



YorkshireWater

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24 June 2020

Dear John,

Re: Innovation funding and competition: further consultation on design and implementation

Thank you for the opportunity to review and provide comments on the recent proposals seeking to address outstanding policy issues and the options for the detailed design and implementation of the new innovation funding and competition.

We have provided appended to this letter our responses to the consultation questions relating to Ofwat's policy and design proposals and general observations on the implementation of the innovation funding and competition.

Should you have any questions in relation to this response please let me know via email at [REDACTED]

We look forward to further engagement and work with Ofwat and others across the sector on the implementation phases of the innovation funding and competition and on the conclusion of the essential joint Innovation Strategy.

Yours sincerely,

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]



Yorkshire Water response to Ofwat's further consultation on the design and implementation of the innovation funding and competition

Consultation questions and responses

Q1: Do you agree with our proposed default arrangements for managing IPR and royalties? Do you think these arrangements work for different types of projects and activities (e.g. new technology vs. process innovation, roll-out activities etc.)?

We welcome the distinction between Background and Foreground Intellectual Property Rights (IPR) within the proposals. We support the proposed treatment of Background IPR (IPR that existed prior to the innovation fund bid but brought into the project for the sole purpose to allow the project to go ahead) in regards to the granting of an appropriate form of license for its use to all participants in the project¹ and beyond, where the Background IPR continues to be required for water companies to utilise the Foreground IPR.

It is critical that innovators or water companies with existing IPR essential to the success of innovation fund projects are confident such intellectual property is not at risk from the structure and policies of the fund and competition.

In our experience and through discussions with partners, innovative collaborators and academia, innovators are naturally very protective of their intellectual property and its potential commercial value. It is vital to attract future investors should an innovative solution need to be readied for widescale implementation, and this is no different in respect to the innovation fund and competition. We consider this attribute is relevant to both Foreground IPR developed within the innovation fund project and existing Background IPR.

Whilst we believe the default royalty-free Foreground IPR position as expressed by Ofwat in the consultation could act as an encouragement to many water companies to be 'fast-followers' in the uptake of innovative solutions proven as effective through the innovation competition, such an approach could be overly restricting and unattractive to many small and novel innovators who may otherwise prove valuable to the sector over the long term.

We therefore welcome Ofwat's proposed flexibility regarding IPR arrangements so as not to limit the incentives on small scale innovators to work with water companies through the innovation fund and competition.

IPR arrangements can be complex and we welcome that project bidders will be allowed to make a case for alternative treatment of IPRs, and we expect such cases to be reasonably considered. However, we believe it is an unreasonably high bar to expect bidders to set out how their project will benefit 'all customers' of water companies through the proposed arrangements. Instead, we would like Ofwat (and its agent) to consider bidders who can make a case for alternative IPR arrangements for projects that can be shown to benefit the

¹ Where Background IPR is provided by a partner to the project group companies under license for a fee, we envisage such fees would form part of the costs of delivering the project and therefore a constituent part of the project groups bid into the innovation competition. Where Background IPR license fees relate to the wider use of Foreground IPR by water companies, we see such fees to be considered as a cost element of rollout of the specific innovation.

majority of customers of multiple water companies (beyond the water companies who are themselves bidders in the project).

Q2: What alternative arrangements should we be considering for IPR/ royalties?

Given that the proposals set out how Foreground IPR generated by innovation competition funded projects is to be made available royalty-free and in perpetuity to all seventeen water and wastewater companies and NAV companies, the realistic prospects for sizeable royalties to be earned on Foreground IPR owned by water companies and/or their innovator partners seems limited in the near-term. Where a water company does earn royalties or income considered in lieu of royalties from Foreground IPR, we agree such royalties or income should be shared with customers (once costs incurred by the water company in maintaining its Foreground IPR have been deducted). This then brings in the questions of which customers should benefit from such royalty sharing and how is the sharing ratio to be determined?

To be clear, we do not expect partner organisations that own or co-own Foreground IPR to share their related royalty income with the customers of water companies.

We believe **all customers of all water companies that have contributed to the innovation fund** should receive the agreed share of water company royalties income, even if not all water companies receive royalty income (as not all water companies will necessarily have innovation fund projects awarded, innovation projects that succeed, or innovation projects that once successful actually deliver royalty income).

