

Streamlining regulation

Yorkshire Water position statement

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YorkshireWater

Summary

Regulation of the water industry is complex. There are multiple different regulators, with different responsibilities and statutory planning processes. The price control process, led by Ofwat, has become a four-year long process that consumes significant management and regulatory time and resource and has become inaccessible to non-regulatory experts.

This level of complexity has implications for public confidence in the water sector, the accountability of the regulatory regime and for the sector's ability to deliver solutions that tackle local and national challenges.

A more streamlined regulatory regime would help in at least three ways:

1. It would make regulatory decisions and processes accessible to bill payers and elected representatives – ensuring regulators can be held to account for their actions and boosting engagement in water companies' future plans to help make sure they reflect consumer needs and priorities.
2. It would reduce costs and management distraction for both regulators and water companies – ensuring tax/bill payer resources are spent on delivering better consumer outcomes rather than navigating bureaucracy.
3. It would unlock innovation to deliver wider government priorities – increasing capacity for companies to focus on innovative solutions or ways of working, such as nature-based solutions.

Ofwat has itself begun to explore how it can streamline the next price control (PR24) in its early thinking around the PR24 methodology. As Ofwat develops its proposals, and government considers the future of regulation in the UK¹, this paper sets out a series of specific recommendations for how the regulatory regime can be streamlined:

¹ Through both BEIS' [Reforming the Framework for Better Regulation consultation and HMT's forthcoming policy paper on economic regulation](#).

1. Ofwat should consider adopting a negotiated settlement approach for large, long-term new investment projects.
2. Establishing a single independent body to decide the cost of capital for each regulated sector.
3. Aligning the timeframes for the statutory plans that water companies are required to prepare and deliver.
4. Increasing Ofwat's visibility in the regions.
5. Reducing the number of performance commitments and simplifying incentives at PR24.

Introduction

Regulation of the water sector has always been complex – as David Gray set out in his review of water regulation back in 2011² “the regulatory landscape for water and sewerage sectors is highly complex due to the existence of multiple regulators, each with different statutory roles and responsibilities, and multiple planning processes each with different degrees of formal effect or influence”.

It is right that a regulatory settlement of the size agreed in the water sector contains detail. However, over time regulation in the water sector has become ridden with unnecessary complexities. For example, new regulatory devices have been introduced, such as the Gearing Outperformance Sharing Mechanism at PR19, and Ofwat has expanded its reach into new areas. At PR19, a total of 675 performance commitments were introduced for all companies, compared with just over 500 at PR14, and there were 3,000 pages in the PR19 draft methodology alone. As Dieter Helm describes:

“It [Ofwat] has developed a large bureaucratic regulatory process. The companies have all developed parallel regulatory teams, and employed armies of consultants, lawyers and other advisors. As noted, the first consultation of the current periodic review ran to 3000 pages. It has, like all such bodies, grown its scale and size. It has engaged in trying to shape corporate governance, in the vetting of non-executive directors, and in trying to determine gearing.”

Ofwat has itself begun to explore how it can streamline the next price control (PR24) in its early thinking around the PR24 methodology, noting that “the complexity of the price review has increased in some areas”³.

Considering the number of challenges that the water sector and others are facing, for example responding to climate change, it is vital that we take advantage of the opportunity to reform.

² [Review of Ofwat and consumer representation in the water sector](#)

³ [PR24 and Beyond: Creating tomorrow, together](#)

We believe our recommendations (set out below) will help achieve a more streamlined, accessible, efficient regulatory regime, one that drives innovation and increases benefits to consumers.

Implications of complex regulation

The current system of regulation in the water sector has become unwieldy and highly complex. It is important there is sufficient scrutiny of water company activities and plans, but we believe the current model has gone too far and the negative implications of complexity now outweigh the benefits of Ofwat's wider reach. Specifically, the complexity of the regime:

- 1. Deters full customer and stakeholder engagement in the activities and future plans of water companies and impacts public confidence in the water sector**

It acts as a barrier to non-regulatory experts engaging in Ofwat's regulatory processes, resulting in the public (and those who represent them) being unable to hold Ofwat to account to ensure its decisions reflect customer and wider stakeholder priorities. As the government looks to ensure regulators offer the opportunity for local authorities and metro mayors to contribute to price control processes⁴, this barrier must be removed.

