evaluating risk, planning and operating to mitigate and manage risks and being able to respond and recover when events occur.

Company business plans need to demonstrate real ambition and innovation on 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 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”.

In the face of challenges like climate change, long term planning is required, but it is crucial that plans are able adapt and evolve as new information on impact of climate change, population growth and effectiveness of demand side measures emerges. This enhances the value of flexible and agile solutions.

When, from September, we assess company business plans, we will be looking carefully at how companies are preparing for the long-term and assessing both their understanding of risks to resilience and how effectively risks are mitigated and managed.

I'd like to note a couple of things here.

- We have been disappointed by the lack of ambition contained in some companies WRMPs (as you will see in our responses which we published this week) – for example in relation to demand management and sharing resources via water trading– and expect companies to address in their business plans.
- Next week we will also be publishing our lessons learned review following the water supply issues following the thaw after the Beast from the East in late February and early March. I'm not giving anything away too much in saying that the incident provided serious lessons for the whole sector to draw from in terms of resilience.

## **PR19: Innovation**

To deliver affordable bills, great customer service and long-term resilience in the round, companies must innovate. There is untapped scope to collaborate as a sector and innovation must be at the core of every company's culture if it is to deliver what customers want and need.

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.

That is why earlier this year we ran a digital campaign (Spark!) 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.

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

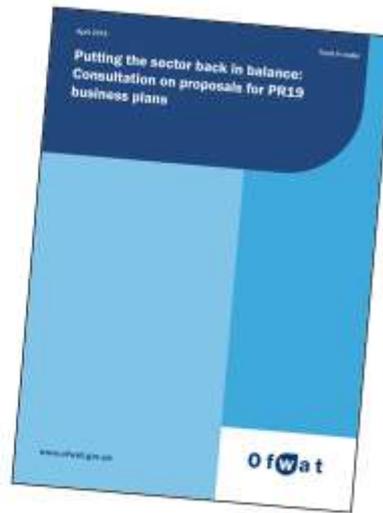
## PR19: Putting the sector back in balance

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Proposals for companies share financing outperformance from high gearing

Expectations for the transparency of policies on dividends and performance-related pay

Demonstrating financial resilience in their PR19 business plans



So those are the key themes for PR19.

Since we published our methodology, as you will be aware, we launched our work to get the sector back into balance with its customers. And, as part of that, in May we launched a consultation on new measures for the 2019 price review which will see customers share the financial gains made by water companies with high levels of debt. We also set out more details on the transparency expected on shareholder dividends and executive pay. And our expectations that companies will demonstrate financial resilience in their PR19 business plans.

Our proposals are targeted amendments intended to help rebuild trust and confidence in the sector and very much complements the PR19 themes.

## PR19 : Enabling innovation through markets



I'd like to finish on markets and competition.

Markets and competition are growing drivers of innovation in the water sector. Within the regulatory framework set by the English and Welsh governments, we are driving innovation by opening up markets, and exposing market participants to competitive pressures.

In the new business retail market, we are starting to see some of the service innovations that save companies time and money. Demand-side service innovations are already starting companies to manage their water usage, to improve resilience and defer system reinforcement requirements as well as reduce bills.

Already around 130,000 supply points have switched (as you will see in our first State of the Market report next month), we have seen new players enter the market and some incumbents exit.

We expect to see increased innovation and service differentiation as the market develops. An early innovation is the development of self supply, where customer essentially self provides own retail service and buys direct from a wholesaler. Clearly, this is not for everyone, but arrangement has already taken up by large multi site and manufacturing customers such as Whitbread, Greene King and Coca Cola.

In terms of other markets, where appropriate, in the 2019 price review, we will promote markets to encourage innovation through:

water trading, including potential to allow business retailers to enter wholesale markets;

- the bioresources market;
- greater third party involvement in large projects, through direct procurement; and
- markets for ecoservices – using market platforms to reveal better solutions to catchment challenges.

In doing this, we want to enable current and future industry participants to find new ways of delivering better outcomes for customers, the environment and wider society.

And that also remains the goal of the overall PR19 framework.

Thank you.