DRINKING WATER INSPECTORATE
Area 1A Nobel House
17 Smith Square
London
SW1P 3JR

Enquiries: 0330 041 6501

Email: [redacted]
DWI Website: www.dwi.gov.uk

DWI Ref: PR24/01

7 September 2022

PR24 draft methodology consultation response
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Dear Ofwat

Drinking Water Inspectorate comments on OFWAT consultation document *'Creating tomorrow, together - Consulting on our methodology for PR24'*

The Drinking Water Inspectorate - 'the Inspectorate', is pleased to have been involved in the ongoing stages of the current price review, PR24, process to date. We have appreciated the ongoing dialogue and engagement, participation in workshops and various other associated communications. It is essential that this engagement and dialogue continues and indeed develops as PR24 evolves towards the final determinations for the period 2025-30. There are a multitude of existing and emerging challenges faced by the sector, consumers, the environment and the sector regulators. PR24 must play a key part in helping us all meet those challenges and also provide an effective foundation towards building the long term delivery of high quality and sustainable services.

This letter sets out the Inspectorate's response to the consultation proposals in the PR24 draft methodology with a particular focus on our regulatory responsibilities for drinking water quality, our more recent responsibilities for Network and Information Systems Regulations 2018 (NIS) and the Security and Emergency Measures (Water and Sewerage Undertakers and Water Supply Licensees) Direction 2022 (SEMD).

Our comments herein should be read in conjunction with our suite of recent planning guidance for companies as follows:

- Guidance Note: Long term planning for the quality of drinking water
- Long term planning guidance – Resilience of Water Supplies in Water Resource Planning
- NIS and SEMD PR24 Guidance

All the above documents are published on the Inspectorate's website.

Catchment management, raw water quality, nature based solutions

Catchment management – We note that the importance of supporting investments in catchment management approaches is highlighted in the draft methodology. There are many benefits to catchment management approaches that address pollution at source: such as improvements to the wider water environment; reduce the need for, or burden on, water treatment facilities; and provide sustainable, long-term, cost-effective solutions. Delivering catchment management solutions should remain the first consideration of all 'source to tap' risk assessments to reduce risks prior to treatment and ultimately mitigate all significant risks to public health, wholesomeness and acceptability of water supplies.

Nature based solutions (NBS) - We support the continued provision for NBS. Delivering successful NBS schemes sits well within the overall complementary approaches for undertaking catchment management solutions. As noted in previous discussions, such schemes require promoters and regulators to understand the risks associated with the uncertainties that may be present in NBS with respect to environmental variables, time and efficacy of the approaches under varying scenarios etc. and these will need to be part of the assessment of each scheme.

Funding for operational expenditure focused catchment management and NBS – We have noted in our comments for previous price reviews, that traditional funding frameworks have been heavily influenced by the distinction between the capital (CAPEX) and operational (OPEX) stages of expenditure despite the evolution of total expenditure (TOTEX) thinking. Catchment management and NBS schemes tend to have a more varied path to delivery, with additional uncertainties that can only be addressed with further iterative work. They also utilise inputs from a broader range and/or number of stakeholders compared to the more traditional plan, design and build solutions. Inherent initial uncertainties with catchment management approaches have not been readily accounted for in funding frameworks that could not explicitly deliver total cost recovery. This in turn created a risk of restrained

ambition, less incentives, more financial risk, and less innovation associated with catchment management options when compared with traditional engineering solutions that could cost more, be less sustainable and have greater adverse environmental impact. We welcome the inclusion of an objective to do further work on the feasibility of capitalising future whole-life operating costs of NBS into a net present value (NPV), as an approach to not disadvantage NBS schemes for PR24. It is something that we would also see as worth consideration for catchment management approaches more generally.

Storm overflows multiple benefits – We recognise the importance of the drivers to improve storm overflow (SO) performance. There can be multiple benefits from reducing the spectrum of poorer quality discharges of SOs. These include improvements to the aquatic environment, reducing pollution events and supporting better access for water based amenity uses. There are also significant benefits from improvements to raw surface water quality, from which companies abstract into water treatment works for the onward supply of drinking water.

