

December 2020

PR24 and beyond: Future challenges and opportunities for the water sector

Ofwat

Introduction

The 2019 price review (PR19) made a significant step towards improving the outcomes delivered by the water sector. Companies are currently getting on with delivering for their customers and the environment, investing in improved services and going above and beyond to support their customers through the impacts of Covid-19. Looking ahead to future price reviews, we want to start considering how we can build on PR19, meet future customer expectations, address future challenges, and deal with uncertainty.

As we set out in this document, the water sector faces profound challenges in the coming years and decades. As a regulator, these are our challenges too. We will need to adapt, evolve and redesign our frameworks and processes so we can best meet the needs of customers, the environment and wider society – not just over the next five years but over the longer term. As in any industry, companies will also need to change if they are to face the future with confidence.

Our initial thinking has been guided by a number of considerations. PR24 will play an important role in delivering our strategy, [‘Time to act, together’](#), which set out our ambition for the sector. We have taken account of our [lessons learnt from PR19](#), including the company and stakeholder feedback we received. We have considered our statutory duties, the strategic priorities and objectives set for Ofwat by the UK and Welsh Governments, government policy and insights from government and expert reviews. Our thinking is also based on what we think the future of the water sector might look like, and the challenges and opportunities it could offer. But at the same time, we recognise that challenges and opportunities can differ geographically, including between England and Wales.

To promote discussion and debate around our future regulation, we have established the Future Ideas Lab. This is a place for anyone to submit their ideas on how we should design future price reviews to meet the challenges and take up the opportunities we have set out. We welcome contributions from all those with an interest in the sector. And we will take all input into account as we progress our thinking.

On the opposite page, we set out 12 key questions for the sector that we think – based on the future challenges and our experience of previous price reviews – it would be useful for Ofwat, companies and stakeholders to aim to answer.

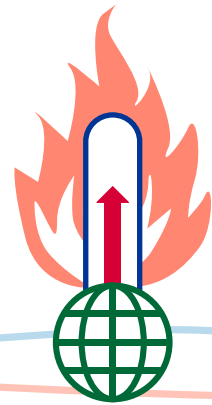
We will need to adapt our frameworks so we can best meet the needs of customers, the environment and wider society

- 1** What could the water sector look like in 2040, and how can Ofwat and water companies work towards that vision?
- 2** How do we best regulate to help companies to achieve long-term goals such as adapting to climate change, reducing leakage, improving water efficiency and delivery of net zero?
- 3** How do we encourage companies to ensure services are affordable for all, both now and in the longer term ?
- 4** How can we encourage companies to innovate and to take advantage of technological change to increase productivity, reduce costs and improve resilience, service and the environment?
- 5** How do we encourage companies to improve service to customers and operational resilience?
- 6** How can we encourage companies to best take account of customer needs and priorities, while ensuring services are comparable across companies?
- 7** What, if any, could the role of the price review be in encouraging or incentivising companies to better deliver public value?
- 8** How do we better use markets to deliver better value to customers and the environment?
- 9** How can we best account for specific issues, circumstances and Government policies/priorities in England and Wales?
- 10** How can we best align the interests of investors with delivering for customers, the environment and society?
- 11** How do we encourage companies to collaborate and work in partnership with others, such as on nature-based solutions, to better achieve outcomes for customers and the environment?
- 12** How can we simplify the price review while increasing value to customers, the environment and wider society?

Future challenges for PR24

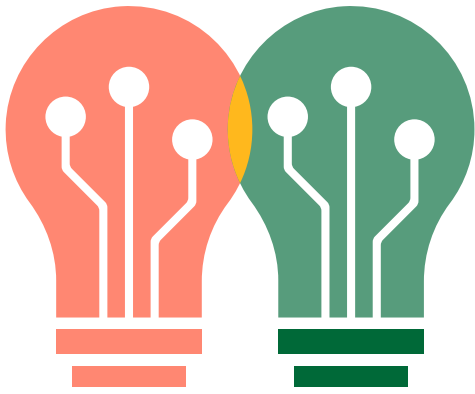


Protecting and improving the environment in the context of climate change



Achieving public confidence and affordability in the face of cost pressures





**Innovating and collaborating
to transform performance
for customers**



**Anticipating and adapting
to uncertainty and change**

Protecting and improving the environment in the context of climate change

A healthy environment is fundamental to both the water sector and wider society – and we know that customers increasingly want their companies to play their part. We consider the water sector should make the strongest possible contribution towards meeting the environmental challenges we all face, while keeping services resilient and affordable. These challenges are interconnected and numerous, but include the need to take effective action to deal with climate change, improve river and bathing water quality, and enhance biodiversity. Addressing these will require companies to work in new ways, in partnership with others, and for Ofwat to enable that work through our price review framework and beyond.

