



Protecting consumers, promoting
value and safeguarding the future

8 September 2009

Dear Sir/Madam

Consultation on the Adaptation Reporting Power in the Climate Change Act 2008

I am replying to the above on behalf of the Water Services Regulation Authority (Ofwat), the economic regulator of the water industry in England and Wales.

We have been pleased to contribute to the working groups, discussions and workshops on this subject over recent months. We now welcome the opportunity to formally express our views on the consultation of 18 June 2009.

We support the implementation of this power and believe it is a helpful step to encourage companies to consider and adapt to the risks posed by a changing climate. In general the proposed approach to applying the power appears reasonable.

Our answers to the specific consultation questions are set out in the Annex to this letter. We would particularly like to focus your attention on the following key points:

Who should report?

We believe all water and sewerage companies¹ need to consider long-term issues and particularly the risks of climate change. We therefore support your proposal to request all water and sewerage companies and all water only companies to report on this issue. We also appreciate that as the economic regulator, we too should be able to explain how we are considering and addressing these risks. However, we believe that this list should not automatically exclude new appointees, since these companies also supply consumers and must adequately assess and address significant risks to their business. We suggest it is a matter for you to decide whether a de minimis level should be established, below which authorities will not be asked to report. More detail on this is set out in the Annex below.

¹ Throughout this document, "companies" is used to refer to the appointed water and sewerage companies which we regulate.

What needs to be done?

Although your proposed plan for the first cycle of reporting appears to be reasonable, we share your belief that water and sewerage companies' management of the risks associated with climate change should be embedded as part of the day to day management of the company. We have made this point clear to companies in our climate change policy statement² and our regulatory policies aim to achieve this. Our aim therefore is that we and the companies we regulate move to a position where regular reporting on adaptation under the act becomes unnecessary. We are keen to take action to ensure that criteria c (i.e. "no existing comprehensive regulation relating to adaptation") no longer applies to the sector. This would mean that the companies only report once under the climate change act, during the first cycle of reporting. This would simplify the overall reporting burden, help companies to align adaptation action planning with all other investment planning and expose adaptation processes and plans to the same level of scrutiny as any other investment proposals. We are keen to work with you in future to understand how exactly we can achieve this.

We recognise that the nature of the reporting guidance means that sensible comparison and assessment of the first cycle of reports is likely to require specialist knowledge, including sector-specific knowledge. We also note that you: "expect some level of public scrutiny, particularly from regulators and other stakeholders". As the economic regulator for the water and sewerage sectors, we are well-placed to offer a view on the reports submitted by water and sewerage companies. Early sight of the reports may also help us to better carry out our functions by giving us access to important information on how companies are adapting to climate change. Therefore we suggest that we adopt an advisory role in contributing to the review of the reports submitted by water and sewerage companies. We would also expect to be closely involved in any decisions resulting from assessment of companies' reports. However, we do not believe that it would be appropriate or practical for us to take overall responsibility for assessing and summarising the reports.

How should it be done?

As explained in more detail below, the draft guidance is somewhat vague and non-prescriptive. We believe that reporting authorities would benefit from more concrete examples and more specific guidance, particularly on cost benefit analysis of adaptation actions. This would aid authorities in producing reports and it would also aid Defra and other bodies to carry out robust and meaningful comparative analysis and summarising of the reports. We support your intention to develop a web-based

² http://www.ofwat.gov.uk/sustainability/climatechange/pap_pos_climatechange.pdf

directory of case studies and further information. We believe sector specific development in this area would be beneficial.

With regard to your request for case studies, we plan to publish a document early next year which will present examples of existing approaches to addressing climate change risks as presented in companies' business plans for the 2009 Price Review. This will include examples of proposed actions which aim to address these risks. We believe this document could provide you and other reporting authorities with a useful resource.

What are the costs and benefits?

The non-prescriptive nature of your draft guidance means that submitted reports meeting the requirements of the direction could take many forms. The resource burden will vary greatly depending on the level of rigour applied by authorities but is likely to represent a significant commitment of resources for any organisation. We would also point out that adequately reviewing and analysing the reports is likely to take considerable time and resources. We believe it is vital that more clarification is given regarding precisely who will be assessing the reports and how any auditing will be applied. It is also vital that more clarification is provided on exactly what the next steps will be after assessment of reports, particularly where a report is deemed to be unsatisfactory in some respect.