Storm overflows balancing the ambition - The significant attention and focus towards additional investment to improve SO performance should be risk based. Consideration should be given to how to prioritise those sites where there is most harm to the environment and raw water quality. There should be critical appraisals about the rate of achieving ambitions, such that it is balanced with the required investment opportunities in other areas of need. For example, to support resilient supply of wholesome drinking water in all areas, recognising that external pressures such as population growth, extreme weather events and seasonal variations of water resources due to climate change already present tangible challenges. Drinking water resilience should not subject to any additional risk from reduced/delayed investments due to the work SOs. The Inspectorate is keen to be a part of ongoing discussions on how to achieve this.

Climate change and operational resilience

Operational greenhouse gas emissions - We welcome the continued focus on supporting the sector achieve its net zero targets. We believe there is an opportunity to go further with the current proposals and additionally drive improvements to capital/embedded emission reductions during the PR24 period. This could support all companies to deliver existing methods and further innovation in an area that has already demonstrated benefits from some companies and in the wider infrastructure construction industry for several years.

Operational resilience - We acknowledge the inclusion of further initiatives to address operational resilience and this focus follows on from the Operational Resilience discussion paper published in April 2022. We suggest that asset health

metrics are explicitly used to encourage companies to deliver further knowledge, understanding and improved clarity of their asset specific risks for all major asset groups. There is an opportunity to pursue this during the 2025-30 period, such that it could subsequently be independently assessed across all companies. In addition, it would be beneficial for companies to demonstrate how maintaining and investing to improve asset health impacts has influenced their overall risk exposure explicitly.

We are concerned that funding for base costs may not be being deployed as effectively as expected by companies to secure long term resilience, particularly in relation to operational assets. There is evidence, collated via our Inspectorate audit programme, to indicate that there are gaps in the service and maintenance performance for a selection of drinking water assets; arguably this may only be a limited insight into the extent of the issue. It is also evident from the extent of company transformation programmes that are and have been underway to rectify risks to drinking water quality. We think further consideration, to be included in PR24, of an approach to monitoring such expenditure versus outcomes/outputs should be a focal point and built upon in subsequent price reviews as part of holding companies to account. The Inspectorate would welcome further discussions between the sector and regulators on this matter.

Drinking water quality

Compliance Risk Index (CRI) - We welcome the proposal to continue to include the CRI as common PC. CRI has proved to be a very good measure of drinking water compliance with statutory parametric values, and this has driven improved company performance. However, we are concerned and object to the proposal in Appendix 9 4.1.2 to reduce the CRI deadbands to zero (it is currently 2.0, as set at PR19); as opposed to reducing them to a more challenging level.

100% compliance is the objective that we expect the industry to be aiming for, however the 2.0 deadband was selected to recognise a) the median 'back calculated' CRI performance of companies ahead of PR19 and b) promote realistic improvements. It implicitly recognised that compliance failures will be inevitable to some degree until certain systemic issues are addressed until which a zero level would be unrealistic and not in line with incentivising improvements. Key examples of matters creating systemic compliance failures not within the complete control of companies include:

- Nickel and copper failures due to the internal consumer fittings (currently there are no specific market controls to mitigate this, and it remains an uncontrolled risk).
- Lead failures due to legacy internal plumbing, brass fittings and presence of lead solder – although there are measures in place to mitigate the presence of

lead on consumer side internal networks there remains a certainty that under certain situations lead levels can exceed the PCV and such risks cannot be eliminated until there is full removal of lead and removal from sale of lead solder products.

- In addition, we also must consider there are other environmental circumstances that alter the incidence of certain parameters such as nitrate, that we have recognised require a collective approach by stakeholders to resolve.

We consider removing deadbands would not 'sharpen' incentives but create a situation where failure of CRI is inevitable and hence disincentivise the incremental improvements as an unintended consequence. It is important that we maintain and improve the trajectory of improvements achieved by the switch to CRI in recent years and lose this by creating a dogmatic approach that is disconnected from the reality of service provision. Narrowing the existing deadbands is the better approach to encourage and deliver improved CRI performance that will produce tangible results and benefits for consumers.

