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Aileen Armstrong
Senior Director of Company Performance and Price Reviews
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Dear Aileen Armstrong,

Response to Ofwat consultation: Methodology for the 2024 Price Review

We are pleased to respond to Ofwat's PR24 draft methodology consultation. As the environmental regulator for the water industry in England our role is to advise government, water companies and Ofwat on the likely environmental opportunities and risks associated with the price review. Our response reflects the high ambition of our Board and the need to radically improve the water sector's performance.

Environmental targets for the water environment are set out in Government's 25YEP. It states that 75% of waters should be 'as close to their natural state as soon as practicable'. Targets are also set out in River Basin Management Plans which require actions to improve waters from 16% to 75% good ecological status. Our National Framework for Water Resources states that if no action is taken between 2025 and 2050 around 3,435 million extra litres of water per day will be needed for public water supply to address future pressures.

Flooding in the past year has shed light on the vulnerability of sewer network assets. The National Flood and Coastal Erosion Risk Management Strategy (FCERM) states that by 2030 water companies will plan for their infrastructure to be resilient to flooding and coastal change.¹ In addition, the Government has recently published its Storm Overflow Reduction Plan which will also need to be considered and factored into PR24.

This is the scale of the challenge we face, and the price review needs to enable water companies to address these now and in the future.

The performance gap

Water and sewerage company environmental performance is unacceptable and Ofwat's methodology must contribute to addressing these failures. Emma Howard Boyd, Chair of the Environment Agency, recently said 'measured against

¹ Strategic Objective 2.7 of the National FCERM Strategy states that by 2030, water companies will plan for their infrastructure to be resilient to flooding and coastal change.

our four-star rating, the performance of most companies declined (in 2021). Four companies were rated only 2 stars, which means they require significant improvement. Two companies fell to 1 star, the bottom of our star ratings, meaning their performance was terrible across the board.² This must change.

The public is increasingly alarmed by the continued failures of water companies and the impact this has on the environment. People expect the operation of storm overflows to be phased out. They want climate resilient infrastructure and a clean environment. Water companies must also step up and meet the challenges of the climate and biodiversity emergencies. This will require significant enhancement investment.

As the environmental regulator it is our duty to address public expectations with an uncompromising approach to protect and enhance the water environment. Our response challenges Ofwat to ensure the final methodology supports and requires urgent and significant action to improve water company operational performance and resilience.

To meet these demands from the public, and the needs of the environment, both Ofwat and water companies must be far more ambitious. Water quality and the water environment cannot, and will not improve, unless water companies significantly improve their performance. We will play our part to ensure they do.

The main points of our response are:

Performance commitments

We question the overall effectiveness of Ofwat's Performance Commitments (PCs) in driving the intended behaviours and outcomes they are set to achieve. Given this, we would welcome further discussion on whether the use of PCs requires review in forthcoming price reviews.

With reference to this consultation, we have the following comments:

1. Penalties for failing to hit targets associated with legal obligations should be significant.
2. We continue to strongly object to companies being financially rewarded for meeting their statutory obligations.
3. We support retaining the outcome-based approach and agree with the principle of bringing in new common measures relating to improved outcomes for the environment.
4. PCs should reflect the compliance targets, obligations and expectations set out in the Water Industry Strategic Environmental Requirements (WISER) and the Water Industry National Environment Programme (WINEP).³

² This is evidenced in the [Water and sewerage companies in England: environmental performance report 2021 - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/94421/water-and-sewerage-companies-in-england-environmental-performance-report-2021.pdf)

³ The targets on total (category 1, 2, and 3), and serious (category 1 and 2) pollution incidents, wastewater discharge compliance, leakage, and permitting set out in Ofwat's draft methodology should be aligned to those we set out in the Water Industry WISER.

