Water UK's Response to Ofwat's Draft Determinations on PR24

28 August 2024

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About this document

This is Water UK's response to Ofwat's draft determinations for the 2024 price review (PR24) on behalf of the water industry in England and Wales. Water UK is the trade association for the UK's water industry and comprises all of the water and wastewater companies of England, Northern Ireland, Scotland and Wales.

This document:

- sets out our overall view of the draft determinations
- proposes changes that will unlock urgently-needed investment for improving outcomes for customers and the environment, and
- calls for Ofwat to change how it is engaging in order to successfully conclude PR24.

Overview of our response

This document consists of:

- an executive summary
- a substantive response to Ofwat's consultation on draft determinations, and
- further details on specific spend and outcome areas (Annex A).

Alongside this document we provide seven further policy papers and reports, including from independent consultants, with more technical details and recommendations:

- a position paper on a common framework for uncertainty mechanisms (by Water UK)
- a report on the investability of PR24 (by Oxera)
- a report on asset health and capital maintenance (by Reckon)
- a report on performance targets and incentives (by First Economics)
- a report on energy costs (by Baringa)
- a report on the cost of new debt and additional borrowing for PR24 (by KPMG), and
- a report on the cost of embedded debt with commentary on Ofwat's draft determination position (by KPMG).

Contents

Executive Summary

Securing investment in the water sector is vital for our society, economy and environment

Investing in the water sector is important for:

- **our society** – millions of homes, shops, schools, hospitals and workplaces depend on high-quality drinking water every day across England and Wales, while improved water infrastructure has become increasingly important for public health and recreation.
- **our economy** – well-functioning water infrastructure enables us to run our businesses, build new homes and unlock economic growth across every part of England and Wales.
- **our environment** – by sustainably managing water resources to avoid over-abstraction and through better treatment of wastewater. We also need more capacity for sewage infrastructure to respond to population growth, climate change and tighter environmental targets.

In recent years the water sector and its system of legislation and regulation have failed to act swiftly enough to meet the expectations of customers. To address this and tackle future challenges, water companies have proposed a near doubling of investment levels over the next five years.

This is only the beginning. According to the National Infrastructure Commission, substantial levels of private investment will be needed every year from now until 2050 to avoid drought and adapt to climate change. The next investment period is the first of many, and we need to get it right. The next few months will determine the contours of a programme that will run for many years to come.[1]

Unfortunately, we and independent commentators have concluded that Ofwat's draft decisions make some fundamental mistakes that result in failure to provide sufficient funding, achievable targets or the ability to attract a sufficient level of investment.

For example, on attracting investment, it is now clear that without changes **Ofwat's draft determinations are likely to make it impossible for the water sector to attract the level of equity investment that it needs**. This assessment is supported by credible independent commentators, such as Moody's[2] (who have warned that Ofwat's decisions may directly affect company credit ratings), is aligned with the view of analysts like Barclays[3] and is now emphasised by independent consultants Oxera – who, in a new and comprehensive report published alongside this submission, analyses the investability of the draft determinations. Indeed, some existing investors have already indicated that, unless the draft determinations change, **they will not provide the substantial injections of new equity initially proposed in their business plans**.

[1] For example, '*Enhancement Expenditure Set to Rise Materially Over the Next 25 Years*' Moody's, October 2023.
[2] "Allowed returns may not be enough to attract equity support for large investment needs" (from '*Ofwat's draft determination increases sector risk*', Moody's, 14 August 2024).
[3] 'Breaking the water cycle – no longer positive', Barclays, 5 August 2024.

Ofwat needs to urgently revise its draft determinations

By making the following targeted changes to its draft determinations, Ofwat can enable the water sector to meet future challenges and deliver for customers and the environment.

1. Provide enough funding to meet obligations and future challenges

Ofwat's record-breaking cuts to proposed improvements of £11.4bn (25%) will make hundreds of projects unviable, even where Ofwat has in theory agreed that they should go ahead. This may force some water companies to miss statutory deadlines, scale back their investment plans, shift activity towards lower-value projects that just tick 'regulatory boxes' (rather than delivering real value) or deprioritise maintenance activities.

Ofwat has also reduced day-to-day expenditure based on unrealistic forecasts and assumptions, which means that companies will be unable to sufficiently maintain and upgrade their infrastructure. This completely misses an opportunity to overcome well-recognised and longstanding shortcomings in asset health maintenance.[4]

Compared with companies' plans, this will likely delay efforts to reduce leaks, sewage discharges and service failures. Supported by new independent analysis, we consider this has four causes:

i. **No additional funding for improving infrastructure such as sewer rising mains,** one of the most serious causes of pollution incidents.
ii. **Overly squeezed funding for maintenance. Ofwat's draft decisions will prevent most companies from investing more in replacing ageing infrastructure**. Indeed, despite claims to the contrary,[5] the evidence shows that Ofwat is actually squeezing funding for maintenance.[6] Unless changed, Ofwat will, again, leave the state of our infrastructure to bear the costs of cutting bills below where they need to be, year after year.
iii. **Ofwat's models for funding asset maintenance use incorrect data and produce false results**. In Reckon's view, Ofwat's models rely on "polluted" data within its models.[7]
iv. Ofwat's rhetorical recognition of the problem is yet to result in commensurate action. Ofwat regularly has to make difficult decisions regarding how best to allocate its limited resources. Nonetheless, it was surprising that Ofwat suspended its asset health team for a crucial year in

[4] For example, Water UK first published work on this calling for a different approach several years ago while independent organisations like the National Infrastructure Commission now also agree there is serious problem.
[5] Ofwat (July 2024), 'UK Government priorities and our 2024 price review draft determinations', p. 13, "Our draft determinations incentivise and enable a greater focus on asset stewardship for the long term in England"
[6] See the accompanying report on asset health from Reckon, "Ofwat's cost assessment seems to implement a funding squeeze on water companies, once consideration is given to the upward trend in companies' base costs over time (which is overlooked by Ofwat) and the factors that are likely to be driving this. This funding squeeze poses risks to capital maintenance and asset health".
[7] See the accompanying report on asset health from Reckon, pp. 10-11: "the historical expenditure data used for Ofwat's econometric benchmarking of base costs is polluted to some degree: companies' decisions on how much investment in asset health to undertake have been made within the context of a regulatory framework that gives more emphasis to companies' near-term cost control and within-period performance than to their longer-term efficiency, asset health and management of risks to future outcomes".

the run-up to this price review. **It also only provided new funding for water mains, with this concentrated on just three companies**.

These problems are exacerbated by Ofwat's policy of financially penalising companies whenever they try to set out the scale of the need as they see it. By acting akin to a judge and a jury with a preconceived judgment in mind, Ofwat uses financial incentives to encourage companies to overestimate the health of their assets. **Companies might reasonably be said, therefore, to face an "honesty tax".**

This is one example of Ofwat not taking a consistent long-term focus. Another is the steep cut to 'enhancement' spend, which in practice would defer long-term improvements into future price reviews. This is despite the evidence from long-term delivery strategies suggesting this will add a wave of additional cost to future investment, which we know will need to keep growing over coming decades. Ofwat's draft decisions therefore stores up problems – and costs – for future generations.

Furthermore, some regions face larger cuts than others. For example, Ofwat has cut over £1.5 billion from the storm overflows investment plan for the North of England and, despite the South East of England being the region with the highest risk of drought without sufficient investment in water security, Ofwat cut South East Water's investment plans by 64%. By not properly taking account of regional characteristics, this could mean large parts of the country are left behind others, with fewer or delayed improvements as a direct result of Ofwat's draft decisions.

Recommendations:

- **Provide sufficient funding allowances for investment**, remove excessive and arbitrary evidence requirements and efficiency challenges and **revert to engineering-based assessments of major projects** that properly take account of regional characteristics and costs, rather than simplistic benchmarking models.
- **Use realistic forecasts of future costs**, based on the evidence provided by companies to refine the allowances, assumptions and adjustment mechanisms for frontier shift efficiency, energy costs and business rates.
- **Revise the proposed approach to asset health maintenance** (see Reckon's report for Water UK which puts forward practical options for PR24).

2. Hold the sector to account effectively

We fully support Ofwat's aim of setting stretching and achievable targets. It is right for Ofwat to seek to push the sector to innovate and deliver improved outcomes for customers and the environment. And, whenever companies fall short, they should be held to account.

However, Ofwat's draft determinations do not achieve these objectives. Because of miscalibrated performance targets and incentive rates, they create excessive levels of downside risk with limited scope for companies to improve their performance. We estimate companies could face significant performance penalties of between £2.5bn and £8.4bn over the next five years.[8] Almost every company

[8] Based on the performance targets and incentive rates in Ofwat's draft determinations applied against two different performance scenarios: the lower figure is based on company business plan forecasts (which are likely to now be too optimistic given Ofwat's proposal to steeply cut funding), or an average of actual performance over 2020-21 to 2023-24 (which may be too pessimistic assuming continued improvements over the coming period).

will automatically fall into penalty (and so be seen as failing) from day one, because Ofwat has not properly taken into account real world performance. As well as making it harder for companies to improve, this will undermine trust and confidence in the sector – including in the regulator and its framework.

Ofwat's late proposals on price control deliverables are not workable. Companies should be held to account for delivering their obligations and be required to return funding to customers if they do not deliver. But as they stand, the proposals duplicate existing statutory requirements and do not reflect the delivery profiles proposed by companies or set by other regulators. They also introduce additional timing penalties that will mean companies cannot deliver new investment projects, particularly due to significant funding cuts. Companies are also prevented from adopting cheaper or greener approaches as they become available over 2025 to 2030.

New performance-based risk protections within the draft determinations are welcome, but they need to be stronger to provide sufficient protections arising from both the determinations and the scale of the investment programme for PR24.

Furthermore, water companies continue to face new statutory requirements in the forthcoming control period that will not be reflected in their allowed expenditure. This creates further uncertainty and risk.

Recommendations:

- **Set achievable and deliverable performance targets** by improving how Ofwat estimates risk in a way that more accurately reflects reality. This should be done by setting targets on the basis of the latest performance data for 2023-24 and further evidence provided by companies.
- **Strengthen performance-based risk protections**, through greater use of caps, collars and aggregate sharing thresholds for outcomes performance.
- **Reduce the coverage, delivery profiles and prescriptive requirements of price control deliverables**, only applying them where they do not duplicate existing statutory requirements, revising delivery profiles to better reflect the circumstances of individual projects and enabling companies to adopt cheaper or greener options over 2025 to 2030.
- **Introduce a common approach for uncertainty mechanisms**, enabling companies to adapt to new legal requirements or material changes in scope as they arise between 2025 and 2030, particularly due to changes in government.

3. Ensure the sector can attract the investment it needs

As it stands, **Ofwat's draft determinations for PR24 represent a critical risk to the sector's ability to raise the levels of investment needed for ensuring the security of our water supply and to stop sewage entering our rivers and seas**. By providing insufficient funding and setting companies up to fail, the draft determinations will force the water sector in some places to either delay or scale back some of their plans. This comes just when the sector needs to overcome a decade of underfunding following the suppression of bills below inflation. This cut £11bn from potential investment over the last ten years.[9]

[9] This is based on Water UK calculations of the amount of investment that would have been available had Ofwat simply allowed revenues to keep pace with inflation from since 2015.

Looking forward, the water sector needs at least £7bn of new equity to finance the improvements required by government and demanded by customers and society. [10] This ensures that customers will not have to pay upfront for those investments, fairly distributing costs over time and keeping water bills manageable. Securing equity finance is also the way we get the largest investment into the environment in the history of the water sector.

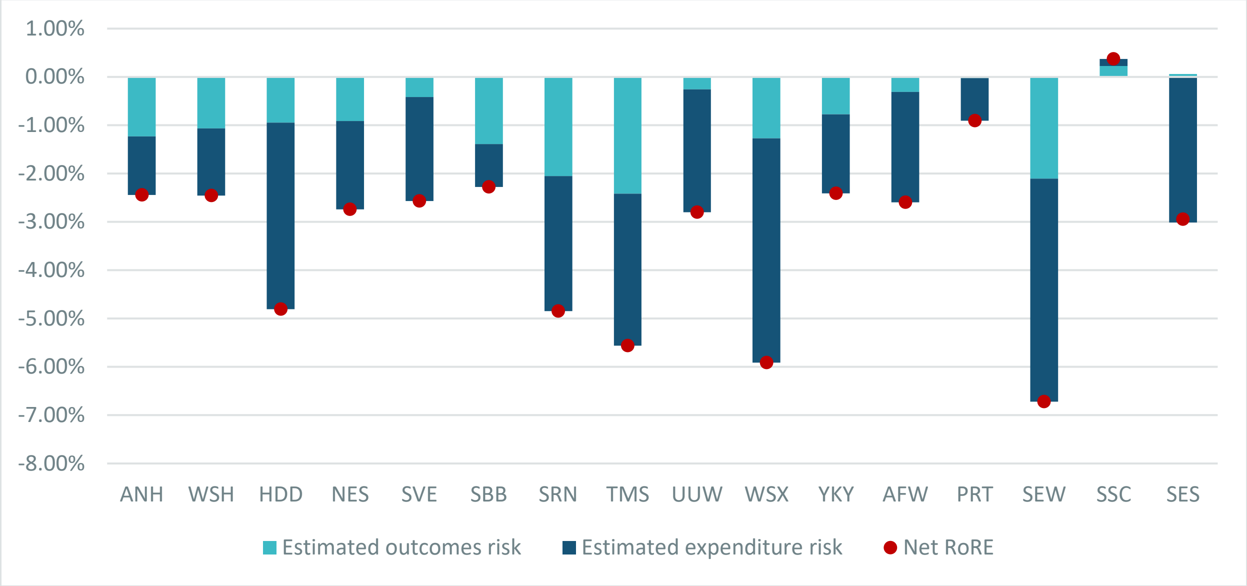
We welcome Ofwat's recognition of the need to attract equity investment to drive forward improvements. It has tried to reverse some of the mistakes of the last price review by being slightly more supportive of investment requests, using more realistic benchmarks for expenditure and performance targets and explicitly aiming to set a cost of equity that attracts new investment. But in other cases, Ofwat has not changed approach, or its proposals will make the sector even less attractive to new investors compared with other sectors.

However, **without change then Ofwat's draft determinations would likely make it impossible for the water sector to attract the level of equity investment that it needs**. As noted above, this assessment is shared by credible independent commentators. Indeed, in its engagement with over 30 senior investors, Oxera found that **there has been a deep and widespread loss of confidence among domestic and international investors in Ofwat's decisions and their ability to enable the long-term investment needed by the sector**. This loss of confidence seems to have grown even from the striking findings of Ofwat's last investor survey (conducted before draft determinations were published in late 2023) which found that every single private equity investor thought that investors were not being listened to, and 90% disagreeing or strongly disagreeing with Ofwat's approach to regulation.[11]

Compared with other regulated sectors, Ofwat's proposed returns are far too low – for example, only one week after the draft determinations, Ofgem consulted on an allowed cost of equity that was almost a full percentage point higher than Ofwat's. In addition, the mix of incentives and penalties is negatively skewed, with the entire sector due to incur net underperformance of at least £8.4bn based on their forecast outcomes and expenditure performance over the next five years (see Figure 1). **Every company faces significant underperformance penalties based on Ofwat's draft determinations, even after its proposed risk mitigations are applied. This makes it unlikely that any company will be able to reliably earn even Ofwat's insufficient allowed cost of equity.**

[10] "PR24 draft determinations: Aligning risk and return", Ofwat, 2024, p. 3. Some commentators have suggested this figure may actually be greater, depending on a range of factors. For simplicity we have used Ofwat's figures as per the draft determinations and based on companies' business plan proposals.
[11] "Investor survey results 2023", Ofwat, 2024, p. 5.