Combining performance indices - As part of PR24 we understand Ofwat's desire to reduce complication and potential inconsistencies between companies by having less general performance commitments (PCs) compared to PR19 that may for example partially overlap or may not be as suitable a measure for some companies compared to others. We have responded in previous discussions with Ofwat, that the overall intention to streamline PCs must not be to the detriment of the granularity of specific measures that form part of the regulatory approach of other regulators. Where there are proven regulatory benefits, good synergy and complementary value across regulators then specific PC measures should be maintained.

Long-term and Adaptative Planning

Considering 25 year strategies – Long-term delivery strategies in their initial concept as outlined would be an interesting and potentially very valuable addition to PR24. We are aware that something similar was attempted with varied success at PR14. We would like to see further detail on how 25-year plans would work in a complementary manner alongside other long-term planning frameworks with a view to better synergies and alignment in the future.

Adaptive planning – Whilst recognising the benefits of an agile and responsive industry we have some concern that a focus on adaptive planning could create an overly conservative and risk averse approach by companies towards investing in longer term, multiple price review period initiatives that address uncertainties around water resources, climate change impacts such as extreme weather events and improved operational resilience. Bearing this in mind, thinking around

supporting enhancement investments and also preparatory work investment is welcomed where these are justified by supporting evidence. As noted above setting price reviews in the context of 25 year strategies has a lot of potential benefits, however how will this be delivered in terms of an actual focus on the long-term periods versus the focus on the five year PR cycle?

Innovation

We support the ongoing drive to develop innovative approaches by companies and build on the initiatives to foster innovation already pursued in current AMP7 period such as the Innovation Fund, StreamLine and the One Stop Shop.

Direct Procurement for Customers

We acknowledge Ofwat's intention to make more use of DPC but would expect this to be done in consultation with relevant sector stakeholders such that direct regulatory and cross regulatory effectiveness is maintained. We have been in ongoing discussion with Ofwat regarding the approach to deliver DPC on operation and maintenance elements of the schemes that are part of the Inspectorate's regulatory responsibility. We have indicated our view that a legislative change is the preferred means to effectively capture the DPC attributes within the full reach of Inspectorate's regulatory responsibilities.

Security and Emergency Measures (Water and Sewerage Undertakers and Water Supply Licensees) Direction 2022 (SEMD)

SEMD - We note that the draft methodology states that as part of overall resilience companies have a duty to maintain a water supply system and provide a wastewater system such that they meet their statutory security of supply and service obligations under SEMD. The inspectorate has issued guidance to companies for SEMD here. In terms of allowances for SEMD provision and any enhancements in response to prevailing and anticipated circumstances, our SEMD team will continue to engage with Ofwat to define the appropriate assessment criteria for PR24. Previous PR periods have introduced significant enhancements to protective security and resilience for in scope assets and systems and it is therefore our reasonable expectation that there will not be a wholesale need for additional measures to be implemented. However, the reclassification of Critical National Infrastructure (CNI) designations by function rather than on a site basis will change the requirements for a number of individual CNI designations which have been confirmed by Defra with individual companies. In addition, the new requirements for alternative water supplies means that from the start of AMP8, as a minimum, companies should plan to provide alternative water for 1.5% of their domestic population for the first 120 hours after the company becomes aware of an incident. This may be a significant change for companies from the requirements set out within existing Local Response Plan Thresholds (LRP).

The Network and Information Systems Regulations 2018 (NIS)

NIS – PR24 will be the first time that companies will have to address requirements under NIS as part of a price review. We would have expected therefore that NIS would be explicitly addressed in the draft methodology as a key area of activity for companies to plan, prepare and deliver important initiatives to address cyber security and information systems risk that are ever more prominent with threats already seen in the sector from global actors. The Inspectorate is currently working with the sector on its latest Cyber Assessment Framework (CAF v3.1) returns and also engaging with Ofwat on setting expectations for PR24. The Inspectorate has issued guidance to companies for NIS here. Since the introduction of the NIS Regulations in 2018, companies have been working towards compliance with the sector specific CAF profile which we have stated we expect companies to achieve by the end of AMP7.

If there are any questions or queries arising from our comments above, please do hesitate to contact me using the details above. We look forward to working closely with Ofwat and the sector towards a successful PR24.

Yours sincerely

Nicholas Adjei
Deputy Chief Inspector of Drinking Water