It would appear to be straightforward to share the royalty income between all customers and the water company with the relevant Foreground IPR in proportion to the project funding provided to the company by the innovation competition. However, there could be an argument that the royalty sharing ratio should not be set at the same ratio as the innovation competition funding (for the relevant project). The customer funding risk is diversified across the whole innovation competition project portfolio, and all customers will share in the benefits from all successful projects that can and do subsequently attract Foreground IPR royalties (through the reconciliation mechanism). However, the individual water company risk on its contributions to innovation competition projects may well be quite different depending on:

- the number of innovation competition projects it has delivered;
- the value of its contributions; and
- how many of the projects succeed and are also able to deliver a royalty income.

We believe determining a royalty sharing ratio based on the specific net risks taken by each relevant royalty earning water company may however be overly complex to administer. Therefore, we agree to the more pragmatic approach that royalties earned should be shared with all customers proportionate to the funding of those relevant projects that attracted the royalties concerned.

We would like there to be a reasonable limit set on the duration of the royalty income customer sharing mechanism, for example to the end of the following AMP period.

In terms of the mechanism for the sharing of water company royalties relating to Foreground IPR, we would like Ofwat to confirm this would be achieved as part of the regulatory settlement of customer revenues across all water companies, and would not incorporate a request for payment from the relevant water companies that collect Foreground IPR royalty income.

Q3: Do you agree with the principle that data generated through the innovation competition should be open by default?

We think it is entirely appropriate for data generated through the innovation competition to be open by default and shared with all seventeen water companies and NAVs in a consistent and regular basis. This aligns with good practice across many areas of research so that results can be scrutinised to ensure they are reproducible and replicable. In this way other parties can have confidence in innovation competition project outcomes and are more open to adopting solutions 'proven' to be effective in delivering benefits to customers, the environment, and infrastructure resilience.

Where an open data approach is not appropriate, for example due to the data that are potentially sensitive (personal data or data with security implications), then this should not be expected to be shared.

Q4: Do you agree with our proposed approach and that we should consider alternative arrangements beyond company contributions?

We agree the proposed approach and we would expect bidding water companies to seek to leverage funding from multiple sources, including bidding partners and other grant funding or innovation funding.

We would also welcome consideration of the provision of contributions in-kind from the bidding group, such as company time, provision of assets, materials, and Background IPR and know-how, which is very much standard practice with other grant funding schemes.

Q5: Do you agree that a guideline minimum company contribution of 10% is appropriate in this context?

We agree that a guideline minimum 10% contribution is appropriate so long as the proposed approach considers the mix and value of contributions as we referenced in question 4, and that the actual contributions can be readily verified and accounted for.

At this stage Ofwat does not clearly identify the manner or mechanism through which the company contribution will operate and therefore we cannot consider whether the approach will be permissible under our covenants. Should the contribution be capable of being considered as a disposal or joint venture this is likely to be in compliance with the applicable covenants that ensure the interests of the regulated business, and therefore our customers, are protected.

Q6: Do you agree with the overarching approach we set out here?

We agree the proposed approach should consider and allow a variety of project types and agendas in respect of competition funding. We strongly support that the focus of the competition approach should be guided by the water companies' joint Innovation Strategy, to ensure the competition accurately reflects key innovation gaps and opportunities, as well as identified stakeholder needs for the sector. We envisage the joint Innovation Strategy to be reviewed periodically during the lifespan of the innovation fund and competition so that its focus reflects the prevailing priorities and latest opportunities evidenced, and that the competition will recognise any material updates.

Although we recognise the importance placed on how innovative solutions within the competition can be rolled-out across companies (as we discuss further in our response to question 8), we do not want to see the project selection criteria having an excessive preference towards projects that are working on already relatively mature solutions. We do not want such solutions to exclusively progress at the expense of more novel and potentially disruptive solutions, or innovations that presently have no presence in the water sector but have demonstrated significant success in completely different sectors. By ensuring the competition remains closely reflective of the joint Innovation Strategy, this risk should be mitigated.