Taking action to deal with climate change is not just the right thing to do. Climate change has potentially serious implications for the long-term operation of the sector. We are likely to see drier summers and more frequent and intense rainfall on wet days. River flows will probably become more variable. Higher average temperatures are likely to induce biological changes in the water environment. And the National Infrastructure Commission has predicted there is a 25% chance of a severe drought in the next 30 years. These impacts, alongside the need to reduce water abstraction to address environmental challenges, threaten the resilience of water networks as well as the environment they operate in. Companies need to sufficiently understand their networks to take appropriate and proactive measures.

However, water companies are in an almost uniquely strong position, not just to protect, but to improve the environment over the coming years. Collectively, they will invest around £1 billion per year on statutory environment programmes at PR19, and have an array of untapped opportunities to work more closely with stakeholders to reduce pollution and improve river quality. All companies have come together to develop a 2030 routemap as a step towards the ultimate goal of embedded and operational net zero by 2050, and have pledged to halve leakage levels by 2050 at the latest. The price review cycle should facilitate and enable the sector to meet long-term goals. It should also encourage companies to deliver solutions as efficiently as possible.

We know there are a range of tools available for companies to meet environmental challenges – although we recognise that achieving outcomes is what is important. We are working with the Environment Agency, Defra and companies to maximise the value of the projects companies deliver through the WINEP. We want companies to explore – and be able to explore – how they can approach their operations in a more catchment-management and systems-based way, avoiding unduly prioritising hard assets over solutions that create wider value, such as nature-based solutions, market platforms or customer behaviour changes. We would like to see companies routinely working with third parties to co-design, co-create and co-fund schemes. And, to fully integrate the environment into their operations, companies should continue to work together to develop suitable natural capital frameworks and applications.

Achieving public confidence and affordability in the face of cost pressures

Water companies are monopolies and customers do not have a choice of who provides their water and wastewater services. The regulatory regime is therefore critical to the public confidence in the sector. Customers will be concerned if they see bills increasing without improvements in services. In particular, high payouts to investors or executives risk damaging public confidence when they coincide with major pollution incidents, high levels of leakage, or unnecessary supply interruptions. Citizens and communities increasingly expect companies – not just in the water sector – to consider the wider impacts of their operations and to deliver public and social value.

At the same time, as customers deal with the economic impact of the Covid-19 pandemic, the affordability of water bills will become an increasing concern. Whether bills are affordable is likely to be a major driver of trust and legitimacy in the coming years. The sector is also likely to face mounting cost pressures as we approach PR24. These might include, for example:

- potential changes required by the WRMP24 water resources planning guideline, including planning to a higher (1-in-500 year) level of drought resilience and action to reduce overabstraction at environmentally sensitive sites;
- long-term targets to hit net zero on capital emissions and to halve leakage by 2050; and
- action on the long-term goal to eliminate harm from storm overflows, removing lead from pipes, and/or improving asset maintenance to deal with future pressures including impact of climate change.

In addition, there is unlikely to be the same level of headroom for bill reduction created by a falling allowed return on capital, as occurred at PR14 and PR19.

Delivering affordable bills while securing public confidence will require a range of actions. There is scope for water companies to deliver increased productivity and efficiency by taking advantage of Big Data and technological improvements, such as smart networks. Greater focus on a systems approach and nature-based solutions may provide further scope for improving efficiency. Companies also have the opportunity to create public value by delivering their core services differently. And, in the face of multiple cost pressures, companies will need to give thought to how they prioritise investments and where markets can create value.

