Sustainability first

22nd July 2021

Dear Ofwat

**Response to PR24 and Beyond: Creating tomorrow, together**

Sustainability First is an independent think tank and charity focused on promoting economic, social and environmental wellbeing in public utilities including the water sector. Please find below our response to Ofwat's initial views on the framework for PR24 and future price reviews.

We also draw Ofwat's attention to relevant recent Sustainability First publications:

- Discussion Paper on How Engagement can maximise public value in the essential services of water and energy, which we will share and publish shortly.
- A framework for considering fairness between generations (sustainabilityfirst.org.uk)
- Regulation for the future: The implications of public purpose for policy and regulation in utilities (sustainabilityfirst.org.uk)

Our response also draws on our significant experience of energy regulation (eg RIIO2) and the lessons the water sector may be able to learn from this.

This response can be published.

## Overarching comments

Given the challenges of net zero, biodiversity and social inequality, we consider that PR24 represents a crucial opportunity to fundamentally change the regulation of the water sector so that it meets the needs not just of current customers but also today's citizens and communities and the interests of future generations. We therefore warmly welcome the consultation document's call for fresh thinking and the need to drive meaningful change.

PR24 needs to firmly put the sector on a glide path to successful delivery of the 25 Year Environment Plan and other long-term goals and take people – customers, citizens and communities – with it on this journey. The **process** of designing the next price control, and **how** the consultation document's high-level objectives are influenced (eg through engagement), interpreted and implemented in practice, and how they interact with other policy, regulatory and governance activity and independent assurance processes, are important. To be confident that a fundamental shift in approach is taking place, the behaviours of all sides need to be given due attention. For public value to be created, relationships need to continue to shift away from adversarial one-shot games to ones which can deal with trade-offs on wicked issues, and the fair share of risk and reward on public value and co-benefits, in a constructive and trustworthy way.

## Detailed comments

## Ambitions for PR24

**2.1: Do you agree that the themes we have suggested for PR24 are appropriate for England and for Wales?**

A: We strongly welcome the dynamic tone of this document - its strong focus on 'fresh thinking' to 'drive real change'. We support the interlinked goals: increase focus on the long-term; deliver greater social and environmental value including with systems-wide approaches; a clearer understanding of customers and communities; and greater efficiency and innovation. These reflect many of the asks from Sustainability First's Fair for the Future[1] and New Pin work[2]. However, we make the following points:

- **Long-term** - It should be noted that it is not just environmental and resilience challenges we face that demand solutions now, and in the future. Social changes (e.g. projected aging and an increasingly disabled population; likely shifts in community and individual inequality; and changing patterns to the way individuals and organisations work and live) will also impact the water sector. This has been illustrated recently, for example, by the increase in water demand as a result of Covid-19 and greater home working, along with the wider social impact of the pandemic on affordability.
- **Maximising environmental and social value -** We welcome the focus on maximising value. The document says that 'companies shouldn't use customer money to pay for work beyond their own functions, but by working in partnership with third parties picking up a fair share of costs, there is the potential to deliver better outcomes overall.'
- We understand the rationale for ensuring that public value approaches are firmly rooted in the delivery of core services. However, there may be instances where water companies are justified and should be encouraged to undertake activities which go beyond their direct functions. In RIIO-2, for example, in the energy sector, one of the gas distribution companies, Cadent, in response to stakeholders' requests and with customer willingness to pay research to back this up, proposed a whole house approach to fuel poverty and an innovative mechanism to plug gaps in government funding. In practice this went beyond their core functions. But stakeholders felt the company was well placed to deliver this given their geographic footprint, their skill set, and as they could do it more cost effectively than other parties due to their existing activity and organisation. Critically there was a gap in provision against high need that the company could fill and the company staff and leadership were supportive of taking on the role. Ofgem had originally suggested that the criteria was around where the company was best placed to deliver support but the question was also one of the scale of support provided. The regulator compromised in the end on the funding of activity (though many proposals were still not allowed) but nonetheless this resulted in the regulator being somewhat at odds with stakeholder opinion and with risks to their legitimacy.
- **Ofwat should be open to some flexibility here where there is strong demand, a robust evidence base of the social return on investment and demonstrable customer willingness to pay.**

[1] Fair for the Future (sustainabilityfirst.org.uk)
[2] New-Pin (sustainabilityfirst.org.uk)

- **Further discussion on the boundaries of responsibility of water companies**/what are deemed core functions and how Ofwat will assess proposals as 'acceptable' use of customer funds would be useful. As noted in Ofwat's Public value in the water sector: a supporting set of principles paper, some companies highlighted the trade-offs they face under the current regulatory framework, and the tension between 'lowest cost versus most cost beneficial approaches' and 'lower-risk versus higher-risk approaches', where in both cases the latter might deliver greater social and environmental benefit. Judgement calls need to be made. Companies also suggested that a greater risk tolerance by regulators could be explored to encourage more innovative approaches.
- **Linked to the latter, to avoid late challenge and conflict, companies should be encouraged to share more innovative ideas on maximising public value as early as possible with the regulator.** Failure to do so could undermine trust in the regulatory decision making and engagement processes. **If the regulator does wish to set red lines in terms of what can be considered, then these should be made very clear and tested with stakeholders in advance**.
- **A clearer understanding of customers and communities** – despite improvements over the last ten years, companies are at different stages in terms of embedding a culture of engagement and many have not yet reached 'engagement maturity'. A continued focus on engagement and the robustness of the evidence base that underpins decisions is therefore especially welcome. It will of course be important for Ofwat itself to also continue to improve how it engages around price controls as well as companies. As our Discussion Paper 'How engagement can maximise public value in the essential services of water and energy' will demonstrate, now is not the time to take the focus off of engagement so we particularly support this theme.
- **Efficiency and innovation** – we especially welcome the focus on improvements to data and digitalisation including the need for companies to embrace **open data, resolving deficiencies in their data**, such as **their data on their business customers,** and to make extensive use of existing data on customer preferences and needs.

**Q2.2: Do you have comments on the considerations we've identified as relevant to the design of PR24?**

A: We agree with the considerations that Ofwat has raised. In particular the desire to: provide greater clarity for future price controls so that individual price controls are seen as 'stepping stones' to longer-term goals; support the need for in-period adaptability, the streamlining of the price control, and the desire to reflect local and national diversity (socially and environmentally) in decision making while maximising the benefits of comparability across companies.

However, the quest for regulatory simplicity and comparability should not be at the expense of improved outcomes for consumers, citizens and communities (See Q3.1 below).

Linked to the latter, while we agree that it may be better to conduct some aspects of regulation outside the constrained timetable of the price review e.g. in relation to consumer vulnerability, for this to work, Ofwat will need to set funding envelopes for those areas that sit outside and ensure appropriate customer/citizen challenge and assurance mechanisms are in place. Ofgem's RIIO-2 'Use it Or Lose It Allowance' (UIOLI) may be one funding model to consider. This allows money to be provided for these smaller initiatives but without the heavy regulatory oversight that is needed for formal Performance Commitments (PCs).

