Towards PR19: legitimacy through efficiency

Speech by Chief Executive Cathryn Ross at Moody's UK Water Sector Conference 12 October 2016

Introduction

Good morning everyone. It's great to be here. And thanks to Neil and the team at Moody's for inviting me.

Last year when I spoke at this conference, I talked about the challenges facing our sector and what they might mean for the sector and our regulation of it. I set out those challenges – about which there is a high degree of consensus - around dealing with the pressures of population changes and climate change while also ensuring that bills remain affordable and customer legitimacy is maintained. I set out how the key to meeting those challenges successfully is a step change in efficiency. And I also set out how establishing markets through the water and waste water value chain and getting them to work effectively is essential for this.

Today I want to build on that.

I want to talk about how the environment in which we all operate has changed since last year and especially since the Brexit referendum.

And I also want to put a bit more flesh on the bones of where we see the challenges, and indeed opportunities, for water companies and investors in PR19.

Changes in the external environment – plus plus ça change, plus c'est la même chose

So let's start by taking stock of the external environment. It feels as though there has been a great deal of change in the last twelve months. And most of it since the Brexit referendum vote last June.

We voted to come out of the European Union – and if we weren't sure what that meant at the time, we know now that 'Brexit means Brexit'…

In terms of the political environment, we have a new Prime Minister and many new faces occupying those positions that touch the water sector.

In fact we have something that feels very much like a new government. A government that is forging its agenda based on a vision of capitalism that delivers for everyone…

In terms of the economic environment the picture is mixed… This month, the IMF cut its forecast for the medium term growth potential for UK GDP from 2.1% to 1.9%. The pound is down, which has pros and cons, although it seems mainly cons, for example in terms of inflationary pressure at least in the medium term. Interest rates are down too, which has pros and cons too – it may be good for housing costs, but not so good for savings and pensions.

OK. So more change and less predictability…?

At the macro level maybe. But when it comes to the water sector maybe not. In fact, in the water sector there are some key elements of continuity – and I want to emphasise three here.

I suspect we will be picking the bones out of the Brexit referendum result for years to come. But it does seem to throw one point into very stark relief, and that is the importance of our economic and political systems, and the institutions that underpin them, retaining a fundamental – existential – connection with every member of society.

For the water sector this is about the importance of customer legitimacy. And it isn't new. Those in the sector are well aware of the vital nature of the public services they provide. Ofwat's strategy has built on this. In particular we have drawn out the fact that customer legitimacy isn't only a function of what customers get – the service they expect (which by the way may not be 'what we all know customers want') at a price they can afford. It's also about how the sector engages with them. How they feel about their service providers, whether that relationship is one of trust and whether that trust has firm foundations.

The second element of continuity I want to emphasise is investability. Through all the turbulence we see at the moment, the fundamentals of the sector remain sound.

There is water in the hydrological cycle. People will always need it, and the water gets to the people who need it using infrastructure that is well known, well understood and not going anywhere.

Yes, we have retail competition coming for business customers, but with retail exit and the potential for ownership changes in that part of the value chain, that’s an opportunity for investors who don’t want to be in retail to get out, and investors who do want that exposure to come in. So that’s upside.

And the economic regulatory regime is untouched by Brexit. Our statutory duties and functions are set out in UK legislation. It is the UK and Welsh Governments that set out their strategic priorities as regards the regulation of the sector, and they do that through a well understood, transparent and consultative process.

These two elements of continuity – the importance of customer legitimacy and the continued investability of the sector – link into the third element of continuity I want to emphasise, and that is our programme of reform. Perhaps most obviously through our Water2020 programme, which leads into PR19, but also through our Finance and Governance programme and our Casework.

