

PR24 and Beyond: Creating tomorrow together - Jacobs consultation response

Overview of response

The current regulatory regime has delivered significant successes over multiple review periods but more of the same will not achieve the level of transformation that the sector needs to meet/exceed the challenges of digital adaptation, increased resilience and improved environmental performance.

Section 2: Ambitions for PR24

Q2.1: Do you agree that the themes we have suggested for PR24 are appropriate for England and for Wales?

We agree that the themes suggested for PR24 are key for the future development and success of the water industry in England and Wales (and also likely to significantly influence adjacent geographies as well). That being said, we also believe that the proposals for the PR24 methodology (as they stand) do not go far enough in supporting the delivery of the suggested themes. In our view, this consultation represents somewhat of a missed opportunity for a more radical and challenging review of the potential approach to the next price review which in turn may have a limited impact in bringing the desired transformation in the water industry.

The current regulatory regime is based on incremental change and has delivered significant successes over multiple review periods but there is now a strong argument that a substantial step change is required to achieve transformation within this sector. The opportunities that the move to net zero present could and should be used as the catalyst to be brave, trusting and bold. Alternative models of regulation and industry governance should be explored in this period as we prepare for PR24 and beyond.

We believe there is merit in Ofwat committing to a broader, more radical review of approach. Options to consider include:

- A closer examination of the proposals around negotiated settlements within the *Submission to the CMA on Ofwat price determinations* by Stephen Littlechild, May 2020. The WICS successfully operate a quasi-negotiated settlement agreed between the Customer Forum and the Water Company.
- De-centralisation and franchise regulation should also be considered. The separate price controls in place already facilitate this.
- Consideration of a vastly simplified PR24 process with a view to investing the 'saved' price control time, effort and resources into an industry wide strategic development framework that will set out both a compelling vision and achievable tactical plan for 2030, 2040 and 2050 sector priorities.

Section 3: How we regulate

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?

The Environment Agency and Drinking Water Inspectorate have separate regulatory approaches which do not always sufficiently align with the Ofwat approach. In our experience, there are at times a fundamental conflict between the regulation of economics and the delivery of improvements to the environment under the current regulatory regimes.

Ofwat has always acknowledged that lowest cost does not always deliver the best environmental outcome and whilst the introduction of the best value concept is intended to address this, in practice this is going to prove difficult to justify at the Price Review. Ofwat has also acknowledged that methodologies are still developing in this area. Our concern is that this means that the evidence to build a justified business case will not be clear (and may not be available) and successful outcomes will potentially be limited.

The sentiment of best value is encouraging but the reality of how this translates is likely to lag behind the desire. As we move away from the key/only metric being financial capital (i.e. economic) there is an outstanding question about the remit of Ofwat not being sufficiently broad to embrace wider capital values. For example, how does Ofwat plan to respond to the issues as set out in the Dasgupta Review 2021 (Economics of Biodiversity) that was commissioned by HM Treasury?

To help alleviate this concern, we consider that Ofwat should be more proactive in joining up regulation with other regulators. It is incumbent on them to make the water industry a success and ensure that there are mechanisms in place to bring all companies up to the standards they should be at. Greater collaboration is not just required but essential for the future success of our sector.

Section 4: Increasing 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?

We agree that a greater focus on the long-term is required. In practice, this will often mean greater upfront expenditure to achieve benefits in future. For this to work, companies need to be able to obtain the revenue to do this, and Ofwat needs to be able to verify, perhaps long into the future, that companies are delivering the benefits they promised in their business plans.

The long-term needs of maintenance and resilience in particular are driving the need for reasonable bill levels (and even marginal increases in some areas). We would highlight though that the focus on keeping bills artificially low is at odds with Ofwat's messaging about WaSCs contributions to society and communities. Ofwat has in the past stated that, "Water companies have a clear socio-economic and environmental footprint as one of a handful of key longterm stakeholders in the areas they operate in". Unfortunately, it can appear that Ofwat fails to consider this when reviewing proposals that look to enhance the value in these areas.

As a comparator, bills and charges for other services rise every year, often beyond the prevailing level of inflation in the economy. The essential nature of water and the wider contribution to society warrant appropriate bill increases to fund and maintain services into the future. Potential bill increases should be considered acceptable alongside the appropriate support for those who cannot afford them to ensure that our funding model continues to be robust and sustainable.

