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Regulation

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Ofwat: Innovation funding and competition: further consultation on design and implementation

Dear [REDACTED]

This note provides our response to the above consultation that was issued on 13th May 2020.

We welcome the consultation and the opportunity to comment on Ofwat's proposals relating to policy issues and the design and implementation of the £200m customer funding available over 2020-2025 for the collectively funded innovation competition.

We support Ofwat's desire for a collaborative approach and also strongly support alignment of projects funded to the water sector innovation strategy. We agree that the process must be supported by a clear and robust set of rules, administered efficiently and fairly, that make use of independent experts in the decision-making process.

We agree that the introduction of innovation funding and an innovation competition can help address the three key barriers to innovation identified by Ofwat: (i) the need for a shift in company culture and more effective joint working, (ii) the perception that the current regulatory framework does not sufficiently encourage innovation and (iii) the need for water companies to innovate to continue delivering safe, reliable and affordable water supplies for all in the light of global strategic challenges.

We also support the proposal to appoint an independent panel of experts. As projects are to be developed for the benefit of the whole water industry, it would be helpful if water companies are represented in some way on the expert panel. This would ensure that projects that have the widest application across the industry are developed, rather than niche projects, and maximise buy-in of all companies to bids that are funded through the competition.

We consider that some of Ofwat's proposals will need to be developed further and are keen to work with Ofwat and colleagues across the water sector to assist with this. For example:

- Intellectual property / royalties – while royalty payments are a practical way of conveying additional value back to customers there should be the capability and flexibility to agree appropriate royalty payments on a case-by-case basis.
- Open data – We understand the principle, however if the approach is to be adopted, flexibility must exist to protect data that is sensitive, for example for commercial (e.g. relating to patent applications) or security reasons (e.g. disclosing vulnerabilities in critical assets).
- We believe that the reward for both leaders and followers should be the benefits realised from the roll-out of solutions and/or the lessons learnt from the initiatives selected for funding. We suggest that consideration should be given to allowing companies to realise the resulting benefits beyond the current AMP to ensure that the incentive to roll-out solutions is not impacted by the timing in the regulatory cycle.

- It is important that any ring-fencing arrangements are flexible and proportionate, as companies will have different preferences and restrictions depending on their financing arrangements, particularly those companies with securitisation arrangements. It would be inappropriate if some companies were unable to take part in the competition because of unnecessary ring-fencing requirements or rules over royalties. We believe that a collaborative approach is the best way to address these issues and we would be keen to work with Ofwat to develop these.

We set out our response to the specific consultation questions in the appendix.

We are very happy to discuss these comments with you if that would be helpful, please contact [REDACTED] as our lead in this area. We are excited about the opportunities that could be enabled for water companies, our customers and our stakeholders.

Yours sincerely,

[REDACTED]

[REDACTED]

Appendix 1

This note provides our response to the specific consultation questions

Q1: Do you agree with our proposed default arrangements for managing IPR and royalties? Do you think these arrangements work for different types of projects and activities (e.g. new technology vs. process innovation, roll-out activities etc.)?

We support the proposal to put in place default arrangements for IPR on the basis that it sets a clear expectation for all stakeholders (i.e. both water companies and other potential project partners). We agree with making a distinction between background and foreground IPR, and we agree with the arrangements for background IPR.

Where the IPR created relates to new processes and ways of working, the arrangements outlined for foreground IPR are generally considered to be practical. In the case of projects that involve the development of new technology (particularly a technology that builds on a partner's background IPR), there is a concern that the default arrangements could discourage partners from bringing forward concepts if they perceive that they will be unable to commercialise the resulting IPR freely. We would therefore propose that foreground IPR can be owned by the project partner. We believe that the interests of customers should be protected by ensuring that projects are structured to deliver value to customers through the application of solutions (and future roll-out thereof), not from the potential future value of IPR.

We do, however, believe that royalty payments are a practical way of conveying additional value back to customers and, in particular, support the creation of a revolving fund. It is important to recognise that the monetisation of IPR from technological solutions typically carries material additional cost (e.g. marketing/business development, maintaining product certifications, maintaining inventory) and risk, and as such there must be flexibility to agree appropriate royalty payments on a case-by-case basis.

Q2: What alternative arrangements should we be considering for IPR / royalties?

Building on our response to Q1, we believe that foreground IPR should vest with the party best placed to exploit that IPR. We believe that appropriate royalty payments would ensure that value is returned to customers.

Q3: Do you agree with the principle that data generated through the innovation competition should be open by default?

We agree with the principle of an open by default arrangement for data generated through the innovation competition. It is important to recognise that, in order to be valuable, data should adhere to standards that make it accessible and that appropriate governance standards should be in place. We feel it could be appropriate to consider developing and implementing these measures as an enabling activity, supported through the corresponding funding stream.