Figure 1: Almost every company faces significant penalties and risk for outcomes and expenditure performance based on Ofwat's draft determinations – even after risk mitigations



Source: Water UK analysis of business plan forecasts and Ofwat's draft determinations (see Chapter 3 for calculations)

Ofwat appears, yet again, to have prioritised lower bills in the short term, instead of providing sufficient funding for investment and maintenance, with billions of investment stuck behind additional regulatory processes before it can be released and £0.5bn of revenues pushed beyond 2030. Ofwat expects that investors will provide money, in the form of new equity, but has not recognised that they will be put off further by Ofwat's latest proposal to restrict dividends for the majority of companies based on their capital structures. **In effect, Ofwat is asking investors not to inject equity to support infrastructure renewal but instead to provide a short-term subsidy for bills.**

Unless Ofwat changes its approach, **equity investors will not provide all the capital the sector needs, especially when more attractive investment opportunities are available elsewhere**. This real risk is reflected in feedback from investors (as shown by Oxera's report). However, there is little evidence of proper analysis by Ofwat of the impact of its draft decisions on investor sentiment inside or outside of the sector.

It is now clear that the kind of incremental changes between draft and final determinations seen in previous price reviews may no longer be enough to secure sufficient equity. As noted above, some existing investors, including in water-only companies, have indicated that, unless the draft determinations change, **they will not provide the substantial injections of new equity initially proposed in their business plans**. Without new equity, either improvements will not happen, or customer bills will have to significantly rise to fund them upfront. To address this, Ofwat now needs to pull every lever to ensure the water sector is investable and financeable.

Recommendations:

- **Set an allowed cost of equity that attracts new equity investors**, taking account of the latest market evidence, reflecting the genuine risks faced by prospective investors and 'aiming up' on the cost of equity to attract new investment (and, if appropriate, compensate for asymmetric risks within the determinations).

- **Ensure companies are financeable with enough revenue to fund their operations and cover their financing costs**, with realistic expenditure forecasts, a higher allowed cost of debt and increased cost recovery rates that properly reflect the profile of expenditure that companies need to maintain and upgrade their assets.
- **Abandon new proposals for companies with gearing above 70%**, reflecting that Ofwat secured new powers to restrict dividends for companies with insufficient financial resilience only last year, and that this new proposal would undermine investor confidence given current gearing levels and the substantially negative signal it sends to potential investors.
- **Support affordability through social tariffs**. Ofwat has pushed back revenue over a longer period to reduce bill impacts in 2025-30. But instead of putting those costs on future generations and creating cashflow issues now, Ofwat should enable the sector to go faster and further in supporting more customers than companies initially proposed.

Ofwat needs to change its approach if it is to successfully conclude PR24

Given the scale of the sector's concerns with the draft determinations and the limited time remaining before the final determination needs to be published, Ofwat needs to engage in a different way.

In particular, Ofwat's assessment seems to have focused on separate elements of its methodology (e.g. outcomes, costs, finance) rather than fully considering the individual circumstances and regional characteristics of each company. Indeed, it is not clear how Ofwat has assured itself that the determinations for each company are, overall, coherent, deliverable and financeable.

Furthermore, and as our analysis shows, unless the draft determinations change, **almost every single company can expect to continue to overspend its expenditure allowances and be behind on their performance targets, reflecting that Ofwat's approach has been based on 'aspirational' rather than 'actual' companies.**

This approach has been exacerbated by limitations in Ofwat's approach, including the absence of an initial business plan assessment stage (as per PR19), a short consultation period for the draft determinations (with a consultation period of less than seven weeks to respond to 3,000 pages) and the late inclusion of new or incomplete proposals (particularly on outcomes and price control deliverables).

At this stage in the process, it is therefore vital that Ofwat takes the time it needs to study carefully the individual issues raised in this and company submissions. The level of concern among industry is now such that **the sector would be willing to work with Ofwat on an unprecedented delay of final determinations to late January 2025** if that would allow more meaningful engagement and a better settlement for customers, the environment and a sustainable long-term industry. This would need to include working with Ofwat on overcoming any practical barriers to agree specific charging arrangements, as well as managing any supply chain issues.

Water UK is willing to facilitate structured engagement over the next few months with water companies and the investor community to help secure a successful conclusion to PR24.

The rest of this document provides further detail, analysis and evidence in support of these positions.

1. Providing enough funding to meet obligations and future challenges

In this chapter, we set out our response to Ofwat's approach to:

- enhancement expenditure allowances, which Ofwat describes as expenditure that is generally to deliver "…a permanent increase or step change in current levels of service, which could be driven by new statutory obligations, higher service quality or new resilience standards."
- base expenditure allowances, which Ofwat describes as including "routine year-on-year costs", expenditure to maintain the long-term capability of assets and comply with legal obligations.

Companies need Ofwat to approve their investment plans. If allowances are insufficient, companies cannot deliver the improvements expected by customers and society.

1.1 Enhancement expenditure allowances

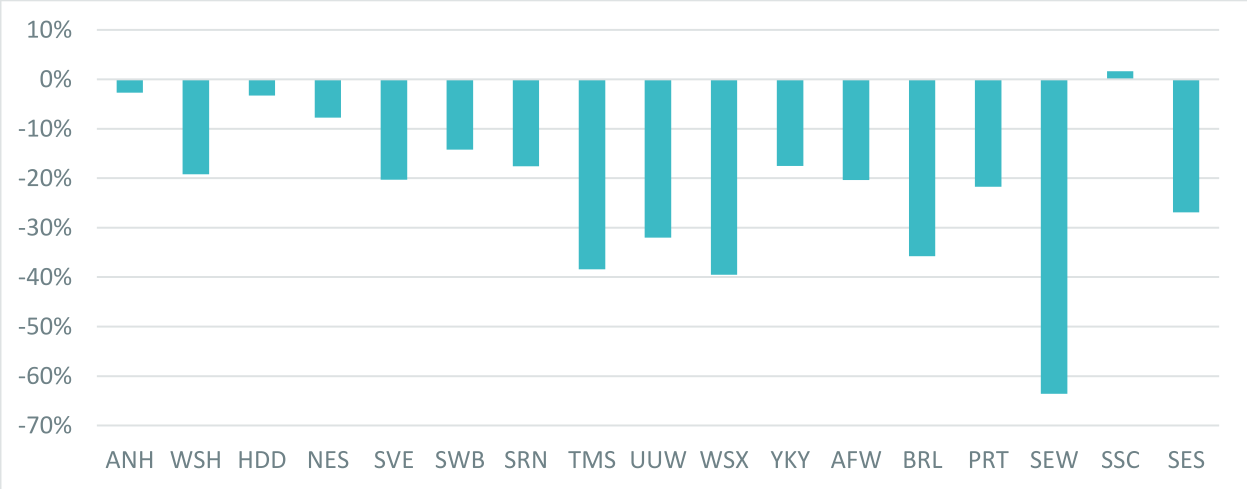
1.1.1 Ofwat's draft determinations

Ofwat has cut too much from the enhancement programme, putting at risk necessary investments to secure our water supplies, upgrade ageing infrastructure and clean up our rivers and seas.

While enhancement allowances are higher than ever before, Ofwat's cuts of £11.4bn (or 25%) to the sector's proposed £46bn are also the largest in the sector's history and as large as the entire enhancement programme at PR19 (around £11bn in today's prices).[12]

Nearly every company has had its enhancement programme cut back, with an overall cut of 25%. The cuts are much greater for some companies – South East Water's enhancement programme has been cut back by nearly two-thirds (64%), Wessex Water's by 40% and Thames Water's by 38%. Only South Staffs Water received a slightly higher enhancement allowance than requested (by 2%). While Ofwat says it has approved almost all schemes, the scale of these cuts, making it doubtful they will all be delivered.

Figure 2: Changes to the sector's enhancement proposals by company in Ofwat's draft determinations (%, before frontier shift and real price effects)



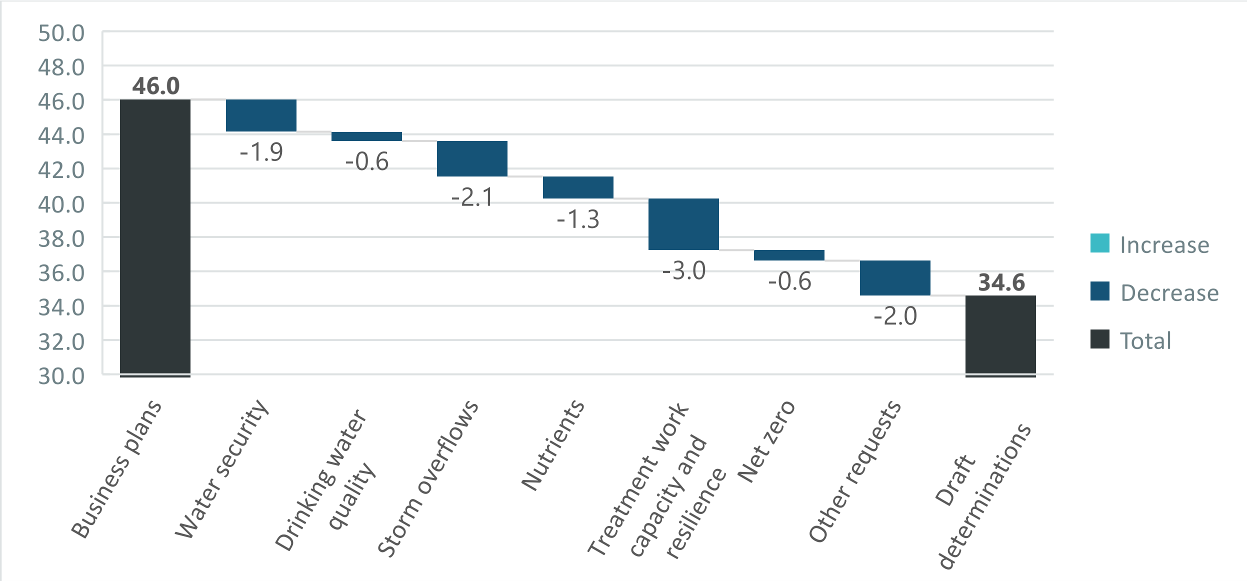
Source: Water UK analysis of 'Expenditure allowances summary tables', Ofwat, July 2024.

[12] Figures in this chapter are before further cuts due to Ofwat's assumptions on frontier shift and real price effects.

As illustrated in Figure 3, these cuts are deeper in certain expenditure areas, with significant cuts to:

- Environmental improvements – with cuts of £2.1bn to storm overflows[13] projects, £1.3bn to reduce the impact of nutrients[14] and £3.0bn to increase wastewater capacity and resilience[15].
- Water security measures – overall cuts of £1.9bn (18%), including for new supply options, metering and leakage reductions (by £0.5bn or 8%) and water resilience and security (by £1.4bn or 37%).
- Drinking water quality improvements – around £0.6bn of cuts (29%).

Figure 3: Changes to key enhancement areas in Ofwat's draft determinations (£bn in 2022-23 prices, before frontier shift and real price effects)



Source: Water UK analysis of 'Expenditure allowances summary tables', Ofwat, July 2024.

We are concerned that customers will not see the improvements they expect because, in making its decisions, Ofwat has:

- Underfunded statutory requirements. This is despite them making up nearly 90% of enhancement requests. These requirements are set by legislation or other regulators. Ofwat also appears to have given limited regard to long-term delivery strategies in its draft determinations, despite the strategies showing that, given the level of investment required by the sector, current investment needs cannot be deferred to future periods.

- Applied excessive 'efficiency' challenges. Where Ofwat has assessed the evidence provided by companies as insufficient, it has reduced requests by as much as 30%, despite many of them

[13] Storm overflow expenditure encompasses investments allocated to combined sewerage overflows (CSOs), event duration monitoring and continuous water quality monitoring programme.
[14] Nutrient expenditure includes investments allocated to nutrient removal, catchment-permitting and nutrient balancing.
[15] Wastewater capacity and resilience expenditure encompasses investments allocated to the water industry national environment programme (WINEP), as well as growth at sewage treatment work and the industrial emissions directive.

being required to meet statutory obligations. In some cases, efficiency challenges have gone far beyond what is credible.

- Had insufficient regard to regional differences. Where Ofwat has used benchmarking, it has relied on new models that take insufficient account of regional factors and appears to have ignored the evidence provided by companies about the real costs that they face. For storm overflows, Ofwat assumes that low-cost options can be applied in every part of the country, with limited recognition of geography. Three quarters of the roughly £2 billion cut to proposed overflow investment will hit the North of England.

- Ruled out 'discretionary' schemes despite clear needs and risks. For example, Ofwat has cut cyber-security proposals for water services by 43% and not allowed any requests for wastewater cyber security. This is despite a global increase in cyber-attacks in the water sector, including at least two water companies in the UK in recent years, as well as successful attacks that have disrupted water company operations in Ireland and the United States.

- Inadequately funded climate change resilience. Ofwat has provided a sector-wide uplift of 0.7% (equivalent to £300m across the sector) which is likely to be insufficient to address the risks from power outages and flooding. While companies were initially discouraged from submitting enhancement requests due to the Quality and Ambition Assessment, Northumbrian Water's request of £89m suggests a more proportionate allowance for the whole sector should be closer to £1.5bn (based on its 6% share of total expenditure).

1.1.2 Our proposals

We propose that Ofwat **enables investment in necessary improvements**, making the following changes to the draft determinations:

- Providing sufficient funding allowances for investment. 'Efficiency challenges' based on weak evidence or arbitrary reasoning should be removed in favour of reverting to engineering-based assessments ('deep dives') of major projects, which were common at PR19, instead of using overly simplistic benchmarking models that underfund improvements. Ofwat should also take more account of real-world issues and risks in assessing projects and their allowed costs.

- Revising its approach to climate change resilience. Ofwat should reassess new requests to increase climate change resilience, recognising that its existing backward-looking approach to base allowances would not provide sufficient funding to meet future risks. If Ofwat maintains a sector-wide uplift, it should ensure that this adequately deals with those risks that are different in each region of the country, and is updated based on revised company submissions and efficiency assessments.

Annex A sets out further detail on the cuts and delivery barriers to individual outcome areas and recommendations for resolving each.

