

Delivering proportionate and targeted regulation – Ofwat's risk-based approach



About this document

This document sets out how we will take a risk-based approach to regulation. We consulted on our proposed approach in ‘[Regulatory compliance – a proportionate and targeted approach](#)’ in October 2011.

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1. Our risk-based approach

Protecting consumers is central to our role as the economic regulator of the water and sewerage sectors in England and Wales – it is one of our primary statutory duties. In order to fulfil that duty, we need to make decisions about the work we do and the way in which we do that work. We have always sought to ensure that what we do provides the greatest possible benefits to consumers. That is not changing.

But, as we set out in our strategy, ‘[Delivering sustainable water](#)’, we face a number of major new challenges that could affect the services we all rely on every day.

These include:

- climate change;
- affordability;
- rising environmental standards;
- rising customer expectations;
- population growth; and
- lifestyle changes.

The nature and scale of these challenges means there is a wider range of uncertainty (for example, uncertainty about climatic conditions and about future levels of demand) than in the past.

To protect consumers we need to ensure we have the capability to be agile in responding to emerging or changing risks and issues, and – where necessary – take swift and decisive action. To achieve that, we need to:

- ensure we focus on those areas that will provide the best possible outcomes and value for customers;
- choose the right ways to go about our work; and
- review what we do regularly to make sure it is meeting our objectives.

So, we will use a risk-based approach to the way in which we regulate. This recognises explicitly that our decisions on where to focus our action, and how we carry out our work, are informed by an assessment of risks. This will help us to anticipate emerging risks and issues, and – where appropriate – take early action to manage and mitigate them.

By setting out clearly how our decisions have been informed by our assessment of risks, we will make our decisions more transparent to customers, the companies and wider stakeholders. This will help promote understanding of the key risks and issues

that the water and sewerage sectors face, and foster a more mature, collaborative approach to addressing those risks and issues.

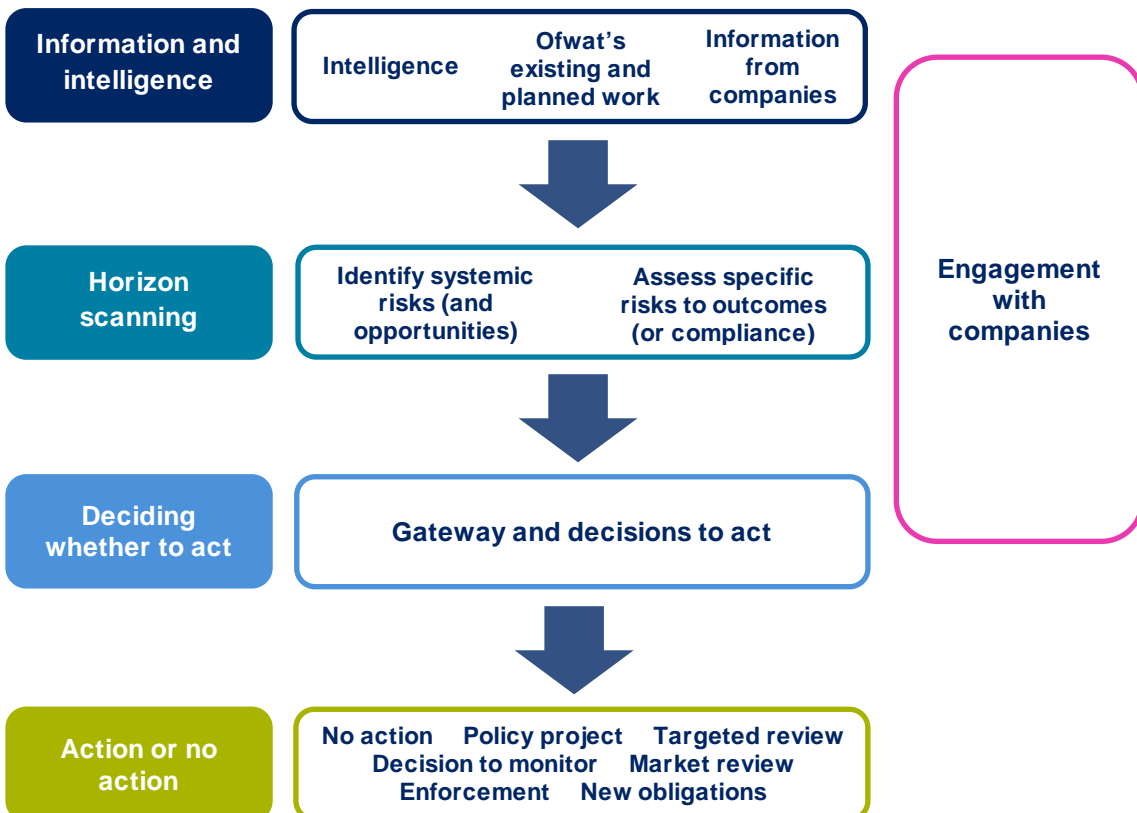
Finally, our risk-based approach will help us to make sure that we regulate in line with the Better Regulation principles, and take appropriate steps to minimise the regulatory burden we place on the companies we regulate. By focusing our activities on the most significant risks to consumers, we can also ensure that regulatory scrutiny and burdens are targeted appropriately and proportionate to the risks we have identified.