**Q2.3: How should we evaluate our progress, and how can we best develop or use appropriate metrics to do so?**

Having a clear baseline and set of well understood, and where possible measurable, desired outcomes is key to successful evaluation. Stakeholder engagement can be used to clarify these issues and to develop any accompanying metrics. These could potentially include

- Running an open and transparent process - with clear reasons for decisions and clarity on expectations;
- Timely provision of information – this can be absolutely key to enable meaningful engagement and response;
- Simplicity – to streamline the process and make it more accessible, less bureaucratic and ensure that companies have greater flexibility in terms of how they deliver outcomes – particularly in the face of uncertain climate impacts, technology etc - the number of detailed outcome based targets needs to kept down. Comparing the number of performance commitments, ODIs etc to the PR19 baseline could be one basic metric;
- Assurance mechanisms – the quid pro quo of streamlining PR24 is that Ofwat also needs to take a view on and encourage assurance mechanisms on wider company commitments and delivery. Developing metrics in this area will be difficult (and processes are moving quite quickly) but could include: development of an assurance map; an assurance gap analysis; an assessment of the strengths of different assurance mechanisms; and meetings with assurance bodies to understand how they have been engaged by companies in the PR24 process;
- Engagement – public expectations are changing and it is vital that Ofwat should keep abreast of and engage key stakeholders in its work. Metrics in this area could cover issues such as quality of Ofwat engagement, resourcing of different bodies that Ofwat seeks to engage with to ensure a variety of views are able to be expressed and taken on board etc; and
- Accountability – Ofwat should evaluate how effective its accountability mechansims in the PR24 process are. Metrics could cover whether it proactively publicly reports on performance against the metrics it itself will use to evaluate success, how many open and timely Q and A sessions it is willing to hold with key stakeholders to discuss overall progress during the review; whether it is willing to commission an independent agency to carry out the PR24 lessons learned exercise etc.

## How we regulate

**Q3.1: How can we best regulate the water sector to deliver value for customers, communities and the environment? Do you agree, or have comments on, our proposal to maintain our 'building block' approach based on outcomes, costs and risk and return?**

A:

- <u>Reducing the number of performance commitments - </u>We support in principle the proposal to streamline the common performance commitments and in particular that as far as possible these PCs should be outcomes not outputs based. This should help to increase transparency and accountability – and give companies more flexibility to deal with an uncertain pattern of climate impacts and changing social expectations. However, a balance clearly needs to be struck. We have some concerns that the regulator's upfront stated quest for fewer bespoke commitments, combined with its desire for greater regulatory simplicity, and comparability could discourage company-level engagement and innovation and lead to consumer/community needs and wants in practice not being heard or met. Or alternatively innovative bespoke proposals that companies develop with and in response to stakeholder needs/wants will be rejected as they are deemed too numerous.

In RIIO-2 for gas distribution for example, the regulator established the Consumer Value Proposition to encourage companies to maximise public value. Companies put forward a range of proposals many of which were driven by stakeholders. In practice Ofgem ended up rejecting the overwhelming majority of bespoke proposals as they felt they were outside of the boundaries of responsibility of the company, disagreed with the evidence base, or in particular as they had no comparable data including no common approach to assessing social return on investment. While the regulator has said they want companies to deliver these outcomes anyway (though not as formal commitments but as KPIs), in practice there is arguably little incentive for them to do so. Many of these proposed PCs had no or little bill impact yet would have delivered positive non-monetised benefits for consumers and communities helping to build trust in the sector. This was a missed opportunity, and the regulator was also heavily criticised for its approach – putting regulatory process before consumer outcomes.

The reality is that companies prioritise their regulatory-agreed performance commitments, in particular those with financial incentives and in 'practice what gets measured gets done'. A smaller number of well-considered outcomes based targets would in theory help to focus company activity on what is most material to consumers. Ofwat decisions on what common outcomes should be selected should be informed by stakeholder including customer feedback. Alongside this reduced number of formal PCs there also need to be mechanisms to monitor and ensure delivery against wider promises that matter to stakeholders including in areas where culture change is needed. In energy RIIO-2, for example, Ofgem is now considering an ongoing role for the Customer Engagement Groups to monitor progress against the bespoke PCs it rejected, now KPIs, strategies for consumer vulnerability, Environmental Action Plans, progress on purposeful business, digitalisation and innovation and engagement. These are areas that sit largely outside of the formal regulatory monitoring process, and also monitoring by the statutory watchdog, but matter to stakeholders and are important to see progress on.

Again the Use-it-lose-it funding model used by Ofgem in RIIO-2 allows money to be provided for these smaller initiatives but without the heavy regulatory oversight that is needed for formal PCs.

- Initial views on the PCLs - In principle we support Ofwat publishing its initial views on PCLs that correspond to the base costs ahead of business plan submission. It will be especially important however to ensure that these are set at a suitably challenging level and in line with stakeholder expectations to prevent unintended consequences.

- Incentive rates - we support Ofwat using findings from collaborative customer research to inform its initial views on ODI rates. A lesson learned from PR19 is that engaging on incentive rates is challenging. Well-designed qualitative and deliberative research is needed for customers and even expert stakeholders to give meaningful informed views.

- Ofwat's approach to addressing costs - There seem to us to be a number of issues around potential limitations to the econometric approach for cost comparison. For example, the approach can, if not carefully applied, discriminate against expenditure which does not have clearly defined and/or non-monetised outcomes. The example cited elsewhere in the document from Anglian Water's community spend is just one of these – others might include waste reduction/reuse of construction spoil and imposing sustainability requirements on supply chains which marginally increase unit costs. We do not think it is sufficient simply to say that companies are free to continue doing these and that the totex amounts are relatively small. We have argued elsewhere that creating a freestanding totex pot, outside baseline totex, to be spent on community and other local/sustainability initiatives, and with assurance of value for money delegated to those communities and/or company specific assurance such as CCGs.

**Q3.2: To what extent is greater co-ordination required across the sector? In what ways might we promote better co-ordination across companies and with other sectors, and how might this benefit customers?**

We strongly welcome Ofwat's focus on collaboration. Greater coordination across the water sector and with other sectors would be valuable in areas including:

- Resilience and safety
- Sustainability and behaviour change
- Consumer vulnerability and water poverty
- Engagement
- Social return on investment

It will be important for Ofwat to incentivise (whether carrot or stick) water companies to collaborate to maximise public value and efficiently deliver core services. While there are examples of excellent collaborative practice, approaches are not consistently good especially strategically across sectors. As noted in our response to Q2.1 in defining the company's boundary of responsibility Ofwat needs to ensure that it doesn't overly limit companies' opportunities to maximise public value from collaboration.

We would also note that the benefits of co-ordination go beyond customers to include communities, citizens, future generations and indeed nature itself. This wider framing – which the government commissioned Dasgupta review[3] has so powerfully highlighted - is important when thinking about why co-ordination is important and the weight that should be given to it in the PR24 process. It is one of the reasons why we consider that a focus on culture and behaviours, and ethical regulation, is also important in the price review (see response to Q5.9).

Resilience and safety

We support Ofwat's view that companies need to improve their understanding of **resilience risks** so that steps can be taken to safeguard future services. In particular there appears to be a need for the sector as a whole to better understand **indirect risks** to company resilience. For example, despite cross-company water resources activity there seems insufficient understanding how other

[3] A central message of the review is that we are part of nature not separate from it. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962785/The_Economics_of_Biodiversity_The_Dasgupta_Review_Full_Report.pdf

companies' and actors (on whom water companies depend) climate mitigation and adaption strategies will impact resilience.

The Covid-19 pandemic has taught us just how dependent we are on our core energy, water and (electrically enabled) communications systems. Water needs electricity. Producing water and dealing with wastewater are energy intensive activities – whether for abstraction, distribution or treatment most water companies use significant amounts of energy and have for many years had an eye to how they can manage those costs. We have also seen how major energy disruptions such as those in 2019 can lead to water supplies being jeopardised if back-up power supplies fail. A focus on increased resilience in water requires thought about how to deal with power outages (and any potential resulting impacts on the communications and transports links on which water companies depend) .

