

Our Ref: PK/LAT/Ofwat

Your Ref:

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Dear Sir

Ofwat's emerging strategy: Driving transformational innovation in the sector

We appreciate the opportunity to respond to Ofwat's emerging strategy document on innovation in the sector as issued on 12 July 2019.

Overall, SES Water welcome and are supportive of Ofwat acting as an enabler of innovation in the sector. As a company, innovation will play a key role in delivering the performance and service levels we have committed to our customers in our recent PR19 Business Plan, and innovating is critical in improving customer experience and driving down costs.

We have a long track record of innovation in our industry and a strong company culture which values and promotes innovation. Our size has allowed us to take a leading role in developing new solutions that benefit both our customers and the environment. This is why we have consistently delivered upper quartile or industry-leading performance in a number of areas, and we continue to develop innovations that will enhance both our services to our customers and our performance.

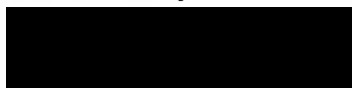
While there are certain barriers to innovation that we have articulated in this response, we agree that, overall, the principles provided in Ofwat's emerging strategy to support innovation are appropriate.

However, as articulated in this response document, we are concerned that customers may not support the additional funding for innovation. This was a clear finding from our own "willingness to pay" surveys conducted as part of our business planning process. In addition, since under Ofwat's proposed model, the resultant innovations must provide value for all customers in England and Wales, our own customers may be unwilling to participate if the innovations developed do not provide localised benefits, or if local concerns will be ineligible for this funding.

In addition, in order for innovation to flourish, and to encourage collaboration, there will need to be effective two-way dialogue between companies and Ofwat, an acceptance of failures and a willingness to experiment.

We have responded to the questions raised in the consultation document in the appendix to this letter and would welcome further opportunities to engage with Ofwat on this subject.

Yours faithfully



Paul Kerr
Finance and Regulation Director



Q:1 What are the main barriers to innovation in the sector and why?

We believe that the main barriers to innovation are as follows:

- The water sector is naturally conservative with respect to innovation, with a reluctance to implement certain potentially innovative solutions that could result in negative changes to the existing water supply arrangements in terms of water quality, availability or price.
- Due to the variety of raw water qualities, treatment processes and distribution systems, water companies are naturally reluctant to adopt certain solutions simply because these has worked for other water companies. As a result, there is a tendency for each company to conduct its own pilots and trials.
- There are currently poor incentives for companies to collaborate and share their findings, particularly in those areas where companies are ranked against one another, for example leakage. The two examples quoted by Ofwat (collaboration between Ford and Volkswagen, and the Offshore Wind accelerator) do not translate well into the water industry, as the first is an industry response to an existential threat and the second being a predominantly desk based research facility, which is already well catered for in the UK Water Industry by UKWIR.
- A number of the water companies have previously self-identified as fast followers, which effectively means that the innovation risk is taken on by a few companies, who therefore have less incentive to share their findings.
- Issues exist in dedicating appropriate management time and resources within companies, especially in the light of competing priorities associated with the operational and regulatory functions of the business.
- Current procurement policies, typically tied into five-year AMP periods, often fail to incentive the framework holder to innovate and similarly prevent other companies winning business in the framework period with innovative solutions.

Q:2 Do you think that the financial support cited in section three is required to stimulate innovation in the sector? If so, what do you believe is the appropriate amount of funding and why?

We believe that it is extremely difficult to gauge the level of funding required to stimulate innovation in the sector.

We have attempted to benchmark to other innovation funding we have seen in other countries. For example, we note that whilst the Dutch collaborative R&D fund is currently at £8M/year, this fund was initially set at £17M/year. Holland has about 7 million properties, therefore at the onset, the funding on innovation equated to £2.40/property/year. In France water innovation spending from the two largest companies is currently over £200M/year, which equates to £5.70/property/year. Data from 57 of the S&P 100 shows that on average the Industrial, Energy & Materials sector spend 3% of revenue on innovation. This would equate to an annual spend of £360M for the UK Water Sector (£14.40/property/year). However, the proposed £200M fund (even including the existing research funding) equates to only £2.96/property/year.

As a result, we are concerned that if there is insufficient funding, then transformational innovation will not occur and that the innovation exercise will subsequently be judged to have failed. We would recommend that there are realistic expectations on what can be achieved by this fund.

Q:3 Do you agree that our proposed draft principles for additional financial support will effectively safeguard the interests of customers?

Overall, we agree that the proposed draft principles for additional financial support would effectively safeguard the interest of customers.

In particular, we agree that innovation should be “just as much about the roll-out” as the “early incubation of new ideas and solutions”, and we recognise that many innovations within the industry fail at this early stage due to insufficient support.