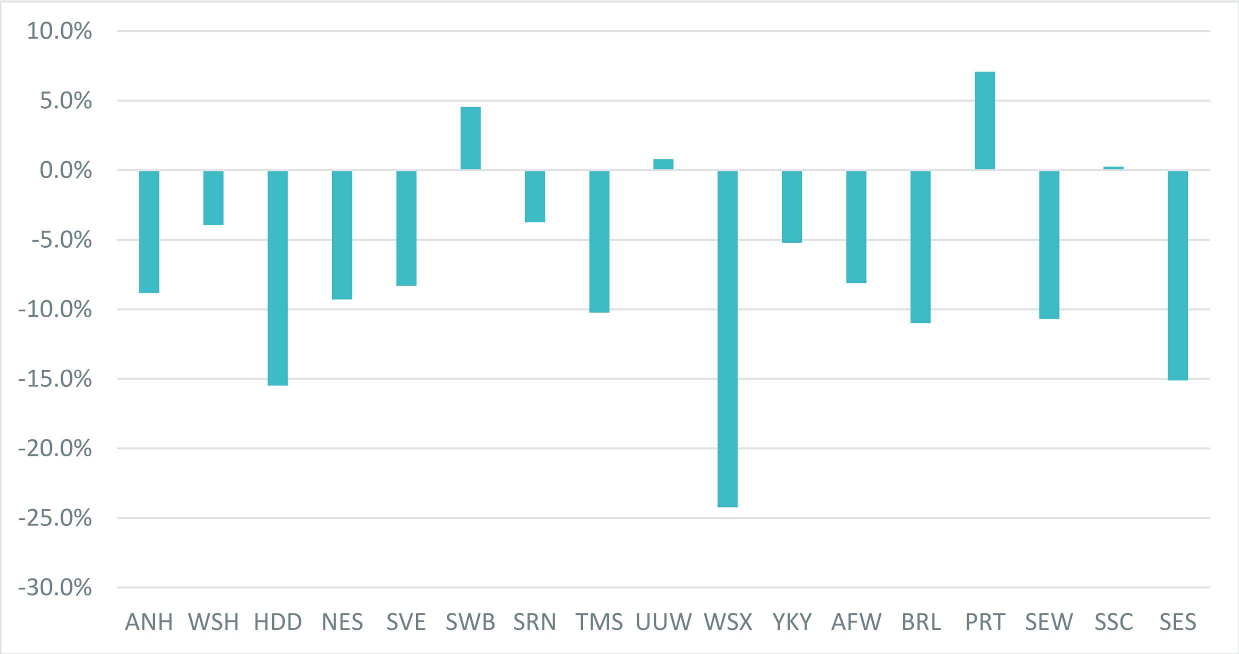
1.2 Base expenditure allowances

1.2.1 Ofwat's draft determinations

We are concerned that Ofwat expects too much from base expenditure allowances – they are substantially below what companies need and are only slightly above PR19 allowances and expenditure despite new risks and future challenges.

Companies proposed £60.8bn of base expenditure, made up of £55.6bn in wholesale expenditure and £5.2bn in retail (household and non-household) expenditure. In its draft determinations, Ofwat proposed an overall cut of £4.4bn (or 7.2%).

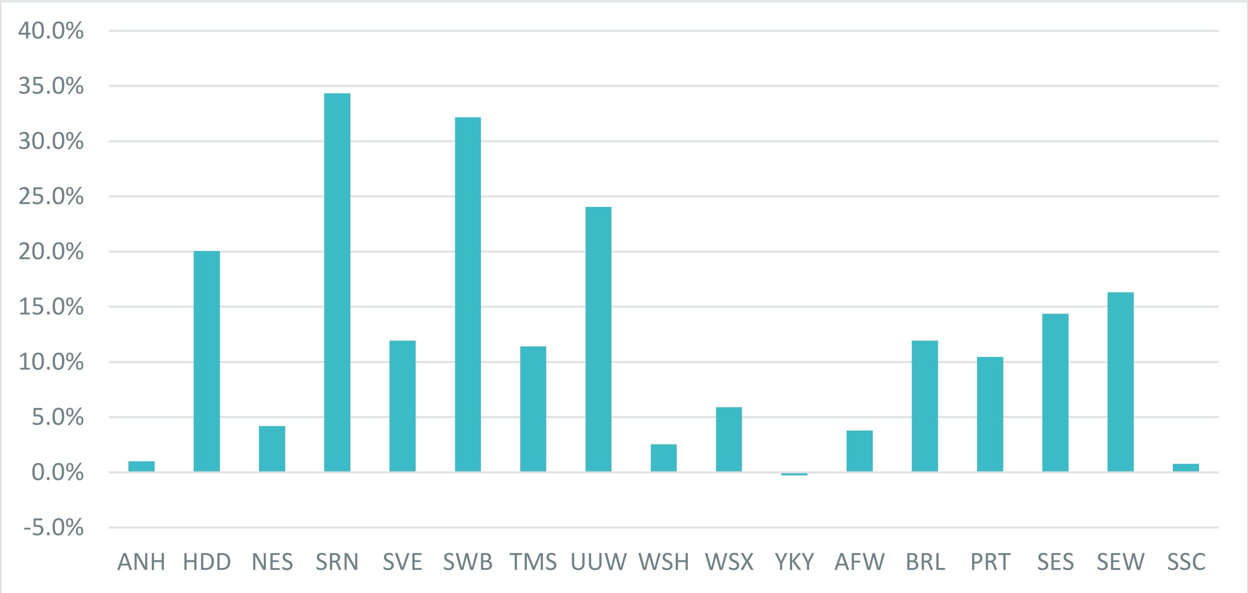
Figure 4: Changes to the sector's base and retail expenditure proposals by company in Ofwat's draft determinations (%, before frontier shift and real price effects)



Source: Water UK analysis of '[Expenditure allowances summary tables](#)', Ofwat, July 2024.

We are concerned that **Ofwat is repeating the mistakes of the past, by assuming that historic expenditure and performance data are good indicators of the future**. All recent evidence suggests this approach has failed. Companies have significantly overspent their total expenditure allowances from PR19. As Figure 5 shows, overall companies have overspent their allowances by £4.4bn or 12%, with South West Water and Southern Water overspending by more than 30%.

Figure 5: Overspending against total expenditure allowances over 2020-21 to 2023-24 (% of wholesale and retail total expenditure, excluding additional controls)



Source: Water UK analysis of annual performance reports (tables 2C and 4C).

In the face of a repeat of this, we are concerned that companies will be forced to cut back in areas that need investment because, in making its decisions, Ofwat has:

- Disallowed £11.4bn of enhancement proposals, insisting companies can fund some of this through already-stretched base allowances. The effect of this is to make enhancement projects undeliverable, or to 'crowd out' base expenditure or maintenance activities (because price control deliverables and the new delayed cashflow mechanism incentivise companies to prioritise the delivery of enhancement programmes over other activities). This suggests that Ofwat's cuts to base spending are much more significant than implied by the 7.2% reduction.

- Made unrealistic assumptions about input costs, such as on energy prices and business rates. Baringa, in its report for Water UK accompanying this submission, sets out how Ofwat's proposed approach on energy prices is inconsistent and would underfund companies[16]. While Ofwat has provided for 10% cost sharing on business rates, by ruling out £1bn of company forecasts it is still underfunding companies by £100m over 2025-30. This will add to financeability challenges if they aren't reconciled until 2030.

- Heavily discouraged companies from submitting realistic base expenditure requests, with the Quality and Ambition Assessment financially penalising companies that undertake detailed and realistic assessments of their future costs using bottom-up methods, rather than just using Ofwat's models. Ofwat's record of rejecting cost adjustment claims has also deterred companies from developing them for PR24. **This is why we are concerned about the perception of an**

[16] See accompanying report "Ofwat's PR24 Draft Determinations for the treatment of energy costs in AMP8", Baringa, August 2024.

"honesty tax" and of Ofwat creating barriers to any meaningful examination of real problems and their solutions.

These issues are made even worse by the limitations of Ofwat's base models, which are unable to tell the difference between genuine efficiency and underinvestment. Through its indifferent treatment between those two possibilities, and by using the lowest spenders as benchmarks for the rest of the sector, this approach locks-in historic underinvestment in capital maintenance. As Reckon observes in its report for Water UK, Ofwat's base models have become "polluted" by misleading historical expenditure data with numbers sourced from a framework that incentivised companies to focus on the short-term over long-term investment and maintenance activities. By not recognising these flaws in its models, Ofwat risks repeating the mistakes of the past.

1.2.2 Our proposals

We propose that Ofwat **sets base expenditure allowances that enable water companies to properly maintain and upgrade their operations**, making the following changes to the draft determinations:

- Fully fund enhancement allowances. This ensures they will remain viable, delivering benefits for customers and the environment, and takes pressure off base expenditure allowances.

- Use more realistic forecasts of future costs, with the following targeted changes:
    - Frontier shift. As Economic Insight has shown[17], UK productivity has declined in recent years. It is therefore implausible to expect water companies to achieve additional year-on-year efficiency gains from their expenditure allowances of 1%, as proposed by Ofwat. Ofwat should reduce the frontier shift efficiency assumption to within Economic Insight's proposed range of 0.3% to 0.7%, with recent evidence suggesting this should be towards the lower end reflecting poor productivity in the last year.
    - Energy prices. As Baringa's report for Water UK shows, Ofwat has incorrectly forecast energy prices in its draft determinations. Ofwat should consider the options set out by Baringa and adopt the recommendations to remove inconsistencies and provide a more realistic forecast of energy prices in the determinations for the 2025 to 2030.
    - Business rates. Adopt companies' forecasts where they are based on evidence.
- Reassess companies' cost adjustment claims. By allowing more cost adjustment claims in its draft determinations than at PR19, Ofwat has recognised that its base expenditure models are imperfect and struggle to adequately reflect relevant factors. Ofwat now needs to go further by reassessing companies' cost adjustment claims, as well as any new submissions from companies in response to the draft determinations, recognising that many will have been discouraged from submitting them in the first place due to the Quality and Ambition Assessment.

[17] "…with a focus specifically on the PR24 time period, it seems likely (both on the evidence and intuition, given the persistence of low productivity) that frontier shift will sit within a narrower range (which we find to be 0.3% to 0.7% for the total water value chain; and 0.4% to 0.6% for water retail)". 'Productivity and frontier shift at PR24', Economic Insight, April 2023 and 'Further evidence on frontier shift at PR24', Economic Insight, March 2024.

In the next section we set out our view and proposals for the specific issues of asset health and capital maintenance, which are largely included in base expenditure allowances.

1.3 Asset health and capital maintenance

1.3.1 Ofwat's draft determinations

We are concerned that Ofwat has failed to recognise the scale of problems with asset health and capital maintenance. Unless Ofwat changes course quickly, this will have increasingly severe impacts on customers and the environment with no further opportunity to put things right this decade.

As early as 2021, Ofwat identified the need to create new asset health measures and reflect the fact that its base expenditure models may not provide sufficient allowances for capital maintenance in the future.[18] Reflecting on the impact of its PR14 price review, Ofwat acknowledged that its regulatory approach creates short-term incentives and conceded that "there could have been greater focus on asset health and its role in delivering resilient services in the long-term during the 2015-20 period".[19] However, in May 2023 the National Infrastructure Commission publicly wrote to Ofwat expressing continued concern about its approach to asset health monitoring and funding. They noted that Ofwat's approach seemed to "imply asset lives of 180 years" for water mains, and asked Ofwat to tackle that by developing forward-looking measures.[20]

Despite this widespread and now longstanding recognition of the drawbacks of the current regulatory approach, Ofwat's PR24 methodology included no new metrics and made no explicit changes to its base expenditure models to tackle asset health concerns. In its draft determinations, Ofwat did make some small changes to its approach, providing an additional £297m for mains renewals for some companies.[21] At the same time, Ofwat has required that every company delivers more mains renewals than the current rate using existing funding (an 'implicit allowance').

While we welcome Ofwat's late acknowledgement that its unaltered base expenditure models are insufficient, we are concerned that the proposal is inadequate because it:

- Provides insufficient funding for companies. Ofwat rejected nearly every funding request to improve asset health, and its proposed 'implicit allowances' provide no new funding for the majority of companies, instead requiring them to use their existing base allowances to deliver maintenance activities. As Reckon notes in its report for Water UK, only six out of 17 companies have been provided with additional funding – with 85% of it allocated to just three companies.

- Only focuses on a subset of assets. Ofwat's approach only focuses on water mains renewals, presumably because data is more readily available. However, other types of assets could create similar or bigger risks to customers and the environment and face very similar vulnerabilities as water mains. Ofwat's decisions may make the overall asset health challenge worse and force companies to invest more of their scarce capital maintenance budgets into one specific group of assets that may not necessarily be the most critical to delivering essential services to customers

[18] 'Assessing base costs at PR24', Ofwat, December 2021.
[19] 'PR14 Review', Ofwat, January 2022, pp. 23-24.
[20] 'Letter to Ofwat on water company asset management', National Infrastructure Commission, May 2023.
[21] 'Expenditure allowances', Ofwat, July 2024, p. 31.

compared to other assets. For example, despite Ofwat identifying concerns with the condition of sewer pumping mains due to low replacement rates, it provided no additional funding to do anything about this. This will inevitably lead to more pollution events and harm to watercourses.

- Does not overcome the limitations of the regulatory framework, including that their incentivisation of companies to focus on short-term performance over long-term investment. There is also no separate modelling of capital maintenance expenditure within PR24, despite it representing around £22bn of expenditure in companies' business plans. This approach is made even worse by the 'pollution' of Ofwat's models discussed above and its interaction with other regulatory mechanisms to create deeply perverse outcomes (for example, companies must pay a financial penalty every time they repair a water main above a certain threshold, disincentivising them from acting to reduce leaks).

Instead of meaningfully addressing concerns with asset health and capital maintenance, Ofwat says instead that it is: *"developing an integrated monitoring framework to form a holistic and complete view of asset health and operational resilience going forward".*[22] We welcome Ofwat's attempts to revise its approach to base expenditure modelling at a late stage, but this and the scale of its future commitments do not match the severity of the issue described above.

1.3.2 Our proposals

We propose that Ofwat **revises its approach to asset health and capital maintenance**, making the following changes to the draft determinations:

- Provide sufficient funding for asset health improvements. Ofwat's approach to calculating implicit allowances does not adequately fund companies for improvements because it is inconsistent. The time period for mains renewals does not match the time period for expenditure models. Ofwat also wrongly expects companies to make improvements through their existing base expenditure allowances, despite cutting them by at least 7% (as discussed above). If Ofwat is serious about encouraging greater mains renewals, it should properly fund them rather than setting unfunded expectations.

- Broadening the scope of any interventions. It is not clear why Ofwat has focused solely on mains renewals when other types of assets (for example, sewer rising mains) may pose greater risks to customers and the environment. By setting accompanying price control deliverables that penalise companies that do not undertake a certain level of renewals, there is a risk that it distorts companies' focus away from other asset types that are higher risk. It is particularly concerning that Ofwat has provided no additional funding, or any intervention, for sewerage assets. Solving this requires funding to be agnostic about asset class, allowing flexibility.

- Accelerate asset health reforms in time for the PR24 final determinations. We welcome Ofwat's recognition of the shortcomings of its existing approach at this late stage of the price review. But we suggest that Ofwat goes further, otherwise customers and the environment will lose out until the next price review. Practical approaches could include:

[22] 'UK Government priorities and our 2024 price review draft determinations', Ofwat, July 2024, p. 12.

a. Applying an industry-wide revenue uplift to every company to improve their asset maintenance. This could be accompanied by flexibility on how it is spent (i.e. agnostic to asset class, allowing funds to be targeted), enhanced monitoring introduced over 2025 to 2030, an adjustment mechanism at the end of the period based on average industry underspending or overspending, and a 'use it or lose it' provision to ensure that the allowance is spent. There are several potential sources for calibrating the level of uplift, but either basing it on specific cases brought by companies, or setting it by reference to its approach to water mains, would be better than what we have.

b. Rolling out the approach used by Ofwat in its draft determinations for Thames Water's gated allowance for asset improvements. While Ofwat raised concerns with Thames Water's proposals, it ultimately provided an additional £1bn to support the company to improve its assets and performance, with the funding subject to special regulatory arrangements and enhanced oversight.

Further detail is set out in Reckon's report for Water UK. This draws on the recent industry-wide project on 'infrastructure health'[23] that has focused on longer term reforms and which has been running since early 2024, including representation from water companies, Defra and Ofwat.

Either option discussed above would provide companies with the certainty and funding to invest in much-needed asset health improvements, without waiting until the next price review. Ofwat should engage with the water sector to ensure any revised approach is viable, and should ensure it does not preclude any broader reforms beyond the PR24 final determinations.

