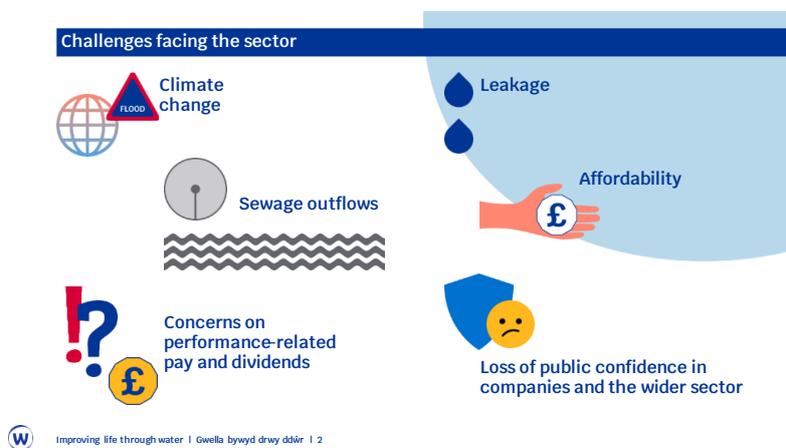


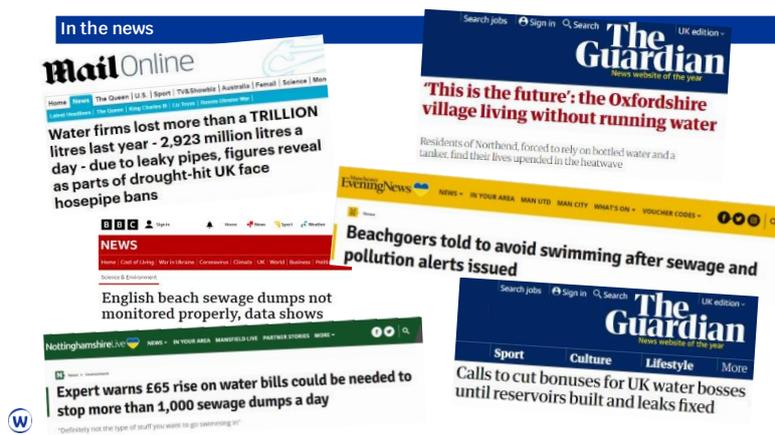
## Next steps for regulation – challenges, opportunities and building on the PR24 draft methodology



It's clear that there's a lot of consensus about the significant challenges the sector is facing. And about the need for robust and effective action to address them.

I'm going to share some thoughts on these challenges. And then I'll highlight areas where I think companies should step up to meet expectations and deliver what customers and the environment need.

And I'm also going to look at what Ofwat can do to enable and drive the changes that are needed, and that isn't just price control regulation.



I don't think we've ever seen such focused attention on the sector. The headlines tell the story.

- Outrage about leakage levels when hosepipe bans are introduced.
- River water quality.
- Questions about how our future water needs will be met.
- Ongoing anger over sewage outflows.
- The impact of investment plans on future bills.
- And against that backdrop, it's no surprise to see anger about performance-related bonuses.

I'll come back to some of the individual issues raised in these headlines.

But I also just want to pause on a couple of overall observations.

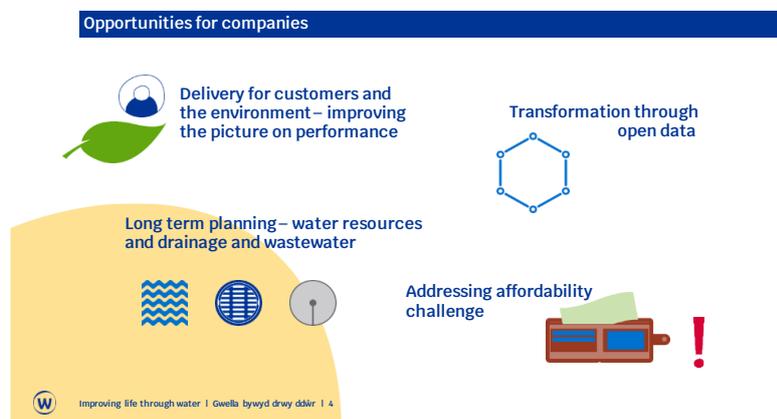
First, I think these headlines give a picture of what people expect from their water and wastewater services. And it's clear that companies' current performance isn't meeting those expectations.