Whether bills are affordable is likely to be a major driver of trust and legitimacy in the coming years

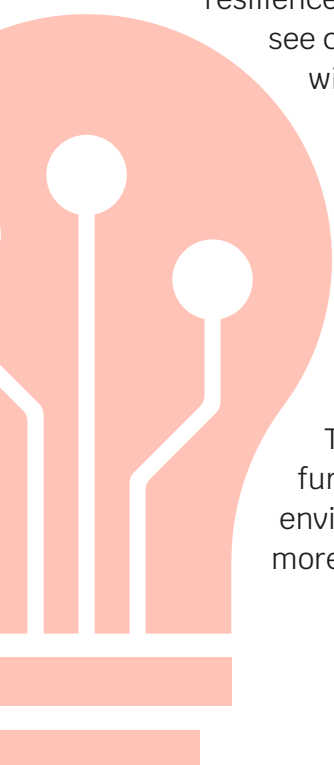
Innovating and collaborating to transform performance

Water is an essential service to customers. Customers increasingly expect their water companies to consistently deliver high levels of service, whilst also responding to their diverse needs, such as those in vulnerable circumstances. Over 2015–20, we saw some companies really push the frontier of what is possible in a number of areas – with some making impressive improvements in a short space of time. However, we also saw high-profile instances of companies failing to deliver for their customers. We want to see improvements in all dimensions of water company performance and to see an increase in the pace and level of change.

The industry has great opportunities to drive up performance. Regulatory improvements like the totex-outcomes framework and the innovation fund help to facilitate the innovation customers need. However, we are constantly thinking about how to help the sector to improve further. For example, service in other sectors is increasingly personalised and digitally enabled. Many useful innovations have been developed by the supply chain, other sectors and in other countries, which can be adapted to the benefit of water customers. That said, sometimes the answers can lie closer to home: there are currently large gaps in performance between the best and worst performing companies in several areas. To make real gains, technological innovations need to align with good leadership and management.

To meet the industry's strategic goals, companies also need to work with others. Collaborative solutions are often win-win, and can deliver wider benefits beyond cost efficiencies. We know that the use of catchment- and nature-based solutions, for example, can help to achieve resilience, lower long-term costs, and reduce emissions and pollution. And we'd like to see companies looking for innovative ways of involving, understanding and working with their customers (and, in the non-household sector, with business retailers) to change behaviour for the better. Reducing overall demand for water will be a key component in addressing future challenges, whether to improve drought resilience, reduce emissions or protect the water environment.

We have established RAPID (Regulatory Alliance for Progressing Infrastructure Development) to promote the development of new water infrastructure and provide a seamless interface for companies to work with us, the Environment Agency and the Drinking Water Inspectorate. The upcoming Drainage and Wastewater Management Plans (DWMPs) offer further opportunities for companies to work together to improve drainage and environmental water quality. A challenge for PR24 is how we can best facilitate that more effective collaboration across the sector.



Anticipating and adapting to uncertainty and change

Across society and the world, recent years have been increasingly defined by rapid, often unexpected change in a number of areas. Events and developments appear to be becoming more uncertain with time. Technology is rapidly evolving, knowledge is expanding, networks are broadening, weather events are becoming more frequent and the consumer is ever-more empowered.

This has significant implications for the water sector. The last price review period saw one of the worst cold waves in decades. At the start of this one, we have already seen much of the economy and society locked down by the Covid-19 pandemic, accompanied by one of the worst recessions on record.

The unpredictability of the future creates challenges, but a resilient industry should be as prepared as possible for anything. And there are real opportunities to capitalise on changes and new developments to improve services and reduce costs, or to win customers' trust by supporting them through challenging times.

The sector has a number of important long-term ambitions. For example, companies need to ensure drought resilience in the future. The National Infrastructure Commission has recommended that companies should increase water capacity by four billion litres by 2050. Taking action now is important – but so is building adaptability and flexibility into long-term plans. Things will change over the coming decades, whether in the form of supply shocks or natural disasters, or game-changing innovations that drive down the costs of solutions. Companies should consider how their planning might interact with a range of future scenarios, and as a regulator we need to play our part to help the sector face the future with confidence.

To cope with shocks and changes, companies also need to ensure they are resilient. All companies have raised their game in response to the immediate challenges of Covid-19, but in 2018 the 'Beast from the East' showed that the industry needs to get better at providing reliable water supplies when extreme events occur. Securing financial resilience is just as important, so that companies can avoid, cope with and recover from disruption. High levels of gearing, for example, can threaten financial stability and place undue risk on customers.