Further, effective economic regulation is an important driver of public confidence in and legitimacy of a regulated sector, as the government's National Infrastructure Strategy identifies⁵. Yet the benefits of effective regulation can only be fully realised if the public and those who represent them can access and understand regulatory decisions. This is not an argument to dumb-down or over-simplify regulation. Rather it is a call to favour the pragmatic over the theoretically perfect.

- 2. Does not incentivise investment in innovative, sustainable solutions**

⁴ [National Infrastructure Strategy](#)

⁵ [National Infrastructure Strategy](#)

The number of performance commitments and related penalties and rewards imposed by Ofwat mean water companies' management teams tend towards familiar and proven approaches. They have less capacity to consider and implement innovative solutions where the outcome may be more uncertain. Further, in some cases, the complexity of Ofwat's incentive framework means those that develop and deliver the solutions cannot easily understand (without support from economists) the incentive framework that is intended to incentivise them.

In practice, this means traditional (and often carbon-intensive) engineering solutions are favoured over innovative nature-based solutions that could bring considerable environmental benefit, helping deliver the government's environment plan and meet its net zero ambitions.

3. Creates conflict between regulators' priorities and requirements

Looking beyond Ofwat, the uniquely fragmented regulatory landscape in the water sector can result in tension between regulators' priorities and requirements. For example, responsibility for flooding spans multiple different organisations, each with different planning cycles and regulatory frameworks. Further, the Environment Agency has responsibility for setting companies' environmental plans and Ofwat then decides whether to allocate cost allowances to deliver the plans. In addition to business plans for Ofwat's price control process, water companies must prepare and deliver:

- River basin management plans (RBMPs) every 6 years (next one will cover 2021-2027)
- Water Resource Management Plans (WRMPs) every 5 years (next one will cover 2024-2029)
- Flood Risk Management Plans (FRMPs) every 6 years (next one will cover 2021-2027)
- Drainage and Wastewater Management Plans (DWMPs) every 25 years (first one will cover 2025-2050)
- A water industry national environment programme (WINEP) every 5 years (next one will be agreed in 2024, to cover 2025-2030)

In recent years, Ofwat's focus on applying downwards pressure on bills has come into conflict with the Environment Agency's environmental ambitions. In some cases – and in part a consequence of the misalignment of the statutory planning process – this has meant insufficient allowances have been given to companies to deliver their WINEP obligations.

For example, Ofwat's PR19 final determination did not give sufficient cost allowances to enable us to meet our WINEP target for removing phosphorus from rivers in our region. We raised our concerns with the Competition and Markets Authority (CMA), who supported our case and granted us an additional £9m for phosphorus removal.

4. Diverts company management attention and resources away from delivering outcomes for consumers

Regulation is both costly and time-consuming. The price control process begins almost as soon as the previous price control has ended – taking around four years of planning before final determinations are published.

This means that water company management teams must focus constantly on responding to regulatory consultations, developing business plans and providing detailed evidence to Ofwat; using time and resources that could be spent further improving the way the company delivers its water and wastewater services for customers and creating wider public value.

Streamlining regulation

Proportionality is one of the key principles underpinning the Government's proposed new Framework for Better Regulation in the UK⁶ and we believe must be at the heart of UK water regulation to address the issues outlined above. To achieve this, and to streamline the current regulatory regime, we propose five specific reforms:

1. Ofwat should consider adopting a negotiated settlement approach for large, long-term new investment projects

⁶ [Reforming the Framework for Better Regulation](#)

Negotiated settlements are a process where the regulator facilitates a negotiation between interested parties and the company to agree the regulatory determination. The regulator provides information to the interested parties and turns any agreement into a draft determination.