There will be some limitations to the data that can be made available and/or the timing of making such data available. The flexibility must exist to protect data that is sensitive, for example for commercial (e.g. relating to patent applications) or security reasons (e.g. disclosing vulnerabilities in critical assets). We propose that the specific arrangements for open data should be outlined in bids submitted to the innovation competition to ensure that expectations are aligned for all parties.

Q4: Do you agree with our proposed approach and that we should consider alternative arrangements beyond company contributions?

We agree with the proposed approach and believe it strikes a good balance between transparency and flexibility.

Q5 Do you agree that a guideline minimum company contribution of 10% is appropriate in this context?

We support a minimum company contribution of 10%. In practice, it will be more challenging to make a 10% contribution to a large, high risk project in which benefits are expected to accrue beyond the AMP (which is likely to characterise the most transformational projects that are brought forward) than a project that is small, low risk and/or expected to deliver a rapid return. Taking this into account, we support including flexibility to propose alternative arrangements where appropriate.

Q6 Do you agree with the overarching approach we set out here?

We agree with the proposed approach and are particularly supportive of retaining the flexibility to support projects at different technology readiness levels (TRLs), scale and type. We also strongly support an approach in which the projects funded are aligned to the water sector innovation strategy.

Q7 What are your views on introducing separate, proportionate, arrangements for small-scale projects? How might we define small-scale projects for the purposes of the innovation competition?

In principle we support arrangements that are proportionate to the scale of the projects being funded, i.e. a lighter-touch approach for small-scale projects. We would define small-scale projects as any project requiring less than £100,000 funding through the competition. We would, however, like to take the opportunity to highlight our support for targeting transformational innovation, and, as such, one opportunity may therefore be to fund smaller projects that inform and enable larger-scale projects to be brought forward to the competition. We do of course recognise that smaller projects can be transformational and that there is merit in a balanced portfolio. We would urge Ofwat and your delivery partners to ensure that there is a strong focus on projects at scale that cannot be readily funded through existing channels, to maximise the chances of truly innovation and transformative initiatives with real benefits for customers.

Q8 Do you agree with our proposal for ensuring roll-out is at the heart of the innovation competition? How might we reward both leaders and fast followers in?

We are entirely supportive of ensuring that roll-out is at the heart of the innovation competition. It is important to note that in some cases innovation may be transformational for one company or a sub-set of companies, but the solution may not lend itself to every company. As such, when assessing the impact of roll-out, this should be considered in absolute terms rather than based on the number of companies to which the solution is applicable.

We believe that the reward for both leaders and followers should be the benefits realised from the roll-out of solutions rather than the creation of any specific incentives. Notwithstanding this, we agree that a proportion of the funding could be made available to support/accelerate roll-out. We also feel that consideration should be given to allowing companies to realise the resulting benefits beyond the AMP to ensure that the incentive to roll-out solutions is not impacted by the timing of the regulatory cycle. There is otherwise a risk that companies might be encouraged to delay roll-out, and hence, benefits realisation, until the subsequent AMP. We also recognise that whilst the goal is to transfer knowledge to companies that did not participate directly in a project, there will always be some risk to a company embarking on a roll-out based on knowledge transferred from a third party. As such, Ofwat might consider part funding the roll-out of solutions developed through the competition for fast followers and/or where the broader benefits of roll-out are less certain.

Q9 What practical arrangements should we introduce to ensure adequate ringfencing of the innovation funding?

Ring-fencing arrangements need to strike a balance to be sensible and not unnecessarily onerous. Revenues from customers that are identified for the purpose of collective innovation funding or those allocated to companies from the fund do not need to be ring-fenced into a separate bank account. That would not be a meaningful or practical solution. We already have ring-fenced money e.g for Strategic Water Resources or other specified projects and they do not need to be formally ring-fenced into separate bank accounts.

It is important that the arrangements are flexible, as companies will have different preferences and restrictions depending on their financing arrangements, particularly those companies with securitisation arrangements. It would be inappropriate if some companies were unable to take part in the competition because of unnecessary rules over ring-fencing monies. Companies will need to have a full understanding of the impact of ring-fencing on securitisation arrangements. Making changes to the securitisation documents could cost more than the funds being awarded from the competition, which would clearly be inappropriate. The rules could be set flexibly to avoid any need to change securitisation documents. We believe that a collaborative approach is the best way to address these issues and we would welcome the opportunity to support Ofwat in this.

Q10 Do you think the proposed innovation challenge approach will help better enable partnerships and collaboration between companies and third-parties, in particular smaller innovators? Are there alternative approaches we should be considering? How can we make sure this approach works in practice?

We are supportive of the innovation challenge and believe that it will help to enable collaboration by improving visibility of common challenges to the supply chain and innovators. By creating a point of focus for innovators, we believe this approach will be particularly beneficial for new entrants that may not currently have links with individual water companies. It is important to recognise that the success of the approach outlined relies on challenges that are very well defined at the outset; this will require significant resources and co-ordination to ensure that benefits are not diluted. For example, issues that occur because there was a lack of understanding of the operating context of different water companies which limits the direct transfer of a solution across the industry.