As an additional observation, we would like to understand if opportunities could be built into the governance and selection process that seeks to identify innovation projects that are being run outside the innovation competition, either as part of a company's PR19 business plan, or outside its core plan but via another innovation funding regime. It would be sensible, if feasible, to look holistically at the range of innovation ideas being actively pursued across the sector to avoid disproportionate repetition of research and development (although we accept some repetition can be valuable in demonstrating whether there are fundamental strengths or flaws in a concept and whether the benefits are replicable in other settings perhaps). Through the work of Heads of Innovation and Innovation Managers across the water companies and NAVs, it may be useful to maintain an ongoing register of innovation projects that will help inform the joint Innovation Strategy and the competition at each year.

Q7: What are your views on introducing separate, proportionate, arrangements for small-scale projects? How might we define small-scale projects for the purposes of the innovation competition?

We believe it would be useful to have a streamlined and proportionate approach to evaluate and award to small-scale innovation projects. This may include providing support to novel proof-of-concept projects (especially ones that are in areas of research that water companies would not usually pursue in their business plan activities) or projects that require some initial feasibility work to prepare it for qualification of a larger fund bid. The focus on planning for roll-out would naturally be very limited in such projects and this should not be viewed as a negative factor in the evaluation for funding award.

Q8: Do you agree with our proposal for ensuring roll-out is at the heart of the innovation competition? How might we reward both leaders and fast followers in this space?

The effective and timely implementation of successful innovation across the water sector is the key deliverable of the innovation fund and competition. However, being too restrictive or challenging of competition bidders on their subsequent scale roll-out plans may limit the range and ambition of projects put forward for consideration. An over-reliance on roll-out may inadvertently reward projects and solutions that are near market ready but offer only marginal benefits to customers above many companies existing plans. The fund should be looking to bring forward novel innovations and those with potential to be truly disruptive and deliver a step change in performance and efficiency that companies would otherwise not explore as part of their own plans.

We recognise companies that are ‘fast-followers’ do not avoid all risks associated with innovation. Indeed, due to their lack of exposure to and understanding of the solution during its creation and development, they may be unsighted on risks or key contributors to successful adoption and exploitation of the solution. Therefore, being in a fast-follower position is not risk-free. However, in considering making any ‘rewards’ available from the innovation fund for fast-follower companies there needs to be careful calibration relative to the actual risk the company is taking and benefit to be gained for its customers from early adoption. In this way, successful innovation projects rolled out that deliver marginal gains to customers will not absorb significant innovation funds in de-risking positions for companies.

Fast-follower companies should also be required to take a default open-data approach to share evidence on challenges and benefits achieved deploying the innovation, which may be both a driver for ongoing wider adoption and a very valuable feedback loop to the innovating group that includes the leading company or companies.

We believe the proposed virtual Water Innovation Centre of Excellence could play a key role in proactively putting roll-out and successful implementation at the heart of the competition and the fund regime in general.

When assessing if innovation works in an operational setting and at scale, we suggest it needs to be judged against known criteria, for example four detailed below:

1. *Safety* – Does the innovative solution work safely for all those involved? For example, is customer data secure, physical safety of staff and public, water quality standards maintained/improved, etc.
2. *Efficacy* – Does it work in the way it was designed and is it getting used the right way in practice?
3. *Accuracy* – Does it work as accurately as expected and produce the intended outcomes, within set bounds, in the real world as it does in the pilots or lab settings?
4. *Value* – Does it provide value for money in the real world?

How will we judge value across companies if we rely solely or mainly on the innovator? There could be a role for the Centre of Excellence, in a similar way to how in healthcare, the National Institute for Care and Excellence (NICE) are responsible for endorsing digital healthcare related products that are economically of value and are safe to use at scale.

NICE use an evaluation framework that encompasses issues that may not be seen in a pilot setting², and this is effectively like the gold standard in the UK for digital healthcare. If a company's new product passes this level of rigour, they usually find it a lot easier to enter the UK health sector and increase their commercial value and in turn improve the value and performance of the NHS.

If the Centre of Excellence could perform rigorous evaluation of products in the real world, it could offer some sort of product endorsement. This would help encourage other water companies to consider and then adopt the innovative product, increasing the uptake of innovation and assisting the aims of the innovation fund and competition to be delivered.

We support Ofwat directing a portion of the innovation fund to independently assess and evaluate how well products output from the competition projects can be operationalised, as it is only then the customers will experience at scale the benefits from the innovation fund.