1.1 Assessing and responding to risk

Our decisions about how best to protect consumers’ interests are informed by our assessment of both short- and long-term risks and opportunities, in the context of our statutory duties (and functions) and our strategic objectives.

We focus our activities on the areas that present the greatest risks to customers and the outcomes they value. This applies to all our work, such as policy development, regulatory reporting and setting price limits. Figure 1 sets out in more detail the approach we use to ensure our decisions are informed by our analysis of risks and opportunities.

Figure 1 Our risk-based approach



Alongside this approach, we are working to foster a more mature relationship with the companies. We want to have open discussions about existing and emerging risks, the steps the companies are taking to manage them, and our decisions on the actions we need to take. The nature and frequency of these discussions will be tailored to the company's particular circumstances. For example, where we need to take action in response to a compliance failure, we may need more regular (or more formal) progress updates. On the other hand, where a company has a proven track record of managing risk effectively, we may have fewer (or less formal) discussions.

We are already working to build relationships with the companies (through our Board Lead Contact and Company Advisor roles) that facilitate these discussions and instil confidence that our actions will be proportionate to the risks and issues.

1.1.1 Identifying and assessing risks

As we set out in '[Future price limits – a consultation on the framework](#)', we intend to take a more outcomes-focused approach to the way in which we regulate. This means focusing on the outcomes that customers want, and holding companies to account for the outcomes they deliver, rather than how they deliver them.

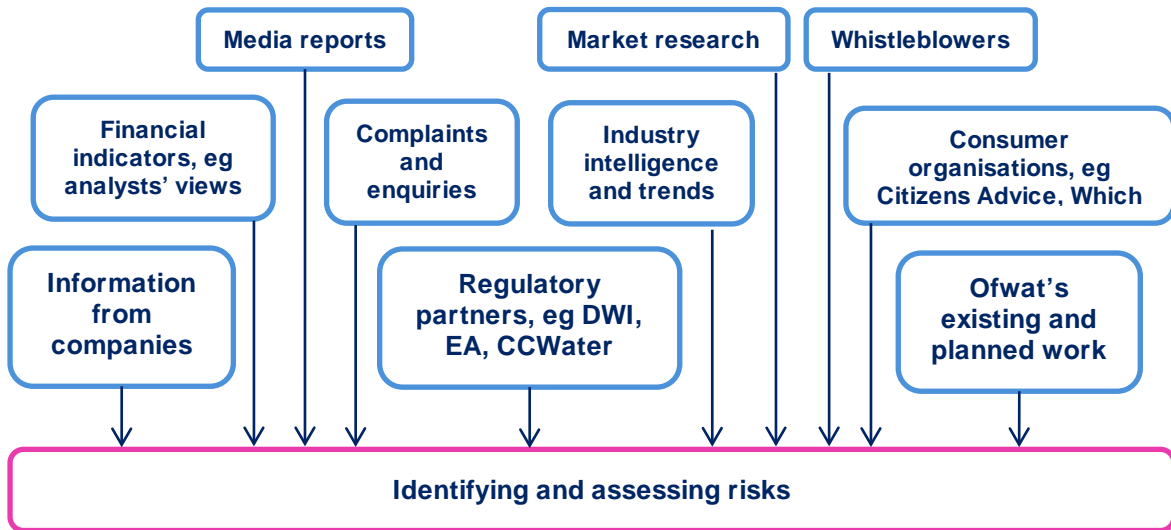
In line with this approach, our risk analysis focuses primarily on risks to outcomes, but may consider other issues. For example, when assessing compliance risks we will need to consider risks to the companies' statutory and licence obligations. Since an outcomes-focused approach will not be implemented fully until the 2014 price review, we will also need to look at risks to the companies' delivery of the outputs specified in their 2009 final determinations in the transitional period to 2014-15.