5. PCs should be designed to drive the right culture, behaviours, actions, and long-term strategies.⁴. Companies should not be given the opportunity to trade off the delivery of one PC against another.
6. Further discussions on the design of the biodiversity, river water quality and bathing water PCs are required to ensure they drive the right outcomes.
7. We would support the introduction of a new penalty-only common performance commitment (CPC) on abstraction licence compliance.
8. We would welcome a discussion on designing a temporary use bans (TUBs) performance commitment to drive TUBs being implemented with optimal timing to manage drought.
9. We agree on the need to reduce the number of bespoke commitments. This would be beneficial as some have had unintended negative consequences in the past.

Expenditure allowance

1. We agree with the principals and approach to setting efficient expenditure allowances at PR24.
2. Customers should not be asked to pay for inefficiencies, but it is important to recognise that significant enhancement and base expenditure investment is required to meet the water challenges facing this country.
3. We have some concerns that the base expenditure allowances are not resulting in the improved company performance that we would expect.
4. We support the increased focus on longer-term adaptive planning, as this is an essential tool for making the right choices to adapt and mitigate to climate change.
5. Planning water resources at regional scale is also essential to making the right choices for water supply and environmental protection. As such expenditure allowances should support companies taking appropriate leading roles in regional water resources planning.
6. We need companies to step up now and show leadership on current performance and compliance. Planning over the long-term is vital but there are immediate challenges that need to be addressed in the short term. Long-term strategies should be used to sensibly profile enhancements over current and future price reviews, not a mechanism for delaying immediate action.
7. Successfully profiling investments requires flexibility and we welcome moves to facilitate multi-period investments. Price review cycles themselves should not be a blocker. We strongly support moves to enable investigations and resulting solutions to be completed in the same price review period. Again, this needs to be transparent and as simple as possible to implement.
8. Moving towards more sustainable treatment options is essential. We support providing companies with additional surety of funding for catchment and nature-based solutions.
9. The overall goal for companies should be to maximise benefits across all their environmental programmes. This includes wider benefits relating to net gain, net zero, flooding, resilience, access, and human health.

⁴ This includes establishing baselines for the future measurement and tracking of flood resilience.

10. Water companies should be encouraged to look at alternative ways to fund activities. The innovation fund is an excellent mechanism, but companies should continue to explore other private and public funding opportunities to reduce the impact on customers and do more for the environment and communities.
11. More detail is required on the price control deliverables and how they will operate.

Understanding customers and categorising business plans

1. Environmental Performance Assessment results should be considered when categorising company business plans. For example, we would not expect 1 or 2-star companies to be categorised as outstanding.
2. Ensuring water companies are managing water to deliver what is required to protect the environment, enable growth, and build resilience is a major challenge. The Regulatory Alliance (RAPID) has been a success and we support the continued use of development funding and incentives to support it.

In Annex 1 we have limited our responses to specific issues that we feel are relevant to our role in protecting people, communities, and the environment.

Yours sincerely



Deputy Director Water Management and Investment

Annex 1. Environment Agency response to questions in the draft Methodology consultation

This set of questions is drawn from: [Draft-methodology-main-document-3.pdf \(ofwat.gov.uk\)](#)

Q2.1 Do you agree with the challenges facing the sector and the ambitions for PR24 we have identified?

The price review has fallen short in previous years of delivering the climate resilient infrastructure and performance we expect and need. Ofwat's help is essential in holding companies to account to achieve the targets set out, for instance, in the 25YEP, the expectations in WISER, and the actions and targets required in RBMPs and the National Framework for Water Resources.

To meet these ambitions, water companies need to work differently and embed cultural changes that increase transparency and trustworthiness. One way this might be facilitated is to require water companies to publish more of their own data in a way that is easily accessible for the public. Publishing regular and accessible data, for example on pollution incidents, permit compliance, sewer flooding, leakage, supply interruptions, and drinking water quality, would increase accountability and help drive the right behaviours.

The methodology captures our shared ambition for the water industry to be resilient to flooding, drought and climate change as outlined in our respective strategies including the [National FCERM Strategy](#). PR24 is an important mechanism for turning these ambitions and expectations into outcomes for communities and the environment. We need Ofwat's help to make this happen through the PR24 methodology to incentivise/make the companies behave and plan for the long term.