Ofwat notes that companies should not be funded twice to deliver the same thing and we entirely agree. However, in relation to asset health it is difficult to conclude whether companies have delivered what they have previously been funded for in the absence of a precise definition of asset health. In some areas, the perceived duty or service of the asset has shifted from its original design intent. An example we would highlight is sludge digestion – originally designed and operated to stabilize sewage sludge and minimise risk to public health, there is now much greater focus on energy production and minimization of GHG emissions. Assets that were not designed for this require additional maintenance / enhancement on top of what has been previously funded. This does not mean that the asset health has necessarily declined, but its required duty has changed.

Alongside a definition, there may be merit in setting a minimum standard for asset health or a performance standard. If a company has a poor assessment / track record the investment required to improve is too significant and is unlikely to be funded under the current regime. A step change is not

achievable without the funding. A minimum standard to achieve may be more appropriate in this instance.

Section 8: Design and implementation of price controls

Q8.1: Do you agree with, or have any comments on, our general approach to the design and implementation of controls, i.e. to retain separate controls with the same broad structure as at PR19, but with improvements to our implementation?

We consider there are a number of areas where the approach to price controls could be reconsidered.

DPC is currently limited to new assets. There is potential benefit in considering this for failing assets. There is also scope for DPC to operate at different levels:

- National e.g. SROs
- Regional e.g. regional wastewater treatment works and bioresources
- Sub-region e.g. asset of community interest

There are also more potential applications for conditional allowances as used for the SRO gated process and for Thames Water's resilience work. Ofwat should consider this further as a means to helping the market be more efficient.

Section 9: 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?

We agree that a focus on fewer PCs is appropriate and that there is a role for a core of common PCs for all companies. Clarity on when common measures and target setting will be revealed is required. Early sight of this would allow companies to fully consider their targeted performance for PR24.

The experience of adopting common PCs for AMP7 has shown that it takes time for consistency across the sector to embed. This practicality should be considered when new PCs are developed for AMP8 and beyond.

Moving away from bespoke PCs presents a risk that genuine differences between companies are not fully reflected. Customer preferences may not be represented. There may be potential for better performing companies to be given greater freedom on setting bespoke PCs.

We would also note that it is not clear to us (and others) how the AMP7 Innovation fund will be incorporated into PR24 and whether this will have any links to new PCs.

Section 10: Cost assessment

Q10.1: What should be the priorities for improving our approach to cost modelling and assessment?

Water companies are not all the same. They have duties and obligations to deliver the same basic services and each has varying degrees of success in doing so. Factors such as geography, topography, natural resources, socio-economics, population density are all influencing factors outside of a company's control. Cost adjustment claims are the intended mechanism to adjust these standard models to reflect a particular company's circumstances which do not match the model parameters. The reality is that achieving a successful adjustment is increasingly difficult as the evidential bar is not defined.

As the water industry has developed over time it has become more difficult to make simple comparisons and these comparisons have become less relevant. Whilst Ofwat considers there is increasing benefit in developing more base cost models and using these to drive efficiencies we consider there are other factors to consider.

We consider the current bench marking approach will not bring the transformation across the sector that Ofwat aspires to. More local specific targets and performance requirements may be more appropriate. For example, the poorest performing companies will never catch the best performing up if all they are trying to do is take the people, processes and procedures that others implemented 5 years ago and have now moved on to more advanced approaches. More realistic targets for what is achievable should be considered.

Increases in productivity come from reducing opex. The water industry invests in long-life assets. Replacement of these can only be incremental. The pace of change is constrained by the ability to invest and renew these assets. For example, once an investment has been made in an asset with a life of 20 years it is unlikely to be economic to replace it significantly in advance of its end of asset life even if there are opex savings to be realised.

One of the fundamental challenges the industry is facing is it's need to demonstrate greater empathy and consideration to its customers, communities and the environment and that this when measured in terms of economic efficiency is almost impossible to achieve. Without embracing value over efficiency the transformations required to achieve Net Zero and a sustainable water industry will not be achievable.

Future solutions need to be founded on new approaches which embrace the principles of:

- Circular economy
- Natural capital
- Sustainability
- Third party money
- Best value
- Systems thinking
- Digital solutions and smart systems

Nature based solutions have the potential to drive best value. Capex may be higher but whole life cost and wider benefits will be greater.