[23] See https://www.water.org.uk/investing-future/infrastructure-health

2. Holding the sector to account effectively

In this chapter, we set out our response to Ofwat's approach to:

- outcomes – Ofwat's approach to performance targets and outcome delivery incentives (ODIs), including the customer measures of experience.
- price control deliverables – mechanisms that are intended to incentivise timely delivery and return funding to customers for not delivering their expenditure allowances.
- managing uncertainty and future delivery – recognising the levels of uncertainty and risk facing water companies and regulators over 2025 to 2030.

Alongside adequate expenditure allowances, the water sector needs a deliverable set of performance targets and regulatory requirements against which companies can be held to account by Ofwat and wider stakeholders. If the performance framework is unachievable, or the regulatory framework becomes overly restrictive or burdensome, then water companies will consistently be judged to fail regardless of real-world improvements, and will not be able to adapt to changing circumstances.

2.1 Outcomes

2.1.1 Ofwat's draft determinations

Ofwat's draft determinations mean 61% of performance commitment levels are more stretching than companies' proposals. In most cases, Ofwat has also reduced the number of 'caps and collars' that reduce risk from individual Outcome Delivery Incentives and, for others that remain, widened 'caps and collars' (such that companies are more exposed to the financial impact for high levels of outperformance or underperformance).

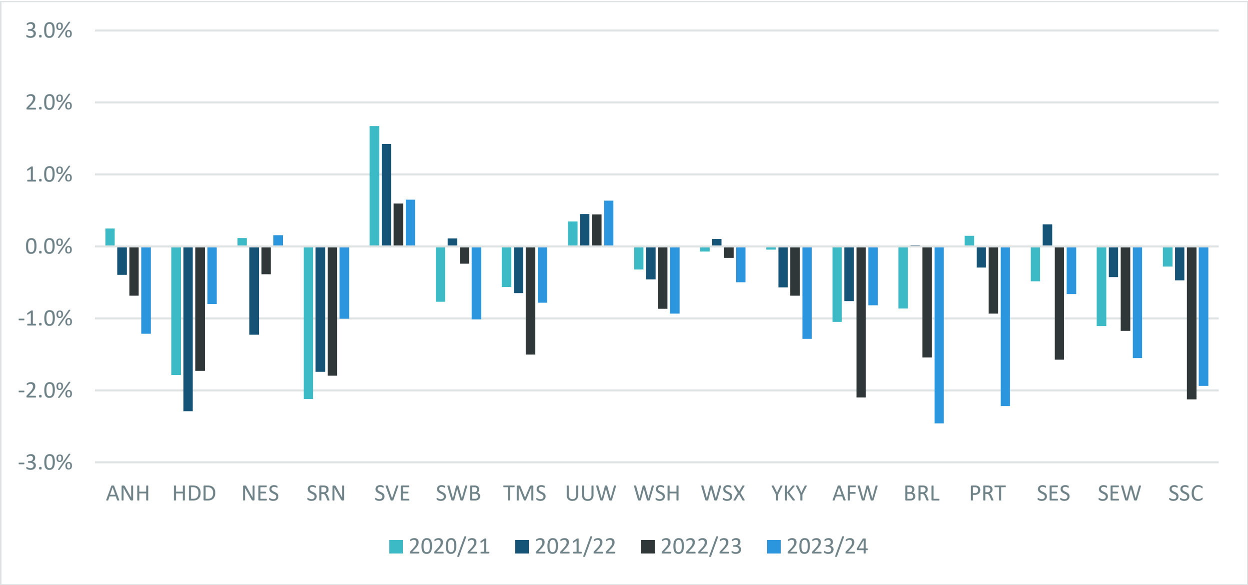
We understand and fully support Ofwat's aim of setting stretching and achievable targets, pushing the sector to innovate and deliver improved outcomes for customers and the environment. And, whenever companies fall short, they should be held to account. We also acknowledge that Ofwat has modified the outcomes framework compared to PR19, such as ensuring performance commitments have outperformance payments by default. However, we think Ofwat has severely underestimated the degree of practical challenge from these targets (particularly given all the difficulties introduced by its other decisions). This brings a number of significant risks to companies, customers, the environment and the reputation of Ofwat itself:

- Overall, performance targets are not deliverable. Companies did not propose performance targets in their business plans in isolation – they also considered the expenditure required to meet them. By cutting total expenditure by 16%, companies will be unable to deliver their proposed performance targets, let alone the increased stretch that Ofwat has applied. For example, on storm overflows, Ofwat has set targets that are around 13% tougher than companies' proposals while cutting enhancement expenditure for storm overflow improvements by 18%. Without sufficient funding, performance targets will not be met.

- Ofwat's incentive rates are likely to drive the wrong behaviours. By applying a common unit rate for each performance commitment to every company, this can lead to incentive rates that in practice are likely to be excessive for the activity being incentivised. For example, Ofwat's proposals include a penalty for most companies of £6,800 for every contact by a customer relating to drinking water quality.[24] Companies may also incur multiple penalties for the same incident under the UK government's recent proposals to increase compensation payments.[25]

- Ofwat's draft determinations do not learn the lessons from PR19. It is now clear that Ofwat's PR19 targets were unrealistic about what companies could deliver. For example, 15 out of 17 companies have net penalties over 2020-24, with only Severn Trent and United Utilities earning modest net rewards of +1.1% and +0.5% respectively as a proportion of notional regulatory equity. At the same time, water companies have overspent their total expenditure allowances by 12% over 2020-24. From the draft determinations, it is not clear that Ofwat has sufficiently changed its approach – and based on the expenditure cuts and performance targets it has set out, performance risk looks greater than at PR19. This is made worse by Ofwat's general assumption that companies will meet their performance targets in 2024-25, despite clear evidence to the contrary based on performance since 2020-21.

Figure 6: Company performance against outcome delivery incentives for every year from 2020-21 to 2023-24 (% of notional regulatory equity)



Source: Water UK analysis of annual performance reports (table 1F).

- The outcomes package is not balanced. Setting a balanced package would suggest that a company has as reasonable a chance of outperforming its performance targets as it does underperforming them, with the central probability being no net payments. As Ofwat acknowledges in its own risk estimates, however, this is not their expectation, with a negative skew of at least -0.3% return on regulated equity (RoRE).[26] But the problem is likely to be far worse than this, because Ofwat's analysis is theoretical and only weakly linked to the reality of actual performance or business plan forecasts. As shown in Box 1, Ofwat's draft determinations will likely lead to net penalties for the entire sector of £2.5bn over the next five years based on

[24] 'PR24 ODI rates v1.0', Ofwat, July 2024.
[25] 'Consultation on updating the Guaranteed Standard Scheme', Defra, August 2024.
[26] 'Aligning risk and return appendix', Ofwat, July 2024, p. 15.

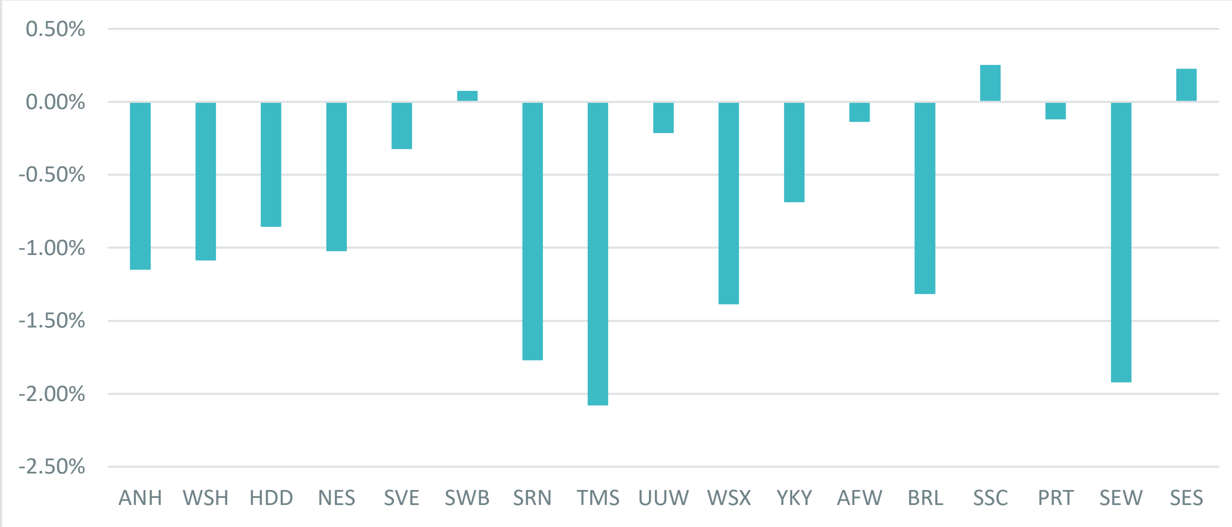
business plan forecasts (or around -0.9% RoRE for the median company). This increases to £8.4bn (or around -3.5% RoRE for the median company) based on an average of actual performance over 2020-24.

- This assessment is supported by analysis in the reports accompanying this document from Oxera and First Economics. Both highlight the level of stretch creating substantial levels of challenge within the draft determinations.

Box 1: Estimates of performance risk in Ofwat's draft determinations

Based on their business plan forecasts, companies could face substantial performance penalties of £2.5bn over the next five years. We apply Ofwat's proposed performance targets and incentive rates to companies' business plan forecasts of their performance. As Figure 7 below shows, 14 out of 17 companies would expect to be in net penalty, with eight incurring penalties greater than -1% return on regulatory equity (RoRE) every year. Of those three companies that would expect to receive rewards, they are at most +0.25%.

Figure 7: Estimated outcome delivery incentives based on companies' business plan forecasts over 2025-30 (% of notional regulatory equity, averaged over 2025-30)



Source: Water UK analysis of Ofwat's ODI risk payment calculator and PR24 business plans

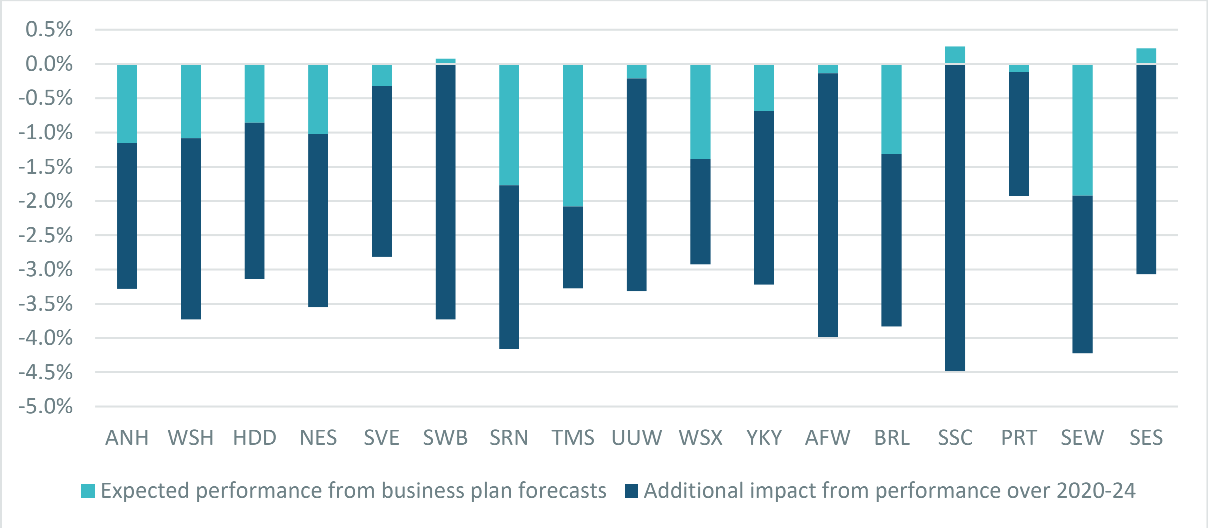
Importantly, **these figures are likely to underestimate the scale of penalties** because:

- Ofwat has also cut expenditure allowances by 16%, making it more likely that company performance will be worse than they forecast, and
- they are based on business plan forecasts, which were influenced by Ofwat's Quality and Ambition Assessment which financially incentivised companies to submit ambitious forecasts.

Under a more realistic scenario, companies could face significantly higher performance penalties of £8.4bn over the next five years. Because business plan forecasts are unlikely to be achieved given the above, we have applied an average of companies' actual performance over 2020-24 to the performance targets and incentive rates in Ofwat's draft determinations.

Assuming companies perform in line with their recent performance, this means that every single company would be in net penalty, with negative returns greater than around -4.0% for four companies (Affinity Water, South Staffs Water, Southeast Water and Southern Water) even after Ofwat's risk mitigations are applied.

Figure 8: Estimated outcome delivery incentives based on companies' actual performance over 2020-24 (% of notional regulatory equity, averaged over 2025-30)



Source: Water UK analysis of Ofwat's ODI risk payment calculator, PR24 business plans and company annual performance reports

While comparing actual performance in 2020-24 to potential performance over 2025-30 does not take account of the likely impacts of enhancement allowances that will be made at PR24, it helps to demonstrate the scale of potential penalties, particularly since the impact on performance of enhancement allowances are unlikely to materialise until later in 2025-30.

2.1.2 Our proposals

We propose that Ofwat **sets achievable and deliverable performance targets and incentives that enable companies to improve their performance and deliver for customers and the environment**, making the following changes to the draft determinations. Specifically, we recommend that Ofwat:

- <u>Sets achievable performance targets</u>. They should take account of the latest performance data for 2023-24 and the further evidence provided by companies on the disconnect between expenditure allowances and performance targets within Ofwat's approach. In particular, Ofwat should revise the assumptions that companies can be expected to meet their targets from PR19 in 2024-25. If Ofwat wants to retain the level of stretch in its draft determinations despite evidence of performance against PR19 targets, then it needs to provide sufficient funding for companies to meet stretching targets over 2025-30 so that they are achievable.

- <u>Cross checks rates to ensure they have the intended effects on companies</u>. Using common values has created anomalies within the draft determinations for some performance commitments, as mentioned above with respect to the incentive rate for water quality contacts.

- Strengthens performance-based risk protections. Provided the above changes do not deliver a balanced package, as described above, Ofwat should make greater use of caps, collars and aggregate sharing thresholds for outcomes performance to manage the level of risk placed on companies and customers to ensure that it is proportionate. Should Ofwat be unable to balance the outcomes package, then it should ensure that there is appropriate compensation for asymmetric risk within the wider determinations (see Chapter 3).

2.2 Price control deliverables

2.2.1 Ofwat's draft determinations

Price control deliverables (PCDs) are new for PR24 and are intended to hold companies to account for delivery, returning money to customers if commitments are not delivered.

While we strongly support the principle that customers should only pay for what they receive, many of these new controls have been introduced at a late stage of the price review and look likely to have unintended and undesirable consequences. As proposed in the draft determinations, price control deliverables:

- Duplicate existing obligations, adding unnecessary complexity. Some price control deliverables apply to projects that companies already have a statutory obligation to deliver, such as environmental projects within the WINEP programme, which means they are already subject to enforcement if they are not delivered. Others apply to projects that have other mechanisms to protect customers from the consequences of non-delivery, such as outcome delivery incentives. This means that there is a risk that water companies will be penalised twice for non-delivery of the same output or that the detail of competing regulatory frameworks come into conflict.

- Reduce flexibility to deliver and innovate. As they stand, price control deliverables lock companies into delivering specific projects, even if they later become obsolete or a new, more efficient or more collaborative way of delivering specific outcomes is discovered during the period. This is at odds with the original intention of the 'totex/outcomes' framework introduced at PR14, which sought to allow "companies more flexibility to deliver customer outcomes in the most efficient way".[27] This is particularly problematic given the degree of uncertainty and potential for change over 2025-30 and particularly undesirable given the apparent constraints it will impose on some nature-based solutions.