More generally, if Ofwat is to achieve its ambition for the water sector, the methodology needs to be explicit in setting out the limits of what the water environment can 'afford' in a changing climate. The focus in assessing finance and financial resilience (Chapter 8) within the methodology rests on financial risks. Non-financial stress testing (that will manifest into financial risks), such as risks from floods, drought, and climate change are not considered. Water companies should be required to adopt a common approach to using climate scenarios for assessing these risks such as the forthcoming UKWIR adaptation framework.

This need for clarity has wider implications in setting out the challenges, balancing priorities, and the pace of delivery. For instance, how are the differing priorities to be delivered when considering carbon costs and financial costs versus expectations, or the delivery at pace versus lower cost or lower carbon solutions. The methodology must offer clarity to customers as well as water companies about managing expectations and trade-offs.

Q5.1 Do you agree with our proposed package of common performance commitments? Is water demand best incentivised through separate performance commitments on household and domestic consumption and leakage or through a performance commitment measuring total demand?

In 2013 our CEO Dr Paul Leinster, wrote to water companies that we expected zero pollution incidents by 2020. Nearly 10 years later water companies are hopelessly short of this target. Performance commitments set by Ofwat are not driving the intended behaviours and outcomes they are set to achieve.

Evidence relating to PR19 performance commitments shows immaterial environmental benefits have resulted from common performance commitments (CPC). For example, if we consider Ofwat's in-period settlement relating to total pollution incidents in 2020, the small gains made at a sector level in reducing the number of pollution incidents were both too low in number and too slow in pace to counter the effect of tighter ODI threshold increases from 2020 to 2021. For example, the minimal improvement in reduced incidents (1713 to 1677) was lost in the sector ODI target tightening from 1297 to 1260 incidents. The difference in what the sector reported vs the ODI sector target was only 1 incident difference each year – 416 in 2020 and 417 incidents in 2021.

Nor do the proposed PCs incentivise major investments in sustainable drainage systems, surface water separation before sewer, and solutions such as catchment based/nature-based solutions. These are all important if water companies are to meet net zero by 2030.

We support Ofwat's proposal that performance commitments designed to reduce water demand should cover business customer demand, in addition to leakage and household customer demand (per capita consumption). We consider that separate measures for leakage, business and domestic consumption should be used as a minimum. These could support an overall consumption target and align with the targets in the Environment Act.

We welcome continuing our conversations around the use of CPC's for PR24.

We have provided further comment to specific CPC concerns in our responses to QA6.5-6.9.

Q5.2 Do you agree with our proposed guidance for bespoke performance commitments?

We support the move to fewer and more locally targeted bespoke performance commitments in line with Ofwat's proposals. However, we consider that the definition and parameters of all environmentally focused bespoke performance commitments should be developed in consultation with the Environment Agency. This will help mitigate the perverse behaviours displayed by water companies as an unintended result of PR19's performance commitments.

We agree with the targeted focus on local circumstances and/or specific areas of poor performance, for instance where past performance data shows a trend of ongoing poor or stagnant performance or a trend of deteriorating performance. We encourage Ofwat to draw attention to the poor performance of water companies through bespoke PCs and would welcome increased penalties to incentivise change.

Abstraction Incentive Mechanism (AIM)

We are pleased Ofwat have recognised our previous feedback and we agree AIM should not be a CPC.

As recognised in the methodology, in the past there has been little scrutiny or certainty of the benefits of AIM schemes. The benefits should be compared to agreed flow targets (the default target being the environmental flow indicator or EFI). If the benefit of AIM falls significantly short of the flow target, then we consider it may be appropriate to go with Ofwat's alternative option for water companies to instead report publicly on progress without it being set as a performance commitment. It is not clear from the methodology how a water company's claims relating to the benefit of the AIM scheme will be scrutinised. We deem the reference to the EFI or an agreed flow target to be the best approach.