When assessing risks and opportunities, we aim to establish the:

- probability that the risk (or opportunity) will materialise; and
- potential impact in the event that the risk (or opportunity) does materialise.

To make that assessment, we will use a wide range of information to identify and assess risks. Figure 2 sets out examples of sources of information we may use in our assessment.

Figure 2 Identifying and assessing risks



A key part of identifying and assessing risks is the information provided by companies. This includes (but is not limited to) information provided through formal regulatory reporting. The companies should be accountable for assessing and managing their own risks. We expect them to inform us where significant new risks arise (or crystallise), as well as the steps that they are taking to manage and mitigate these risks.

We recognise that some sources of information may be more reliable than others. In general, we would expect information provided by regulatory partners, consumer bodies and by the companies (whether through their regulatory reporting or through another route) to be the most reliable. We will need to consider carefully the reliability of all available information on a case-by-case basis.

1.1.2 Responding to risk

We expect the companies to assess and manage the risks that they face. Where risks crystallise – or look likely to – companies should take action to manage and deal with the consequences. We expect them to be aware of their obligations and to understand and take action to meet their customers’ expectations. It is also for companies to demonstrate how they comply with their obligations to their customers and to their regulators.

If we identify a particular risk or issue that is not being managed effectively – either at an individual company or more widely across the sectors – we will need to consider carefully how best to address that risk or issue.

There are a number of possible actions that we could take in response to a particular risk or issue (examples of which are shown in figure 1). One possibility is that we will carry out a targeted review – a more detailed examination of a specific issue (or issues) across one or more companies. This is a key part of how we protect customers and ensure that companies are meeting their obligations.

The way in which we carry out a targeted review will not always be the same. For example, we may seek information or data from all companies, some companies or a single company, and our enquiries may be more or less detailed. We will tailor our approach to reflect the particular risk or issue at hand, weighing up the costs and benefits of the different approaches to ensure our response is proportionate and we balance how we use our resources.

When we choose to take action, we will use the results of that action to inform our risk analysis and our judgements on where to focus our work and activities. For example, a targeted review might reveal more significant risks or failures in a particular area of company performance. In turn, this might lead to us to carry out more monitoring of that area of performance. Alternatively, we may discover that risks are less significant than we initially envisaged (or are being managed particularly well), which might lead us to reduce our activity in that area.

We will be transparent about our decisions on the actions we take, and our reasons for taking (and not taking) action. We will also be transparent about what we find, highlighting good or best practice and identifying areas where there is room to improve. Where we find companies are not complying with their obligations, we will take action.

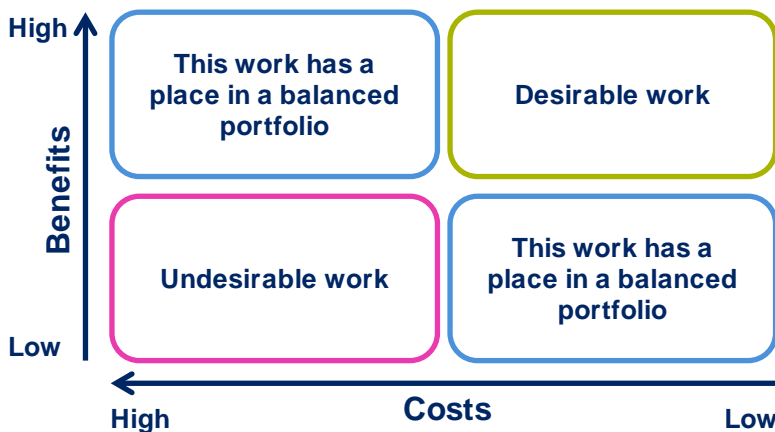
2. Prioritising our activities – the Gateway

The Gateway is a structured process for prioritising our activities, which we use both to take decisions on whether (and, if so, how) to take on new work, and to review our ongoing work. It is designed to:

- **maximise benefits** – to ensure that we direct our resources to the areas of greatest risk to outcomes for water consumers, or the areas with the greatest opportunities to realise benefits to consumers; and
- **minimise costs** – of regulation both in terms of costs to Ofwat and costs to the companies and so, in turn, costs to water customers.

