

20 September 2019

Innovation consultation
Ofwat
21 Bloomsbury Street
London
WC1B 3HF

By email: Innovationconsultation@ofwat.gov.uk

Dear Sir

OFWAT'S EMERGING STRATEGY: DRIVING TRANSFORMATIONAL INNOVATION IN THE SECTOR

We welcome the opportunity to respond to this innovation consultation on what is a vitally important topic for the sector. Overall, we are supportive of the approach but there are three areas we believe need consideration to get the best benefit for customers.

Customer equity

Further initiatives by the regulator to reduce the acknowledged barriers to innovation will help to embed a growing innovation culture and accelerate delivery of broader sustainable benefits to customers. We believe that this proposed approach needs to be thoughtfully designed, principles agreed with protections in place for customers, but equally needs to be mindful that the balance of risk is at the heart of innovation so needs to be fair and flexible leaving collaborators with strong incentives to participate.

The consultation is helpfully progressive however, we have concerns over the way the fund will be raised through increasing customer bills. Our customers were not asked during the price review process whether they would be willing to pay an additional £1.50 for an industry wide innovation pot, we would suggest that customer research is undertaken on this principle before considering whether they are adequately safeguarded. We have not carried out specific research on this but where we have engaged with our customers on similar topics for example the £50 government contribution that in the strength of feeling of views, it is very clear that subsidies going out of the region would not be popular at all, that if bills went up for money to go elsewhere it would be disliked unless it was very clear how South West Water customers would net benefit from it. With affordability a major concern for our customers and a commitment from our Board to address water poverty, customers must be allowed to make their views known.

If Ofwat were to proceed, we would welcome the opportunity to work together to develop the approach that adequately protects and is equitable to all customers. If the innovation pot or incentive

is likely to be funded by an increase in customer bills, care must be taken to ensure any innovation is applicable to all customers, either directly or indirectly. That the value raised in each region is returned as a minimum in benefits. There may be specific challenges some companies face that others do not. Such challenges may not be appropriate for this kind of fund, unless there is a means for balancing the benefits across customers e.g. in project selection. Otherwise, it may be difficult to see how customers would be protected – we have put forward similar arguments where vulnerability pots for the industry have been considered.

This could be addressed by ensuring that the projects that are successful are ones that solve industry wide issues and the results are made available to all companies.

This would mean that customers in any region would not be disadvantaged by work being done outside of their area. In making the results of the innovation available to all, the opportunity for take up across all companies is maximised and hence the maximum possible benefit to customers is achieved.

Importance of efficient project delivery

We support initiatives aimed at encouraging the industry to take their own collaborative steps. The scope of an industry strategy will be a challenge given companies diverse interests, but we believe commonality can be found and are very willing to work together to secure long term resilience. We also believe that transparency and all the principles of good regulation will be crucial to providing confidence, so consideration is needed as to how some of the initiatives under that heading might be taken forward in a 'light touch' regulation way.

One of the key features of Ofwats approach is that the funding is focused on collaboration, again Ofwat noted our business plan as *'an ambitious plan to use collaboration and markets to secure resilient and sustainable water resources for the long term'* and therefore we are supportive of this approach.

In 2017 we established an ongoing collaboration with the University of Exeter to develop an Innovation and Resilience Centre for Water and Waste (CREWW). The aim is to have the state of the art research facilities fully operational by September 2022, progress has met expectations and in July 2019 success in the venture's bid was achieved with £10m of match funding from Research England awarded. South West Water are currently committed to investment during 2020-25, however with the opportunity to address business challenges, whilst also furthering the aims of the broader sector means that potentially this could lead to further investment in our plans beyond 2025.

The focus of the Centre will be to develop innovative solutions designed to solve some of the most pressing global environmental challenges of our time, including: how to manage natural resources to ensure there is sufficient water to cope with population growth, the pressures of climate change, and improving resilience to the potentially devastating impacts of flood, drought and merging pollutants. The new Centre will accommodate state of the art, specialist laboratory facilities, and safe environments to carry out trials that will go some way to address risk adversity and to encourage collaborative research between academics, experts from the water industry and a broader network of industry collaborators. We have a resource dedicated to the Centre to work with the business to promote innovation opportunities that can be developed into CREWW projects that support delivery of our business plan and obligations to customers and stakeholders.

There are many commonalities between the proposals set out in the consultation with the Research England bid process and work we have already undertaken with the University of Exeter in developing our Innovation and Resilience Centre. An outline of our proposal was set out in our PR19 business plan – Targeted Controls, Markets and Innovation document. We also have a process for how innovation projects are passed through to research to ensure they deliver tangible benefits. We believe it would be beneficial to explore these similarities and potential areas of cross over with you as you develop and finalise your thinking in this area. We would welcome the opportunity to do this either as an extension to our Draft Determination meeting on 17 October or at another convenient date of your choosing.