Companies can have seemingly poor visibility of their **dependencies on other sectors and stakeholders**. According to Dr Emily Cox[4] the impact of interruptions in essential services on other sectors appears to be relatively understudied, particularly regarding shortages of labour and skills, which could be caused by disruption to transport systems, healthcare and education.

Mitigating and adapting to climate change including more severe and frequent droughts, storms, intense rainfall and urban heat, and repurposing existing infrastructure, new technologies alongside security threats and increased interdependencies between energy, water, and communications, means ensuring safety and providing reliable affordable supply is becoming **increasingly challenging but also increasingly important**. The increased risk of flooding creates an adaptation challenge for the energy sector. Finding solutions that benefit both sectors is an opportunity that should be explored.

These crucial interactions around resilience have been highlighted by the National Infrastructure Commission and need to be built into PR24. But also companies themselves need to share resilience plans and understand the risks as each other sees them. As Sir John Armitt, the Chair of the National Infrastructure reminds: "To be resilient, we need to move beyond managing individual risks and assets, to thinking about the system as a whole and how the services we all rely on can be sustained and disruptions minimised. … To achieve this we need to think more about the interdependencies between different sectors, and do more to manage the cross cutting challenges. We should also consider how to better take into account public expectations of infrastructure services – we are all infrastructure users after all."[5]

**Safety** is hard-wired into utility culture. But linked to the above, delivering safety is becoming more challenging. In the short-term, *anecdotally,* we have heard that during Covid in the energy sector there has been an increase in 'near-miss' safety incidents. This could be for a variety of reasons including as a result of behavioural challenges such as staff only able to take in one safety message at a time (with Covid front of mind), fewer people seeing safety warnings with home working or changing patterns of work leading to new risks. We would welcome understanding if water companies are facing similar challenges and if there is sufficient collaboration on safety. In particular, how do water companies seek to **understand potential future safety risks that result from whole system challenges**? Any lessons must be captured, learned and good practice shared.

Our previously mentioned Engagement Discussion Paper will highlight that companies, government departments and regulators need to further improve how they engage and work together across-

[4] The impacts of energy disruptions on society | UKERC | The UK Energy Research Centre
[5] https://nic.org.uk/app/uploads/NIC_Resilience_Scoping_Report_September_2019-Final.pdf

sectors to better understand new safety challenges and resilience interdependencies and risks. Involving staff, consumers and citizens to better understand the dependencies between the different services that they use in their day to day lives, and during times of crisis, is important.

We would also flag the potential for further work on water and health interactions in terms of public safety that the pandemic has exposed – hand washing, monitoring wastewater for early signs of Covid-19[6] etc.

Sustainability and behaviour change

As Ofwat has highlighted, it is no longer enough to rely on traditional top-down supply side focussed solutions to resilience and sustainability – solid/hard brown/grey infrastructure and technically focussed measures. Arguably less controllable and less reliable domestic and business consumers and wider stakeholders (including farmers, land-owners, developers and transport bodies – along with communities) need to be part of the solution to more sustainable and reliable services. However, public awareness of the need, and the 'enablers' to help them change behaviours, are not generally well known. Many companies also lack in-house expertise on behavioural approaches. And there has not been sufficient focus on how to build from and effectively link individual behaviour change initiatives to wider societal, cultural and systems change.[7]

Energy efficiency and water efficiency have been promoted for a number of years with ad-hoc efforts to link the two issues more closely. Saving water will always save energy (as less water has to be produced) but saving hot water delivers a double whammy. Current messaging around water efficiency does not always give that additional focus to hot water usage that it might and neither sector strategically links consistently to the wider sustainability debate (eg through educational outreach programmes)[8].

Place-based solutions such as catchment management when done well can be more cost-effective in delivering sustainability and resilience and offer greater public value. But these systemic solutions are arguably not yet sufficiently incentivised by siloed sector based decision-making frameworks. Engagement can help identify common local interests and the co-benefits that could encourage all sides to help deliver such schemes.

Recommendation 4 on our Discussion Paper on engagement is that utilities including water **companies should set up a central net zero/sustainability umbrella engagement body to develop national cross-sector 'sustainability' campaigns and whole-systems behaviour change** innovations to help consumers and citizens better understand the 'big picture' climate and biodiversity challenges facing utilities, how these will impact them and society, and the consumer/citizen role (and choices) linked to this. This would sit above and compliment and support water sector specific, regional and company activity alongside more deliberative engagement e.g. current water efficiency campaigns, Smart Energy GB communications; and any engagement around low carbon heat / net zero and biodiversity. It could ensure lessons learned (not reinventing the wheel) from campaigns to date; enable common messaging, a recognised pre-requisite for behaviour change; help to coordinate existing fragmented activity to maximise impact and set out the wider climate change and biodiversity challenge. Campaigns need to build not just awareness but true public

[6] https://www.gov.uk/government/news/testing-and-sequencing-of-sewage-ramped-up-to-help-tackle-covid-19-outbreaks
[7] Sustainability First will be holding a conference on this topic from a climate perspective on 21/22 September. Further details available on request.
[8] Sustainability First is piloting educational outreach activity in this area in the run up to COP26 and will be evaluating this in due course. Please get in touch if you would like to partner with us in this area.

understanding and consider how sustainability can be properly and consistently included in school curriculums.

**Net zero**

Beyond water, the Committee on Climate Change's Sixth Carbon Budget has emphasised the need for significant behaviour change to deliver net zero and estimated that over 40% of the carbon reduction in the scenarios to 2035 is from consumers adopting new low-carbon technologies and a further 15% requires consumer choices; both to reduce demand and improve efficiency.

With the water sector looking to decarbonise its own operations – as reflected in Water UK's Net Zero Routemap - many water companies are looking to invest in renewable generation at their sites. However, the changes being driven through by Ofgem on transmission charging reportedly mean these plans are no longer viable. The changes are designed by Ofgem to ensure that the fixed costs of the networks can be recovered in a fair way (as the water companies still need the networks to be there even if they don't plan to use them except in emergencies). Water companies are not unique in facing these challenges but this highlights the importance of them keeping close to developments in energy regulation.

There may be opportunities for water companies in the huge growth **expected in energy flexibility** and the potential for water companies to adjust usage at times when there is either too much or too little energy on the system. The Power Responsive programme which Sustainability First helped establish for National Grid provides a way for companies – including water companies – to understand the future needs of the grid and the commercial opportunities that presents.

Attempting to put this into practice, a network innovation project led by National Grid ESO working with United Utilities looked at the scope for water management services to be used to provide flexibility services to the grid by how they manage their catchment. The innovation funding now being provided by Ofwat could provide a further opportunity for developments in this space.

**Biodiversity**

PR24 presents a vital opportunity to progress and mainstream nature-based solutions in the sector's work. As nature is frequently 'mobile' and 'dynamic' these approaches often require significant co-ordination across the sector and in particular joint solutions with other actors (landowners, farmers, developers, community groups etc). Current work to improve the measurement of natural capital and on biodiversity net gains should make a stronger case for such approaches.

In PR24 it will be important to clarify roles and responsibilities – eg what is the role for water companies when the biodiversity and habitats impacts of an activity are not central to their core operations but which other actors consider are important? To address some of the complex interdependencies in these areas, PR24 will need to firmly align with the work of WINEP and other related activities and consider company strategies and strategic partnerships in these areas. Water companies, which often have significant natural capital expertise, will also want to show social leadership in terms of delivering public value by sharing this expertise with others inside and outside of the sector.