- Create undeliverable and punitive downside risk. By overwriting companies' proposed delivery profiles, or setting them based on money spent rather than delivery, Ofwat is constraining companies' flexibility to undertake and deliver projects in the way they see as most appropriate. It is also failing to recognise that there are significant lead times involved in detailed design and construction work and so, for much of the work (e.g. PFAS removal), the majority of outputs will only be completed towards the end of the AMP. This will put companies into automatic penalties from day one, something that Ofwat does not recognise in its risk estimates. The risk faced by companies is compounded by the 25% cuts to the enhancement programme, which means that

[27] 'PR14 Review', Ofwat, January 2022, p. 50.

companies will be penalised for both non-delivery and late delivery for projects that have been made unviable by Ofwat's own determinations.

2.2.2 Our proposals

We propose that Ofwat **revises price control deliverables to be more focused, proportionate and supportive of flexible delivery**, making the following changes to the draft determinations:

- Reduce coverage, so that they only cover areas of expenditure where companies do not already face enforcement or other regulatory mechanisms to incentivise delivery.
- Increase flexibility, which should include:
    - Amending the levels of prescription (such as by reducing the stretching requirement that smart meters must operate at least 95% of the time over five years – to reflect the realities of current technological capabilities[28], the impact of installations or upgrades in sub-optimal locations and challenges with communication networks).
    - Enabling companies to amend project plans should there be sufficient evidence that would warrant it (for example, when a greener or cheaper option becomes available).
- Manage deliverability and risk, which should include:
    - Revising delivery profiles, so that they better reflect companies' delivery plans, and relate to the delivery of outputs rather than the profile of expenditure.
    - Resetting timing penalties to more appropriately reward on-time delivery. Ofwat has based its proposed asymmetric timing incentives based on the delivery of WINEP over 2020-25, which does not recognise the scale and scope of investments at PR24.
    - Ensuring that water companies are not penalised twice for the same level of late delivery through both price control deliverables and outcome delivery incentives.

2.3 Managing uncertainty and future delivery

2.3.1 Ofwat's draft determinations

As Ofwat recognises in its draft determinations, companies continue to face new statutory requirements in the forthcoming control period that they could not yet have reflected in their business plans. This creates further uncertainty and risk.

For example, seven months after they submitted their business plans to Ofwat, the Drinking Water Inspectorate (DWI) requested companies include investments on PFAS (per-and polyfluoroalkyl substances, a group of synthetic chemicals) in their plans. As recently as the 21 August 2024, the DWI published new guidance setting out additional requirements for companies. This demonstrates the need for a more responsive funding approach to emerging issues.

Other requirements are also likely to be imposed on companies after 2025. For example, under future rules relating to civil emergencies, companies may need to supply water to customers for longer periods under conditions that have never been experienced before (such as national-scale power outages). Further changes in government policy are also likely to lead to new legal requirements on companies.

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28 'Price control deliverables appendix', Ofwat, July 2024.

Ofwat has acknowledged the level of uncertainty in this price review, and has proposed a limited number of mechanisms designed to address them. For example, it has proposed an uncertainty mechanism in relation to storm overflows. It has also created mechanisms where it is uncertain about the deliverability of new investment projects, such as through gated processes for large projects or the new 'delivery mechanism' which Ofwat has proposed should only apply to Southern Water and Thames Water. However, these do not go far enough.

2.3.2 Our proposals

We propose that Ofwat recognises the growing need for uncertainty mechanisms over the coming period, enabling the sector to manage uncertainty and ensure delivery. To this end, we suggest that Ofwat considers implementing a common framework to uncertainty mechanisms.

This would recognise that different types of uncertainty are likely to be best dealt with using different types of mechanisms. For example, where costs are certain, but volumes are uncertain, a volume-based mechanism is likely to be appropriate. Where there is less uncertainty, particularly relating to legislative changes over 2025-30, then targeted reopeners are likely to be appropriate.

We consider a common framework would ensure that inconsistencies can be minimised, helping to create a shared understanding among stakeholders including companies, regulators and investors. In all cases, uncertainty mechanisms should be designed so that they are financeable – it is not enough to approve a change in scope without ensuring that companies can finance them, otherwise improvements will not be able to be delivered.

To help Ofwat, we have included a position paper from Water UK which sets out how a common framework could be developed. It draws on Ofgem's approach for the RIIO-ED2 price controls. Supported by our consideration of key policy areas in Annex A of this response, we have also suggested which areas may be best suited for uncertainty mechanisms.

3. Ensuring the sector attracts the investment it needs

In this chapter we set out our response to Ofwat's approach to:

- Financeability and affordability – Ofwat says its approach to financeability is designed to assess whether an efficient company with a notional capital structure can generate cashflows sufficient to meet its financing needs on reasonable terms, while protecting the interests of customers now and in the long run.[29] Because this relates to revenues, it also has potential impacts on the affordability of customer bills over 2025 to 2030.

- Investability – While Ofwat does not directly discuss this concept, Oxera defines this as an assessment of whether Ofwat's draft determinations ensure that it is highly-likely that the water sector can attract and retain equity needed to deliver desired investment.[30]

Ofwat needs to ensure that water companies have enough revenue to fund their operations and cover their efficient financing costs. Given the investment needs of the sector for PR24 and beyond, we consider that Ofwat needs to set a determination that enables water companies to attract sufficient equity to finance the largest investment programme in the sector's history. Without that, companies will be unable to deliver the expectations of customers and society, or customer bills will have to significantly increase to fund them upfront.

3.1 Financeability and affordability

3.1.1 Ofwat's draft determinations

In its draft determinations, Ofwat's financeability assessment considers whether an efficient company with a notional debt structure has sufficient cashflows to meet its financing needs.

However, Ofwat's approach only looks at debt financeability, focuses on notionally efficient companies that fails to account for the circumstances of real companies, and assumes that equity will be available to solve financeability problems created by the draft determinations themselves (see below) through either new equity or dividends restrictions.

Ofwat's draft determinations create financeability problems because they provide less cashflow than companies need. This is because Ofwat has proposed to:

- Use unrealistic cost forecasts, which means that companies either have to absorb the difference between Ofwat's assumptions and what they actually spend, or wait until the next price review to receive a share of the difference through the reconciliation process (we set out further details on where Ofwat has used unrealistic forecasts in Chapter 2).
- Set the allowed cost of debt too low, as set out by KPMG's reports on the costs of new and embedded debt which found certain limitations in Ofwat's approach that, taken together, suggest the allowed costs are insufficient for the 2025-30 period (see further details below).
- Introduced a new cashflow delay delivery mechanism, designed to penalise companies for being behind on the delivery of their enhancement programmes, which will add to the existing risk of

[29] 'Aligning risk and return', Ofwat, July, p. 23.
[30] See accompanying report 'Investability at PR24', Oxera, August 2024, p. 5.

losses should a company fail to deliver agreed work – all of which comes at the same time in which Ofwat has cut enhancement expenditure allowances by 25%.

- Reduced cost recovery to beyond 2030, with £0.5bn of revenue explicitly pushed to beyond 2030 by reducing RCV run-off rates.[31] And further billions of pounds locked behind 'gated processes' for major projects. As well as putting pressure on cashflows for companies over 2025-30, it also puts burdens on future customers through higher bills and reduced funds available for maintenance and investment now.

In making these decisions, we are concerned that Ofwat appears again to have prioritised lower bills in the short term without recognising the future costs and risks that this stores up for customers and the environment from reduced cashflows. As a result, unless Ofwat makes significant changes, companies will be unable to withstand reasonable downside risk. It is not reasonable to suggest, as Ofwat has done, that mitigation could occur through, "…further reductions to dividends or the provision of additional equity injections."[32] Ofwat is wrong to consider that the additional revenue received by companies from PR19 reconciliations is sufficient to provide "additional headroom".

Indeed, given that Ofwat admits that it, "…anticipates companies may need to raise greater levels of new equity under their actual structures than is modelled in [its] notional assessment," the draft determinations, if they do not change, would not enable companies to finance the investments they are required to make.

3.1.2 Our proposals

We propose that Ofwat fulfils its statutory duties and ensures that **water companies are financeable, with enough revenue to fund their operations and cover their financing costs**, making the following changes to its draft determinations:

- Use more realistic expenditure forecasts. Both within ex ante expenditure allowances and real price effects (as set out in Chapter 2).

- Set a higher allowed cost of debt, taking account of findings from KPMG's reports provided as part of our response on both the cost of new debt and additional borrowing and the cost of embedded debt, which suggest that Ofwat's estimates are insufficient for the 2025-30 period. Specifically, KPMG's analysis finds that the following amendments are required to derive a reasonable allowance for the notional company:

    - The analysis on new debt should be updated to reflect more recent (i.e. April 2023 to June 2024) company debt issuance as it would result in a more accurate benchmark of the cost of new debt that companies will incur over 2025 to 2030.
    - Costs relating to basis risk management (i.e. costs arising from transitioning to full CPIH indexation of the RCV and assuming that all index-linked debt held by the notional company is CPIH-linked) should be allowed, based on pricing evidenced from banks and consistent with Ofgem's approach to date.

[31] 'Aligning risk and return appendix', Ofwat, July 2024, p. 47.
[32] 'PR24 draft determinations: Aligning risk and return', Ofwat, July 2024.

  - The approach to cost of carry (which reflects the cost of issuing debt ahead of need (e.g. to pre-finance maturing debt)) should reflect that companies need to issue 18 months ahead of need to support going concern and rating agency requirements on liquidity, rather than the six months that Ofwat has assumed.
  - The approach to embedded debt (i.e. existing debt) should capture all categories of debt instruments (in line with companies' actual approaches to managing debt, as well as the Competition and Markets Authority (CMA's) approach in the PR19 redeterminations) and reflect companies' 'all in' costs rather than using a 'double notionalised' approach that has limited incentive benefits.

- Reverse delayed cost recovery, so companies have the money they need for investment and maintenance. This should include reversing the explicit and deliberate reductions to RCV run-off rates, so that they properly reflect the 'natural' lifecycle of projects and, therefore, the profile of expenditure that companies need to properly maintain their assets. It also means providing companies with sufficient financing costs when they need it for any investments that are approved through gated processes, otherwise companies will struggle to finance and deliver those new projects, even if Ofwat provides approval between 2025 and 2030.

Where Ofwat has concerns about any trade-offs between financeability and the short-term affordability of customer bills over 2025-30, instead of artificially reducing revenue allowances by delaying cost recovery beyond 2030, Ofwat should increase the availability and scope of social tariffs. This would be more targeted to those customers that need it most, while also providing companies with the funding for maintenance and investment now, benefiting customers and the environment. Otherwise, Ofwat's approach puts these costs and risks on current and future generations.

As part of this, Ofwat should support companies to provide social tariffs to their maximum possible under existing regulations, and explore further expansion by working with companies and government to remove barriers to more expansive social tariffs that reduce bill impacts on the most vulnerable customers, going faster and further in supporting more customers than initially proposed.

3.2 Investability

3.2.1 Ofwat's draft determinations

In its draft determinations, Ofwat expects there to be £7bn of new equity in the water sector by 2030[33] and some industry analysts estimate the sector needs to raise up to £10bn.[34] While it does not explicitly refer to investability in its draft determinations, at its City Briefing in July 2024 Ofwat's CEO acknowledged the importance of water companies being able to access equity markets compared with previous price reviews.[35]

In a new report for Water UK, independent consultants Oxera have offered the following definition of investability:

> *"For a price control to be 'investable', it must be highly likely that the company can attract and retain the equity capital needed to deliver desired investment."*[36]

As part of this, Oxera found that Ofwat's draft determinations fail to pass the framework it has developed to assess investability:

> *"if implemented as proposed, Ofwat's Draft Determinations would likely result in significant investability issues for the sector as a whole. In particular, there is a material risk that the sector is unable to raise the new equity investment required to finance the proposed investment programme for AMP8, as well as the high levels of expenditure expected over the coming decades."*[37]

This is reflected in the feedback and views expressed by independent industry analysts following the publication of Ofwat's draft determinations, with Moody's recently signalling that it is considering revising down its rating for the water sector from 'Aa' to reflect the "less supportive framework" for investment as set out in the draft determinations - in contrast to Ofgem's 'Aaa' rating. [38] Barclays also recently noted that "(a)fter examining the Draft Determinations (DD) and Annual Performance Reports (APRs) we are no longer so positive on the sector".[39]

It is also reflected in feedback from investors, as part of Oxera's engagement with around 30 investors has found a deep and widespread loss of confidence among domestic and international investors in Ofwat's decisions and their ability to enable the long-term investment needed by the sector – among both listed and unlisted investors:

- Universally, investors express severe concerns with Ofwat's approach to investability, the absolute level and balance of risk and return in the draft determinations. The high perceived level of water equity risk and the very small premium to available debt returns raised severe issues in their minds as to PR24's risk-reward calibration.

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[33] 'Aligning risk and return appendix' Ofwat, July 2024, pp 62-63.
[34] 'UK Water: Breaking the water cycle – no longer so positive', Barclays, 5 August 2024, p. 61.
[35] See 'City Briefing – transcript', Ofwat, July 2024.
[36] See accompanying report, 'Investability at PR24', Oxera, August 2024, p. 33.
[37] See accompanying report, 'Investability at PR24', Oxera, August 2024, p. 1.
[38] 'Regulated Water Utilities—UK: Ofwat's draft determination increases sector risk', Moody's, 14 August 2024.
[39] 'UK Water: Breaking the water cycle – no longer positive', Barclays, 5 August 2024, p. 1.

- There is notable reluctance to support further investment into a sector based on the draft determinations approach to the calibration of risk and returns, dividends and gearing. Investors point to recent transactions at levels that imply below-RCV valuations, which are a negative signal with respect to investability.
- Ofwat's proposals to restrict dividends based on allowed levels of gearing is inconsistent with investors' expectations, as reflected in their experiences from other sectors. This is a concern for most investors, both listed and unlisted.
- Both listed and unlisted investor emphasise the global nature of their investment approaches, and hence that investing further in UK water is not a necessity for them, and that more attractive risk-adjusted returns are available in other sectors and geographies.
- Existing water sector investors are concerned about long-term attractiveness of the sector. They take a view that existing long-term investors face a risk being driven out and replaced with other investors that have higher return requirements, such as 'special situation' value investors that typically show interest in sectors under severe stress, which risks materially increasing the sector's long run cost of capital and consumer bills.
- Investors are struggling to get to grips with the complexity of the regulatory framework that Ofwat is proposing to adopt for PR24.

These negative perceptions are reinforced further by the experience of PR19. In Chapter 2, we highlight that all but two companies have experienced net underperformance payments for outcome delivery incentives over 2020-24. As First Economics notes in its independent report, this becomes just one when only looking at common performance commitments only, which reflects Ofwat's decision to remove bespoke performance commitments at PR24.

As Box 2 shows, we estimate that the performance risk for companies is even larger when accounting for total expenditure. Every company has overspent its allowances over 2020-24, which has a direct financial impact on companies and their investors. This means that overall, every company has negative performance risk over 2020-24. Faced with a similar or greater level of performance exposure, equity investors are unlikely to find this a sufficiently attractive investment environment.