I have had conversations with various people from the sector and the investor community since the Brexit referendum result. And while there is a lot of support for the ambition we have for regulation in the sector, one or two of them have followed that with a suggestion that – what with everything else going on at the moment – ‘now is maybe not the time’…

... well, in my view, now is exactly the time. Now more than ever. And that goes right back to everything I said in my speech here last year about the imperative of this sector finding ways of delivering more for less if it is to maintain customer legitimacy in face of the combined challenges of service delivery, resilience and affordability. And it goes back to the fundamental importance of customer legitimacy for the continued investability of the sector.

… if one of the things the Brexit referendum result is telling us is about the paramount importance of customer legitimacy, the evolution of the regulatory regime to inform, enable, and incentivise the sector to deliver much more for less, is even more important now than it was before.

And if it is even more important after the Brexit referendum for investors to be able to put money into a sector where the fundamentals are sound, the regulatory environment is predictable and where all this is underpinned by customer legitimacy – it should be even more important for investors to work with us on that evolution.

What does this all mean as we approach PR19?

The key elements of the framework and direction of travel are already clear

Our direction of travel is clear.

Our strategy, including our regulatory model, remains the same and will remain the same through PR19.

In our **May Water2020 policy document,** we have set out some of the key aspects of the policy framework that will govern the next review:

- how we want to see stronger, deeper customer engagement, how we propose to empower the engagement process further in the next review, and bolster the role of CCGs.
- where we want to see markets develop – in water resources and bioresources and with direct procurement for customers
- how we propose to separate price controls further to enable this to happen,
- and how we want to transition away from indexation based on RPI to CPI or CPI(H), to maintain the robustness and legitimacy of our price controls.

We are **currently out to consultation** on our approach to the cost of debt. We expect to maintain our use of notional capital structures – placing the risk associated with choice of capital structures squarely with companies and investors, where it belongs. But we have proposed a mechanism that would introduce a true up for the difference between the expected and outturn sector-wide cost of debt, removing the forecast risk cost premium.

We have a **further consultation** coming later in the year on outcomes. To benefit customers, we are looking at three things:

- how we can get performance commitments that are truly stretching,
- how we can get ODIs that are more powerful and dynamic,
- and how we can ensure that resilience is built into the outcomes that companies deliver for customers.

And some clear themes for PR19 are emerging

Of course there is a lot still to do – we will have more to say on some big issues like our approach to cost assessment and efficiency, our approach to the cost of equity, and the Risk Based Review as we work with the sector to prepare our methodology for PR19, which you will see for consultation in July.

But some things are emerging as big themes for PR19. I want to highlight four.

The first is **resilience**. We have a new statutory duty. And although I would argue that resilience has always been important to customers and to Ofwat, we need to think about what that new duty means in the context of the review.

A few things are already clear to us.

We are clear that resilience is a broad concept. You may remember that we adopted the definition of resilience set out by the independent task and finish group that Jacob Tompkins chaired. This defined resilience as: "the ability to cope with, and recover from, disruption, and anticipate trends and variability in order to maintain services for people and protect the natural environment now and in the future".

And that means that the resilience of services is closely related to the resilience of the complex systems that underpin them, which include traditional infrastructure but also eco-systems and communities. It also encompasses financial and corporate resilience.

We are clear that customers care about resilience. And that, because of this, a good customer engagement process is perfectly able to include issues of resilience. Any attempt to say that Ofwat's expecting business plans to be informed by good customer engagement militates against providing resilience is going to get short shrift.

But… it does seems to us as though one of the issues in engaging customers on **improvements** in resilience is a lack of clarity on the levels of resilience that exist **today**. And a lack of clarity on how these vary between companies and quite possibly within companies. If companies are going to factor increasing resilience into their plans, this information is essential. So, one of the things we have been discussing with companies is how best this might be addressed.

And, linked to this, another thing we will need to be satisfied of – not only but **especially** where a company's plan seeks funding for increased resilience – is that the company has been doing everything it should have, both in terms of price control settlements and the licence, to invest in resilience. We cannot ask customers to pay twice.

The second theme I want to draw out is **customer service**. This is something that has been brought home to me in particular through two pieces of work we have done recently.

