

Delivering strategic priorities in the water sector

Yorkshire Water position statement

September 2021



YorkshireWater

Summary

The UK is facing new social, environmental and economic challenges which the water sector is both impacted by and well-positioned to help tackle. Climate change will cause more extreme weather events, increasing flooding incidents and droughts. Population growth will put further pressure on current infrastructure, increasing the need to invest to build a resilient water sector. We also face wider economic challenges arising from the Covid pandemic, exacerbating inequalities within our communities and putting a major burden on the next generation.

In response, the UK government is taking action; it is working with the private sector to deliver net zero emissions by 2050, protect the environment, boost infrastructure investment to improve resilience and level up the economy. To unlock the potential the water sector can offer in supporting these priorities, the sector's independent economic regulator – Ofwat – must focus its regulatory tools on the Government's agenda. Ofwat is already starting to do this – for example Ofwat's 'PR24 and beyond' report¹ emphasises the need to increase focus on the long-term and deliver greater social and environmental value.

The strategic policy statement (SPS) issued by the Department for Environment, Food and Rural Affairs (Defra) and approved by Parliament is the main mechanism for achieving alignment of Ofwat's actions with government's policy objectives. It provides strategic direction to Ofwat by setting out the outcomes government wants to see in the water sector.

As such, it is an important tool at the heart of the system of independent regulation in the UK water sector – enabling Ofwat to decide *how* to deliver the objectives and outcomes government wants to see. This is a common approach for the transmission of policy into regulatory action across sectors – the Department for Culture, Media and Sport last set out its strategic policy and objectives for the telecommunications sector to Ofcom in the statement of strategic priorities (SSP) in 2019 and the Department for Business, Energy and Industrial Strategy is due to publish a draft strategic policy statement for Ofgem later this year.

¹ [PR24-and-Beyond-Creating-tomorrow-together.pdf \(ofwat.gov.uk\)](https://www.ofwat.gov.uk/pr24-and-beyond-creating-tomorrow-together.pdf)

The last Defra/Ofwat SPS was issued in 2017 and there is an updated draft currently being consulted upon. Yet we believe there are shortcomings in the way the SPS is used to set priorities for the regulator, resulting in Ofwat having a democratic deficit as it is both inaccessible and unaccountable to the public or elected representatives.

As Defra continues preparing the next SPS for Ofwat, this paper explores how the SPS can be better used to enable the water sector to help address the major challenges facing the country, whilst maintaining the independence of the regulator and resolving Ofwat's democratic deficit. It makes a series of recommendations, focused on two main issues:

1. Providing greater clarity on how to deal with trade-offs between different priorities through the addition of an explicit steer on how Ofwat should prioritise different objectives.
2. Strengthening accountability mechanisms through:
 - a. Creating a formal role for the Environment, Food and Rural Affairs (EFRA) Select Committee in assessing Ofwat's delivery of the SPS annually, ensuring it is prioritising in accordance with government priorities.
 - a. Including measurable targets for Ofwat in the SPS.
 - b. Building a stronger role for the National Audit Office (NAO) and Public Accounts Committee (PAC).
 - c. Creating a role for the Office for Environmental Protection (OEP) in the price control process.
 - d. Setting requirements for Ofwat's impact assessments to improve the quality and expand the level of detail to cover the impact of its decisions on SPS priorities.

Introduction

Ofwat is an independent regulator accountable to Parliament. Its duties are enshrined in legislation through the Water Industry Act 1991. It has more than 15 duties – primary and secondary – covering, principally:

- Protecting consumer interests
- Securing that the functions of each company in the water sector are properly carried out, and that companies are able to finance the proper carrying out of their functions
- Guaranteeing the long-term resilience of water companies' water supply and wastewater systems

The UK's system of independent regulation is well-established and has been replicated by other countries across the world. It provides a means for the Government (with approval from Parliament) to set out the outcomes it desires, while giving the regulator freedom to decide on the way those outcomes are achieved.

Defra sets the Government's strategic priorities and objectives for regulation of the water sector in England through the SPS. The Secretary of State for Defra was granted powers to issue an SPS through the Water Act 2014 (amending the Water Industry Act 1991) which stated: "The Secretary of State may from time to time publish a statement setting out strategic priorities and objectives for the Authority in carrying out relevant functions relating wholly or mainly to England."² The SPS must be approved by Parliament and is an important tool through which the Government (and Parliament) provides Ofwat with a strategic direction, reflecting the priority issues for the sector at the time. Ofwat must then choose how to use its regulatory tools to deliver these priorities. The SPS is thus an important tool for delivering an independent system of regulation.

This tool works best when the strategic direction provided by government is clear and when there is a clear mechanism for holding the regulator to account for the delivery of government objectives.