Our overall prioritisation assessment is a judgement that takes into account all relevant factors and weighs up, in the round, the costs and benefits of proposals (see figure 3).

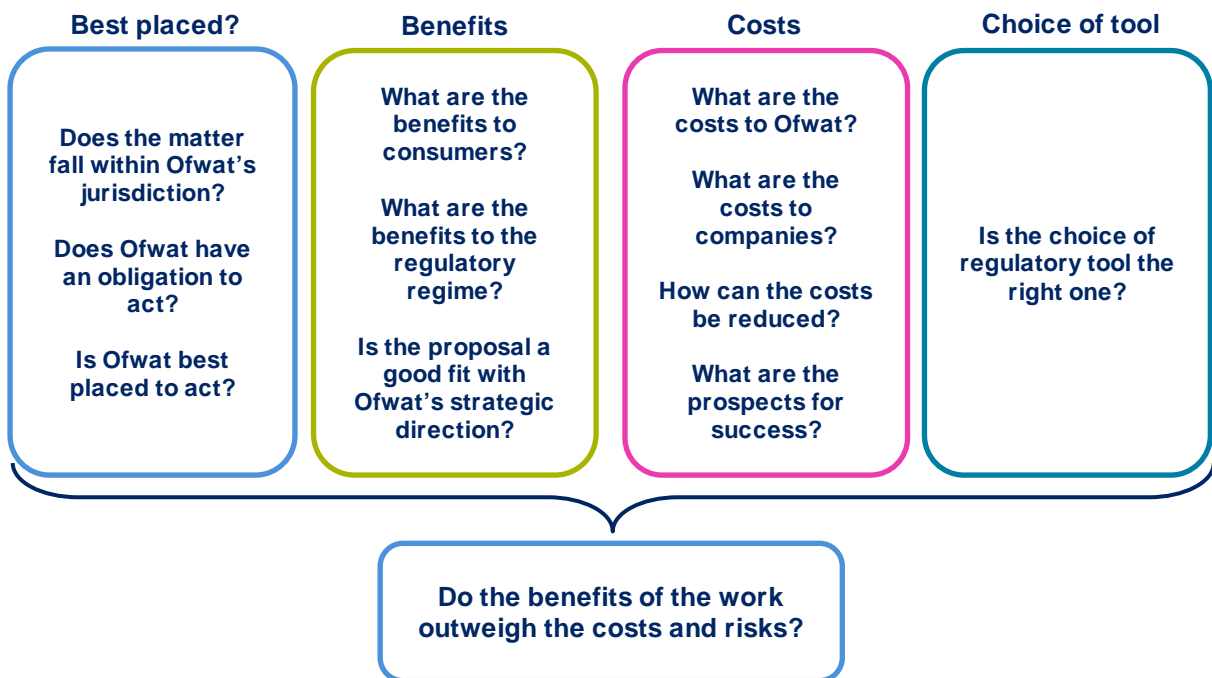
Figure 3 Balancing costs and benefits of our work



Ideally, most of our work would fall into the high benefit and low cost category. But we recognise that we may identify areas of work where activity to address risks to consumers has the potential to bring about high benefits but may have unavoidable high costs. This is a necessary element of any regulator’s work, but our actions need to be proportionate, and reflect the nature of the risk. Carrying out work with the prospects of low benefits but high costs is undesirable, and we will seek to eliminate it from our work portfolio.

The Gateway uses a simple framework (see figure 4) for prioritising regulatory action to review any proposals to take action and make our decisions on whether to act. We will also use the framework to weigh up the costs and benefits of different types of action and take decisions on how to act in a particular case.

Figure 4 Framework for Gateway decisions



We now consider each of the four elements of the Gateway framework in turn.

2.1 Is Ofwat best placed to act?

Where we identify particular risks to compliance with regulatory obligations or to a company meeting the outputs and outcomes that were included in its price review settlement, we need to take a decision on whether to take action. There are areas where our discretion may be limited, and in some cases we may decide that we are obliged to act. But even then, we will consider the benefits and costs of doing so as a matter of good practice and good management in prioritising our work.