They are used all around the world, such as in the US gas sector and the Scottish water sector. A negotiated settlement approach would reduce the burden on both company and regulator. As Stephen Littlechild noted in his submission to the CMA:

“this [negotiated settlement] route was much more efficient than the conventional rate case: it took months rather than years. It eased the burden on the regulator...and it left both customers and the company feeling satisfied because they had negotiated an outcome that was mutually acceptable and preferable to the regulatory alternative”.⁷

Ofwat has discounted use of negotiated settlements at PR24. We are not proposing they are applied for the whole regulatory determination, but we believe there could be value in using a negotiated settlement approach for discrete investment proposals (such as a new reservoir). Ofwat could remove such proposals from its cost assessment process, instead facilitating decision making directly between customers/relevant stakeholders (potentially local authorities) and the water company. This would promote customer and stakeholder engagement in the process and provide confidence that the outcome best reflects local needs.

2. Establishing a single independent body to decide the cost of capital for each regulated sector

The cost of capital is one of the most complex aspects of a regulatory settlement – it is also the most disputed. Every five years the UK’s various economic regulators must make a similar assessment of market conditions and companies and stakeholders supply detailed evidence to influence where they end up.

⁷ [Stephen Littlechild – Submission to the CMA on Ofwat Price Determination](#)

The process is technical and inaccessible to those not expert in financial economics. It is a major burden for companies, their investors and the regulator. An independent body focused solely on determining the cost of capital for regulated sectors would remove the cost of capital debate from the already-complex price control process. Modelled on the Office for Budget Responsibility, such a body would provide an input to the price control process, enabling the sector regulators to focus on cost assessment and customer outcomes.

3. Aligning the timeframes for the statutory plans that water companies are required to prepare and deliver

Yet the relationships between the statutory plans are not clearly defined and the timelines often mean that decisions are made around one plan that conflict with desired priorities for another.

Bringing all plans together into one strategy, covering the same time horizon (or multiples of it), would help streamline the process, minimise conflicts and provide clarity to customers and stakeholders on when and how they can get involved in the regulatory process.

The statutory plans, agreed by the Environment Agency / Defra, would inform the outcomes Ofwat must provide efficient cost allowances to deliver. Finalising the plans two years before the beginning of the next price control period would enable them to be fully incorporated in companies' business plans and in Ofwat's determinations.

Alternatively, if the plans are decided later, Ofwat could use uncertainty mechanisms to revise its regulatory settlements during the price control period to reflect companies' environmental obligations.

4. Increasing Ofwat's visibility in the regions

Customers and local stakeholders view Ofwat as a remote, disconnected institution, reinforcing the view that it and its decisions are inaccessible. Increasing the number of Ofwat visits to each region – meeting with key local stakeholders and customers – would help put a human face to the complex regulatory decisions. It could help break

down barriers to public participation in the regulatory process, enable Ofwat to clearly explain what it does and how in layman's terms and could improve Ofwat's understanding of customer priorities and how to most effectively communicate with them.

5. Reducing the number of performance commitments and simplifying incentives at PR24

As set out above, the number and complexity of performance commitments and incentives has expanded in recent years. As Ofwat notes, "the large number of PCs impeded their intended purposes. In particular, it diluted their incentive properties within the five-year period"⁸.

Ofwat is proposing to reduce the number of performance commitments at PR24 and simplify its approach to setting incentive rates. We strongly support this and would encourage Ofwat to maintain focus on outcomes rather than outputs to help create space for companies to innovate in the way they achieve the outcomes. To help Ofwat cut the number of performance commitments, Defra could introduce a percentage reduction target and a "one in one out" rule thereafter, in line with recommendations in the Penrose review of regulation and competition.

Conclusion

It is right that regulation is thorough and robust, particularly when it relates to an essential service such as water and wastewater. However, we believe the complexity of the water regulatory regime is having a negative impact on customer and stakeholder engagement with (and accountability of) regulatory processes; innovation; delivery of other statutory duties and water companies' management teams' focus on delivering a quality service for customers; and creating wider public value.

As Ofwat prepares its approach to the next price control, and government considers principles underpinning regulation in the UK, this paper

⁸ [PR24 and Beyond: Creating tomorrow, together](#)

recommends a series of measures that could simplify the water regulatory regime. If adopted, we believe they could create the right environment for innovation, improve public confidence in the sector and remove unnecessary red tape.

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