Healthcare funding example from the National Institute for Health Research on Artificial Intelligence: <https://www.nihr.ac.uk/explore-nihr/funding-programmes/ai-award.htm> This link explains the phases of innovation – for example: phase 1 is an idea, phase 2 is a prototype, to phase 4 where product is already operational but not verified if it is effective/value for money.

We would welcome clarity on the timeframe for roll-out being supported financially by the innovation fund and whether this would be open to early implementations or deployments of an innovation that commence in the following AMP or the AMP beyond that.

Innovations identified and encouraged by the innovation fund and competition will alert companies to new products and services and create needs that may not have been conceived before. Any appointment by water companies of contract partners to roll-out an innovation success from the competition would need to be compliant with the Utilities Contract Regulations of 2016 (UCR). Companies becoming aware of an innovative new solution would need to create a tender or competition exercise for the need the solution satisfies. This process could be accelerated by having received specification information from the relevant leading company, but this would need to be reviewed and may be adapted such that it does not artificially narrow competition.

Alternatively, the company seeking to award a contract could issue a Voluntary Ex-Ante Transparency Notice which states the intention to award a contract and seeks parties that could join a competition to come forward to challenge the uniqueness of the proposed award solution. We do not believe innovation partnerships allowed within UCR would apply to fast-follower companies looking to contract with the innovation supplier entirely without competition.

² <https://www.nice.org.uk/Media/Default/About/what-we-do/our-programmes/evidence-standards-framework/digital-evidence-standards-framework.pdf>

Q9: What practical arrangements should we introduce to ensure adequate ring-fencing of the innovation funding?

The presentation by Ofwat of the three stages where ring-fencing protection is required for innovation funding from customers contributions is helpful. We agree it is appropriate to keep funds related to the innovation funds distinct and discrete from funds that are related to normal business activities relating to business plans and allowed revenues, i.e. funding for the innovative competition is to be ring-fenced and administered such that it cannot be used for other purposes.

It is not clear from the Ofwat proposals as documented as to the legal nature of the innovation funding payments and rationale behind companies and/or its customers being required to fund in this manner. As mentioned in our response to question 2., we assume that this type of cash outflow could be deducted as a form of regulatory settlement rather than an actual payment by the company. However, should this type of innovation funding amount to a payment by the company, then it may need to fall within the definition of Permitted Disposal within our Common Terms Agreement (CTA).

Furthermore, the “ring-fencing” of innovation funding which has been awarded to a water company under: (i) an innovation competition for the purposes of delivering a project; or (ii) where a water company has been awarded funding for enabling activities. The legal ring-fencing or segregation of funds would be contrary to the terms of our CTA. We consider instead that it would be possible to internally account for, and from a house-keeping perspective “ring-fence”, innovation funding from a documentary standpoint (i.e. via ledger entries).

Q10: Do you think the proposed innovation challenge approach will help better enable partnerships and collaboration between companies and third-parties, in particular smaller innovators? Are there alternative approaches we should be considering? How can we make sure this approach works in practice?

We welcome the proposal for a specific activity and possibly a set amount of funding to be available in the first year to smaller third-party innovators (perhaps not exclusively) to pitch their project proposals to companies as a group/panel in response to specific key challenges faced by the sector.

The challenge scheme should be designed in such a way that this does not compete or undermine other existing arrangements companies have in place to encourage and attract novel and innovative solutions to water resource, leakage and demand management challenges through the water resources bidding market. Companies have advanced a ‘we are open for business’ approach through the bid, assess, and test/deploy mechanisms they have respectively put in place in accordance with their published bid assessment frameworks.

The setup and governance of the proposed Innovation in Water Challenge should be minded that any projects proposed into the ‘Challenge’ are not also in one of more of the bid assessment processes with companies. The Innovation in Water Challenge should primarily be about supporting and proving the value of untried and untested innovative and novel

solutions from smaller innovators who have limited existing relationships as part of water company supply chains. Therefore, the innovations identified may not necessarily be at or near a market ready stage and the filtering and selection process will need to be diligent yet efficient. The challenge may well bring together innovators and sponsoring water companies which may accelerate bringing novel solutions into contention against companies more conventional solutions or to address previously unidentified opportunities.

We think the bulk of customers innovation funding across AMP7 should continue to be directed to the main innovation competition.