<u>Consumer vulnerability and affordability</u>

**Partnership working**

Our SUSTAINABILITY FIRST research has found that the pandemic has increased the number of households in financial difficulty and the depth of poverty for those who were already struggling pre-Covid. Existing geographical variations in deprivation and inequalities between different social groups have also grown. Ultimately affordability is a cross-sector issue which requires a cross-sector approach to cost effectively tackle it. However, our Project Inspire report found that collaboration between companies and across sectors can be more expensive, time-consuming and complex to set up[9]. Our experience is that not all companies are willing to collaborate even when they share customers. SUSTAINABILITY FIRST's Engagement Discussion Paper outlines the benefits of partnership working on consumer vulnerability issues.

Recommendation 10 of our Engagement Discussion Paper is that: Cross-sector utilities and relevant third sector organisations should collaborate with interested and impacted stakeholders to set up place-based vulnerability community partnerships, equivalent to the Australian Thriving Communities Partnership (TCP), in their areas of highest deprivation and greatest vulnerability need. These should go beyond bi-lateral collaborative approaches. Formal partnerships can enable a more flexible customer-centric approach to vulnerability and can be relatively cost-efficient in meeting consumer and community affordability, inclusion and resilience needs. This would be especially valuable given resource constraints and could potentially support the 'levelling up' agenda.

Regulators should consider how they can 'encourage' more strategic cross-sector partnership working and reward those who show leadership in this area when designing the PR24 methodology. For these kinds of place-based approaches to work regulators have to agree to accept the decisions of the community when making their final determination. This would also appear to be in line with UK Government's Civil Society Strategy 'where people are empowered to take responsibility for their neighbourhoods'.

**Vulnerability evidence base** - **Companies should improve their affordability and vulnerability evidence base through joint commissioning of research and timely sharing of engagement and research insight.** Engaging customers in vulnerable situations or hard to reach groups can be more difficult and more expensive, making it all the more valuable that company research funded by customer money is shared in a timely way. Sharing insight beyond companies can also allow third parties to use it to deliver wider public value. Some challenges are common to all companies or groups of companies in a given region and in some instances companies have the same customers.

Vulnerability insight is currently not well shared, with much duplication of effort. Competition between companies (arguably a healthy 'desire to be the best') can discourage in-sector sharing as can: regulatory business plan incentives with a company comparative competitive element, resource constraints, lack of will, or misaligned timetables and priorities. 'Higher performing', companies who share research can become frustrated by one-way sharing relationships with utilities who don't foot the bill, nor share the burden of research project management, but reap the benefits of the outputs.

**Ofwat should ensure that they do not unintentionally discourage collaboration and consider actively rewarding those companies that show leadership in this area**. Late in the PR19 business plan development process, the then CEO of Ofwat verbally indicated that companies that showed leadership in sharing engagement learning would be viewed positively by the regulator. This kind of important regulatory signal should be made at the beginning of the business planning process and apply equally to BAU.

An additional reason for co-ordination in this area is that due to a lack of collaboration, resource

[9] Inspire (sustainabilityfirst.org.uk)

strapped stakeholders can also be asked comparable questions by multiple companies which is inefficient use of their time[10].

Social return on investment

Recommendation 1 of SUSTAINABILITY FIRST's Engagement Discussion Paper states that companies, regulators and public interest groups should work together to co-develop agreed social return on investment (SROI) metrics for essential services for assessing public value. This would help to support best public value decisions and ensure opportunities to deliver wider societal benefits are properly understood and not missed. It would also help provide transparency around the values, assumptions, methodologies, and trade-offs made in decision-making including for PR24 business plans.

Public engagement will be key to understanding social impacts/returns. For RIIO-GD2 business plan development a number of companies used SROI in making their business case for investment. In its final determination Ofgem stated that as "GDNs currently do not have a common SROI tool, we are unable to implement this metric for the start of RIIO-GD2" but encouraged companies to work together to develop this. The electricity DNOs have taken this further and have a common methodology although it remains unclear whether this has Ofgem's full support. The CMA appeals in water also highlighted the need for Ofwat to be more transparent in how it makes its 'discretionary' decisions/value judgements to have legitimacy and build trust. Providing such clarity early in the process will help companies in shaping their plans. It is in Ofwat and companies' interests to prioritise and accelerate achieving a consensus in this area.

Potential mechanisms for supporting collaboration

Competition can be valuable at driving innovation and cost efficiency, but it can also disincentive collaboration and timely sharing of information which would be in the public interest. Ofwat needs to consider carefully therefore where it uses competition and where incentives to collaborate would be more beneficial.

Ofwat's proposed Principle 5 in its recent public value principles document[11] that "Companies should consider where and how they can collaborate with others to optimise solutions and maximise benefits, seeking to align stakeholder interests where possible, and leveraging a fair share of third-party contributions where needed" **is helpful at setting industry expectations but not on its own sufficient.**

The industry's track record to date and our more recent experience of Water Resources South East is that not all companies collaborate well with some of the larger water companies with greater resources contributing the least. **Cross company and in particular cross-sector collaboration can be more complex, risky and time and resource consuming there needs to be some mechanism - whether carrot or stick - to encourage cooperation.**

This could include the following:

- **Financial/reputational incentives** - In the RIIO-1 price control in gas distribution Ofgem set up a financial stakeholder engagement incentive, one element of which was to encourage cross company engagement on safety and other issues. As the awards and commentary

[10] Discussion Paper: How engagement can maximise public value in the essential services of water and energy – July 2021

[11] https://www.ofwat.gov.uk/publication/public-value-in-the-water-sector-a-supporting-set-of-principles/

were published this also acted as a reputational incentive. While not without its lessons learned (which we are happy to discuss), this was ultimately quite effective at driving improvements.

- **Targeted challenges** on the areas where collaboration is needed could also help drive improvements.
- **Regulatory signals and procedural incentives** - In PR19 Ofwat said companies would not be fast-tracked if they did not carry out high-quality engagement. This was a useful incentive – and collaboration in this area should be part of this.
- Require effective in-sector and cross sector collaboration to be part of a **minimum business plan requirement or the company faces a penalty. E.g.** In RIIO-2 for energy transmission and gas distribution, companies were expected to undertake high-quality engagement (which could include collaborative working) else they risked a penalty and would not be able to access financial rewards.
- **Incentive payments** contingent on industry performance or stakeholder involvement. This would give greater incentive for collaboration and for the leading companies to share knowledge.

**In all cases care would need to be taken to ensure the approach didn't result in tokenistic partnerships rather than strategic meaningful collaboration.**

Whatever the incentive introduced its should be supported by a requirement on companies **to develop an engagement strategy** for the next AMP (Ofgem required this of energy companies for RIIO-2). This would among other things require companies to think strategically about engagement. In particular to identify key impacted and interested stakeholders and also those that impact the company's performance and sustainability; and critically to identify opportunities for leadership and partnership working to support both efficient delivery of core outcomes and also to maximise public value.

## Increasing the focus on the long-term

**Q4.1: What are your views on the need for greater focus in companies' regulatory business plans on how they will deliver for the long term?**

A: We agree with Ofwat that a rebalancing towards the long term is required. This is both because of the twin challenges of adapting to climate change, net zero and the biodiversity crisis; and what we view as a systemic underweighting of the interests of future consumers. These issues of inter-generational equity have been explored in a paper that was produced for us recently by Frontier Economics[12].