The unpredictability of the future creates challenges, but a resilient industry should be as prepared as possible for anything

Next steps

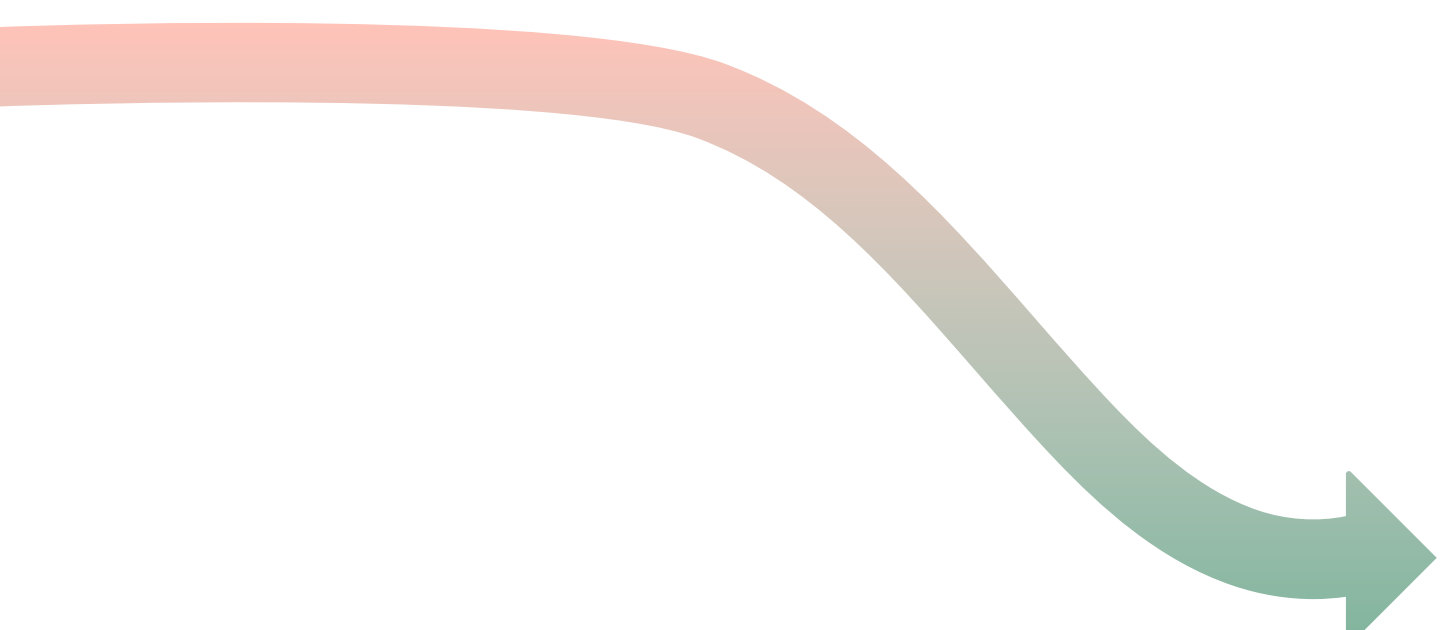
The opening of the Future Ideas Lab kicks off the 2024 price review. Alongside this document, we have made available three other publications to inform thinking around PR24 and beyond:

- [Reflecting customer preferences in future price reviews: a discussion paper](#) inviting stakeholders to contribute to a discussion about how best to reflect customer preferences in future price reviews;
- [Our reflections on lessons learnt from PR19](#): an exploration of what we have heard and our own reflections on lessons we have learnt from PR19, following our extensive engagement with the sector; and
- [PR14 review – call for input](#): we are calling for input into our review of PR14, which evaluates the impact it has had on the sector.

Going forward, we will engage with companies and stakeholders on what future price reviews, including PR24, could look like. This includes setting up a regular working group to consider the future of our outcomes framework. We plan to announce further events, workshops and working groups to develop thinking.

We intend to publish an initial consultation on our high level approach to PR24 in May 2021, outlining our initial thinking and providing an early view around the design of the 2024 price review. Submissions to the Future Ideas Lab will inform our thinking throughout PR24 and beyond.

We then expect the PR24 timetable to mirror the timetable set out at PR19. Accordingly, we plan to release the PR24 draft methodology in summer 2022.



Contributions to the Future Ideas Lab

We welcome your contributions to the Future Ideas Lab on how we could evolve the price review to address the challenges we have set out and help the sector to deliver better outcomes for customers, the environment and wider society.

We encourage respondents to take into account the key questions we consider the sector should address, as outlined on page 3.

To make a contribution, please upload your submission on the [Future Ideas Lab](#) submission page.

For any queries, please email futureideaslab@ofwat.gov.uk.

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Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533

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