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Dear David

### **Creating tomorrow, together: consulting on our methodology for PR24**

Yesterday, we submitted our detailed response for consultation on methodology, but I thought it might be helpful to draw out some key messages.

We are all aware that the water industry faces significant challenges from sewage discharges, droughts, and leakage to the cost-of-living crisis and growing expectations around the health and cleanliness of our waterways and coast. The message to the industry from the public, campaigners, regulators and government could not be clearer: the industry needs to raise its game and we must rebuild public trust.

Companies, regulators and government bear joint risk in delivering the aims of the 25 Year Environment Plan (25YEP). We need a radical approach to simplify regulation, focus on outputs and drive efficiency, otherwise there is a real chance we will not meet our obligations or public expectations.

Water regulation initially worked well after privatisation, but it has become overcomplicated, obscure and sometimes drives perverse behaviours. It targets site-specific outputs which in turn force companies to implement asset based solutions. These increase carbon in the middle of a climate emergency, are at best neutral for biodiversity in the middle of a nature emergency and increase bills in the middle of a cost-of-living crisis. Regulation should be an enabler of – not a constraint to – ambition. So we need a regulatory reset.

The current framework fails because it is fragmented across sectors, output not outcome focused, and overly prescriptive. Outcome Based Environmental Regulation (OBER) can meet the goals of the 25YEP in a far more efficient way and deliver a virtuous circle of benefits, including improving the environment for lower private and social cost, encouraging cross-sector collaboration, increasing public value, enabling investor value, and facilitating private investment in the environment. We can deliver better solutions faster and cheaper if we are given the flexibility to do so but the draft methodology does not provide that flexibility.

The high-level messages in the consultation document strongly support the work we have been doing with yourselves, the Environment Agency and Defra to develop OBER. It is clear that Ofwat's stated ambition to move to a proper outcome-based approach is reflected in the consultation, albeit only at a high level. So, we offer our support to help bridge the gap between the high level and the detail before the final methodology is published.

It is good to see that the methodology supports an advanced WINEP and also the recognition that more needs to be done to create a level playing field between traditional capex solutions and opex/nature-based approaches. However, as it stands, the draft methodology risks the proliferation of an unsustainable approach to regulating the water sector. In the five years since the last draft methodology, it appears that little has been done to find alternative, innovative solutions to the well-known problems – particularly to address the fragmented, prescriptive, output-focused, and non-systems-based approach to regulation. Again, we would be happy to support the work required and will share further thoughts on potential detailed options.

We are disappointed to see the lack of joined up thinking between government and regulators. For example, the proposed new duty on water companies in the Levelling Up and Regeneration Bill to reduce nutrient loads from wastewater treatment centres to Technically Achievable Limits (TAL), the expectations set out in the Storm Overflows Discharge Reduction Plan, and the probable continuation of an input and output based (rather than outcome based) Water Industry National Environment Programme means that our customers are likely to face unprecedented bill rises. Our initial forecasts predict that our consistent historical capital expenditure of £1.2bn-£1.4bn over each of the previous five price reviews will grow to £3.2bn or more at PR24.

We fully support the move towards a more streamlined, outcome-based approach to set performance commitments and for these to be focused on those outcomes that matter most to customers and the environment, delivering service improvement over the longer term. But again, the detail needs more work particularly around discharge compliance, leakage/PCC/ business demand and asset health. There are significantly more efficient ways to deliver the environmental improvements required and we need to work together to develop a framework that enables those efficiencies to be found. This needs to happen for PR24, or we will be halfway through the 25YEP without realising the benefits of a different approach.

There is a commitment in the draft methodology that developers should pay for nutrient neutrality, which we fully support but there also needs to be realism on the possible rate of progress and ensuring the “polluter pays” principle is applied to funding more widely.

We are pleased to see the recognition that there were limitations in the PR19 cost assessment models and are therefore surprised that little change is proposed in the methodology. As you point out, the link between cost and service is key and so it is important we move away from backward-only looking assessments towards a focus on efficient and economical delivery, and properly understand the base versus enhancement issues, particularly around resilience.

Finally, the proposals for company boards to demonstrate that they have challenged management and to explain the process they have used, is excessive. Indeed, given the current legislative and environmental requirements that seem to be heading our way, it is most unlikely our board will be able to provide assurance of value for money because many of the current mandatory proposals do not represent good value for money.

All this leads us to be cautious about how business plans will be assessed for quality and ambition. We fully support incentives to create excellent plans and intend to submit a plan that is outstanding. However, the consultation suggests we might not even meet the quality threshold if we submit an alternative plan that is in the interests of customers, communities, and the environment, unless it explicitly uses all the assumptions in the methodology.

We want to be radical and support the reset the industry needs to rebuild public trust. A key part of that reset is that we intend to submit an outcome-based plan and we therefore seek assurance from Ofwat that we will not be scored as 'inadequate' just for being different.

Whilst the consultation on the draft methodology asks us to respond to a set of technical, old-fashioned questions, which we address in the main body of our response, we remain committed to playing an active role in the reset that the sector needs, and society demands.

Yours sincerely

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Group Chief E>