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A New Business Model

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I would like to add my welcome to the Tenth Water UK City Conference. Ten years is a milestone for an annual conference. It means it has the legs to stride into the next decade – like the water industry. And if anyone has any doubts – about the conference, or the industry – the quality of today’s speakers and delegates tells you all you need to know.

Two other things you may also know about are: Malcolm Gladwell and his book ‘The Tipping Point’. Gladwell got his idea from epidemiology. The tipping point is the moment a virus infects the mass of the community – and he applied it to life and business and everything. He said that ideas can be contagious, like a virus.

I think our industry is coming to a tipping point right now. The big idea in our community is that we need a new business model to take us into the future. When I say “our community” I mean the industry, regulators, government and opposition, and stakeholders, including customer representatives.

The industry wants a business model that gives companies better incentives to go on doing what they’ve been doing for years – raising standards and improving service to customers.

But it’s good that others share this view. It’s good that the government has taken a collaborative approach in the Flood and Water Management Bill going through Parliament – and says it will act on the Walker and Cave Reviews early in the next Parliament. I would specially like to thank Huw Irranca-Davies who will be here to speak to us later. It’s good that the Conservatives are planning a white paper if they are elected... and that the Lib Dems are taking a serious interest.

It's good too that Ofwat has announced the first full review of water regulation since privatisation in 1989.....and that it recognises its duty to sustainability and future customers, as well as short-term goals. And good that the Environment Agency, under new management, is looking at regulation in new ways. For example, it's taking more account of the high cost of the Water Framework Directive and who should pay.

Today we're going to hear ideas about change from all sides – but crucially we'll be listening and talking with the investors who make possible the changes we all want to see.

I would like to set out a framework for a new business model and raise some questions I hope other speakers and delegates will take up during the day. The industry's main concern is to be able to respond properly to changing demands – but at the same time, we need to go on providing reliable returns to investors who (let's not forget) have no obligation to prefer us over other sectors. The framework I'm proposing is a set of actions and I'll look at each in turn.

The actions are:

- Recognising the strengths and weaknesses of the present business model
- Linking water to other critical infrastructure
- Building investor confidence; and
- Reforming regulation to create a more responsive service.

So, my first action – strengths and weaknesses. Beginning with strengths.

Privatisation has been a success. We're starting on the next stage from a place many would envy. We provide a good service...at a price a large majority of customers finds acceptable.

Our investment record is impressive - £85 billion – over twenty years – at no cost to the taxpayer. And we've kept the funds flowing in the most difficult times. We have a fine record of strengthening the country's national infrastructure. This adds real value. The water service is a foundation of the whole economy, obviously – but also a benefit to individual sectors such as property and recreation.

But we now face challenges of a different order.

In the past we had the clearest possible objectives – to sort out drinking water quality and wastewater standards and stop the national shame. Today's problems are less obvious and the solutions much less in our control.

Take population growth – and the associated environmental impacts. Or higher expectations about service and the environment. Or pressure on water resources – and not only in the South and East. Or more volatile weather, which will disturb the regular water cycle. The industry can't rely on business as usual to deal with these changes.

We have to find new ways of working – for example new partnerships – with government and regulators – but also with other sectors and groups in civil society. Above all, companies have to work differently with customers – because customers can make the difference between success and failure in meeting the new challenges. If individuals and communities think they will be better off by making even small changes in how they use water, the system will work better, the cost will be lower, and the service will go on improving. On the other hand, if customers can't be engaged, we will all be worse off.

And here's where the weaknesses of the existing model are obvious.

First, regulation is holding now back the ability of companies to respond. It's driven by incentives that work against new ways of solving the specific problems of different communities and environments. It imposes rigid rules for allocating expenditure. And it demands that companies take a long-term view, but still falls short on genuinely sustainable solutions.

Second weakness in the present model – it has developed separately from other infrastructure services and public services. They are natural partners to water, but partner-*ships* are off-limits for most purposes.

Third, the model gives customers a smaller voice than regulators and special interest groups when it comes to big spending decisions. This led the Walker Review to say that environmental costs will be seen as “stealth taxes”, if we don’t begin to involve customers more.

So much for strengths and weaknesses.

They lead me to a couple of thoughts. First, the industry needs attention, but it certainly ain’t broke. There would be no gain whatsoever in rushing through change for change’s sake, or because of a dogmatic view of how things should be. Second, someone might say the problem is just about regulation and a few changes will sort things out. I reject this. Regulation is vital, but we are about so much more than regulation. We have to look more widely for ideas and experience to take us into the future.

This brings me to my next action for creating a better model. It is to give the industry scope to work more innovatively with other infrastructure providers and services.

This matters because today many of the solutions we call “sustainable” are only possible through partnerships. I mean solutions that measure success over the longer-term; solutions that use resources efficiently; and solutions that are effective in cutting carbon.

The sectors I’m talking about are gas and electricity – but also telecoms and transport and waste management and other local services. These sectors play an integrated role in the national economy and many of their operations are mutually dependent.