We may not always be best placed to act, and others may be able to bring about the potential benefits at a lower cost, or more effectively. In these situations, possible alternatives may include:

- joint or co-ordinated action with another regulator or partner organisation;
- action by another regulator;
- action by Government; or
- private action by the companies or consumer groups in the courts.

In particular, we recognise the desirability of working in partnership with others, and the benefits that this can bring. We will look to build on recent successes, such as our work with the OFT on the [organic waste market study](#), and with the Environment Agency on water trading and key indicators.

We will take these considerations into account in our assessments.

2.2 What are the benefits of the proposed work?

We always intend to express the potential benefits of our work in terms of benefits to end consumers. This does not mean that we will disregard benefits to incumbent companies, future new entrants or investors, but that we will assess these in terms of the benefits they should ultimately deliver to consumers. We will consider these potential benefits in the round – including potential benefits foregone should we decide not to take action, as well as the opportunity to gain benefits (and the types of benefits) by taking action.

2.2.1 Benefits to consumers

In considering the potential value of the benefits that might be realised, we will take into account the social, economic and environmental benefits to existing and future water consumers. We will also have regard to whether these benefits impact on particular groups, such as the disabled and the chronically sick, or those of pensionable age, on low incomes, or residing in rural areas.

2.2.2 Benefits to the regulatory framework

In some areas, we will be faced with a decision to act where the main benefit is the development of the regulatory framework we oversee. Proposals to devote resources to policy matters may fall into this category. So, for example, a project looking at developing our capability or expertise may result in overall benefits to the framework and better regulation of the water and sewerage sectors – and benefit consumers as a result.

In any consideration of the benefits to the regulatory framework, we will also assess how it fits with our overall strategy.

2.3 What are the costs of the proposed work?

The costs of taking action are critical to the assessment, both in terms of taking into account the available regulatory resource and the costs to the companies, which may represent a regulatory burden. We will seek to minimise costs. We will also include the risks of carrying out the work (or the prospects for success) in our cost assessment.

2.3.1 Our costs

Any assessment of our costs should include:

- internal and external resources over the expected duration of the project or case;
- any direct expenses of research, consultants, legal advice and day-to-day expenses, such as travel and hosting events; and
- the risk of incurring future costs, such as the costs of litigation.

2.3.2 Costs to companies

We will rarely – if ever – be in a position to quantify the costs to the companies of our projects and cases. But we will consider these costs in general terms, and be alert to (and, where appropriate, responsive to) what companies tell us about the costs and regulatory burden of different approaches. For example, Competition Act cases and other data-intensive exercises may impose a significant cost on the companies, while a policy project examining the effectiveness of regulation may impose a low cost.

In this context, the cost to the companies is the cost of carrying out this work, not the costs of any regulatory action that may result from the work. Our assessment will not include the costs and benefits of any remedy that may be required if a company is found to have breached a regulatory obligation – this is a matter for an impact assessment at the conclusion of the work.

We will consider options for minimising the burden that we impose, for example by seeking out options that may reduce data requests, or choosing a less burdensome way of organising the activity.

2.3.3 Prospects for success

This is an assessment of the likelihood that the project or case may be successful in realising the potential benefits, including whether a proportionate and practical remedy to any perceived problem is likely to be available.

Risks to success may include:

- the difficulty of the work in relation to the skills available;
- a changing external environment in terms of the actions of Government or enforcement partners;
- legal uncertainty;
- practical difficulties in collecting information or evidence; or
- difficulties in securing co-operation from stakeholders.

2.4 Is the choice of regulatory tool the right one?

In some circumstances, we may not have a choice of regulatory tool. Where we do have one, the choice of regulatory tool may impact on the overall costs and benefits, and we will consider reasonable alternatives.

Of course, this initial assessment should not be taken to restrict our freedom to change regulatory tools at a later date if that turns out to be appropriate.

3. Keeping our approach under review

We will keep our approach under review and assess regularly how well our approach is working. We will also use any lessons learned to help us decide whether it could evolve further. We will then work with the sectors to determine the best way forward.

In line with the recommendations of the [‘Review of Ofwat and consumer representation in the water sector’](#), we are also developing measures to help us to identify what impact this approach has on the regulatory burden and use these to inform our review of the approach.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.



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