And second, they reflect a sense that companies aren't always being run in the interests of their customers and the environment. It's clear that some companies' behaviours are undermining trust and confidence in the sector.

A linked issue for me has also been the lack of visibility of the sector – at least at a national level. When everyone is talking about water and sewage it's vital that company CEOs are front and centre. Public accountability includes being seen and heard when the media is discussing the issues that matter to the public and for the environment.

We all need to recognise that these concerns and headlines are not going to go away without real change. And I think the pressure is only going to intensify over the coming months. Winter challenges are just around the corner. And so too are companies' announcements on their bills for next year, which of course will be taking account of the highest rate of inflation for more than 35 years.

So the opportunities to address these challenges need to be taken now.



There are a range of things that companies can – and should – be doing right now to deliver for customers and the environment. And to be building the trust and shared understanding of the issues that is so important for progress.

I'll draw out four key areas where I see opportunities for transformational action –

- One – improving companies' current delivery for their customers and the environment;
- Two - opportunities for transformation through open data;
- Three - really effective strategic long term planning;
- and Four - innovating to rise to the affordability challenge.

Let's start with current delivery. Halfway through this regulatory period, we're seeing a mixed picture on performance against companies' PR19 commitments.

Some companies have performed well in the areas where we set common performance commitment levels at PR19, but others are lagging behind. Companies need to step up, and they should look for best practice to emulate the top performers. And this need not require significant investment. New technology may reduce ongoing costs. Or better operational processes can lead to improved services. And new partnerships can deliver innovation.

The sector is not meeting the challenges set in key areas.

- The sector has failed to grip environmental challenges. Earlier this year, in its environmental performance report, the Environment Agency said that *the environmental performance of England's water and sewerage companies was the worst it had seen for years.*
- And we've also still not seen evidence of the sector being able to get on track to deliver essential improvements in water efficiency. It's clear that a step change is needed here, and we think there's potential for companies to pull together and find innovative ways to encourage and enable customers to use less water. And we believe there's significant potential for companies to work with retailers to make progress in the non-household sector too.

The second area of opportunity is open data. We still want to see more action to open up data sets. This will provide greater transparency and accountability on performance.

It will also be a stimulus for innovation and collaboration. Our H2Open paper – published last October – set out our expectations for the industry. We said we would review industry progress in autumn this year and we are commencing the review now. If we find little or no progress is being made, we will consider the formal tools we have to ensure this opportunity is seized.

The third area of opportunity is around strategic planning. Companies should be in the final stages of planning for two of the key challenges facing the sector – how to deliver the water resources needed into the long term, – and how to deliver the sustainable, resilient systems for our drainage and wastewater needs into the future.

We want companies to redouble their efforts to consider alternative options, and to really come up with best value, sustainable solutions.

For long term water resources, companies and regional groups will be publishing their draft Water Resources Management Plans for consultation in the next couple of months. These plans should set out how companies will efficiently deliver resilient, sustainable and best value water resources for customers and the environment, both now and in the long term. This objective should be at the centre of company planning and decisions.

And companies have recently submitted their draft drainage and wastewater management plans. These set out what companies think they need to do to address issues such as storm overflow spills, sewer flooding and pollution incidents over the short, medium and long term. It is critical that DWMPs provide a solid evidence base to make sure the right investment proposals are put forward for PR24.

But our assessment of draft plans identifies that companies have some way to go to do this.

We want companies to demonstrate ambition in the improvements that they can make through existing expenditure. And to consider fully the costs and benefits of options

such as nature-based solutions before deciding the answer is additional storage. I will be writing to water companies shortly to set out our feedback on draft plans and our expectations for final plans.

The last opportunity I want to highlight for companies is the opportunity for fresh thinking on the affordability challenge.

Last week, we called on water companies to be more innovative about setting charges and to establish trials directed at customers struggling to pay. Companies would need to determine what approaches would work best for their customers and we proposed to support high quality trials through communication and facilitating shared learning.

We want companies to be ambitious in supporting and enhancing customer affordability. And we see charging innovation, now as well as for 2025 onwards, as an important dimension in supporting customer affordability. And companies also need to consider the timing for future investments. Companies must ensure that affordability is front and centre of their thinking as they develop business plans for PR24.