Overall, the principle of AIM does have potential, however, in most places water companies do not have sufficient 'spare' water to use it to deliver significant environmental benefits. Companies could be encouraged to plan for investments which would enable delivery of more significant environmental benefits under AIM in the medium-term. It may be appropriate to consider this under Environmental Destination investigations or as part of innovation funding.

Catchment Management (please also see our response to QA6.9)

We consider there is a need for a performance commitment on nature-based solutions and a catchment management approach that leads to environmental improvements. We note there are ongoing discussions concerning the design of the biodiversity, greenhouse gases, and raw water quality performance commitments which may address this need; however, we would like to see a performance commitment which sufficiently incentivises water companies to move away from end of pipe solutions and work with stakeholders. We would also welcome the taking of a broader consideration around a catchment management performance outcome focusing on natural assets, safeguarding ecosystem services and climate adaptation (preparing for climate change).

Q5.6 Do you agree with our proposed approach to incentivising asset health performance?

We support the concept of incentivising water companies to maintain and improve asset health above and below ground. Further we welcome the continued inclusion of the three asset health CPCs proposed, although we ask Ofwat to consider asset health of the sewerage network more broadly for example, pumping stations and online storage.

We consider it essential that rather than focusing on reactive measures after incidents have occurred, these CPCs should focus on the preventative incentivisation of asset health i.e., for the unplanned outage CPC, it is essential that it ensures effectiveness to maintain clean water assets, rather than employing reactive approaches to mitigate pollution to maintain works at the expense of potentially locally catastrophic incidents or loss of supply/licence breaches.

Q6.1 Do you agree with our proposed approach to setting efficient expenditure allowances at PR24?

We agree with the principals and approach to setting efficient expenditure allowances at PR24. It is good to see mechanisms that will help speed up delivery of enhancements (investigations through to solution in one price review)

or will encourage nature-based solutions or will enable companies to collaborate and work across price reviews.

We do have concerns that base expenditure allowances are not resulting in the improved company performance that we would expect. Some asset health measures may have improved but overall rates of permit compliance rates are down and the number on pollution incidents is increasing. This may be due to the historical nature of the base allowances, but we do not have evidence to support this. We do not support rewarding poor performance, but, if necessary, we would support cost adjustment claims where there is compelling evidence that additional capital maintenance is required to meet statutory obligations and fund pollution incident reduction actions.

More detail is required on the price control deliverables and how they will operate in practice. We support price control deliverables in principle, but they need to work in tandem with WINEP. They must not enable, or be used by companies, to challenge the timely delivery of WINEP actions.

We expect water companies to meet the requirements of the governments storm overflow discharge reduction plans and our WINEP driver guidance on storm overflow reductions.

Q6.4 Do you agree that resilience enhancement should be used to fund companies to manage increasing risks to specific hazards that are beyond their control and not covered by base expenditure and other enhancement areas?

Yes. To ensure water companies are in a strong position to deliver partnership schemes, through joint investments that support resilient solutions and help protect communities and the environment from flooding, it is critical that Ofwat are clear on what evidence is required by water companies. This is to demonstrate improved resilience in their business plan delivery through the suggested 'resilience enhancements' and establish a baseline and enable measurement and tracking of flood resilience.

Companies should be more transparent on how resilience funding is allocated and spent. They should use adaptive approaches to maintain a focus on the long term and identify, develop, fund, and deliver schemes to improve resilience of the water supply and wastewater and drainage services provided to customers, including to the risks posed by floods and climate change.

Companies should provide evidence on how they are meeting expectations set out in the WISER and commitments outlined in both the [Joint Approach](#) (June 2022), and the objectives of the [National FCERM Strategy](#). Both align with the Table 6.1 'Examples of collaborative working and third-party funding', which provides good evidence of partnership schemes. This good practice should now be common practice,

There are further examples that demonstrate the effective management of surface water flooding through the [Innovative Resilience Fund](#), these include; and could be added to the list of examples provided in the methodology in table 6.1:

- the [Blue Heart project in East Sussex](#) which is developing a smart, integrated water management system to warn and respond to heavy rainfall
- the [Slough Metropolitan Borough Council](#) project applying the 'sponge' catchment approach to support communities and reduce the impacts of surface water flooding
- developing SuDS retrofit solutions in combination with advanced storm water monitoring and modelling in [Doncaster, Immingham, and Grimsby](#).