The first is our review of the **costs and benefits of retail competition** for residential customers in England. It was a bit of a wakeup call. If economic regulation of monopoly is supposed to mimic the effects of a competitive market, that review left me feeling as though we have a long way to go in terms of informing, enabling and incentivising genuinely excellent customer service in the sector.

The sector has done a great job over past couple of decades at improving operational levels of customer service, in terms of supply interruptions, sewer flooding, water quality and environmental improvements. And it has done a lot to improve on some important aspects of the customer experience, for example in terms of responding to enquiries and complaints. The regulatory regime in the past has, understandably and quite rightly, focused on getting the basics right, and companies have responded.

But … if you look at the sort of innovation in services and customer experience that have happened and continue to happen in competitive markets, I think we – all of us, Ofwat and companies – should be looking for more stretch here, and a more dynamic approach.

In competitive retail markets, there has been radical change, with innovation, and technology-led advances in service. In other sectors customers are used to having a wide range of service packages available, so they can choose one that best meets their needs. And they are using online tools to help them make those choices. Many customers are used to managing their finances and controlling their home using smartphones – and this is only going to increase over time.

In contrast, in the water sector the possibilities offered by advances in technology have largely been left unfulfilled – for example, we could only find two water companies offering an app for customers to manage their account. Undoubtedly, service levels have improved but the range of services offered hasn’t. And this is only going to become more apparent as we observe the change that competition in the business customer market will bring.

The other work I referred to that has changed our view on customer service is the report that we put out on **vulnerability** back in February this year. This highlighted the often transient nature of vulnerability – the fact that half of us at some point in our lives will experience circumstances that make us vulnerable.

Our report showed that risk of not being able to pay your bill increases significantly where households spend more than 3% of their income on their water bill – 24% of households across England and Wales fall into this category. 32% if you take Wales alone. Almost half of adults don't have enough saved to cover an unexpected bill of £300. And recent research from CCWater showed 1 in 5 customers reported finding their water bills unaffordable – up from 1 in 8 last year.

I could go on. But this has really shifted our view of what good looks like when it comes to vulnerability.

While there will obviously be some particular groups of customers that need special attention, it means that vulnerability needs to be **integrated** into a company's plans to deliver great customer service overall, really getting to know and understand the circumstances of its customers. And this is something we will be taking into account in our assessment of plans.

Which brings me to the third theme I want to highlight. The **quality of plans, and in particular the evidence** underlying them.

Back in PR14 we were very conscious of the extent of the changes we had made to the price review. There were some formal changes we had made, with the separation of different controls and the introduction of the risk based review. And some profound changes to our methodology – for example in relation to outcomes, customer engagement, totex and risk and reward. And on top of this we were asking companies to take ownership of their plans to a much greater extent. In the face of this, I genuinely think companies achieved a lot. But from our perspective there was rather more iteration and hand holding than we had initially expected. It was the right thing to do, and it got everyone, including customers, a better outcome from the review. But this isn't something we plan to repeat in PR19.

In PR19, we will be simultaneously **raising the bar** on the quality of plans and **reducing the extent to which, during the review, we help companies to get over that bar**. We are moving from four separate price controls in PR14 to six in PR19. And while we expect this will enable us to take a more targeted approach to our regulation from 2025, it means we have a lot to do in PR19, and we have a lower budget to do it. So we will need to take a more focused approach in deploying our resources. It is also entirely in line with companies taking ownership of their plans, and companies and their investors bearing the risk associated with the quality of those plans.

The quid pro quo – and I accept this – is that we do need to be clearer upfront about what good looks like. Not in terms of providing a 'cook book' – we won't be doing that – but in terms of setting out the principles. The evolutionary approach we took in

PR14 didn't lend itself to a hard line during the process. But we have been much clearer much earlier on about what PR19 will look like. Indeed, companies have been very much involved in developing the policy framework. So we are all much better placed this time round.