Let me now turn to the areas where Ofwat needs to act.

In some of these cases, it is a source of frustration that we need to intervene to push companies to do the right thing or to ensure that there is 'safety-net' protection for customers.

So where do we need to act? We are concerned about remuneration committees' grip on executive pay in a sector that clearly has a long way to go to meet the public's expectations.

We have been clear that performance related executive pay must demonstrate a substantial link to stretching delivery for customers, including the environment. And taken in the round, regrettably, we don't see this outcome has yet been achieved.

A number of companies fall short of our expectation of good practice agreed at PR19. And in some cases, we have concerns about how environmental considerations have been taken into account. Given the scrutiny across the sector on environmental performance, we are disappointed that greater restraint was not shown. We also expected to see better explanations and justifications of why awards are being made, including one-off payments, and especially where performance overall is poor.

We intend to take further steps to reinforce expectations in this area to ensure customers' interests are protected. There are a number of ways to approach this. For example, we could use targeted principles backed by the licence. Or *perhaps* we could approach this through cost allowances, in circumstances where it is not reasonable for customers to pay for rewards.

A second area of focus is the need for companies to ensure that they are financially resilient.

In a long-term sector, providing an essential service, it is vital that companies have access to the financial resources necessary to deliver their obligations and their commitments to customers at all times. Inadequate financial resilience puts customer money at risk and undermines the ability of companies to focus on customers and the environment.

In recent years we have seen a number of companies take steps to improve their financial resilience through the introduction of new equity or the retention of dividends.

But in some instances when we have raised concerns, companies have been slow to acknowledge that their financial position needs to be improved, and have been unwilling to engage openly on these issues. We have also seen recent cases of companies stepping back from public commitments to improve financial resilience.

These experiences have indicated that the backstop financial protections across the sector need to be improved. And so we have recently consulted on changes to the regulatory ring fence which will enable us to step in and protect customers where necessary.

A third key part of our regulatory toolkit is our enforcement powers, to ensure that water companies are meeting their legal obligations. We are currently investigating all wastewater companies in England and Wales in relation to how they manage their wastewater treatment works, and within that investigation we have six live enforcement cases.

Recent years have seen an increase in our enforcement activities across a range of different topics, from leakage and transfer pricing, to smart metering and wastewater treatment works. Our recent cases have also seen us secure our largest fines and spending commitments from enforcement action, demonstrating the costs to shareholders of a company failing to deliver on its obligations.

I want to end with a few points on my ambitions for PR24, and how the proposals in the draft methodology can help deliver into the long term for customers and the environment. And for companies to be clearly accountable for this delivery.

We have always regulated this sector with a focus on the long term. The construct of the RCV has enabled investment to be made when needed, but with payment for that

investment shared with the future customers who will also benefit from it. And we continue to build on how the sector can deliver sustainable, long term, best value outcomes for customers and the environment.

The long term delivery strategies that companies will produce for PR24 will not only drive better planning and evidence to help identify the key actions that need to be taken by companies in the next few years. They'll also help us to hold companies to account in consecutive review periods for the money they have received from customers. And we've been clear that in streamlining the outcomes regime, we're focusing on issues of enduring importance, so companies can be confident that great performance in these areas will attract outperformance payments into the future.

We are also driving companies to deliver the best outcomes for the environment. Again this builds on previous price reviews. At PR19 we provided for 4.8 billion pounds to deliver the ambitious environment programmes agreed for England and Wales. And we have tested proposals to encourage more nature-based solutions and incentivise innovative approaches to reach net zero. And we intend to make greater use of measures to help track delivery and keep companies on the hook to deliver their programmes of investment.

And we're very conscious of the importance of trust and accountability throughout our system of regulation.

For PR24, we're well into our nationwide research which will give us a much better understanding of the views and priorities of customers of all water companies.

And we're proposing to introduce open challenge sessions for companies to hear directly from their customers and other interested groups, and for us to hear those voices clearly and directly in the review process. We need to keep identifying ways to hear directly from people about what they want and need from water companies.

And it's essential that companies take every opportunity to turnaround performance, be accountable, and demonstrate the behaviours that the public expect. There is much still to do.

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