

RESPONSE TO OFWAT CONSULTATION

‘Setting price controls for 2015-20 – business planning expectations’

1.0 Summary

1.1 The Environment Agency welcomes the opportunity to comment on Ofwat’s consultation on business planning expectations. This builds on our response to Ofwat’s recent consultation on the methodology for setting price controls for 2015-20. We look forward to continuing to work with Ofwat to deliver better environmental and customer outcomes, while safeguarding and building on the environmental improvements water companies made through previous price reviews.

1.2 We support Ofwat’s ongoing commitment to reduce the burden of regulation on water companies to encourage them to be more flexible and innovative in their approach. We want to work with Ofwat to strike the right balance between protecting people and the environment, and freeing companies from unnecessary bureaucracy. The main points of our response are as follows:

- We welcome the risk-based approach to reviewing company business plans and agree that plans should clearly show how they have taken customers’ needs and wishes into account while meeting their statutory obligations.
- We agree that a high-quality business plan is one that delivers ‘good outcomes for customers and the environment’. We believe that good outcomes should reflect the ‘wants’ from customer engagement and the ‘needs’ from legislation and be supported by high quality evidence. The benefits of good outcomes are likely to be achieved over the long term, and depend on a range of stakeholders.
- We believe it is for the companies to explore how to deliver outcomes most effectively. It is the role of Customer Challenge Groups (CCGs) to challenge whether the risks from delivery solutions proposed to meet statutory requirements are properly explained and supported by customers.
- We actively participate in the CCGs, which are a helpful forum for customer engagement. However, we are concerned about the change in emphasis Ofwat is placing around the role of CCGs. We do not see the CCGs as the main forum for engagement with environmental regulators. As a regulator, there is a separate role for the Environment Agency in working with Ofwat to assess the

degree to which companies' business plans meet environmental obligations and deliver secure supplies. We think that we should also have a role in assessing the quality and category of each company's business plan. We believe this will lead to higher quality business plans and ensure that Water Resource Management Plan (WRMP) requirements are represented, and adequate allowance included for the measures in River Basin Management Plans (RBMPs).

- In high-quality business plans, we would expect to see how environmental investment by companies will result in long-term benefits for the economy, society and customers.

1.3 We agree that the companies' current performance should be assessed as part of the risk-based review of business plans. We suggest that evidence from sources such as the annual Environmental Performance Assessment report, key indicators, tripartite performance meetings, and WRMPs should be taken into account.

1.4 Under the proposed tests for outcomes we believe companies should:

- Demonstrate how they have incorporated the requirements of WRMPs, and environmental measures likely to be included in the second cycle of RBMPs.
- Show how they are discharging their duties as risk management authorities.
- Show what mitigation measures they have adopted to manage the risks to their services from future climate change, development growth, extreme weather events and how they are complying with the requirements of the Cabinet Office 'Keeping the country running' guide.
- Demonstrate that they have identified innovative ways of improving services and meeting their environmental obligations.

1.5 We recognise the step-change Ofwat has made to reduce the amount of information required in the data tables. It would however be helpful to us and companies if provision can be made for the inclusion of the costs for environmental measures. This data also forms the water industry programme of measures within RBMPs and will be required by ministers in their assessment of disproportionate costs.

1.6 In line with the Department for Environment Food and Rural Affairs' Statement of Obligations, we would expect Ofwat's final methodology statement to confirm that allowance will be made for the 'managing uncertainty approach'. The mismatch in timescales between the Periodic Review, and the statutory

River Basin Management Plans and Water Resource Management Plans, means that companies will need to include measures which have not been formally signed off, but for which there is a reasonable certainty that they will be necessary.

- 1.7 In our response to your recent methodology consultation we commented that we were concerned by the suggested removal of the change protocol, we look forward to continuing to work with you, to address this issue over the summer.

2.0 ENVIRONMENT AGENCY'S RESPONSE TO DETAILED QUESTIONS

Question 1: Do you agree with our definition of a high-quality business plan? Is anything missing? Is there anything you think we should change?

- 2.1 We agree with Ofwat's definition of a high-quality business plan to deliver good outcomes for customers and the environment and help companies meet their statutory obligations. We will continue to work with companies and CCGs to define specific, measurable and achievable outcomes and performance measures and, in identifying opportunities to innovate and improve efficiency.
- 2.2 We look to companies to align their environmental outcomes with Government's and our stated priorities and to use all environmental information available to them when creating plans. We expect any companies granted an 'enhanced business plan' rating to have complied fully with their environmental and security of supply obligations.
- 2.3 As well as company Board assurance and performance in 2010-2015, we suggest that information in the annual Environmental Performance Assessment report, key indicators, and WRMPs should be assessed. This evidence already underpins the annual Environment Agency, Ofwat and water company tripartite performance review meetings.

Question 2: Do you agree that our preferred package of reputational, procedural and financial incentives will incentivise high-quality business plans? If not, what do you think we should add to the package, or change?

- 2.4 We agree there are reputational and financial incentives in publishing the assessments of business plan quality. We believe the reputational incentive could be improved by explaining why companies have been categorised as 'enhanced', 'standard' or 're-submission'.

Question 3: Which of the options (elements earn procedural and financial rewards; two-category approach; two-process approach for retail; later decisions on resubmissions) do you think we should use, if any? Why?

- 2.5 We support Ofwat's preferred approach and believe that later decisions on resubmissions seem sensible, to avoid the risk of poor planning.

Question 4: Do you think that our proposals will be effective in meeting our objective of handing back ownership of the business plans to company Boards?

- 2.6 Companies with the best business plans will clearly benefit from the risk-based approach, which should encourage greater ownership of the plans by their Boards. We believe that there is a direct link between good environmental performance and good business performance as measured by share price, profitability and brand strength.