We already review how the potential impacts of climate change will affect the successful delivery of our regulatory functions, and we have a number of existing policies and plans in place to deal with those impacts. This work is most clearly set out in our climate change policy statement. Our report will focus on how climate change will affect the operation of our regulatory functions and will build on the work which we have already done. We would expect to work with you in deciding what precise approach to take, and would welcome further guidance and clarification, particularly on what precisely is expected in regulators' reports.

As part of our existing policy, we already plan to carry out a wide-ranging sectoral review of companies' adaptation to climate change during the AMP5 period. This review would be partly informed by the reports companies submit on adaptation and would contribute towards our aim of ensuring comprehensive regulatory coverage on adaptation in the sector.

Conclusion

We welcome the proposed implementation of this reporting power to the water and sewerage sectors as a helpful step in encouraging companies to take a serious and

robust approach to assessing and addressing the risks of climate change. Companies have made significant progress on embedding a risk-based approach to investment planning over recent years and we believe the sector has begun taking the steps required to adapt to a changing climate. In future, consumers should have confidence that water and sewerage companies are adequately adapting to climate change without the increased burden created by the necessity of regularly reporting under this separate regulatory provision.

We would welcome the opportunity to work further with you and other stakeholders on these issues. Should you wish to discuss any aspect of this response, please do not hesitate to contact me.

Yours sincerely

Dr Mike Keil
Head of Climate Change Policy, Ofwat

Annex 1 – Response to consultation questions

Who should report?

Q1. Are there any other sectors which you believe should have been included in this list?

No – but see the comments below regarding the inclusion of new appointees.

Q2. Do you agree that the criteria for identifying eligible authorities are reasonable? Are there others that might be useful?

We do not agree that the water sector currently has no existing regulation relating to adaptation. We appreciate that current regulatory coverage could be considered by some to be not “comprehensive” in this area. This is mainly due to the fact that there is no regulatory requirement for a document which is specifically dedicated to addressing climate change risks. Instead, we expect companies to consider all risks, including climate change risks, within their business plans, annual reports, water resource plans and strategic direction statements. We believe that considering risks together leads to better solutions which have multiple benefits.

We would question whether adequate description has been provided of what constitutes “no comprehensive regulation relating to adaptation”. It appears that a subjective definition has been applied in determining which sectors meet this criteria. However, we appreciate that the high-profile nature of the water and sewerage sectors and the public health implications of potential risks mean that this is an important area for focus in the first cycle of reporting. Building on this proposed first round of reporting, we aim to achieve a situation where criteria (c) no longer applies to the sector. We would like further explanation from you on how you think this can be achieved and we would welcome the opportunity to work with you on the subject.

Q3. Do you agree that Option 2 should be the preferred option given costs and benefits (including those detailed in the Impact Assessment)?

We are disappointed by the brevity of the impact assessments carried out for the three proposed options. We are particularly concerned about the lack of any quantitative value assigned to the benefits of each option. This means that the three options are currently quantitatively incomparable. We suggest that, at minimum, a comparative benefit value should be derived for the three options. This could be based on the estimated relative impacts of climate change to the organisations being asked to report under each option and quantification of the likelihoods of the qualitative benefits, which you outline, resulting for each authority. Where these quantifications involve assumptions, sensitivity analysis could be carried out in line with degrees of uncertainty. This would at least make some comparative cost benefit analysis possible, and better inform your decision on which option to choose.

Despite the above concerns, we have no major objections to option 2, other than that it represents increased regulatory burden, which we believe should be minimized through the incorporation of adaptation into business as usual processes within both regulated companies and their regulators.

Q4. Are there any authorities which the Government proposes to Direct which you believe should not be included in the priority list; or any authorities which have not been included in the list which you believe should be?