The final theme I want to highlight for PR19 is one I have spoken about a lot before, but it would be remiss of me not to mention it. And that is **efficiency**. This is central to maintaining legitimacy. A step change in efficiency is the only way the sector is going to deliver great service, with genuine resilience, at a price that is not only affordable but – and this is just as important – seen to be fair.

At last year's conference I highlighted our expectation of a tougher **totex** efficiency challenge at PR19 than PR14. This comes in part from the frontier shift we are already seeing from those companies who have really got off the blocks in terms of really running their business to take advantage of an outcomes and totex based approach. It also comes from our expectation that we will get significant challenge on wholesale costs from retailers in the competitive market for business customers in England. And it reflects my expectation that our methodology will be tougher – possibly with a benchmark that moves from upper quartile more towards frontier, possibly with a more forward looking, rather than historical, benchmark, possibly with a significantly shorter glide path to get to that benchmark. All that remains true.

I should also take the opportunity to say something about **retail costs**, in particular for the residential part of the market.

I said earlier that the process of doing the review of residential competition in England had been an eye opener on customer service. It was on retail costs too. It was clear to us from that study that retailers in competitive markets have significantly lower retail costs than most water companies. Some of those efficiencies might relate to economies of scale. And it certainly relates to better ways of managing bad debt. We said our report, in our most cost-beneficial scenario, that we think **bad debt costs** could be brought down from £21 per customer to £9. Yes, that was in part informed by comparators with energy. And yes, energy companies can disconnect customers and water companies – for very good reasons – can't. But (a) disconnection is something that is hardly used in energy – last year 204 domestic electricity accounts were disconnected and only 49 gas accounts. And (b) I'm not sure how many people in debt to their water company actually know they can't be cut off. And (c) a lot of that bad debt cost in water is made up of people who water companies haven't identified as users of water and who they aren't billing, rather than those who won't pay or can't pay.

I'm not saying £9 average bad debt per customer is the benchmark we will use in the next review. But it makes you think. And it particular, makes you think when you read the recent Water UK report on long term water resource planning, which makes the case for an additional spend of £4 on the average bill to create new water storage to improve resilience. Obviously the solutions suggested in the report will have to go through the WRMP process, so it isn't yet clear that is what is needed. But if it is – I don't think it leads you to conclude that bills will need to rise to fund resilience.

Indeed, I'm going to take the opportunity to be really clear on this now. We had a strong suspicion in PR14 that some companies worked their business plans backwards from flat bills - we saw a number of companies that did their customer engagement on the basis of options that involved either a flat bill or a bill going up (albeit with more delivered for that higher price) rather than offering the option of a bill reduction. If any company out there now is thinking of working their business plan backwards from a flat bill, still less a baseline of flat bills with various 'resilience increments' on top, it ought to be obvious by now that this is not what good will look like.

While I am talking a lot about the tough efficiency challenge we will bring at PR19, I should also make clear that we continue to believe very strongly in the incentive that gains from **outperformance** provide to achieve new efficiency frontiers. So yes, companies will face a tough challenge at PR19. But there will be opportunities to outperform – in particular by doing things that deliver benefits for customers.

There will be scope to outperform on **totex**, in particular for those companies who make good use of markets – those already existing, and those we will help develop in water resources, bioresources and significant new projects through direct procurement.

There will be scope to outperform on **ODIs**. We've already said we would be interested to explore the scope for putting more money at risk through ODIs, which we capped out at +/- 2 percentage points on RORE at PR14.

And, even under our proposed approach to the cost of debt, there will remain scope for outperformance on **financing** costs – because we don't envisage departing from our sector-wide notional approach to cost of debt and cost of equity, so individual companies have scope to do better.

I also want to highlight the fact that – as with retail and wholesale in PR14 – our shift towards separate price controls for water resources, bioresources and water network plus and waste water network plus will create opportunities in the **market for corporate control**. It will enable us to take a more nuanced approach to assessing the loss of a comparator. And as markets emerge and reveal information, especially in respect of water resources and bioresources, we will be less reliant on comparisons between incumbents.