Question 5: Do you agree with the four high-level groups of tests (outcomes, costs, risk and reward, affordability and financeability) are the right ones? If not, what do you think we should add or remove?

- 2.7 We agree with the four high-level groups of tests. Environmental obligations are a key area of company proposals that should be included within the outcomes test. We suggest a set of criteria for assessing how environmental obligations have been met in our response to question six.
- 2.8 We expect this approach to allow companies flexibility in what they deliver up to and beyond 2020. Clear milestones should be set for achieving longer-term outcomes.

Question 6: Do you think we have set out the right tests in each group? If not, what do you think we should add or remove?

- 2.9 We agree with the tests for outcomes and are pleased to see that this will include whether the company has given adequate assurance that its performance commitments are consistent with the Department for Environment Food and Rural Affairs' Statement of Obligations, relevant statutory requirements, and licence obligations.

Under the proposed tests, we would like companies to demonstrate:

- How they have incorporated the requirements of WRMPs, and environmental measures likely to be included in the second cycle of RBMPs.
- How they are discharging their duties as risk management authorities.
- What mitigation measures they have adopted to manage the risks to their services from future climate change, development growth, extreme weather events such as drought and flooding, and how they have complied with the requirements of the Cabinet Office 'Keeping the country running' document published in 2011.

- That they have identified innovative ways of improving services and meeting their environmental obligations for example, through catchment approaches.
- How they have maximised partnership working/funding opportunities.
- Whether they are looking to profile improvements to longer-term environmental challenges over more than one price review.
- How they are using the Drainage Strategy Framework.

Question 7: Do you think our proposals for business plan assurance will be effective in meeting our objective of handing back ownership of business plans to company Boards?

2.10 We believe that the proposals for business plan assurance will hand ownership of business plans to company Boards.

Question 8: Our objective in specifying the data tables (and the August submission) is to ask for all of the information we need, but no more than we need. Do you think that we have achieved this? Is there any information that you think we might not need? Is there any information that you think we will need but we have not included in the data tables?

2.11 We support the fact that these tables are flexible and that water companies can tailor them and add other drivers as they see fit. We agree with what is already listed within the data tables, and would like some minor additional information included.

- We would like to see the Floods Directive (Flood Risk Regulations) added to the appointee information table A6 section B and the Flood and Water Management Act (2010) to section C. This will allow an understanding of the total planned expenditure that companies make to meet their responsibilities as risk management authorities.
- Under the line for catchment management programmes, we believe it needs to be clearer what information companies are being asked for. For example, it would be helpful if it included expenditure to tackle both diffuse pollution issues and the partnership actions needed to manage surface water before it enters the sewer.
- Currently the wholesale water table (W4) only contains lines on proportion of distribution input from impounding reservoirs and river abstractions. We are unsure why this information is being requested and why other sources of water are not listed.

- 2.12 We welcome the expectation that company demand predictions should be consistent with the 'weighted average water delivered' volumes in their water resources management plans.

Question 9: We aim to collect data on a consistent basis from all companies. Are the data tables clear and well specified? Are there any areas where we need to look again at the way we have asked for the data to remove any ambiguities in the request?

- 2.13 We believe there are some detailed areas within the data tables where clarity is required and would be happy to discuss these with you separately. For example, we would like to see the 'Business planning data – appointees and wholesale sewerage' tables more closely reflecting the guidance we provided to companies on 'Water quality planning: identifying measures for the PR14 National Environment Programme'.
- 2.14 We also think that the nationally co-ordinated Phosphate trials should be listed in table S3 with a separate entry indicating the monies the companies have already spent on innovative Phosphate trials to-date. This can then be incorporated into the cost allowance for Phosphate trials that Ofwat makes.
- 2.15 We believe it is important to provide more detail under the 'Environmental Quality' rows by separating actions and investigations, particularly to provide a breakdown of costs for the water industry Water Framework Directive (WFD) programme of measures. This information will be needed from the companies to enable WFD requirements to be set, and it would seem consistent with reducing regulatory burden to ask for this information once only, through the provision of this detail in the company business plans.
- 2.16 Under 'costs', an opportunity should be included to consider the cost of carbon both embedded and operational.
- 2.17 We would expect the rainfall scenario (guide to table A20) to include normal and extreme weather that could result in flooding or drought.

Question 10: Do you agree with our proposal to continue to set price limits for new appointees using a relative price control? If not, what alternative do you prefer?

- 2.18 We agree with the proposal because of the clarity it provides over the prices that new entrants might be able to charge. This should be positive for market entry.

Question 11: Do you agree that we should set Cholderton & District Water its own simplified price control?

- 2.19 We agree.

Question 12: Do you think that we should develop a new small company service incentive? If so, what form do you think this incentive should take?

- 2.20 We agree. Any incentive should be proportionate, effective and should not compromise environmental obligations.

Question 13: Do you agree with our proposal that small water companies should not be subject to separate wholesale and retail price limits?

- 2.21 We agree.

Question 14: New appointees are growing in size. In the future do you think that we might need to adopt a different approach to regulating their prices and service? If so, what circumstances should prompt a change of approach?

- 2.22 We agree with the principle that there should be a threshold for defining a small company. We believe that the threshold used in the 'joint water resources planning guideline – a navigation tool for smaller water companies' is appropriate. It makes sense for regulators to use consistent criteria for defining a small company and we would welcome a joint approach to setting a sensible threshold.

Further information

For further information please contact Ian Barker, Head of Land and Water, by post at Environment Agency, Horizon House, Deanery Road, Bristol, BS1 5AH or by telephone on 01179 345075 or by e-mail at ian.barker@environment-agency.gov.uk

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