Q11: Do you agree with our proposed approach to returning funds to customers? Are there any other circumstances, not considered here, under which we might consider returning funding to customers?

We wish to ensure our customers interests are protected in respect of the innovation funding and competition and as such we support the principle that unused funds are returned to customers.

We fully support the principle that funds provided by customers should not be retained for lengthy periods without the prospect of them being invested in innovation with an aim for greater returns (service, efficiency, or environmental protection/improvement).

However, there should be flexibility in the approach to returning funds to customers so innovation projects that roll over into next AMP can be funded as agreed or expected by the company and its partners. Regarding funds that are 'unused' and to be returned to customers, should this really mean funds that are unallocated or yet to be ring-fenced funds.

Funds for returning may also need to exclude funds provisionally allocated to implementation of solutions once proven to deliver credible and material benefits at scale. Rollover into the following AMP should not be dependent on the Innovation Fund and Competition being continued/extended for the following AMP. Ofwat recognises that some projects may require funding beyond AMP7, and should Ofwat proceed with its proposed approach to set aside a proportion of innovation funds to support implementation of innovative solutions developed through innovation projects, we believe it is highly likely that funding for enabling activities will run into AMP8 and possibly AMP9.

Regarding Ofwat making funding adjustments where it considers that funds allocated have been misspent and/or projects have not complied with predetermined funding conditions without reasonable justification, we would like more clarity on what would constitute misspent funds. A project run on normal diligent principles could prove to be unsuccessful in delivering a workable and implementable innovation, and this negative outcome should not be further aggravated by demands for innovation funding allocated and used in good faith by the water company and its project partners to be returned to customers at the end of the AMP7 period or thereafter.

Again, we assume water companies who are required to return funds will in some way be asked to fund the lower bills of other water companies customers so that **all customers of all companies share in returned funds** and that all these movements can be accommodated through customer revenue reconciliation.

Q12: Do you agree with our proposed approach for managing interactions with the price review?

We acknowledge the innovation competition will be designed and set up to fund activities that are not funded or otherwise incentivised through the price review. The innovation fund should not be used as another way to fund projects already in companies plans or allow companies to offset spending it had already planned to meet AMP7 PC targets with alternative projects using the fund (so avoiding customers paying twice for a similar outcome).

We believe there is potential risk for a level of underperformance on PC and ODIs as a result of a company trialling an innovative solution in a performance area where normal improvement activities have to be somewhat deferred or suspended whilst the innovative approach is tested. However, we concur with Ofwat that this impact is likely to be of low materiality, and a company facing a significant underperformance risk by exposing its PC/ODI regime to innovation trials and testing may well avoid such projects altogether, unless alternative lower risk testing approaches can be found.

In practice it may be extremely challenging to completely dissociate innovation fund project performance from that confirmed in the company's PR19 Final Determination or Redetermination where the innovation fund project focus is in a key performance area, such as water quality, leakage, PCC etc. And consequently, an innovation fund project that demonstrates rapid gains may well contribute to an outperformance position for the company – benefitting its customers directly within the AMP7 period with an improved service for example and a sharing of ODI rewards (should that result). We do not believe such a scenario runs counter to Ofwat's desire for the innovation fund and competition to be complementary to the PR19 framework, and certainly this would not contradict any of the proposed 'principles.

Our interpretation of Ofwat's statement that "*The Innovation competition will fund activities that are not funded or otherwise incentivised through the price review*", is that this is **not meant to exclude key areas of focus from innovation funding**, but rather exclude specific interventions and projects that are already part of a company's PR19 confirmed plans (at FD).

Within the governance and selection process as part of the main competition it may be prudent to seek explanation or evidence from bidding companies that the proposed innovation project does not already exist in its PR19 plans and where the proposed innovation project may reinforce or improve upon related PC/ODI performance prior to the adoption of the solution by the company.

Q13: Do you agree with our proposed amendments to the principles? Are any further amendments to the principles required to reflect our approach to outstanding policy issues outlined in this document?

Innovation aimed at meeting the key challenges articulated in the joint Innovation Strategy for the sector should understandably be focused on bringing about beneficial and sustainable change as widely as possible, and to that end we support to updates proposed

to Principle 3. We agree it is reasonable to expect bidding companies to set out clear plans for implementing the desired change arising from their project in their area, and where appropriate plans for implementation in other companies' areas.