**Q4.2: What should long-term strategies seek to cover and what details should we expect companies to set out in business plans? Would common requirements help us and other stakeholders to understand each company's approach?**

A: From a climate and resilience point of view, long term strategies should be based around the adaptive approach outlined in the Defra guidance: Accounting for Climate change. This will require wider use of scenarios than traditionally – and there is a strong case for agreed industry wide scenarios. It should also identify areas where action now can create time and flexibility to respond to different futures: for example, to high scenarios for drought and/or lack of action in building regulations on water efficiency. Consideration is also needed as to whether a similar approach is

[12] A framework for considering fairness between generations (sustainabilityfirst.org.uk)

also needed for *some* common biodiversity challenges (whilst recognising the very significant variations that can occur in this area).

In addition, to environmental and resilience issues, companies should set out longer terms strategies for consumer and community vulnerability (to ensure inclusive accessible service and protection in a future world) and as far as is possible affordability, including to meet the 2030 Water UK Public Interest Commitment on water poverty[13]. As mentioned in Q2, in planning a future strategy companies would need to take into account projected socio-demographic change e.g. projected changes in disability and health conditions; impacts of future pandemics; likely changes in how people work and live e.g. growth in single person households which can be a vulnerability risk factor; alongside consideration of the likely impacts of wider social, attitudinal, environmental and technological change.

**Q4.4: How can we allow such strategies and plans to adapt to new information at future reviews while continuing to hold companies to account to deliver expected benefits into the future?**

We can, first, see some scenarios where companies may need flexibility to change plans within price review periods – perhaps along the lines of the Ofgem's reopeners. The need for these may be less marked in water than energy, but we would not rule out in period reopeners for issues such as technological developments (smart meters, AI?), scientific developments (e.g., for major changes in climate projections following the IPPC 2022 exercise) and policy developments (failure to change building regulations or implications of planning reform for water use). Second, we strongly support the creation of clear rules around 'adaptive planning'. Some of the considerations here are set out under our response to Q4.7. Our report '[Regulation for the future: The implications of public purpose for policy and regulation in utilities (sustainabilityfirst.org.uk)' includes an extensive discussion on adaptive planning and adaptive regulation.]

**Q4.7: What are your views on how we could provide clarity over the long-term regulatory framework?**

A: There are a number of challenges to a conventional economic appraisal approach to projects and programmes responding to climate change in particular. The Defra guidance 'Accounting for Climate Change' makes it clear that conventional net present value analysis cannot on its own prove sufficient. We think only Ofwat can take the lead in PR24 in bringing parties together to agree an appropriate appraisal process.

A further related challenge is how to value and appraise the creation of potentially redundant assets, noting that an element of redundancy is a key part of the government's approach to resilience. Again, we feel that Ofwat need to propose the methodological approach here – noting in particular the interrelationship between this issue and the appropriate standards of service which companies should be remunerated for promising to consumers.

**Q4.8: Are there barriers to water companies changing how they deliver their core functions to deliver greater environmental and social value? How can we address any barriers?**

A: We welcome Ofwat's espousal of the public value – the 'environmental and social value' of the question - which can and should be delivered by water companies. We argue strongly however that the cultural change in the industry which is an essential part of delivering public value can only be

[13] Public Interest Commitment | Water UK

achieved by moving away from a company/Ofwat relationship which is dominated by the price control process. This will require Ofwat being willing to take some measured risks, in freeing up companies to develop approaches with other stakeholders and different assurance mechanisms. A number of our other answers to the questions in this consultation and Sustainability First's Regulation for the Future report[14] expand on this: but in essence, the more Ofwat can focus its direct intervention on major spend, efficiency and the cost of capital/financeability the better. But this can only be done with robust alternative mechanisms in place to monitor and provide consumer/community challenge, scrutiny and independent assurance. We are happy to discuss this further.

**4.9: Do you have any further suggestions for increasing the focus on the long term? If so, what are these?**

A: There is a role for deliberative engagement to inform approaches e.g. citizen juries/assemblies. It is also important for Ofwat to work with government actors (eg Defra, the EA, NE, the NAO, the NIC etc) to develop 'safe spaces' to consider some of the trade-offs around the wicked issues that PR24 will need to address.

We consider that a common set of 'sustainability principles' is needed to guide attitudes and behaviours in PR24 (and other price controls ) to support the shift in culture that is starting to take place and which is essential for a more sustainable and long-term approach. Our major new 'Sustainability principles' project has begun to address this issue.[15]

## Getting more for customers, communities and the environment

**Q5.1: Should we undertake an initial assessment of plans at PR24? If so, what areas should we focus on this assessment?**

**Q5.3: Should we streamline the price review by combining different steps in the process? If so, which of the three options outlined in this paper should we consider? And are there other options we can usefully consider?**

A: The key driver of any approach should be maximising positive consumer and community outcomes and minimising risks. With an additional aim being reducing the regulatory burden on all parties. For PR19, the Initial Assessment of Plans and fast-tracking procedural/reputational incentive appears to have encouraged many companies to strive to deliver good quality business plans. However, as Ofwat highlights there was limited movement in key aspects of companies' plans between IAP and draft determination;. arguably as there was seemingly limited incentive for companies to make substantive improvements after Ofwat's assessment had been issued. Ofwat also notes that companies valued the feedback the regulator gave them during the price review, in particular following the IAP stage.

Rather than a relatively back-ended feedback process therefore, we would support an approach that provided companies with **early** challenge and **feedback** on the quality of their business plans, or aspects of their plans, so they have the time and are incentivised to make improvements prior to, but up to, the final submission.

[14] Regulation for the future: The implications of public purpose for policy and regulation in utilities (sustainabilityfirst.org.uk)
[15] https://www.sustainabilityfirst.org.uk/sustainability-principles

A real strength of the RIIO-2 approach in energy is that companies had/have early challenge on the overall quality of the business plans from both the Customer Engagement Groups – CEGs (whose remit goes beyond engagement) and the central Ofgem-led Challenge Group. In the case of gas distribution and electricity and gas transmission, this led to substantial improvements in the plans with, in some cases, whole plans rewritten in the interests of all parties. It also significantly reduced the number of follow-up questions that Ofgem had (which still remained high!) allowing the regulator to focus on clarifying more substantive information.

One downside of this approach which has been addressed in the current RIIO ED2 arrangements was that draft plans were generally not published and hence only the Ofgem Challenge Group was able to look across them (with only a single version submitted to Ofgem). The ability for the CEGs (and other stakeholders) to look across companies would have helped them in gauging whether plans were genuinely ambitious compared to others. This transparency is a positive feature of the previous Ofwat approach that should not be lost.

Ofwat should consider if a draft business plan or certain aspects of the plan could be submitted for early feedback either to the regulator or to a central PR24 expert challenge panel e.g. historical performance or business plan engagement strategies which might be at the beginning while bespoke outcomes would be at the end of the process. Such a Group or Ofwat would have the advantage of being able to take a comparative look across all companies, even while the plans are in development. Good practice/and expected benchmarks could be shared in a timely way between and with companies. This kind of process would deliver better outcomes for consumers and in particular support regulatory decisions/benchmarking in relatively new areas where there is little historical or comparative information. It would perhaps also help Ofwat's assessment process (giving greater visibility of the direction of companies' thinking) and iron out teething problems/issues of interpretation in the methodology early on. This would also arguably be a more collaborative and less adversarial approach in the public interest.

Companies could still be encouraged to establish their own robust challenge processes on the plans. Ofwat's DD would then make a final assessment on the plan so there was an incentive for companies to continue to make improvements up to the final decision being made.