Q11 Do you agree with our proposed approach to returning funds to customers? Are there any other circumstances, not considered here, under which we might consider returning funding to customers?

We agree with the proposed approach of returning unused funds collected from customers back to customers. This should be done as part of the normal end of AMP adjustments and not as a separate rebate to customers.

Success is not guaranteed from innovation projects. We therefore believe that any adjustments to or returns to customers of monies spent should only be made where Ofwat has a high degree of proof that the monies have been misspent and / or the project has not complied with funding conditions.

Q12 Do you agree with our proposed approach for managing interactions with the price review?

We welcome Ofwat's overall approach, which is to encourage innovation for the benefit of customers and companies. While innovations are not likely in general to have a material impact on ODIs, there is the potential for an innovation to materially impact an outcome delivery incentive and in such circumstances, Ofwat should provide a derogation under PR19.

We believe that if a derogation is not provided, companies may not undertake innovations where there is a material adverse risk to outcome delivery incentive performance. This could lead to potential missed opportunities for customers.

For example, in order to prove a technique for trunk mains rehabilitation, a trial at a commercial scale would be required and this could materially impact ODI performance.

Ofwat could further support new innovations by supporting engagement with other water industry regulators (either through the one-stop-shop or existing channels), during the current AMP, where a temporary derogation or a change in regulation could support the development and / or roll-out of innovation. For example, a temporary relaxation of discharge consents at a wastewater treatment works where a new process is being trialled.

Q13 Do you agree with our proposed amendments to the principles? Are any further amendments to the principles required to reflect our approach to outstanding policy issues outlined in this document?

We are supportive of the principles, including the recent amendments. We would like to highlight that, whilst there are many common challenges and opportunities in the industry, there will also be innovations that are not applicable to every water company (and in practice may only be applicable to a small number). In considering the overall benefits to customers, we would urge Ofwat and your delivery partners to recognise that innovations that may only be applicable to some companies and/or customer groups. For example, an innovation might focus specifically on the south east. While this may only be applicable to the needs of six water companies, it would nevertheless have potential benefits for around one-third of the population served by the Ofwat regulated companies. We encourage Ofwat to take a practical approach in assessing potential wider benefits from proposed innovation schemes.

Q14 Do you agree with our proposed focus, major strategic themes and overall approach for the competition?

Yes, we agree with the proposals. We do recommend aligning the themes with the water sector innovation strategy in order to create consistency and transparency for stakeholders and would be happy to work with you to achieve this.

Q15 What is the appropriate split of available funding between the Innovation in Water Challenge, the main competition and enabling activities?

We believe that the majority of the funding, no less than £150m, should be made available for the main competition with the remaining balance split between the innovation in water challenge and enabling activities. Where possible, we would advocate for retaining flexibility to reallocate funding within the three activities based on the quality and volume of bids that are brought forward.

Q16 What are your views on the feasibility of running all three types of activities in the pilot year, and on the proposed timings in Annex 3?

We strongly support running all three activities in the pilot year and believe it will maximise impact within the AMP. We recognise that the pilot year will inform changes to the activities and believe that it will be beneficial to learn quickly so that the approach for the remainder of the AMP can be finalised at the earliest opportunity, thus allowing water companies to plan to bring projects forward with increased certainty around the timings of the funding cycle and wider requirements. Notwithstanding this, we would like to highlight the following considerations:

- As noted in our response to question 10, there is likely to be significant effort required to meaningfully define challenge statements for the **innovation in water challenge** and therefore feel that the timescales outlined may be challenging.
- Given that the main **competition** will focus on projects at scale, the development of bids will require significant time and effort. It is therefore important that there is sufficient time allowed between finalising the arrangements for the competition and the closing date for the first round of bids to ensure that high quality bids can be developed.
- We feel that the timescales for **enabling activities** could potentially be brought forward, noting that funding this activity should directly support both the innovation in water challenge and collaboration to bring forward bids to the competition.

Q17 Do you agree with our proposed approach to key implementation considerations outlined here?

We agree with the proposed approach and welcome the opportunity to work with Ofwat and your delivery partners to support both the implementation, ensuring that it is aligned to the water sector innovation strategy, and evaluation of lessons learned, ensuring that these are reflected in future updates to the innovation strategy (where applicable). We note the proposal to appoint an independent panel of experts and would welcome the opportunity to discuss candidates that you might want to consider based on the stakeholder engagement that the water companies are undertaking collectively to inform the development of the innovation strategy. As projects are to be developed for the benefit of the whole water industry, it would be helpful if water companies are represented in some way on the expert panel. This would ensure that projects that have the widest application across the industry are developed, rather than niche projects, and maximise buy-in of all companies to bids that are funded through the competition.