However, we are concerned that customers will not support the additional funding for innovation. This was a clear finding from our own "willingness to pay" surveys conducted as part of our recent business plan process. In addition, since the innovations must provide value for all customers in England and Wales, our customers may also be unwilling to participate if the innovations developed do not provide localised benefits, or if local concerns will be ineligible for this funding.

In addition, the "open by default" approach to data will need to be carefully discussed with the supply chain who firstly will want to protect their own intellectual property and secondly may be concerned about the shared of data that is not to their benefit, for example failed trails.

Finally, we are particularly concerned about the claw-back option on funding. Projects should not necessarily be considered to have failed if they are not taken forward. If there is a view that companies may be required to bear the full cost of any failed innovation, there will be an incentive not to investigate innovations considered too "cutting edge". In addition, this will create an incentive to push failed innovations into the market to prevent the "claw-back" clause being revoked.

Q:4 What are your views on the collectively funded innovation competition model which we describe in section three? What other key considerations not highlighted should we take into account in designing/ implementing the competition?

We do have concerns regarding the operation of a collectively funded innovation competition model.

For example, we are concerned that as a result of this model, funding would only be awarded to those companies capable of allocating sufficient resources to win the awards. We are already aware that a number of companies are able to dedicate staff, whose specific role is to raise external funding for innovation. As a result, innovation funding can become based on the applicant's ability to fund an impressive application, rather than the merit of the innovation itself. In addition, small companies and inventors may be dissuaded from applying under this model.

We are also of the view that because each innovation may be considered separately, there is less opportunity to build innovation towards a goal, which is what typically happens in the industrial sector. The independent expert entity should be advised to consider innovations against a strategic framework, rather than in isolation.

Finally, should the above concerns be addressed, we would recommend that the funding application should not be overly onerous. Project briefs should be short for a preliminary discussion and investigation, with suitable projects then identified for a more fully scoped brief, similar to the current UKWIR process. This process ensures that the ideas with the most merit are taken forward and furthermore prevents the larger companies from dominating the process.

Q:5 What are your views on the end-of-period innovation roll-out reward we describe in section three? What other key considerations not highlighted (e.g. whether it should be collectively funded or individually funded) should we take into account in designing/ implementing the reward?

We agree that the introduction of an end-of-period innovation roll-out reward would encourage successful roll-outs and the sharing of findings and benefits.

However, we are concerned about how appropriate sharing of this reward would be carried out in order to ensure that companies do not benefit several times over, both from the implementation of the innovation, as well as the innovation reward.

We would recommend that there is robust assessment and decision-making process that rewards genuinely innovative solutions, and that the rewards should be shared between those companies that worked together to develop the solution, and additionally recognise those companies that were able to demonstrate the wide-spread implementation (ensuring clear evidence that the innovation is new and does not represent a retrospective application for previously invested monies).

Q:6 What other potential alternative mechanisms for funding/ rewarding innovation not discussed do you think we should be considering? Which financial support mechanism or combination of mechanisms should we introduce and why? What would be an appropriate split of available funding/ reward?

As already stated, we believe that customers will not be supportive of an industry wide innovation fund, based on our own customer surveys. We note that in the shared energy innovation fund, there is a proportion of the fund allocated to each individual company for innovation purposes, as well as a shared collaborative fund. We believe that a company specific fund, that allows innovation for the direct benefit of our customers, would be far more acceptable.

We also suggest that recognition should be given to the differing roles that companies can play in innovation. In industry, larger companies are able to allocate greater resources to innovation, but typically move more slowly, whilst smaller companies have less resources, but are viewed as being more agile at developing innovation, due to compressed decision-making structures and a better understanding of problems. Given our concern that larger companies are better able to compete for funding, and also the relatively short year timescales, we would suggest that a measure of company agility should be taken into account when awarding the funding. This would also promote collaboration by enabling partnering between large and small water companies, with the smaller companies acting as greenhouses for the innovation development.

Q:7 Do you think the potential industry activities discussed in section four could help drive innovation? Are there other activities not identified which you think the industry should be considering?

We agree that a national centre of excellence could ensure that data sharing standards and methodologies are followed, as well as promoting the dissemination of learnings and best practices. However, the scheme would need to be carefully constructed in order to circumvent the competition issues that we have previously highlighted.

We are of the view that a sector wide joint innovation strategy may constrain individual innovation within companies, particularly given the suggested short timescales for the evaluation of the success of the innovation fund.

Q:8 Do you think the proposals in section five will help drive innovation? Are there other activities not identified which you think Ofwat should be considering?

We are supportive of Ofwat acting as an enabler of innovation, but note that this will require an entirely different approach from the regulator. In order for innovation to flourish, and to encourage collaboration, there will need to be effective two-way dialogue, acceptance of failures and willingness to experiment.

We recognise that this would be a new venture for Ofwat and would therefore recommend that an independent organisation, with the relevant experience in this area, acts to advise Ofwat and liaise with the Water Companies to prevent conflicts of interest and to ensure that this proposal has the greatest opportunity for success.