Areas of focus

In terms of the areas of focus for any assessment we would welcome a focus on how the companies will:

- Address affordability and vulnerability concerns – this is especially important given social changes following the pandemic.
- How companies will maximise public value and how this is embedded throughout their plans
- Preparing for the long-term
- The quality of the evidence base underpinning the business plan including stakeholder insight
- Address whole systems issues, addressing the gaps in cooperation and understanding identified in Q3.2
- Companies' approach to setting bespoke outcomes and strategies e.g. for digitalisation, innovation, engagement.

**Q5.2: Should we consider adopting a more light touch approach at PR24 for companies with a strong track record of delivery during the PR19 price review period? If so, what factors should we consider in our assessment and why?**

A: Ofwat would need to have confidence that: companies have a genuinely strong track record in the area where the regulator is adopting a lighter-touch approach; that company specific risks are taken into consideration (e.g. changes of ownership) and are unlikely to impact performance; and that the business plan was sufficiently ambitious and aligned with longer-term strategies. Companies would need to outline their own alternative mechanisms for customer challenge and assurance in the absence of regulatory scrutiny and the regulator would need to be clear up front on what it would consider robust arrangements in these areas might look like.

**Q5.5: What incentives should we provide for high quality plans at PR24? If we don't make use of early draft determinations, how else might we strengthen incentives to table high quality plans on first submission?**

As noted in Q5.1, we believe there is value in requiring publication of early draft plans and to establish mechanisms to enable early feedback and challenge on the companies' approach and proposals.

**Q5.6: How might we set cost sharing rates at PR24? Should we consider an approach based on our ability to monitor companies' asset health status?**

There are two elements that Ofwat should consider in setting cost sharing rates. The first is to ensure that there remains sufficient incentive for companies to drive for efficiency which will benefit customers and wider stakeholders as these become the baseline for future price controls. The second is whether Ofwat can distinguish between genuine cost efficiencies and cost-cutting that is about failing to deliver in ways that the regulatory regime does not pick up. This could be about letting asset health (infrastructure but also environmental assets/natural capital) slip (if this will only be visible in the longer term) or skimping on other aspects of public value if they are not captured as PCs.

In energy Ofgem has put some effort into developing methods of tracking asset health and this would seem an important focus for a range of reasons. Attempting to fine tune cost sharing rates dependent on ability to monitor it risks introducing uncertainty into the arrangements and hence diluting the incentive. Ofgem introduced more complex rules around cost sharing linked to a judgment on the certainty of the costs involved. This was hard to understand and risked appearing subjective.

**Q5.7: Which areas should we be considering targeted challenges for at PR24, and why?**

A: We consider the shift to focusing on common outcomes (eg on abstraction and environmental quality improvement) is important to help streamline the regulatory process. However, there are some areas where we consider targeted challenges may be appropriate, for example, to accelerate innovation or to deliver whole-system benefits.

We support a targeted challenge on water efficiency and reducing harm caused by discharges from the wastewater network. We've been largely underwhelmed by initiatives to promote the former and there is seemingly significant scope for greater innovation, including better use of data and more strategic engagement and collaboration which could drive improvements (including cross sector initiatives with energy efficiency). Stakeholders including customers, citizens and communities should inform the areas selected and any ambition level set.

A targeted challenge on water efficiency should help companies take a wider / whole systems view than just the direct impact of water efficiency on the environment/abstraction and should encourage focus on the wider benefits this can have e.g. on the link between water efficiency, and heat/electricity use, and the link between that and carbon reduction and resilience of electricity networks, and therefore help support the resilience of water systems themselves.

**Q5.8: Should we use innovation specific incentive mechanisms at PR24? If so what would these be, and what would they add in addition to the other mechanisms outlined in this chapter?**

The idea of an innovation fund has real merit and, as Ofwat indicates, the early experience looks positive. In energy the idea of an innovation fund is that it supports innovations where the 5-year price control arrangement can create a disincentive to innovation (with uncertain paybacks over a longer period). More importantly it also funds innovation in areas such as the environment where the companies do not stand to benefit directly themselves or there is insufficient commercial incentive to innovate. It is important that any innovation funding is conditional on the learning being shared across companies in a timely way. Ensuring wider stakeholders can also participate in funding bids is also important to bring in expertise, so that projects work in practice (eg will stakeholders 'play'?) and to ensure the fair share of risk and reward.

**Q5.9: In what ways might we promote the themes of EBR through PR24?**

In our Regulation for the Future Paper[16] we highlighted the importance of approaches that incentivise whole company cultural and behavioural change over specific outcome incentives which can encourage a short-term, transactional and compliance mindset. This type of approach, and a focus on collaboration (the importance of which is outlined in our response to Q3.2 above), is central to thinking on ethical regulation. We consider that EBR is perhaps best focused in the following areas:

1. Aligning the interests and building consensus between investors, companies and wider stakeholders on the strategic plans that the companies need to develop to meet long-term goals which the PR24 business plans then need to sit within;
2. Guiding behaviours when making trade-offs between some of the key wicked issues that will be tackled in PR24; and
3. Shaping decisions on what a fair share of risk and reward looks like when delivering public value and co-benefits, particularly when these decisions have impacts which go beyond minimum statutory obligations.[17]

For an EBR approach to be effective, Ofwat will need to consider what the package of measures put forward in PR24 looks like in the round. It will need to consider how far its approach to EBR is integrated into the core PR24 process and what it will do - and how it will behave - differently when an EBR approach is taken.

## Reflecting Customer Preferences

The response below should be read in conjunction with our response to Ofwat's earlier consultation: PR24 and beyond - Reflecting customer preferences in future price reviews.pdf (sustainabilityfirst.org.uk)

[16] Regulation for the future: The implications of public purpose for policy and regulation in utilities (sustainabilityfirst.org.uk)

[17] https://www.ofwat.gov.uk/wp-content/uploads/2020/12/Ofwat-Response-to-Public-value-discussion-document.pdf

In addition, we direct Ofwat to our new Discussion Paper – How engagement can maximise public value in the essential services of water and energy, which will be published shortly.

**Q6.1: What are your views on the merits of our proposals for a collaborative approach to standardised and/or nationwide customer research to inform company business plans and our determinations?**

A: For the agreed centralised research, we strongly encourage Ofwat to require nationwide research which involves customers of all companies being included in one research project, with customer samples that are robust at company level, plus a collaborative approach to bespoke engagement to minimise differences. Standardised research which requires all companies to agree a common methodology will likely be more complex to agree and arguably require separate consistent company level assurance to be robust. With the best will in the world, if companies deliver this themselves, it will inevitably be delivered differently and the process would be less transparent, undermining the comparability of the results and the whole point of centralised research. For example, a company may welcome 'flexibility' so they can carry out engagement to their own timetable or combine it with other research activity. The timing of research – what's in the news/events of the day can significantly influence responses; the discussion before a question is asked, can significantly influence responses and how people think about the issue. If Ofwat wants to have confidence that variations between companies' customers are genuine it needs to keep the collaborative research as simple as possible and minimise these differences.

**Q6.2: Do you have any suggestions for how we best implement the collaborative approach to customer research for the price review?**

We think the approach proposed with a steering group, independent advisory group and delivery group - and the roles identified - is sensible. This structure needs to be set up as soon as possible.

We emphasise the following points from our initial consultation response:

- Ensuring effective high-quality of engagement requires two key skills sets – an understanding of research methodology and an understanding of the relevant policy issues being engaged upon e.g. to check the framing of engagement is balanced/companies are asking the right questions. We encourage Ofwat to involve independent research methodology experts with live up to date knowledge, including about more innovative approaches in the Advisory Group. This is really important as none of the key sector players despite their commissioning experience have a track record of using particularly progressive/deliberative engagement or new technologies themselves.
- There needs to be a mechanism for independent members of the Advisory Group to observe engagement in practice e.g. observe cognitive testing of quantitative tools to check they are properly understood and to intervene if they are not fit for purpose. In our experience there can be a significant disconnect between the sales pitch of how great research is and delivery in practice.