Life outside PR19

I have talked a lot about PR19 and the challenges and opportunities it will bring. But as you know we don't only do price reviews…

We have recently completed our first review of companies' **annual performance reports**, for 2015-16 performance.

We have noticed a small number of companies with exceptional performance on **ODIs**, which we hope will encourage others – with focus and determination, it can be done.

We have also noticed a significant level of underspend on **totex**, and particularly that element of totex which companies indicated would be capitalised (capex in old money). Now, it could be that this reflects efficiency developments – either in unit cost terms or efficient substitution of opex for capex. That would attest to the value of the outcomes and totex approach, and provide a useful frontier shift for PR19. But if it reflects companies having been slow off the blocks in terms of their capital programmes, that would be disappointing, especially given the degree of certainty a lot of companies had on this so early in the PR14 process. And if it reflects a degree of compromise on investment – including investment in resilience – that should have happened in this period, then that is not acceptable. And as I said earlier companies cannot expect to press the 'reset button' on this in PR19 and cannot expect customers to pay twice.

Also outwith the run up to PR19, the **business customer market in England will open to competition** in April – indeed, the shadow market has already opened. And it is worth repeating in this forum our appreciation, and indeed the appreciation of the Retail Market Opening Management Group that I sit on with Sarah Hendry from Defra and Ben Jeffs from MOSL, for all the immensely hard work companies have put into getting to this point.

I know it has felt like a big push to get to shadow market opening (and it has been) and I know it will feel like a big push to get to actual market opening (and it will be). But the truth is that this is just the end of the beginning. We will, all of us, companies, investors, customers, and us as the economic regulator, face **challenges and opportunities from that competitive market**. Some of which we can anticipate based on experience from other sectors. Some of which will be unique to water.

I don't have time to do more than log a few here. There are three that stand out even from here.

- The first is the need for all of us to ensure that customers are treated fairly in the market.
- The second stand out issue is customer data – partly because of its importance in customers being treated and feeling treated fairly, but also because of its increasing importance in enabling competition for example by enabling third party provision of search and switching services.
- And the third and final one is wholesale costs. I alluded to it earlier but retailers in a competitive market are going to take a far greater interest in the wholesale services they get and what they are paying for them than we have seen before. A big challenge there for wholesalers.

And of course, it remains to be seen whether the new government decides to go ahead with opening the residential retail market to competition. This is a decision we hope will be taken in time for companies to build it into their planning for the next period and for us to build it into our PR19 methodology.

Conclusion

I remember concluding my speech last year on an optimistic note. I noted that although the challenges the sector faces are substantial, I was confident that it could meet them.

I feel just as optimistic this year.

In fact if anything I feel more confident about that optimism.

Why?

Well, the challenges are no less substantial.

But in the last twelve months the sector has really demonstrated what it can do. Let's take stock…

We have seen through the annual performance reports what companies are doing. There is some great stuff being achieved in terms out outcome delivery and indeed outperformance on outcomes. There are companies out there who have really changed the way they function, the way they think, and look to be on the way to delivering a real frontier shift on outcomes and totex.

We have also seen what the sector has achieved in respect of the opening of business customer market in England to competition. It isn't perfect – of course it isn't - but the shadow market has opened. Companies are using it with live systems.

And have gone into this with an ethos of wanting to learn, and wanting to improve and using the shadow market to expose those opportunities.

And in terms of PR19, we are on track to deliver what we said we would – a policy framework and a methodology further in time to better inform business plan development.

I should also add that we have done that not working in a vacuum, coming up with the answer and visiting it on an unsuspecting not to say unwilling sector. It has been achieved in collaboration with the sector – taking advantage of the best ideas and the most innovative thinking. And I should also take the opportunity to say thank you for the great engagement – the ideas and challenge we have had from investors too.

So yes, challenges and opportunities ahead. But a sector that I'd say was in the best shape it has ever been to rise to them and come through not just unscathed, but shining.

Thank you.