² [UK Water Industry Act \(1991\)](#)

However, we believe the current practice falls short in two ways which, together, reduce the potential for the water sector to deliver government priorities effectively. First, the way in which the water SPS is written currently does not go far enough in clarifying how priorities should be balanced against each other, particularly when they are in tension with one another. Second, the framework that is in place to hold Ofwat to account relies upon self-reporting by Ofwat – meaning the regulator is able to mark its own homework without detailed scrutiny by those to whom it is accountable. In the Competition and Markets Authority (CMA) redetermination of Ofwat’s PR19 decisions, it referred extensively to areas in which it felt that Ofwat had failed to take appropriate account of the 2017 SPS.

A number of changes, which we set out below, could amend the current regime and help ensure the regulatory framework helps tackle the social, environmental and economic challenges that we now face.

In making these changes, the following principles should underpin the SPS process:

- Ofwat is accountable to Parliament and there must be a clear mechanism in place to hold Ofwat to account and resolve Ofwat’s democratic deficit
- Regulatory stability must be preserved as much as possible
- Ofwat is independent. This means a democratically elected government/Parliament can determine a policy position for the sector that is delivered and facilitated by the regulator. It does not mean there should be political interference in Ofwat’s execution of its duties.

Balancing priorities

Challenge

The SPS lists a number of priorities that Ofwat is expected to deliver. In the most recent SPS draft³, these are:

³ [The government’s strategic priorities for Ofwat: draft for consultation \(defra.gov.uk\)](https://www.defra.gov.uk/government/consultations/the-governments-strategic-priorities-for-ofwat-draft-for-consultation)

1. Protecting and enhancing the environment
2. Delivering a resilient water sector
3. Serving and protecting customers
4. Driving markets to deliver for customers where appropriate.

These priorities are intended to complement Ofwat's 15 plus duties. However, there is a lack of clarity from government about how it expects Ofwat to balance the SPS priorities (and its duties) against each other, particularly when they conflict. The absence of prioritisation creates ambiguity around the future regulatory direction and uncertainty for the sector, acting as a barrier to long-term investment.

For example, the language around resilience and customer protection in both the 2017 SPS and 2021 draft SPS include requirements for Ofwat both to "challenge the water sector to plan, invest and operate its water and wastewater services...in a way which delivers value...over the long-term" and "to ensure that the impact of any increased investment remains affordable and has broad customer support"⁴. These priorities are clearly not mutually exclusive, but can conflict where there is a decision on investment to improve long term resilience that will cause an increase in bills in the short-term.

The framing of the 2017 SPS resulted in Ofwat, in the PR19 final determination, maintaining downward pressure on customer bills at the expense of investment in projects that would improve the resilience of water and wastewater supplies.

Recommendations

We believe the government should take explicit steps to provide water companies with the stability needed to invest and innovate to deliver government objectives and tackle national challenges.

⁴ [The government's strategic priorities and objectives for Ofwat \(publishing.service.gov.uk\)](https://www.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/91111/government-strategic-priorities-and-objectives-for-ofwat.pdf); [The government's strategic priorities for Ofwat: draft for consultation \(defra.gov.uk\)](https://www.defra.gov.uk/government/uploads/system/uploads/attachment_data/file/91111/government-strategic-priorities-for-ofwat-draft-for-consultation.pdf)

In particular, we believe that the government should provide **an explicit steer on how Ofwat should prioritise** the objectives set out in the SPS, particularly around balancing investment with bills. There is precedent for Government providing guidance on how priorities should be balanced. For example, DCMS' SPS to Ofcom states that "the Government's view is that promoting investment should be prioritised over interventions to further reduce retail prices in the near term."⁵ This is particularly important given the urgent need for new long-term investment to protect the environment and ensure resilience of water infrastructure against climate change.

Improving accountability

Challenge

Ofwat, as an independent regulator, is ultimately accountable to Parliament. As we have set out, the SPS – drafted by government and approved by Parliament – is an important part of how Parliament shapes Ofwat's strategic direction. Currently Ofwat is held accountable for delivering the aims set out in the SPS through its obligation to report back to Defra and Parliament on how its decisions and plans (such as its forward work plan) support delivery of the SPS aims and through occasional select committee sessions where the chief executive or chair of Ofwat are questioned by the select committee members.

For example, during the PR19 process, Ofwat published a document outlining how its final determinations support the achievement of the priorities and objectives of the SPS.⁶ It previously also set out how the PR19 methodology would contribute to the delivery of the SPS⁷. Further, last year the Public Accounts Committee held an inquiry looking at the work of Ofwat, Defra and the Environment Agency in strengthening the resilience of water supply.

⁵ [Statement of Strategic Priorities for telecommunications, the management of radio spectrum, and postal services \(publishing.service.gov.uk\)](https://publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/421147/Statement_of_Strategic_Priorities_for_telecommunications_the_management_of_radio_spectrum_and_postal_services.pdf)

⁶ [UK Government priorities and Ofwat 2019 price review final determinations.pdf \(ofwat.gov.uk\)](https://www.ofwat.gov.uk/price-reviews/pr19/pr19-final-determinations/)

⁷ [UK Government priorities and Ofwat 2019 price review final methodology\(ofwat.gov.uk\)](https://www.ofwat.gov.uk/price-reviews/pr19/pr19-methodology/)

These types of reporting and scrutiny should continue but be developed. Ofwat's current obligations to report on how it is delivering the SPS essentially result in Ofwat marking its own homework and focusing only on the decisions and activities that support the SPS. There is little external interrogation of Ofwat's assessment; select committee scrutiny of regulators, whilst impactful, is currently ad hoc and infrequent.