**Q6.3: Are there aspects of negotiated settlements that could be reflected in our price review framework?**

Allowing some elements of the business plan to be agreed between the company and stakeholders – perhaps within a Use It Or Lose It framework for funding – can be seen as in the spirit of negotiated settlement. This activity should be value add, though to minimum common standards, for all water companies.

'Ceding control'/letting communities take the lead, may be especially suited to areas of relatively low monetary value e.g. consumer vulnerability, but high consumer and community importance; where collaborative cross-sector working is especially important in the public interest e.g. on resilience; in geographic areas where existing governance structures or initiatives are already in place e.g. net zero city/local authority initiatives; and policy areas where regulators have less visibility of local needs.

We think it is for companies to identify and propose areas where this might be useful. Autonomy could potentially be earned by high performing companies with a strong track record of good quality engagement.

Companies would have to demonstrate that they have effective stakeholder engagement and assurance processes in place. This kind of collaborative decision making could take a range of forms e.g. formal partnership agreements, creation of Community Interest Groups, water company participation between local authority or other locally led initiative. Companies and communities should come forward with their ideas as to where regional or community led-decision making, rather than regulator-led, is in the public interest.

We would encourage Ofwat to require companies as a minimum to co-develop strategies and action plans for engagement for the next AMP in the following areas: consumer vulnerability; community resilience; and digitalisation. Companies could establish their own independent challenge mechanisms to monitor and transparently communicate progress against these. The former would help to further embed a culture of engagement; consumer vulnerability strategies should require a cross-sector approach to maximise value as should the company's community resilience strategy.

See also Sustainability First's discussion paper – How engagement can maximise public value in the essential services of water and energy – which will be published shortly for further examples.

**Q6.4: What are your views on our proposals for customer challenge of business plans and assurance of customer engagement? Q6.5: What are your views on whether we should develop minimum standards or provide guidance in other areas?**

We broadly welcome the proposals. We see three key activities or roles that are required:

1. **Independent engagement assurance (quality of engagement and use of insights)** for a) the company's bespoke local engagement for the PR24 business plan (engagement outside of the centralized process) and b) also for 'continual' engagement. This is so Ofwat and wider stakeholders can have confidence in the quality of the evidence base that underpins company decisions and transparency that they are responding to customer needs and views. As outlined in our initial consultation response, to ensure consistently good quality engagement, minimum commonly agreed standards are critical.

2. **Holding the company to account** for a) its commitments to stakeholders and b) to ensure it responds/adapts to changing stakeholder views and needs in the business plan and within price control periods. This is especially important given the streamlining of performance commitments and as more company activity is likely to sit outside of the formal price control process.

   Minimum standards should include a requirement on water companies to ensure those holding the company to account are a) genuinely independent and able to operate independently b) are provided with balanced information and views from a variety of perspectives including CCW and Ofwat and c) that scrutiny is undertaken by people with the skills, knowledge and expertise to perform the role. This may seem like an obvious point but some CCGs appeared to lack the research methodology skills needed to provide an assurance role on engagement, and we are aware that the quality of scrutiny by stakeholder fora is incredibly variable, often only as good as the quality of membership who are able to participate.

Following its review of its enhanced engagement process**,** Ofgem is expected to recommend an ongoing role for the in-company independent customer engagement groups to hold companies to account for their business plan promises. This will include regular reporting on company progress. This is likely to include a focus on the delivery of: the companies bespoke ODIs, engagement strategies and roadmaps, environmental action plans, consumer vulnerability and purposeful business/responsible business. This kind of ongoing challenge role would be particularly valuable in areas that sit outside of formal regulatory or CCW monitoring process and for bespoke company promises where existing organisations lack the resource to robustly monitor.

3. **Early expert challenge on the business plan –** to support the delivery of high-quality plans. This could include an expert PR24 Challenge Panel (see Q7.3 for our recommendations related to this) alongside company-designed critical friend mechanisms.

While we welcome CCW publishing its report on best practice triangulation we are aware that during the PR19 CMA challenge process that it became apparent that Ofwat and CCW had different views on what good triangulation looked like. Achieving a timely consensus is therefore especially valuable.

We strongly support the focus on developing agreed minimum standards over guidance. We think the standards proposed provide a useful starting point but need further developing. We look forward to discussing them in more detail with Ofwat and wider stakeholders. In particular, it will be important that minimum standards can be transparently assured against (that a third party is able to take a view as to whether they have been met/not met and knows what evidence might be provided to meet the standard); that they focus on the areas that have the biggest impact on consumer and community outcomes and that they specifically target common company engagement weaknesses e.g. strategy and planning, feedback loops, strategic stakeholder mapping, golden threads and triangulation . There are lots of lessons learned from water experience to date and from the energy sector.

## Planning Together for PR24

We welcome Ofwat's recognition of the importance of getting input on its approach from wider sector stakeholders. We encourage the regulator to proactively identify and reach out to key non-water stakeholders. See also our engagement Discussion Paper which will be published shortly.

**Q7.1: How can we ensure that companies bring together the outputs of the strategic planning frameworks in the most coherent and effective way for business plans?**

A: We support the early and central identification of systems issues which are best handled outside individual company approaches, for common agreed scenarios and assumptions, and for guidance on adaptive approaches and on the creation of potentially redundant assets.

We would commend Ofwat on their approaches to WINEP and RAPID but would argue for more explicit join up between these two approaches. We also note the absence from the consultation document to the need to join up not only with Environmental Land Management but also Natural Flood Management, as funded under the Environment Agencies' flood budget.

**Q7.2: What are your views of our thinking on our and companies' roles in engaging with other regulators between business plan submission and our issuing of the final determinations?**

Engagement and co-ordination with other water focused regulators is important for PR24 to provide a coherent framework for the sector to operate in. Working closely with environmental regulators in particular is vital if the shift towards a more long-term approach is to be achieved. Whilst getting the joined-up frameworks for business plan submission as clear as possible up front is desirable, some issues will only become clear during the process and some may benefit from an iterative approach. There is therefore an argument on certain issues for some degree of continued engagement during the review. However, this must be as transparent and treat all parties fairly. Ofgem's net zero advisory group that includes other parts of government advising on strategic issues in this area could be a model although we have yet to see how effective it is in practice. Ofwat could also leverage lessons from the experience of WICs, SEPA and Scottish Water in its approach.

There clearly is also a need for engagement with other regulatory bodies outside of the water sector at both a strategic level and on the individual company plans. The UKRN can play a role here but this needs a more strategic focus in key areas such as net zero and also needs to take greater account of climate impacts. The work of the NIC also has an important role to play here; it will be producing its second National Infrastructure Assessment during the period of the PR24 negotiations. Its emerging thinking on resilience , natural capital, net zero and levelling-up will need to be reflected in the PR24 process as this progresses.

**Q7.3: How could we best involve a 'PR24 Challenge Panel' in the price review process to help ensure that our decisions best reflect the interests of customers, communities and the environment?**

Our experience as members of the Ofgem Challenge Group – which also had a role in challenging Ofgem thinking as well as the company plans – is that this can be a valuable part of the process. Key is for the regulator to be happy to accept challenge and to share early thinking. Drawing on the expertise that has been developed through the current CCGs would seem to be one way forward**.** Ofwat needs to be realistic however about the resource required to support such a Panel (secretariat and information provision) and about the time commitments needed from members who would be required to scrutinise a large number of water business plans.