However, innovation solutions that may not initially be appropriate for rollout across all companies and all customers in England and Wales could over time and through further adaptation and contributions become highly beneficial for the sector as a whole. We would urge Ofwat to keep the funding selection criteria flexible and to not down-select too severely or penalise projects that otherwise present novel and disruptive concepts and ideas but do not initially meet a 'wider rollout appropriate' test.

Irrespective of the rollout plans set out by the bidders for innovation funding, the bidding company is not under any formal obligation to secure a commitment or assurance from other companies in advance of, or following, the conclusion of the funded project, should its innovation prove effective, that the other companies will deploy that innovative solution or service. After all, companies who are competing for the same Innovation Funds initially are unlikely to be making commitments in advance to back another horse. Ofwat may be in a better position to encourage wider adoption of proven beneficial innovation in areas that align well with the agreed joint Innovation Strategy where companies seem resistant to do so and have not found or deployed suitable alternatives.

We support the amendment to Principle 5 confirming the approach to company contributions to the innovation competition at a minimum of 10%, as long as such contributions can take a variety of funding forms.

Q14: Do you agree with our proposed focus, major strategic themes and overall approach for the competition?

We agree with the proposed focus and note that the joint Water Innovation Strategy aligns with this proposal both in terms of what are the key strategic themes for innovation advancement and how we will innovate, including an open data approach and delivery of public value.

We support the overall approach to the main competition as proposed but would caution whether the idea of a limited focus on challenge areas for each annual round could result in only a handful of large projects being put forward for consideration each year. Keeping the range of areas broad aligned to the joint Innovation Strategy will allow and encourage many bids from small to large projects. Importantly, although this may seem to encourage more speculative bids to be made in the early years of the competition, it will allow bidding innovators and companies that have been at first unsuccessful in the annual round to refine and improve its project and bid again in subsequent rounds. Restricting the areas or themes covered in any one year of the competition may severely limit the opportunities for improved re-bids with possible novel and disruptive innovations.

We support the consideration of enabling activity and that this may require funding to help bridge the gap between proving an innovation delivers tangible value and facilitating the wider mobilisation of that innovation into multiple territories and securing those benefits in reality at scale.

We would welcome more clarity around the concept of the virtual Water Innovation Centre and have confirmation that this will be operated and governed separately from the main competition, enabling activities, and the Innovation in Water Challenge.

Q15: What is the appropriate split of available funding between the Innovation in Water Challenge, the main competition and enabling activities?

We suggest that the main competition should be allocated the bulk of the innovation funding, around 90-95% over the five years of customer contributions, with enabling activities and the costs of administering the fund, the competition and the innovation challenge allocated around 5-10% in total (noting that the Innovation in Water Challenge is presently scoped as being a first year only initiative and for relatively small value projects).

Q16: What are your views on the feasibility of running all three types of activities in the pilot year, and on the proposed timings in Annex 3?

It seems feasible to commence the competition pilot year by the end of 2020/21. It may be prudent for the Innovation in Water Challenge to be moved to early in year two to allow time for both companies and innovators to prepare. The key first step is to design and mobilise the administration and governance arrangements and set up separately the virtual Water Innovation Centre.

Each company will need to establish its own internal governance processes which will facilitate the collaborative approach, seek partners and secure resources to support the development of sound and well prepared competition bids. Companies will also need to prepare for the evaluation stage of the Innovation in Water Challenge and the delivery stage for projects paired to them.

Q17: Do you agree with our proposed approach to key implementation considerations outlined here?

We support the proposal to appoint an independent organisation to design and run the innovation funding competitions and to recruit an independent expert panel to advise Ofwat on project funding decisions. We would be very happy to be involved in the process or criteria setting for determining the expert panel. Working together with companies may allow these early design and mobilisation stages to be streamlined whilst keeping administration costs to a reasonable level.

We welcome Ofwat's consideration of the key implementation components from the competition application process, assessment and decision-making, through to monitoring of awarded projects (against a number of parameters and performance) and evaluation of the effectiveness of the competition overall.

We look forward to working with Ofwat and its selected partner on the details of the implementation plans and working with the sector on finalising the first joint Innovation Strategy, which will be fundamental in informing the evaluation process and decision making in relation to funding awards.