As a result, it is difficult for customers, taxpayers and elected representatives to see a full picture of Ofwat's compliance with, and delivery of, government priorities and effectively hold it to account.

Recommendations

To improve this, we propose:

1. **The EFRA Select Committee should have a larger role** in assessing Ofwat's delivery of the SPS and ensuring it is prioritising in accordance with government priorities. The Committee could hold an annual evidence session scrutinising Ofwat's delivery of the SPS and how it has balanced priorities. To further resolve Ofwat's democratic deficit, this session could be informed by evidence from relevant stakeholders (including customer groups and local authorities given the regional nature of water companies) offering an external perspective on how Ofwat is delivering against the SPS.

Increasing the accountability of Ofwat to bodies that represent the public is more important than ever as the current direction of travel appears to be taking away the regional customer voice in favour of a centralised process.

2. That **the SPS should include measurable targets** for Ofwat, on which Ofwat should report in its annual report. This was recently proposed in the BEIS consultation on CMA powers, where the document recommended "setting out specific metrics against which government will measure the state of competition in the

economy and the CMA's performance."⁸ In the case of Ofwat, this could include:

- a. Investment unlocked to meet environmental needs
- b. Environmental targets on pollution or flooding incidents
- c. Levels of customer satisfaction with Ofwat's decisions
- d. State of competition, including in the supply chain
- e. Evidence of progress on partnerships between companies and other organisations, including increase in number of co-funded projects

3. **A stronger role for the National Audit Office (NAO) and the Public Accounts Committee** in holding Ofwat to account. The NAO may currently carry out examinations into the economy, efficiency and effectiveness with which any department has used its resources in carrying out its functions.⁹ For example, a 2020 NAO report examined the effectiveness of Defra's oversight of the water industry and how it provides direction to regulators and companies to secure long-term resilience. It gives these reports to the Public Accounts Committee to support its scrutiny of public bodies. To strengthen their roles, we propose:

- a. The NAO reviews Ofwat's performance once every two years, focusing on whether it has spent its resources in the right way according to the SPS and publishing a report accessible to the public and Parliamentarians.
- b. Following the NAO report, the Public Accounts Committee holds a session scrutinising the work of Ofwat over the relevant period with a particular focus on how it is spending its resources in compliance with the SPS (using Ofwat's impact assessments – see below – as a key input).

4. **An explicit role for the new Office for Environmental Protection (OEP) in the price control process.** The OEP is being established to assess progress in the delivery of the government's environmental plan. In line with this, the OEP could assess whether the financial settlement for companies proposed during the price review

⁸ [Reforming Competition and Consumer Policy \(publishing.service.gov.uk\)](https://publishing.service.gov.uk)

⁹ [UK National Audit Act 1983](#)

process will allow them to effectively deliver on the government's environmental objectives.

5. **The government sets clear and specific requirements for Ofwat's impact assessments** to improve the quality and expand the level of detail to cover the impact of its decisions on SPS priorities. Ofwat (like all regulators) is required to carry out an impact assessment for all of its major regulatory decisions. In line with recommendations from the Taskforce on Innovation, Growth and Regulatory Reform, BEIS is currently exploring how it can improve regulatory impact assessments across the board, recognising that they are an important tool for improving transparency of regulatory decisions¹⁰. We welcome this. In the water sector, we believe Ofwat's impact assessments could better enable customers, Parliament and companies to see a fuller picture of Ofwat's delivery of the SPS if clear guidance was published that requires Ofwat to:
- a. Extend its impact assessment to cover the impact of all of its major decisions (e.g. around cost efficiency, financing and incentives) on SPS priorities
 - b. Cover both positive and negative impacts to enable those outside Ofwat to understand the trade-offs
 - c. Use the impact assessment as a genuine input into regulatory decision making, rather than as an ex-post justification tool.

Conclusion

The government is already taking an active approach to tackle the climate and environmental crises and level up the economy. The current system of independent economic regulation already has structures in place for the government to set out the priorities that should inform the regulatory approach in the water sector. We welcome these.

However, the benefits of the current system can only be fully met if it provides greater clarity on balancing priorities and accountability. The

¹⁰ [Reforming the framework for Better Regulation \(publishing.service.gov.uk\)](https://publishing.service.gov.uk)

measures recommended in this paper support these two objectives. They can help ensure that the regulatory process adapts to better reflect the priorities set by the government and deliver a resilient water sector that can successfully help tackle the significant challenges facing the UK's economy and environment.

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