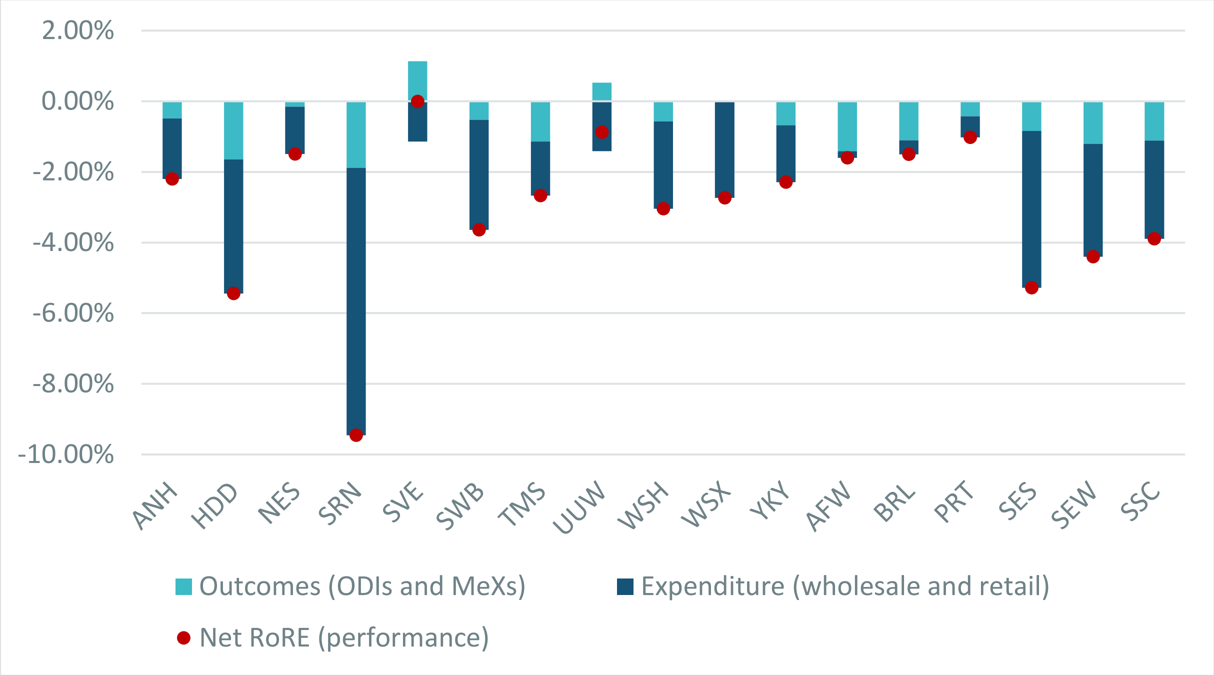
Box 2: Observed performance risk at PR19

Under PR19, water companies have faced significant penalties related to their performance over 2020-24. 15 out of 17 companies are in net penalties on ODIs and the customer measures of experience (MeXs) (a total of £738m in penalties) with Severn Trent and United Utilities due to receive £260m in rewards. This result strongly suggests that, overall, the targets that Ofwat set were unachievable for almost every company.

Similarly, companies have overspent their expenditure allowances by around £4.4bn (or 12%) over 2020-24, with investors bearing more than half of this (around £2.6bn), leading to negative returns on notional regulatory equity relating to total expenditure of -1.8% on average (from -6.7% for Southern Water to +0.4% for Portsmouth Water). Again, this strongly suggests that Ofwat's estimates about how much expenditure is needed to fund operations and investments were flawed.

It is worth considering this in the context of a longer-term trend of declining and increasingly volatile investor returns in the water sector over consecutive price review periods, as noted by Oxera.[40]

Figure 9: Companies' operational performance against the PR19 determinations over 2020-24 (% of notional regulatory equity, average for each year from 2020-21 to 2023-24)



Source: Water UK analysis of annual performance reports (table 1F)

Every single company has experienced negative returns for their operational performance under the PR19 framework, including Severn Trent and United Utilities, which have small negative returns of -0.01% and -0.88% respectively, based on an average of the first four years of PR19. Their outperformance on outcomes is offset by their underperformance on total expenditure.

Faced with a similar or greater level of performance exposure, equity investors are unlikely to find this a sufficiently attractive investment environment. Even though some of this has been partially offset by financing outperformance since 2020, that is unlikely to continue into PR24 as the opportunity for outperforming the allowed cost of debt reduces.

Within this context, **we are concerned that, without change, Ofwat's draft determinations will overall make it impossible for the water sector to attract the level of equity investment that it needs**. More specifically, this reflects the following limitations in Ofwat's approach:

- The allowed cost of equity does not reflect the water sector's need for investment, or level of relative risk. Ofwat's allowed cost of equity is unlikely to attract the levels of investment necessary when compared to other regulated sectors. For example, Oxera notes that the

[40] See accompanying report, 'Investability at PR24', Oxera, August 2024, p. 25.

majority of infrastructure investors are across regulated sectors and geographies, with further investment in the water sector dependent on how it compares with other infrastructure opportunities. While they are not perfect comparisons, Ofwat's allowed cost of equity is materially below other core infrastructure investments – according Oxera, compared to Ofwat's draft determination, Ofgem's range for its RIIO-3 sector specific methodology decision is between 61 and 150 basis points higher, and the largest US listed water company recently received a regulatory determination that was 300 basis points higher.

Investors have choices, and while Ofwat has 'aimed up' by choosing a point towards the upper end of its estimated range, to attract new investment this does not appear to be sufficient. For example, the range does not reflect current macroeconomic conditions, in particular relatively high interest rates. Using a 'through the cycle' approach for 'total market return' (the expected return a marginal investor requires to invest) is likely to understate returns required by investors in periods of relatively high real interest rates, as now.[41] In contrast, Ofgem explicitly recognised this as an issue for RIIO-3 regarding the forthcoming periodic review for energy transmission companies.

- <u>This is exacerbated by the lack of balance within the price review package</u>. As Box 3 shows, most companies can expect to overspend their allowances and underperform their performance targets based on Ofwat's draft determinations. Negative average returns of -1% on outcomes and -2.2% on expenditure means that companies could reasonably expect to face risk exposure of -3.3% - and higher if outcomes performance is worse for the reasons given in Chapter 2.

  The scale of likely penalties and underperformance means that companies and their investors cannot reasonably expect to earn Ofwat's allowed of cost of equity. This does not meet Ofwat's objective of providing a 'fair bet'.

Box 3: Estimated performance risk at PR24

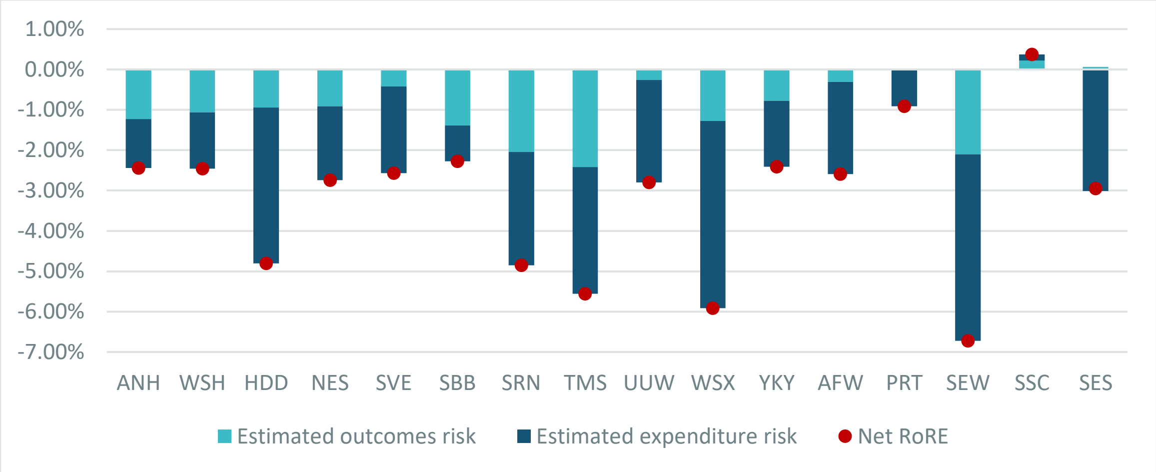
We have estimated the potential level of risk facing companies based on Ofwat's draft determinations. Chapter 2 sets out the ODI risk ranges for each company based on Ofwat's proposed performance targets and incentive rates compared to business plan forecasts.

We estimate the level of totex risk by calculating the difference between business plan proposals and Ofwat's expenditure allowances. We consider this a reasonable way to estimate future risk given the level of overspending over 2020-24 is 12%, which is similar to the reductions to expenditure proposals made by Ofwat at PR19.[42] This shows that the cost gap between companies' proposals and Ofwat's allowances is such that the average impact returns on regulatory equity (RoRE) is -2.2%. While RoRE impacts may be lower if companies do not spend as much as requested in business plans, this may be because the regulatory framework forces companies to cut back their spending plans, leading to further missed opportunities to improve performance for customers and the environment.

[42] For simplicity, we assume that investors bear 50% of the difference on wholesale base allowances, 40% on enhancement allowances, and 100% on retail allowances. In reality, some companies face different cost sharing rates on wholesale base costs and a subset of costs such as business rates. We also apply Ofwat's new aggregate sharing mechanism for wholesale expenditure , which equally shares risk beyond thresholds of ±2% RoRE over the five-year period ('Aligning risk and return appendix', Ofwat, July 2024, p. 10).

We combine both estimates of outcomes and expenditure risk in Figure 10. This shows that **companies can expect to face significant levels of downside risk from Ofwat's draft determinations, even after its proposed risk mitigations are applied**. Overall downside performance risk based on business plan forecasts would be -3.2% RoRE on a notional basis, with South East Water, Wessex Water and Thames Water exposed to more than -5% RoRE risk. Only South Staffs would earn a positive return under these estimates, which would be a modest +0.4%. If these estimates become reality, they would heavily erode Ofwat's already insufficient allowed cost of equity, making it very challenging for new equity investment to enter the sector without major changes to Ofwat's proposed incentive package.

Figure 10: Estimated performance risk from Ofwat's draft determinations, even after risk mitigations (% of notional regulatory equity, averaged over 2020-25)



Source: Water UK analysis of business plan forecasts and Ofwat's draft determinations (for outcomes, this is based on business plan forecasts and an estimated impact of C-MeX based on an average of performance over 2020-24; for total expenditure, this includes wholesale and retail performance compared to business plan forecasts, with a simplified aggregate sharing mechanism applied to wholesale underperformance greater than -2% RoRE)

- <u>Wider proposals are likely to further deter equity investors – on potential dividends restrictions related to gearing levels, equity issuance costs, and reductions to cashflows</u>. Ofwat's proposals to restrict dividends for companies with gearing above 70% will further deter investment. Investors have major concerns with Ofwat's latest proposals, which will limit the ability of companies to attract new equity and debt. This is particularly serious given that this new requirement would be imposed at a time when companies are trying to attract more equity and fails to recognise that there is a trade-off between reducing dividends and attracting investment. Specifically, it is inconsistent with current investors' preferences, who tend to accept below market average returns in exchange for stable and predictable dividends, as well as other sectors' approaches.[43] It is also unclear why Ofwat is proposing this change given it introduced new licence conditions relating to financial resilience only last year.[44]

[43] See accompanying report, 'Investability at PR24', Oxera, August 2024, Chapter 4.
[44] '<u>Ofwat announces new powers on water company dividends</u>', Ofwat, March 2023.

Similarly, Ofwat's assumption that dividends can be reduced to 2% for all companies in order to maintain gearing close to the notional value is unsupported by market evidence on dividend yields, as well as Ofwat's own decisions with respect to the Thames Tideway Tunnel (a £5bn London wastewater investment that is financed, owned and managed separately from Thames Water). Ofwat's additional assumption that new equity can be injected in cases where gearing is above 57.5% demonstrates no market testing of whether this is realistic.[45]

Furthermore, Ofwat is effectively requiring equity investors to subsidise customer bills, both for this control period and potentially for the future. As discussed above, Ofwat is seeking to push cost recovery, and therefore cashflow, beyond 2030 to keep bills artificially low. However, as Oxera notes, this "[signals] to investors that the regulator is willing to use financial levers in an unpredictable manner to delay cost recovery".[46] This has the potential to undermine investability, which is made worse by Ofwat's suggestion that it may do the same again at PR29.[47]

All of these issues are exacerbated by no explicit assessment within the draft determinations that considers the risks to attracting equity given Ofwat's wider approach (or, indeed, a definition of investability). This is surprising given the scale of new equity required (the level of which has not needed to be tested within Ofwat's previous periodic review approaches)[48] and is in contrast with Ofgem's recent assessment for energy network where it explicitly considered "whether the allowed return on equity is sufficient to retain and attract the equity capital that the sector requires".[49] Instead, Ofwat has only narrowly assessed financeability, which tends to be more focused on debt financeability than equity financeability. Such assessments are inherently sensitive to the assumptions made about a notional company (e.g. optimal capital structure, performance) and do not reflect the longer-term horizon for investment decisions.

Current investors in the water sector generally seek lower risk and stable cashflow investments and income streams – something Ofwat undermines in its draft determinations. While other types of investors could be attracted to provide the necessary levels of equity, that would likely necessitate a higher cost of capital allowance. As it stands, Ofwat's draft determinations are unlikely to attract either type of equity investor – putting investment at risk.

3.2.2 Our proposals

We propose that Ofwat ensures **water companies are investable, with the sector able to attract new investment to deliver improvements for customers and the environment**, making the following changes to its draft determinations:

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[45] See accompanying report, 'Investability at PR24', Oxera, August 2024, p. 37.
[46] See accompanying report, 'Investability at PR24', Oxera, August 2024, p. 95.
[47] Ofwat states that: 'Any increase to customer bills beyond 2030 will be spread over a number of years, and there are options to similarly mitigate bills at the PR29 price review' in 'PR24 draft determinations: Aligning risk and return appendix', July 2024, p. 44.
[48] As discussed further in Oxera's report, RCV growth has largely (though not entirely) been debt financed. See accompanying report, 'Investability at PR24', August 2024, pp. 18-19.
[49] 'RIIO-3 Sector Specific Methodology Decision – Finance Annex', Ofgem, 18 July 2024, p. 100.

- Setting a competitive allowed cost of equity. Ofwat should be able to demonstrate, as a minimum, that it takes account of the latest market evidence, risk exposure and market costs (e.g. equity issuance cost allowances). It should also reflect that the water sector faces new levels of risk, such as from the construction of major projects, as well as ever higher political and regulatory risk. This can be achieved through revising the parameters of the allowed cost of equity, such as equity beta, or explicitly choosing a higher point estimate. Ofwat should also cross-check against returns available in other countries and other sectors, such as energy networks, to ensure that the water sector is able to attract investment given the alternatives available to investors.

- Abandoning the proposed dividend restrictions for companies with more than 70% of gearing. Failure to do so would undermine financeability, send a negative signal to potential investors and would be unnecessary and unduly hasty due to new licence conditions having been introduced only last year. If Ofwat wants to increase equity, it could revise its proposed equity issuance cost allowance, which is meant to cover the costs of raising new equity, from the 2% it proposed in the draft determinations. Based on market evidence, Oxera suggests this should be at least 5% of the new equity, plus an additional allowance of around 5% to cover indirect costs[50]

- Setting a balanced price review package. The current imbalance in the draft determinations undermines the attractiveness of the sector to equity investors further. In practice, no company is likely to achieve the allowed cost of equity, even if it were sufficient in the first place. To address this imbalance, Ofwat can either:
    - address asymmetric risk at source – by adopting the range of approaches set out throughout this response, this can create a balanced package for water companies that ensure that they are able to achieve the allowed cost of equity on average (the 'fair bet' principle).
    - compensate for expected asymmetric risk – by explicitly quantifying and providing compensation for the expected negative skew within the draft determinations.

  We consider it preferable for Ofwat to attempt to address asymmetric risk at source. Doing so would ensure that companies are set up to succeed, and any perceived underperformance would be due to genuine underperformance rather than the miscalibration of the regulatory framework.