The [FCERM Strategy Roadmap](#) also provides enabling actions that support water companies in achieving objectives that will result in greater resilience and reference should also be made to this. It is important that companies clearly understand the resilience risks they will be addressing and that business plans include details of risks and any potential mitigating actions.

It is also important to note that climate change may be an unquantified risk factor impacting on water company services. Consideration needs to be given to the point at which expenditure in this area moves from enhanced to baseline or vice versa.

Q6.5 Do you agree with our proposed approach to setting performance commitment levels at PR24?

We have serious concerns over the current level of performance of some water companies and see this element of the price review as essential for driving better performance. We strongly support the performance commitment levels being consistent with achieving statutory requirements and the targets set by government and this should be extended to include the expectations set out in WISER. While it is acceptable for companies to develop their own long-term forecasts, these should wherever possible be common across the companies. They should be stretching and once set the proposed performance improvements should be scrutinised by all the water regulators to ensure they lead to real progress.

Q6.7 Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?

We are broadly supportive of the proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows. Like yourselves we want companies to make rapid progress in addressing greenhouse gas emissions and reduce storm overflow spills whilst moving towards government long term targets.

More detail is required on the baseline data for greenhouse gas emissions and how this will be used to set the level of reduction ambition.

We would also welcome further discussions on how incentives for reducing storm water overflows factors in the impacts of climate change on frequency and intensity of heavy rain.

Q6.8 Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 regulatory framework?

Appendix 9, Section 5.5 should be updated to reflect the announcement that companies in nutrient neutrality (NN) areas will be required to upgrade to technically achievable limits (TAL). This should be through the lens of sustainable green solutions where possible. We would like to be included in discussions relating to NN and TAL to reflect ongoing policy development in this area.

Q6.10 Do you agree with our proposed approach to removing the potential disadvantage that nature-based operating expenditure solutions may face in relation to the treatment of enhancement operating expenditure?

We are broadly very supportive of actions to remove barriers to the implementation of nature-based solutions. To note, not all nature-based solutions will need significant operating expenditure. Those solutions which work to protect and restore natural physical processes (for example, habitat creation through restoration of rivers, floodplains, and their natural processes) can be self-sustaining, working with nature and avoiding/reducing the need for future maintenance. The performance commitment framework should seek to encourage those options which work with nature and where possible not incur / minimise additional operating expenditure.

Appendix 9 refers only to nature-based solutions in the context of statutory outcomes. Acknowledging the role of nature-based solutions in wider environmental outcomes, the biodiversity performance commitment, and the restoration of natural function, needs to be part of how we deliver a resilience and sustainable water sector. The non-statutory nature-based solutions sit alongside those delivering regulatory outcomes as mechanisms to improve catchment resilience and secure the natural capital benefits that the water companies use in the future.

The following set of questions is drawn from [Appendix 6 – Performance commitments - Ofwat](#)

QA6.5 Do you agree with our proposed definition for the biodiversity performance commitment?

We welcome the inclusion of a CPC which focusses on biodiversity. This commitment has the potential to be a significant driver of land use change, biodiversity improvement and restoration of natural processes. The biodiversity CPC supports several other outcomes within the methodology. As a result, it is, for instance, cited as a reason for the lack of catchment/climate adaptation commitments. These outcomes and reasoning are not set out within the commitment itself. The description of the metric in Appendices 6 and 7 should make clear the links back to climate adaptation and catchment management (6.12).

We consider that further clarification on fish drivers should also be included. Without the inclusion of metrics such as kilometres enhance, the delivery of WINEP PC becomes essential to achieving these targets since the biodiversity CPC is unlikely to pick these up accurately.