They share a lot of constraints with us. They are tightly regulated and need continuing high investment. Like us, they face a demand for big cuts in emissions. And like us they live with political sensitivity and the media spotlight.

But, equally, like us they have big opportunities. Because most people now accept that modern infrastructure is an economic imperative. It's essential for competitiveness; essential for a clean environment; and essential for quality of life when there are high expectations.

I'm pleased that the government and the opposition both recognise the importance of investing properly in critical infrastructure...and a planning system that gets it built when it's needed, not after years of delaying tactics and frustration on all sides.

The water sector must be a key player in the next decade of infrastructure development and we can't do this from the sidelines.

My third action for a relevant business model is to accept that the sector will be cash-negative for a long time to come – and deal with the implications.

In the next five years many billions of pounds of debt will need to be re-financed. We will need investor confidence and access to the markets. We know how fragile confidence can be. The last Water UK Investor Survey showed that regulatory action was causing investors to reappraise UK infrastructure as a home for their funds. This means that establishing the new regulatory model will need to be done carefully – through evolution, not revolution.

Investors will still be looking for predictability. It should be a priority for us all to avoid unnecessary risk. Investors will also be conscious of the potential for political risk, particularly given the forthcoming election. If we don't take care in designing and communicating changes, the perception of higher risk could result in a higher cost of finance and an unavoidable impact on customers.

This applies particularly to increasing the role of market mechanisms. So it's only prudent that the main stakeholders have begun to discuss the risks in the Market Reform and Finance Forum set up by Defra. The aim is to pre-empt anything that could affect City views of the stability of the sector.

Stability is one of our greatest assets. Whatever else happens, it's vital for the sector to retain the support of the markets when the regulator and the government are making far-reaching changes.

My fourth and final action for a new business model is to reform economic regulation and create a more responsive service.

We need to adapt the present system with its narrow focus on incentives for capital expenditure. It needs an urgent review. It's too burdensome, too detailed, and too costly. This is a widely-held view. The FT said: "The current swings and roundabouts system needs to become more collaborative, more certain, less volatile and less complex". The Guardian said: "The complexity of reviews seems to have grown out of all proportion with the size of the industry".

Obviously society must have total confidence in its water service, because we're one of the building blocks of life and health. There must always be firm, transparent, and accountable regulation. But it's surely not beyond us to find ways of giving this assurance without a regulatory burden that just keeps growing – and let's remember that it's customers and society who carry the weight in the end.

We need an updated regulation model that will make some big improvements. Here are six.

It will take more account of infrastructure maintenance.

We've already set out on this path. The proportion of capital maintenance investment has increased over the price reviews. It now accounts for well over 50 per cent of capex which isn't surprising as it has to cover assets from the early years of privatization as well as many that are much, much older.

New model regulation will take operations more seriously.

The challenges of the future will involve more operating solutions than expenditure on traditional end of pipe. Two examples are: catchment management and water efficiency. In both cases, opex-based approaches will deliver wider benefits. And let's not forget that the industry is being asked to take on additional responsibilities, including for private sewers that will need a new mix of opex and capex.

The new model will also incentivise resource productivity and carbon reduction.

Take the UK's targets for reducing greenhouse gas emissions by 34% by 2020 and by 80% by 2050. The industry can and will play its part in meeting this challenge, but the targets will be nothing more than aspirations unless the incentives are in place to cut emissions and use resources more efficiently.

Next, as mentioned, regulation must provide more certainty for investors.

A lot of our success has been due to a partnership between the industry (with its continuous need for capital) and investors, who value the long-term certainty the sector provides. This partnership must be nurtured. We have to avoid swings between regulatory periods or what's been called "pendulumitis". And I might add that big swings within regulatory periods don't help either. Most people thought the draft determinations in PR09 were unrealistic. There must be room for reflection on all sides about why such a de-stabilising step was necessary.

New model regulation must also protect present and future customers.

There is always a temptation to focus on the short-term. Future customers must be given proper weight. This will ensure that we're not storing up trouble by neglecting capital maintenance, or failing to invest in tackling climate change and making the service more resilient.

Finally, future regulation must reflect the consensus on the big questions raised by the Walker and Cave Reviews.

Both reviews are backing a steady, evolutionary approach to change. Both raise issues that deserve the attention of politicians and all stakeholders from now on. Walker is right to insist that affordability must be addressed as the proportion of metered customers grows. And there are big questions about different kinds of tariff, and whether water customers should pay for highway drainage. From Cave, the role of market reform must be fully explored. The issues are complex and everyone agrees that there is real scope for unintended consequences – or even own goals – if we take the wrong decisions.

So to conclude... Many people now agree that the structure of the industry and the regulatory system that have provided society with some remarkable benefits should now evolve. The evolution must recognise the strengths we have built up. It would be madness to put at risk the quality of customer service and the confidence of investors.

I have proposed changes that would see the companies able to work more productively with other critical services; to retain and enhance their partnership with the markets; and to provide a service that is targeted at meeting the particular needs of their particular customers.

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