  Addressing asymmetric risk at source should include the proposals set out in earlier chapters with respect to real price effects, outcomes and price control deliverables. Ofwat needs to set achievable performance targets and forecasts, coupled with proportionate incentives and sufficient risk protections. However, it may not be possible to precisely balance the price package given the intricacy of the regulatory framework at this late stage of PR24 and stakeholder expectations of performance targets. In that case, a sufficient adjustment would ensure investors are fairly compensated for the asymmetric risk that is present in the price review package. This could either be applied through:

[50] See accompanying report, 'Investability at PR24', Oxera, August 2024, p. 100.

- an upwards adjustment to the allowed cost of equity – this is the approach taken by the CMA during the PR19 redeterminations, which largely chose to not revisit the underlying components of the outcomes framework, or;
- a targeted revenue allowance that is equal to the expected penalties that an efficient company is expected to incur over the 2025-30 period, which is similar to the 'asymmetric risk allowance' used by the Civil Aviation Authority for Heathrow's H7 price control.[51]

In both cases, Ofwat needs to more effectively estimate the risk faced by water companies, which is lacking from Ofwat's draft determinations.

As discussed in section 3.1 above, Ofwat should also remove the RCV run-off adjustments that it proposes to address perceived affordability concerns and signal that it will not do this for future price reviews. As well as addressing financing issues, this would help assure investors' concerns around future uncertainty.

[51] 'CAP2524 Economic regulation of Heathrow Airport Limited: H7 Final Decision', Civil Aviation Authority, March 2023.

4. Concluding PR24 successfully

In this chapter we set out a way forward so that Ofwat and the water sector can successfully conclude PR24, enabling improvements for customers and the environment from next year.

4.1 Ofwat's draft determinations

While all price reviews have their challenges, the PR24 process, so far, has heightened the risk of worse outcomes for customers and the environment:

- Insufficient consultation: Although the timing of the General Election produced unavoidable issues for the draft determinations, a consultation period of seven weeks to understand, assess and assure the draft determinations has turned out to be insufficient, especially given the scale of the expenditure, the risks and the issues under discussion. This has been exacerbated by the lack of an initial stage (as at PR19) and limited or no early consultations on new areas such as price control deliverables.

  The volume of material to digest has not helped (with over 3,000 pages across 101 documents, as well as hundreds of models), nor has the limited number of company-specific documents (which have been very helpful in previous price reviews) and the late publication of some cost and risks models that informed the draft determinations.

- Late changes in the context of a very complex regime: As Oxera notes, even experienced professional investors say they are "struggling to get to grips with the complexity of the regulatory framework that Ofwat is proposing to adopt in AMP8".[52] Ofwat has introduced a range of new policies and regulatory mechanisms as part of the draft determinations, including new approaches and requirements relating to oversight, approvals, monitoring and reporting. As well as being challenging to understand their impacts, they also increase the intricacies of a regime that was already creaking with complexity, with associated risks and costs to companies and Ofwat. At this stage, it is not clear that they are fully workable and proportionate.

- Inconsistency with the CMA's PR19 redeterminations. Where Ofwat and the companies have previously disagreed on particular approaches of the regulatory framework, the CMA's previous redetermination processes can help to provide clarity on, and set a precedent for, determining those issues. It is therefore surprising (and disappointing) that Ofwat has chosen to take a different approach compared with the CMA (e.g. on embedded debt, where the CMA said that all categories of debt instruments should be included).

- Lack of obvious coherence: Ofwat's approach to assessing companies' business plans appears to have focused on component parts and it is not clear how Ofwat has assured itself that each company's draft determination is deliverable and financeable as an overall package.

- New and evolving requirements: While it is outside of Ofwat's direct control, it should be noted that wider government-led requirements on the sector, and the associated legislative context,

[52] See accompanying report, 'Investability at PR24', Oxera, August 2024, p. 87.

have continued to evolve, which makes it especially difficult to develop and agree a stable business plan.

These factors have contributed to draft determinations that are incomplete in parts, and which, as we have set out throughout this document, will be inadequate for enabling the sector to deliver the scale of improvements needed for customers and the environment.

4.2 Our proposals

It is vital that Ofwat takes the time it needs to study carefully the individual issues raised in this and company submissions.

The level of concern among industry is now such that **the sector would be willing to work with Ofwat on an unprecedented delay of final determinations to late January 2025** if that would allow more meaningful engagement and a better settlement for customers, the environment and a sustainable long-term industry. This would need to include working with Ofwat on overcoming any practical barriers to agree specific charging arrangements, as well as managing any supply chain issues. Doing more of the same will leave water companies with limited choices when faced with their final determinations.

Water UK is willing to facilitate structured engagement over the next few months with water companies and Ofwat (as well as the investor community and other stakeholders) to help secure a successful conclusion to PR24.

Annex A: Further details on specific investment areas

This section provides more detail on the specific implications of Ofwat's decisions for individual outcomes for customers and the environment. We also provide recommendations for overcoming issues and barriers to delivery.

Storm overflows

The cuts to the storm overflow programme are striking given companies' huge ambition to address this issue, Ofwat's stated desire to see such ambition and the obvious public interest in making rapid progress. Despite Ofwat's view that it supports over 2,500 projects put forward by companies[53], Ofwat has, in fact, cut the program by £2.1bn, amounting to a 18% cut in spend. We have the following concerns:

- The scale of the cuts will put significant pressure on companies' programmes to address sewage discharges and, in others, may simply make them unfeasible. In the North West of England, for example, United Utilities has seen its program cut by over 40%, which places sewage discharges in this region at a serious disadvantage compared to other parts of England. It is essential that all regions of England are treated fairly, with the same high ambition shown for more than just the South of England.
- Similarly, we are concerned that cuts and a simplistic approach to average unit cost will force companies to narrowly focus solely on meeting mandatory targets (like average number of spills across all overflows) rather than delivering a more beneficial programme that fully takes into account environmental sensitivity and/or customer benefit. This will lead to perverse outcomes, such as intensively improving low-benefit overflows to get to very low network-wide average spill numbers rather than including improvements in more valuable places, such as parts of coastline that are not designated for bathing but still used for recreation (where the unit cost of improvement will tend to be higher but deliver more benefits).
- Ofwat's focus on dictating specific engineering outputs rather than requiring outcomes reduces the accountability of companies for delivering actual environmental benefits and reduces the possibility for companies to use the best projects at lowest cost to customers. This is because:
    - First, on the face of it Ofwat's guidance on Price Control Deliverables (PCD) seems to explicitly rule out substituting green solutions for grey or hybrid solutions, reflecting how the cost modelling was undertaken. This should be clarified or amended.
    - Second, Ofwat's PCD uses 'equivalent volume of storage' as the key metric. In practice, this will discourage solutions such as rainwater separation in favour of concrete and steel storage options, given the burden of modelling, designing and thereby demonstrating to the regulator that these equivalent volumes will indeed be achieved, especially given the inevitable changes that must be made as scheme design progresses. This disincentive will result in perverse outcomes that act against the public interest. This approach leaves

53 Our draft determinations for the 2024 price review: https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-DD-sector-summary.pdf, Ofwat, August 2024.

little room for innovation in costs and results, instead chaining companies to a specific output metric (and, in practice, design assumptions) chosen by an economic rather than environmental regulator.

- Exacerbating this further, the design of the Storm Overflows Performance Commitment does not allow sufficient flexibility to allow for weather variations: it appears to randomly penalise companies during years with higher rainfall, which is a factor they cannot control. This reduces the strength of the intended incentive and increases uncertainty.
- The disproportionate number of Price Control Deliverables for this program (44) compared to others further illustrates what appears to be an excessive focus on outputs rather than outcomes, contradicting the government's steers to Ofwat via its Strategic Policy Statement[54] and Ofwat's own previous professions to recognise the value in focussing on outcomes.

To address this we ask that Ofwat:

- **Reconsider the funding case for the Storm Overflows programme, taking account of the needs case and additional evidence companies have provided as part of their response, to avoid any delay in delivering on the ambitious program put forward; and**
- **Review the number of Price Control Deliverables applicable to this program, and work with companies to better understand how the proposed metric will work in practice, ensuring that it leads to the desired outcomes.**

Emergency overflows

Originally, the Environment Agency, via its 'WINEP' programme, required companies to implement 25% accredited ('MCERTS') monitoring of Emergency Overflows by 2030. Suggestions from at least some companies for more ambition were not supported. However, we understand this may now change in future, with a reversion to a higher-ambition programme. This introduces a high level of uncertainty: either companies put forward plans now that suggest higher ambition (which may see them penalised for including excessive cost) or their plans will need to change in future, after the point at which funding has been agreed.

To address this, we ask that:

- **Ofwat include an uncertainty mechanism to cover the possibility of extending the delivery of the emergency overflow monitoring. Ideally this would be part of a wider framework (see Water UK's position statement on uncertainty, published alongside this document); failing that something specific would be required.**

Bioresources ('sludge')

Ofwat, in its draft determinations, said the following:

> *"We are also proposing a notified item in all wastewater companies draft determinations in respect of potential increases to bioresources costs over the 2025-26 to 2029-30 period. This*

[54] 'Strategic Policy Statement', "Water companies and regulators need to be outcome focused", HM Government, February 2022.

notified item applies to any increase in costs reasonably attributable to any new or changed legal requirements in relation to the application to agricultural land of fertiliser derived from sludge. This would allow price controls to be changed in-period through an interim determination if the impact on costs, alone or in combination with other eligible items, met the materiality threshold in licence condition B. We consider that a notified item is appropriate because spreading treated sewage sludge is the main outlet for bioresources operations, the impact of changes could be material and new or changed to legal requirements would not necessarily otherwise qualify for an interim determination because they might not apply directly to companies. In addition, we acknowledge that bioresources activities might be affected by the Environmental Permitting Regulations (EPR) replacing the Sludge (Use in Agriculture) Regulations (SUiAR). These requirements are due to be defined within the Environment Agency's Sludge Strategy and its implementation date is yet to be confirmed.”[55]

This is a very helpful acknowledgment of a serious issue, but we are concerned that the scope of the proposed notified item fails in practice to provide an effective uncertainty mechanism and so should be updated for Ofwat’s final determination. This is because the proposed trigger rests on *new or changed legal requirements*; however, there are a number of foreseeable events that may occur over the coming period that do not meet this definition but which may in practice have comparable, serious effects.

To address this, we are asking that Ofwat:

- **Rephrase the uncertainty mechanism for bioresources in a slightly clearer way to ensure that eventualities beyond short term disruption are covered.** This would include:
    - confirming that the PR24 WINEP for the 2025-30 period does not cover wholesale changes to landbank availability that may be caused by changes to the implementation and enforcement of sludge and bioresources regulations in AMP8.
    - confirming that factors other than ‘*new or changed legal requirements*’ may still act as a trigger for the notified item. Such changes could include re-interpretation of Defra’s Farming Rules for Water, new or amended *guidance* or other material decisions by a regulator or government. The industry has developed a list of such plausible events that we recommend Ofwat use as examples of possible triggers; alternatively, the trigger could be phrased as ‘loss of landbank’ rather than legal change.
    - consistency with Water UK’s position paper on uncertainty mechanisms, published alongside this document.
- **Consider further use of the WINEP to fund research into alternative to land use of bioresources**, currently not made possible by the Environment Agency.

Water resources

Water companies’ multi-decadal Water Resources Management Plans (‘WRMPs’) foresee a shortfall of nearly five billion litres of water per day by 2050 across England and Wales - one billion litres higher than last forecast as recently as 2020.

[55] ‘*PR24 draft determinations: Expenditure allowances*’, Ofwat, July 2024, p.189.

To address this gap, companies set out £6.6bn of new investment by 2030 to secure water supplies into the future, with more supply options being progressed over the next ten years than seen for over a generation. Companies' plans proposed that nearly a third of the missing five billion litres of water would be met from new supplies, with the remainder met through demand management and reduced leakage. Many supply options take at least five to ten years to deliver, leaving demand reduction as an essential tool for securing water supplies in the short term and for meeting environmental goals.[56]

In its draft determinations, Ofwat reduced 'enhancement' funding by 8% across all of these solutions. In addition, Ofwat's decisions implausibly require some of this (reduced) funding to also be sourced from 'base' day-to-day expenditure, which is already heavily stretched and covering other areas of expenditure. These cuts will have two effects: the first is the addition of yet further pressure on companies' financial health and sustainability. The second is the risk of undermining companies' delivery of resilient programmes for reducing demand and leakage.

For example, an important part of this funding is for smart meters (essential for reducing both demand and leakage). However, this programme is being put at risk by a 13% cut to funding, which is the result of a very simplistic approach to modelling that does not reflect important differences in the cost and complexity of installing different types of meters in different contexts. Meter costs vary greatly depending on whether the meters are installed internally or externally; rural versus urban locations; and whether they are installed in businesses or homes.

Companies included different costs in their plans to reflect the variations in types of meters as well as the geography of their areas. Cost variations also relate to the different experiences companies have in rolling out smart meters as well as the stage of their procurement processes.

To address this, we ask that:

- **Ofwat use the evidence submitted by companies from tendering processes within benchmarking models, using revealed costs that are supported by market-tested rates rather than theoretical models.**

This issue with funding is then further exacerbated by Ofwat's approach to the smart meter price control deliverable, where we see three issues:

i. The smart meter price control deliverable measures the technology of smart meters and not the outcomes, which is to deliver water efficiency and leakage reduction. This can result in companies being forced to pursue specific technologies, which stifles innovation, reduces choice of suppliers and places pressure on supply chains.

ii. The price control deliverable does not recognise operational realities. Factors such as geography, urban environments, battery lives, signal strengths and signal types in a given location all affect smart meter installation and connectivity. By not accounting for these factors Ofwat risks compelling companies to avoid meter fitting in many locations, and customers in certain types of dwellings and areas not benefiting from the meter programme. Ultimately this reduces companies' ability to deliver against ambitions on leakage reduction and water efficiency.

[56] In particular, demand reduction lies at the heart of the Environment Act (2021) target to reduce the use of public water supply in England, per head of population, by 20% by 2037-38 from a 2019-20 baseline.

iii. Price control deliverables should not be set as a stretching target as the purpose of these are to protect customers by ensuring delivery of a commitment. The proposed 95% or higher success rates for completeness and connectivity does not take into external challenges. To develop sector-appropriate performance levels, Ofwat should consult with a range of smart metering delivery providers across water and energy to understand the challenges faced in installing meters, connectivity issues at time of install and over the lifetime of a meter, and battery constraints in water meters.

To address this, we ask that:

- **Ofwat considers alternative formulations of price control deliverable that would continue to provide customer protection while avoiding some of the downsides of the current approach. We would welcome further discussions with Ofwat on these alternatives.**

A final concern is Ofwat's performance commitment on water supply interruptions. Mains replacement is a key solution to reducing leakage levels, however, the installation of pipes has the potential to cause water supply interruptions. Water companies are penalised for water supply interruptions of more than three hours and, as a result, companies are compelled to use technologies that are not cost efficient, creates greater disruption to customers and road users, and increases carbon emissions.

Given the high levels of mains replacement planned between 2025-2030, **we ask that:**

- **Ofwat exempts the three-hour rule for planned asset renewals to enable companies to make use of alternative technologies**. Customer protection can continue to be delivered through existing requirements for proactive engagement on planned interruptions, including support to vulnerable customers.

Drinking water quality

Drinking water in England is among the most tightly regulated and best quality in the world. Companies consistently meet the regulatory standards for drinking water, with 99.97% of samples demonstrating compliance in 2023. Water companies maintain this standard by undertaking rigorous treatment and monitoring processes to ensure clean and safe drinking water at every step of the process, from source to consumer taps.