Furthermore, in ensuring that projects selected for the fund are efficient, in developing your framework we also think consideration should include in the assessment process how proposed projects will use existing or new collaborations – such as the above - to reduce the cost to customers of the proposed activity. This will also help ensure that existing knowledge in the sector is maximised and projects aren't funded where research in that area has already been undertaken or opportunities for joint working are missed. This will help ensure efficient project delivery.

Removing wider barriers to innovation

Access to additional funding, with appropriate objectives and governance, has the potential to strengthen the impetus for companies to innovate and share best practice. In doing so we can build on the many emerging good examples of where companies do that already. We must however keep in mind that sometimes, not always, there is good reason why some innovation in the water sector takes longer than other sectors to deliver benefits to customers because of potential risk of failure and impact on public health.

It has taken South West Water seven years from piloting innovative new water treatment technology to building our newest water treatment works in Plymouth. We are now one of three companies in the world to have this water treatment technology and the first in the UK. This experience is being shared with other companies in the sector who are considering this new technology and we have recently signed a memorandum of agreement with PUB (Singapore's National Water Agency) and PWN to share knowledge, data and best practices on ceramic membrane systems for the next five years.

Consequently, where the innovation fund could be used in the sector to encourage and support trials and the 'incubation' and 'roll out' of new ideas whilst managing risks, this is to be welcomed and would benefit all customers.

In addition, there is undoubtedly innovation undertaken by the sector that could be publicised more. We have recently become the first UK water company to acquire Advanced Valve Technologies' (AVT) EZ Valve™ kits. The acquisition of these kits means South West Water operatives now have the ability to quickly install valves to control burst situations and reduce service interruptions to customers. Recognising customers' priorities, the company is focused on delivering further improvements and innovation in this area, particularly given the challenging targets it has set itself for the 2020-25 period.

Equally, collaboration between companies is increasing, especially in areas where we all face significant challenges such as leakage and water resources. In the South West the water companies located in our regional have been collaborating as part of a West Country Water Resources Group to enable transfers of water to the East of our region and area of appointment. We have also developed

a leakage and a water efficiency working group to share ideas and best practice (note this is something we routinely achieved as part of the Bournemouth Water merger).

We therefore support the consultation in its aim to deliver greater innovation and sharing and as set out above there are good examples of this happening now. However, looking at the sector as a whole, we think it would be particularly helpful to examine the responses to the barriers to innovation in the existing framework in Question 1 of the consultation. Specifically, to examine what part of the current regime they occur in. If we can unlock those barriers it would in theory negate the need for the fund. This would have wider customer benefits and in turn address some of the challenges such as customer equity that an innovation fund brings with it.

We have included answers to the specific questions raised in the consultation as an Appendix to this letter and as noted above would welcome the opportunity to discuss with you as appropriate. As the consultation asked, we will commit to our continued engagement with the sector on this important area and attend any workshops held by Ofwat.

Yours faithfully



Sally Mills
Regulatory Director

D: 

E: 

Appendix – answers to consultation questions

1. What are the barriers to innovation in the sector and why?

- Actual risk from failure e.g. public health impact
- Security of delivery e.g. new water treatment works – risk of customers rejecting water, technology working, environmental impacts
- Time – some innovative solutions take years to be tested, realised and accepted e.g. new treatment works and therefore straddles across price review periods which may not be accounted for
- Variety / Lack of data and technology standards – establishing standards or agreeing on a single standard will aid collaboration, data sharing and research/innovation. OpenWater demonstrated that the lack of data standards in the industry creates significant challenges. While not insurmountable, it would help if standards could be agreed.
- Service impact failure e.g. penalties, fines and reputational impact
- Difficulty in obtaining regulator support for innovation e.g. upstream thinking and catchment management, which now is seen as normal and encouraged sustainable solutions
- The need to keep bills low can often inhibit innovation, with budgets focused on actual delivery
- Regulatory drivers need to be intelligent – sometimes competition can drive innovation, sometimes it can hinder innovation where collaboration is needed
- Difficulty in capturing the wider (beyond the company) benefits of innovation
- A legacy of risk aversion driven by years of facing the above potential failures

2. Do you think 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?

- Agree that additional targeted financial support may help companies overcome barriers, addressing the risk around costs and/or rewards – the way it is targeted and the principles for allocation will be crucial
- Funding is not sufficient on its own: encouraging a mindset of innovation and willingness to work together in the industry will be important, as will regulatory collaboration and commitment to the incentives established
- The use of an innovation funding competition sounds like a good idea to explore. The objectives, criteria and governance are all crucial to success, and many examples, not least Ofgem to draw on
- Other incentives similar to ODIs are less attractive because there may be less clarity and certainty about the circumstances of their being awarded and may be costlier for customers/less effective
- Ultimately need to be very clear on the method of assessment for either avenue – one reason innovation isn't an ODI is that it is inherently difficult to measure.