Within WISER, the Environment Agency and Natural England require water companies to have a strong commitment to protect and enhance the environment. There should be a strong incentive for companies to meet biodiversity targets on land they own. Water companies own large tracts of land,

many of which are in areas of outstanding natural beauty (AONBs) and other protected sites (for instance, United Utilities, Yorkshire, and Severn Trent own large areas of land in the Pennines/Peak District), but Ofwat focus on water management aspects predominantly.

The proposed measure is limited to company owned land/3rd party land on which a company operates. However, water companies benefit from the ecosystem services provided by the wider catchment. Therefore, the biodiversity PC should emphasise and encourage efforts to restore and protect ecosystem function/services in the broader catchments upon which a company is reliant, rather than solely on the land they own or operate. We consider this is partly the intent of the biodiversity performance commitment as referenced in Appendix 6, Section 6.12 and would welcome clarity on this in further discussion.

We are keen to ensure that this CPC drives sustainable actions which maximise multiple benefits for biodiversity and wider catchment resilience to climate change (for example, process-based river restoration to generate self-sustaining habitat), rather than short term, less sustainable site-based interventions that could achieve lower but quicker net gain return. Environment Agency geomorphological, fisheries and ecological expertise is crucial to encourage this sustainable long-term investment in the right places

We also question whether there are sufficient trained surveyors to carry out biodiversity surveys on all company and third-party land. The methodology expects surveys to begin before 2025 and be completed in 2028, presumably with a second survey to assess improvement before 2030 if the incentives are to be applied in this price control period. This is not clear in the appendix 6 and 7 references to the biodiversity metric.

QA6.7 Do you agree with our proposal that the performance commitment on serious pollution incidents should only apply to water and wastewater companies?

Water quality cannot improve until all water companies improve their operational performance. We are uncompromising in our expectations that serious pollution incidents and regular storm spills are 100% unacceptable. For 2021, the sector performance for serious pollution incident numbers was much worse than 2020 – and there has been no sustained trend for improvement for several years in total incident numbers or compliance with conditions for discharging treated wastewater. As such, while we would support a penalty only CPC for WoC's, we would not support an outperformance incentive equal to the current baseline standard.

QA6.8 Do you agree we should focus the bathing water performance commitment on the outcome that customers have received and should continue to develop an alternative definition to do this?

We have serious concerns about the proposed approach to the bathing water performance commitment. We consider that bespoke PR19 performance commitments have resulted in water companies attempting to manipulate data to maximise potential rewards and limit penalties and we judge that there is the potential for perverse outcomes to result from current PR24 proposals.

A CPC looking to incentivise both coastal and river bathing waters, which are intrinsically different, is both complex and difficult. We are yet to be reassured that water companies would not be adversely penalised/rewarded based on geography (landlocked vs. coastal).

Furthermore, Ofwat's methodology refers to bathing water treatment including UV disinfection. Although this may be a regulatory requirement, we would welcome Ofwat reflecting the position set out in WISER which states: "*water companies are encouraged to investigate alternative technologies to ultraviolet disinfection*".

We have welcomed the opportunity to engage with Ofwat concerning this CPC and continue to do so, however, based on current proposals we do not support the inclusion of the bathing water CPC as proposed.

QA6.9 Do you agree with our proposal for the river water quality performance commitment to measure the reduction of phosphorus entering rivers?

We advocate having a river water quality CPC, however we do not support the combined CPC for wastewater discharged by water companies as well as catchment actions in partnerships, such as nature-based solutions and catchment management - indeed we support both activities being assessed, but not as a combined metric. We would like to see the river water quality CPC focus on incentivising water companies in adopting sustainable solutions such as nature-based solutions and catchment management.

We consider that the CPC should cover phosphorus only and no other pollutants. Moreover, we do not support incentivising to go beyond the proposed 80% phosphorus reduction target in the Environment Act. We judge the target to be set appropriately and there are no justifiable benefits of reducing further. We wish to see water companies being measured on their own actions, with actions from partnerships being measured separately. Furthermore, we do not support incentivising companies to deliver reductions early, as this may encourage use of less sustainable options.