You propose that new appointees and water supply licensees should not be asked to report, but instead only contribute towards the reports of larger nearby companies. We believe that, in principle, new appointees should be included. This is on the basis that they are providing a critical service, are potentially as vulnerable to climate change as any other water company and are subject to the same expectations and responsibilities. These companies, although they currently only supply low numbers of customers, should have access to the resources and expertise needed to assess and address significant risks to their business; and therefore should be in a position to assess their own vulnerability to climate change.

We recognise however, that there are issues of proportionality and resource limitations. It is a matter for you to decide whether a de minimis level should be established, below which authorities will not be asked to report. Currently, we would suggest that Independent Water Networks Limited and Scottish and Southern Energy Water, the two most significant new appointees should be in a position to report without disproportionate administrative burden. Other new appointees might be asked to report on a voluntary basis. On the basis that only one business customer is currently supplied by a water supply licensee, we suggest that the six existing Water Supply Licensees need not report.

Q5. Are there any other authorities that would like to be invited to report on a voluntary basis?

See above.

Q6. Do you agree with the additional situations in which reporting authorities may be asked to report? Are there any others that you can suggest?

Although we agree with the additional situations in which reporting authorities may be asked to report, we would point out that any request is likely to represent a significant regulatory burden on an authority. Careful consideration should always be given to whether specific uses of the power are likely to be cost beneficial, particularly after an extreme weather event. We do not want to encourage knee-jerk responses to the challenges presented by a changing climate; instead we would like to see a system in place that fosters a long-term sustainable approach to the challenges across all sectors of the economy.

We would also comment that a clear understanding and agreement on regulators' "required standard against objectives" must be reached before any adaptation report is requested where there is a perceived failure against such objectives. Regulators already have mechanisms in place to address poor performance in the companies they regulate and care must always be taken to avoid overlapping regulatory burdens.

What needs to be done?

Q7. Are there any changes you would like to make to the way the Direction has been drafted?

Section 5a of the Direction is somewhat confusing. As we understand this direction, a better form of words might be; "a description of any previous or existing policies which assess potential actions for adapting to climate change and assess their costs and benefits".

Q8. What in your view are the areas, if any, in which we should make specific changes to the Direction for a particular sector or organisation?

If asked to report, we will assess how climate change will affect our functions with respect to their impact on the water and sewerage companies we regulate and their ability to provide safe and reliable services, at a fair price, into the future. We will also assess how climate change is likely to affect our functions with respect to protecting consumers, promoting value and safeguarding the future. Since we would expect to do these things in responding to the main requirements of the direction, we question the necessity of the specific paragraphs 7 and 8 of the direction.

We have considered whether or not our submission should build on and be informed by the regulated companies' submitted reports. The intention of this exercise is not for us to report on how others are adapting, but to demonstrate that we have adequately considered how climate change might affect the successful carrying out of our regulatory functions. We therefore believe that regulators should report early and without sight of the regulated companies' reports.

Your explanatory note states that "it is likely that the reporting authority will need to consult with the named body or person in order to comply with these paragraphs". In compiling our report, we would not expect to carry out a full consultation exercise like this one but would instead use our existing knowledge, informed by ongoing dialogue, in order to understand and address effects on other bodies. We may decide to consult on specific actions or policies which form part of our report's action plan in

line with our existing policy on consultations³. We will always consult on actions which form part of our forward programme.

Q9. If your organisation is a proposed priority reporting authority how long do you think it will take to respond in the detail outlined here and in the Statutory Guidance?

As set out above, our expected response time will vary depending on the approach we decide to take in compiling our report. We would expect a period of 12 months to be adequate for compilation of a report which satisfies the criteria set out in the draft direction and the draft guidance.

Q10. Are there any particular confidentiality issues that you believe will need to be taken into account in your sector/organisation?

Our transparent approach to regulation means that we do not expect any confidentiality issues associated with submission of our report. However, we expect that some of the regulated companies may legitimately consider some of the information which may be included in their reports to be price sensitive. However, this is dependent on how much detail the company decides to include and we believe the draft guidance is ambiguous enough to allow any company to compile a report which is wholly free of confidential information.

Q11. What additional help, guidance and support might an authority want from the Adapting to Climate Change Programme?