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

- We have concerns over the way the fund will be raised through increasing customer bills. Our customers were not asked during the price review process whether they would be willing to pay an additional £1.50 for an industry wide innovation pot, we would suggest that customer research is undertaken on this principle before considering whether they are adequately safeguarded. We have not carried out specific research on this but where we have engaged with our customers on similar topics for example the £50 government contribution that in the strength of feeling of views, it is very clear that subsidies going out of the region would not be

popular at all, that if bills went up for money to go elsewhere it would be disliked unless it was very clear how South West Water customers would net benefit from it. With affordability a major concern for our customers and a commitment from our Board to address water poverty, customers must be allowed to make their views known.

- If Ofwat were to proceed, we would welcome the opportunity to work together to develop the approach that adequately protects customers. If the innovation pot or incentive is likely to be funded by an increase in customer bills, care must be taken to ensure any innovation is applicable to all customers, either directly or indirectly. That the value raised in each region is returned as a minimum in benefits. There may be specific challenges some companies face that others do not. Such challenges may not be appropriate for this kind of fund, unless there is a means for balancing the benefits across customers e.g. in project selection. Otherwise, it may be difficult to see how customers would be protected – we have put forward similar arguments where vulnerability pots for the industry have been considered.
- Agree that the fund should specifically be for projects that demonstrate collaboration to deliver industry wide benefits – the point here will be to address issues that are widespread across the industry and could therefore have large benefits for all customers – and wouldn't otherwise be done or might take a very long time. It will be challenging for a panel to clearly identify these.
- The use of any clawback mechanism must be clearly specified and how failure risks are shared between customers and collaborators must be carefully thought through in order not to stifle or skew incentives to participate.

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?

- Our concerns shared in our response to Question 3 are relevant here also
- The use of an innovation funding competition sounds like a good idea to explore. The objectives, criteria and governance are all crucial to success, and many examples, not least Ofgem to draw on
- We do not believe the principles are clear enough currently to make an assessment
- South West Water has already established an independent entity support for the Innovation and Resilience Centre
- If a product is developed and commercial revenues are generated who receives the benefits – all customers?

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 to the principle of end of period rewards as a supplement or to companies who have delivered the most benefit to customers through innovation – how this will be measured objectively will be a not insignificant challenge.
- The scale and timing of the reward needs careful consideration because of the potential impact on customer bills with all the other adjustments being made in year one of the regulatory cycle

- 6. What other potential alternative mechanism for funding / regarding innovation not discussed do you think we should be considering?**
- Could annual incentives be considered
 - Upfront payment and true up similar to WaterShare
- 7. Which financial support mechanism or combination of mechanism should we introduce and why? What would be an appropriate split of funding / reward?**
- We believe the most transparent mechanism would be an upfront allowance that is trued up at the end of the regulatory cycle
 - We do not believe end of period rewards are necessary, particularly if an innovative solution could be sold to generate commercial income
- 8. 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?**
- Developing a joint innovation strategy or framework is challenging because of the inevitable challenge of all companies wanting to lead it and protect the interests of their company first and foremost. A very high-level strategy might be possible. E.g. agreeing what the challenges are, where technology/process, innovation could make the biggest differences industry wide to outcomes and or cost etc. Agreeing where transparency/best practice/data sharing might be useful
 - As noted in the covering letter, we are firmly of the opinion that a Centre of Excellence can drive benefits to the sector and that is why we have partnered with the University of Exeter to develop an Innovation and Resilience Centre for Water and Waste. Through its training and skills workstream this initiative will also help secure the skills and capabilities we need in the sector for the future.
- 9. 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?**
- Possibly. The more collaboration there is between regulators to deliver the best outcomes for customers in an aligned and effective way the better. Not just economic regulators.
 - Aim would be to support 'light handed' regulation, transparency and incentives. Companies may be better placed to consider evolving uses of IT / social media technologies for data use and involving customers in decision making etc. It may be better if Ofwat incentivises individual companies rather than hoping industry as a whole would develop some of these initiatives.