In addition, it should think carefully about the areas of the business plan where early external expert challenge could most add value and ensure members appointed have up to date expertise and are prepared to 'role their sleeves up'. We'd suggest avoiding the financial aspects of the business plan where Ofwat is arguably best placed to make decisions. Areas where a Panel could especially add value could include the companies' strategic approach and plan for business plan engagement – this would be particularly useful to ensure a coordinated, effective engagement approach and was an area of weakness for many companies during PR19. It could help to identify where more coordinated approaches would be useful and share good practice, eg: digitalisation and data; planning for the long-term, maximising public value; historic performance; whole-systems; customer service and consumer vulnerability and affordability; purposeful business; strategic approach to bespoke outcomes.

## Design and implementation of price controls

**Q8.3: Do you agree with, or have any comments on, our proposals spanning multiple parts of the value chain, i.e., for major projects and future reconciliations?**

A: work for the PR19 portfolio of evidence by First Economics identified a very useful checklist for the kinds of projects which are likely to benefit from direct procurement (i.e., where the increased innovation and efficiency from non-regulated solutions is likely to outweigh the loss of regulatory certainty as it impacts on financing costs). The more operational factors can be included in scope, the more likely direct procurement is to have a positive return.

## Outcomes

**Q9.1: What kinds of performance commitments should we include in the price review? What outcomes require financial incentives for all companies for the foreseeable future?**

Sustainability First welcomes Ofwat's desire wherever possible to have outcomes orientated PCs which might be longer-term goals that companies could have flexibility in how they meet. In some instances, these would need to be underpinned by a longer-term strategy document and route maps developed with experts and stakeholders that outline how they propose to meet the targets and milestones to monitor progress.

We would like to see a focus on a range of outcome areas, including:

- Eradicate water poverty by 2030 in line with the Public Interest Commitment + companies should co-develop an affordability strategy and route-map with impacted and interested stakeholders who can monitor progress against this.
- Target customer satisfaction scores (a comparable cross sector metric broken down by different customer segments including those in vulnerable situations, and scores following incidents.)
- Service is accessible (an inclusive service score – this is something that South East Water is exploring developing with the Research Institute for Disabled Consumers) + a consumer vulnerability strategy and route-map co-developed with relevant stakeholders
- Target level of interruptions to supply. But a mechanism is needed to get behind average performance as some communities are regularly impacted by recurrent problems and they can remain hidden in reporting.
- Water efficiency target + behaviour change challenge
- Leakage target – customer side and company side
- Water pressure
- 0 pollution incidents/sewer overflows + challenge area
- Protecting wildlife and biodiversity net-gain + strategy with deliverables and route map
- Achieve net zero/climate positive outcomes by x date + strategy and route map
- Water quality targets

The decision on the precise outcome, measure, target and incentive mechanism should of course ultimately be informed by a robust evidence base including views from the company's own stakeholders and take into account public interest need

**Q9.2: How do you think we should monitor outputs that are not clearly linked to the outcomes incentivised in the price control? Would it help to distinguish between PCs that monitor outcomes and PCDs that monitor outputs? What other options could we consider?**

A: We can see a strong case for third party assurance on these outputs, for example through CCGs, the approach to public value assurance which is being worked up between CISL and the BSI (though desk-based process assurance inevitably has its limitations), and through local fora.

Alongside Ofwat setting core minimum baseline standards and PCs, we'd encourage the regulator to require companies to co-develop with stakeholders consumer/community vulnerability and affordability strategies; cross-sector community resilience strategies; a strategy for business as usual PR24 engagement (to help further embed a culture of engagement and ensure strategic partnerships) and responsible/purposeful business with associated road maps for delivery. Importantly Ofwat should set a clear expectation that companies assurance mechanisms should be suitably independent and those assuring have appropriate skills and expertise to perform the role (See Q6).

**9.3: Do you consider there are aspects of company performance where it would be better not to set expectations as part of the price control? What approaches should we consider in these cases, so that companies act in the interests of customers?**

A: As set out in our Regulation for the Future Paper[18] we believe that approaches which incentivise whole company cultural moves towards public value can in many places be better than specific outcome incentives which place companies into a compliance mindset, with responsibility nested in regulatory departments.

Crucially though for this kind of approach to work water companies would need to have sufficient 'engagement and public purpose maturity' (importantly this is not yet consistently demonstrated) and regulators would need to have confidence in company activity and commit to respect the agreements that were made at a devolved level. Independent assessment, accreditation and leadership are critical. PR24 could be used as a stepping-stone to lighter-touch regulation in the future and is an opportunity for companies to further demonstrate they can be 'trusted' and have the engagement skills and capability needed for greater price control autonomy.

**Q9.4: What should be our aim in setting the levels of performance commitments? Do you agree with the suggestion that performance commitment levels should be set, as a starting point, at what can be achieved by an efficient company with base costs and that deviations from this are proposed in company business plans? If not what alternative proposals should we consider?**

Perhaps not unsurprisingly in principle we support stretching but achievable targets. Ofwat's reference to minimum standards reminds us of Bill Shankly's quote – "Aim for the sky and you'll reach the ceiling. Aim for the ceiling and you'll stay on the floor."

## Cost assessment

**Q10.2: In what areas (both historical water sector and external) can we improve the range of benchmarks we use in cost assessment?**

[18] [Regulation for the future: The implications of public purpose for policy and regulation in utilities (sustainabilityfirst.org.uk)]

A: There is a case for wider use of regional data on cost drivers. We are seeing reports of quite wide regional variation in, for example, labour and construction materials availability and cost inflation.

**Q10.4: Do we need to amend our cost assessment approach to take account of nature-based solutions?**

A: Yes, but this will not be straightforward. Evidence from the Exmoor Study shows that similar nature-based interventions can have very different impacts only 1km apart. There are also important issues about rural/urban cross subsidies – nature-based interventions may benefit rural areas most, whereas 'use value'/amenity benefits may be greatest in urban areas. And the multiple benefits (environment, carbon sequestration, flood reduction) from nature-based solutions call out for a multi-agency assessment approach. In our view, this is one of the major challenges, but also opportunities, of the PR24 review. The difficulties inherent in this area underline the need for a robust approach to stakeholder engagement that extends beyond customers to also include citizens and community groups.

**Q10.8: Are the most significant challenges to the operational resilience of the sector adequately captured within current strategic planning frameworks?**

See Q3.2 above.

**Q10.9: How can we strengthen incentives for long-term operational resilience and improve the assessment of resilience enhancement expenditure while continuing to protect customers' interests?**

A: See answers above. Cost assessment under uncertainty probably requires different tools (see Defra's guidance on accounting for climate change). A clear approach to the appraisal of potentially redundant assets seems to us highly desirable.

## Risk and Return

**Q11.1: Are there areas of our risk allocation framework where mechanisms could be added, simplified or removed in a way which would benefit customers?**

A: It seems to us likely that some long-term investments under uncertainty will have fundamentally different risk characteristics and that this may need some adjustment to risk allocation frameworks. There may be parallels with the arguments for and against adjustments to gas transmission and distribution investments and assets under increased stranding risk.

**Q11.3: Should we index the allowed return on equity, and if so, how ought this to be implemented?**

A: Yes. Ofgem have demonstrated that indexing the cost of capital more widely is an important enabler for in period flexibility/reopeners.

If you would like to discuss the contents of our response, please do not hesitate to get in touch.

Yours sincerely

Sharon Darcy, **Director**

CC: Zoe McLeod, Martin Hurst, Maxine Frerk

22nd July 2021