As noted elsewhere, we believe further sector specific guidance and case studies would be helpful to authorities. In particular, we would like to see more clarification on what *regulators* are expected to provide in their reports in order to inform our decisions on what approach to adopt.

We note that the case studies presented in the consultation document are superficial, and there is no accompanying narrative to explain whether these examples are of sufficient depth to be included within reports.

Q12. Do you agree with the proposed role for the ASC in considering the reports? If not, what alternative or changes would you envisage?

We see no reason why the ASC, providing it has sufficient resources, should not take the role proposed in your consultation. However, as outlined above, we believe that sensible comparison and assessment of the reports is likely to require specialist knowledge, including sector-specific knowledge and engagement. We are willing to take an advisory role in contributing towards the assessment of the reports submitted by water and sewerage companies. We would expect to be closely involved in any decisions on actions resulting from analysis of the reports and believe we would add

³ 'Ofwat's code of practice on consultations' Available at: http://www.ofwat.gov.uk/consumerissues/pointofview/gud_pro_havvoursay20040722.pdf

value in this area. For example, where you consider it may be appropriate to ask a company to report again.

How should it be done?

Q13. Is there any more detail that you would like to see in the draft guidance?

The draft guidance set out in the consultation is currently quite vague and non-specific and will, we believe, lead to a wide range in the quality and content of submitted reports. We understand that this is primarily because it aims to be broadly applicable to many different organisations. However it would be greatly beneficial to set some more specific standards on what should be contained within the reports submitted by reporting authorities. This should include some more specific guidance on the expected scope and depth of the reports, and perhaps guidance on the sections which should be included, and the order of those sections. Given the lack of clarity on responsibility and the apparent resource limitations for analysis of the reports, it may also be helpful to limit the size of reports to a standard size range.

You state in Annex C that all actions included in reporting authorities' plans are assumed to be cost effective. We believe your guidance should make this point more forcefully and set out more clearly how an organisation should carry out a robust cost benefit analysis based on sound economic principles. Many of the organisations included in the list of proposed reporting authorities (including the water and sewerage companies) do not operate in a competitive environment and it is therefore vital that all planned adaptation actions which have a significant associated cost can be proven to provide adequate benefits and represent best value. In our view, assessing how well authorities have compared and selected the most sustainable, best-value adaptation options is likely to be a vital element of the assessment of the reports.

Our primary concern is that companies and organisations might use the opportunity to produce adaptation action plans to justify action and investment which does not represent best value for money, or produce adequate benefits.

Specifically, the guidance might benefit from more detail on the types of costs and benefits which authorities are expected to quantify and consider when planning adaptation action. This information may be best provided in sector-specific guidance, or in the form of case studies which you plan to release. We note that some further detail on the expected costs and benefits of adaptation is currently included in Annex C. You should also consider whether there are any costs or benefits which authorities are not expected to consider, for example avoided private costs.

Our experience in assessing business plans has revealed cases where cost benefit analysis has been carried out poorly or incorrectly, which can result in a sub-optimal

option being selected. The guidance should more explicitly build on and refer to documents detailing cost benefit analysis best practice. All reporting authorities should be encouraged to undertake cost benefit analysis based on sound economic principles, such as those set out in HMT Green Book⁴. We recognise the June 2009 supplementary green book guidance on accounting for the effects of climate change⁵ also offers helpful guidance and should be referred to. We would certainly expect water and sewerage companies to use business-as-usual, industry best-practice processes in carrying out cost benefit analysis for any adaptation options included in its reports. We have clearly set out our expectations of companies in our regulatory guidance and the water industry research body, UKWIR, has also produced a range of material offering guidance and tools to aid companies in carrying out robust cost benefit analysis.

The statement on pg 79, which states that UKCIP has identified “increased likelihood of winter storm damage” as a primary impact, is poorly supported. The most recent UKCP09 reports state that “It has not been possible to produce probabilistic projections of changes in frequency, strength and location of future storms and anticyclones”. From preliminary analysis of Met Office experiments, UKCIP conclude that “The frequency and strength of storms remain relatively unchanged in the future simulations”⁶.

Q14. Would you be able provide us with other examples or case studies that we could use to support this guidance? If so, please provide details.

We plan to publish a document in future which will present examples of existing approaches to addressing climate change risks as presented in companies’ business plans for the 2009 Price Review. This will include examples of proposed actions which aim to address these risks. We believe this document could provide you and other reporting authorities with a useful resource. We would be happy to work with you in making use of this resource in future.

What are the costs and benefits?

Q15. Is climate change one of the risks you account for currently in your decision making?

Yes.

Q16. How do you incorporate climate change risks into your decision making?

We direct you to our climate change policy statement published on 31 July 2008 for further information:

http://www.ofwat.gov.uk/sustainability/climatechange/pap_pos_climatechange.pdf

⁴ ‘The Green Book’ Available at: http://www.hm-treasury.gov.uk/d/green_book_complete.pdf

⁵ ‘Accounting for the effects of climate change’ Available at:

<http://www.defra.gov.uk/environment/climatechange/adapt/pdf/adaptation-guidance.pdf>

⁶ UKCP09 Climate change projections Report (June 2009; *Version 2, amended July 2nd 2009*) Available at: <http://ukclimateprojections.defra.gov.uk/content/view/824/517/> **pg 181**

Our wider principles on sustainable development in the sector are set out in our sustainability document:

http://www.ofwat.gov.uk/sustainability/sustainabledev/pap_pos_watertoday.pdf

Q17. Do you carry out the risk assessment in-house or contract an external consultant?

Thus far consideration of climate change risks has been carried out in-house, across the organisation. This is likely to remain the case.

Q18. What resources are currently spent on analysing climate change risks (number of staff/number of hours/hourly wage)?

The climate change team consists of three full-time staff; dealing with both adaptation and mitigation issues. However, consideration of climate change risks takes place across the organisation.

Q19. What's your timescale for assessing climate risks (5-10 years, 10-30 years, or >30 years)?

The price setting element of our regulatory cycle means that emphasis is placed on the assessment of risks over the next 5 to 10 years. However, our regulatory framework is placed in the context of long-term sustainability which aims to encourage long-term approaches to the assessment of risk in the companies we regulate. Typically, companies are expected to assess and plan in the context of climate change for at least 25 years into the future. Companies were required to do this in their strategic direction statements and in water resource plans companies must forecast and plan for supply and demand 25 years into the future.

Q20. Do you agree with the list of benefits? Are there any additions that you would make? Could you quantify any of these benefits?

We generally agree with the benefits you have set out in your impact assessment. However, as explained elsewhere, we believe these should be more clearly explained and, at least some attempt made at quantification.

We may be in a position, after the current price review process is complete, to provide you with indicative values for the costs of specific resilience measures in the water sector. However, since specific measures and necessity differs radically across the sector, these values could only be indicative.

Q21. What adaptive measures to reduce the vulnerability of your activity to climate change would be in your remit?

- Changes to regulatory framework
- Changes to infrastructures
- Others

The key adaptive measures available to us are:

- Changes to regulatory framework and taking regulatory action: including requiring the provision of information, setting defined outputs, providing for finance for companies through price reviews and taking enforcement action where companies fail to comply.
- Changes to internal processes and arrangements to cope with risks of climate change to the operation of our functions.

Q22. Do you have the internal capacity to fulfill the reporting obligations stated in the Statutory Guidance, i.e. compiling the forms and submitting them to Government?

Likely yes. However, as explained elsewhere, the nature of the guidance means that the extent of resources required is not yet clear.

Q23. How much time and resource would you expect to put into producing this report for your organisation in terms of personnel and hours (5-10 hours, 10-20, 50-100 hours, or more than 100 hours)?

This is dependent on our choice of approach but is likely to be above 100 hours of work. We expect this to be true for most reporting authorities.

Q24. How much of the information required under this power is already available within your organisation (in percentage terms)?

As noted above, we have an existing climate change policy which identifies the potential impacts of climate change on our regulatory activity and sets out actions to address these risks. This could form the basis of a report which we believe would be compliant with the draft guidance. We already plan to carry out further work in this area and therefore we cannot offer a precise answer in percentage terms to this question.