Water companies are fully committed to maintaining compliance. However, they face challenges to their existing assets and processes due to climate change, population growth and the introduction of new requirements to address emerging threats. Water companies requested drinking water quality enhancement investment of £2.1bn to address raw water deterioration, upgrades to water treatment works, improve taste, odour and colour, reduce lead and mitigate against per and poly fluoroalkyl substances (PFAS) risks.

In its draft determinations, Ofwat has reduced water company enhanced investment request by £553m (or 29%) on the basis that the proposed measures overlap with base maintenance spend, including mains replacement, that companies provided insufficient information on measures proposed or failed to justify higher costs. Specific reductions include:

- Taste, odour and colour has been reduced by 50% (cut of £194m)

- Raw water deterioration has been reduced by 25% (cut of £317m)
- Average 10% cut across different lead schemes (cut of £44m).

These cuts place significant financial challenge on water companies to use their base allowance, despite the significant stretch already present within base funding.

There are further points that cause difficulty:

- For lead, Ofwat is considering applying a more stretching efficiency benchmark at final determination, which is very concerning in light of Ofwat's previous cuts to lead enhancement investment.

- Ofwat has introduced a high level of reporting and assurance via price control deliverables that to a large extent duplicate controls already imposed by the Drinking Water Inspectorate. Third party assurances will increase costs.

- Ofwat has reserved the right to change price control deliverables to a more granular level (possibly even with interim deliverables for those running into PR29), which creates uncertainty.

To address these issues, we ask that:

- **Ofwat reconsiders its enhancement cuts to ensure water companies are funded to continue to deliver safe clean drinking water.**
- **Ofwat allows funding for all DWI approved projects and removes price control deliverables on schemes that are already subject to undertakings by the DWI.**

Customer measure of experience (C-MeX)

We understand Ofwat's desire to set outward looking customer service performance standards for the sector. We agree that improving customer service requires us to look beyond the water sector and we support Ofwat's aspiration for continual improvement in customer service. We are committed to improving and investing in the service customers receive from their water company.

However, Ofwat's proposed changes to C-MeX may not achieve these aims. Based on Ofwat's own data release, every company would be in penalty based on their performance relative to the UK Customer Satisfaction Index (UKCSI) benchmark in 2023-24.[57] This is not compatible with Ofwat's stated aim to set a balanced package of risk and return, either at the level of the outcomes framework or for the price review package as a whole.

We are also concerned about the robustness of the UKCSI as a benchmark for C-MeX, which in some cases can be based on very low sample sizes, leading to a significant degree of volatility.

Some water companies are proposing a delay to reconsider the approach for C-MeX ahead of April 2025, possibly with less controversial changes implemented in 2025-26 such as the reweighting of surveys.

However, if Ofwat is minded to maintain its proposed approach, then it needs to address the clear asymmetric risk that it creates for companies in order to achieve a balanced package.

[57] 'UKCSI benchmarks – response', Ofwat, August 2024.

To address this, Water UK considers there is merit in exploring the following options:

- adjust for asymmetric risk by 'aiming up' in the allowed return on capital, or through an upfront revenue adjustment, as discussed in our response for outcomes risk more broadly, or apply a targeted outturn adjustment within C-MeX every year, which would mean:
  - calculating C-MeX scores based on the UKCSI as proposed by Ofwat in the draft determinations,
  - applying a revenue adjustment to the median company in C-MeX such that its final payments are zero,
  - calculating the return on regulatory equity (RoRE) for the adjustment made to the median company, and
  - applying the equivalent adjustment in RoRE terms to every other water company, so that the overall payments or penalties to all water companies are reasonably balanced while maintaining relative payments and incentives on individual companies.

- Ofwat to work with the Institute of Customer Service and water companies to develop an appropriate and robust external benchmark to C-MeX that is both stretching and encourages improved customer service by recognising industry specific factors and addressing concerns around target predictability.

Cybersecurity

Ofwat has been clear[58] that companies' *"drinking water supply and distribution services are required to be resilient against 'limited capability attacks' by March 2025 and against 'moderate capability attacks' by March 2028, following Government guidance[59] and DWI requirements[60]".*

Reflecting this and wider threats relating to cybersecurity (as have been well-documented in recent years[61]), companies requested £429m in funding to protect clean water assets. Four companies also sought funding of £116m for wastewater interventions/enhancement.

Despite the known and growing risks, Ofwat has cut funding to £245m (a reduction of ~43%). It argued that maintenance, and the upgrading of security assets and systems with modern standards, should be delivered from base expenditure.

However, a significant proportion of this proposed investment is to meet new requirements from the Drinking Water Inspectorate, which has introduced new and additional requirements over previous standards via an 'enhanced Cyber Assessment Framework[62]. This marks a significant departure from historic approaches, with requirements expected to continue evolving quickly as threats continue to change. The need for constant adaptation against higher standards means that base expenditure, set by reference to historic practice, will no longer cover requirements sufficiently.

[58] 'PR24 draft determinations: Expenditure allowances', Ofwat 2024, p. 122.
[59] See NCSC, Cyber Assessment Framework.
[60] See DWI, The Network and Information Systems (NIS).
[61] See Moodys.com - Cyber Risk Global Cyber heat map & National Cyber Security Centre Annual report 2023.
[62] See NCSC, Cyber Assessment Framework.

We are very concerned that Ofwat is not treating this risk with sufficient seriousness and is leaving the sector and its customers unnecessarily exposed. This is no longer a hypothetical problem – it is a threat being actively managed by all companies, as illustrated by recent serious and disruptive attacks against companies, including incidents at Southern Water and South Staffordshire. At the international level, we observed two major cyber security incidents targeting clean and wastewater assets earlier this year. BlackJack, a Ukrainian group possibly linked to Ukrainian intelligence, claimed responsibility for a cyber attack on Moscollector, a major Moscow-based utility managing wastewater services. Sandworm, a Russian hacktivist group with alleged ties to Russian state actors, claimed attacks on water facilities in France, Poland, and the U.S., including dams and water pumps. These attacks targeted critical infrastructure, posing risks to operational continuity, environmental safety, and public health.

By disallowing all cyber-related funding for wastewater enhancements on the basis that sewage is not considered 'critical national infrastructure' (CNI), Ofwat is not treating the threat with the attention it deserves. We have a number of concern about this:

- **Protection of all parts of a company's IT estate is necessary to ensure it is adequately protected from cybersecurity threats**. In practice, IT and operational technology that helps control water and wastewater estates operate as combined systems. Attackers will not care which part of the network they are breaking into but, once they are in, will attempt to traverse into as many of the system and as much of the network as they can, as we have seen in many cyber-attacks.
- **Wastewater assets are highly likely to be considered Critical National Infrastructure in the near-future, highlighting the importance that they are adequately funded to protect from cybersecurity threats**. As part of the recent King's Speech, the new government has outlined that Critical National Infrastructure controls would be expanded as part of the Cyber Security and Resilience Bill due in the coming months. The Bill is almost certain to expand beyond existing clean water assets and bring wastewater assets into regulatory attention. Failure to invest now could prolong the exposure that water companies have for this part of their estates.
- **Investment to strengthen cybersecurity in wastewater is essential for environmental and societal reasons**. A cyber-attack on a company could have a major impact on wastewater management and processing, potentially resulting in large scale spilling with knock-on effects on clean water.

To address this, **we ask that:**

- **Ofwat significantly revises its allowed expenditure for cybersecurity to reflect the serious scale of issues faced by the sector**. This should include a proper treatment of the protection of sewage assets. As part of this, it would be useful for Ofwat to engage more closely with relevant experts in cybersecurity, such as the chair and experts from our Water UK Cyber Security Network. Water UK would be happy to facilitate these discussions.

Biodiversity

We are concerned that Ofwat's approach to this will deliver perverse effects on the ecological outcomes delivered. As a result of Ofwat's approach – which has set a common target of 0.73 biodiversity units by 2029-30 instead of adopting the tailored and bespoke company forecasts ranging between 0 and 84.73 -

suboptimal solutions will be encouraged, such as interventions that develop benefits *quickly* as opposed to those *best suited to the ecological potential and context* of the site. Ofwat has set a common performance target for all companies based on the median of companies' forecasted performance. However, companies defined their targets based on what they consider achievable in AMP8 and based on their local knowledge of the biodiversity value and potential of their candidate sites. The median target does not take any company specific issues into account and is a gross over-simplification. This approach will expose companies to underperformance penalties by default and/or encourage low-value interventions.

The rigid adoption of four-yearly survey cycles means that no further land will be added for assessment beyond year one, as benefits would roll over into the following AMP. Likewise, key improvements to a previously surveyed habitat may emerge *within* the four-year cycle and therefore not qualify for recognition/reward under the performance commitment.

There is a considerable level of prescription and risk within the definition of the performance commitment. For example, there are no protections for force majeure events (such as storms or fires) which could undermine habitat improvements and eliminate any biodiversity uplift, thereby risking significant underperformance payments.

Baseline surveys and enhancements conducted in AMP7 were expected to be valid for the purposes of the performance commitment, as agreed in the performance commitment working group.

To address these issues, we recommend that Ofwat:

- **Adopts companies' forecast performance**. This will hold them to account for delivering improvements judged to be deliverable within the AMP.
- **Revise the performance commitment definition** to enable to enable early surveys and works to be included, conduct surveys more flexibly/discretionary and exclude from the cap and collar exceptional events that are outside companies' control that may impact biodiversity, such as wildfires and floods.

Net zero

Ofwat has professed to match companies' ambition on net zero and called for a reduction in operational greenhouse gas emissions by 11%.[63] On the face of it, this is in line with the government's ambition, with the now Secretary of State for Energy Security and Net Zero, Ed Miliband, stating in February 2024 that, if elected, the government would 'ensure net zero is at the heart of all relevant regulators' duties'[64]. Miliband reiterated this prioritisation of net zero in July 2024 after being confirmed as Secretary of State, stating that his department would be 'leading […] accelerating our journey to net zero'[65].

However, despite the importance to society and for public policy, the achievement of the target stated in Ofwat's proposed draft determinations is jeopardised by the level of allowed enhancement costs, where Ofwat has cut investment relating to net zero by £619m (66%). The justification for this was to

[63] 'Our draft determinations for the 2024 price review', Ofwat, 2024.
[64] See https://www.ft.com/content/ba299d26-84de-4285-882a-900d52833c1d.
[65] See https://www.gov.uk/government/news/energy-secretary-ed-miliband-sets-out-his-priorities-for-the-department.

avoid double-counting spend; this principle is legitimate (indeed, vital for maintaining trust) however it is important to reflect on changes which have occurred since PR19 which will make using base more challenging. For example, in PR19, water companies were able to finance gas-to-grid schemes through the revenues of the sale of corresponding Renewable Gas Guarantees of Origin (RGGOs) certificates while also being able to claim these emissions reduction toward their net zero efforts. Ofwat has updated its operational greenhouse gas emissions performance commitments definitions and companies now have to retain their RGGOs to be able to claim emissions reductions.

For PR24, it is very likely that the only way for water companies to be able to finance gas to grid schemes will be to continue selling corresponding RGGOs, and as a result water companies will not be able to claim the emissions reductions from gas to grid toward their targets. Ofwat has also failed to recognise some solutions as qualifying for enhancement expenditure despite these being part of Ofwat's own 2022 net zero technology list and for use in PR24.[66] For example, requests for enhancement costs to finance real time nitrous oxide control was rejected as being a base expenditure, despite its presence on Ofwat's own list.

For substantial progress to be made on net zero, Ofwat needs to ensure emissions and decarbonisation are considered throughout the plans, giving greater weight to less carbon-intensive options. It is regrettable that the investment programme as a whole will be carbon intensive given the low possibility for nature-based solutions, which further demonstrate the far-reaching implications of regulatory decision-making for climate outcomes.

To address these issues, we ask that:

- **Ofwat carefully reviews companies' submissions in response to the draft determinations and make all necessary efforts to provide companies with the means to meet the ambition of the net zero and greenhouse gas emissions reduction targets.**

Climate change adaptation: flooding and power outages

Eight companies requested enhancement funding of £188 million across water and wastewater for power and flood resilience (fluvial and pluvial).

Ofwat rejected aspects of all company's climate change adaptation measures on the basis that they had not adequately justified investment cases, particularly in relation to increasing climatic risks. While companies are separately providing additional evidence to help address Ofwat's specific concerns with their cases, it is worth noting the importance of funding in this area for preventing serious pollution incidents and maintaining customer services. Specifically:

- Climate change adaptation funding cuts for Sewage Pumping Stations and Sewage Treatment Works will leave both more exposed to increasingly abnormal weather patterns. This will lead to a higher number of water supply outage incidents and more severe environmental impacts. Waste operations, in particular, can be disrupted by abnormal weather patterns (e.g. flooding, high groundwater levels or infiltration), leading to inundation and environmental discharges (sometimes outside of permits). This can have a knock-on effect

[66] 'Net Zero Technology Review', Ofwat, August, 2022.

on clean water supply abstraction points as, in many cases, wastewater assets are located upstream of these locations and within source protected zones[67].

- Power cuts at water works and sewage pumping stations pose significant risks, leading to pollution and other incidents. The water industry argues that the responsibility for these risks, stemming from failing power distributors, should not be placed on water customers or companies. Instead, these risks should be managed through dedicated power resilience measures, aligning with recommendations from the National Infrastructure Commission[68].

- The government needs to determine where these risks should be allocated and how they should be managed, with Ofwat reflecting this approach in the regulatory framework. This could include specific enhancement allowances. Until such decisions are made, water companies will require either additional funding to address these power-related issues or the reinstatement of extreme weather exceptions, which Ofwat has removed for PR24, to account for the uncontrollable nature of these risks.

- Climate change risks and impacts differ based on regions - partly because the weather patterns will be different, but also because those changing weather patterns will affect infrastructure and other local factors in different ways. For example, in the North East of England, wind storms are a big challenge, exacerbated by existing poor energy infrastructure resilience (e.g. power suppliers and national grid); in other areas, temperatures or flooding are more problematic; some have potential salinity issues due to rising sea levels. These elements need to be considered separately, not as a simplistic sector increase of 0.7% of the base allowance.

- Resilience funding cuts will also prevent companies from tackling the impacts of extreme heat at both clean water and wastewater sites, especially during drought incidents or extended heatwave events similar to the one experienced in 2022. Funding in this area is important to help companies to invest in generators, upgrade existing backup generation systems on site and optimise site cooling systems, ensuring that assets won't fail during high-demand events.

- Asset health and asset expansion (both base and enhancement) funding for treatment works (clean and waste) were also cut, preventing companies from carrying out proactive replacements (Ofwat's analysis shows that this funding should have already been available in base, but water companies disagree for two reasons: a) funding provided in PR19 was entirely spent in the previous asset management plan (AMP) and b) companies have scoped in different sites for this cycle.

Ofwat's approach to climate change resilience funding primarily relies on base allowances derived from historical expenditure and past performance, assuming these are adequate for future challenges. However, this approach overlooks the increased vulnerability of water companies to extreme weather events, and other factors, including power interruptions that are not climate change related – e.g. poor

[67] 'Source protected zones, Section', Environment Agency, 2024, see 'How we defined the zones'.
[68] 'Government Response to the National Infrastructure Commission' report 'Anticipate, React, Recover: Resilient Infrastructure Systems', HM Government, 2021

maintenance by the Distribution Network Operator (DNO), which is beyond their control and are not adequately addressed by existing funding mechanisms.

By conflating climate resilience with general operational resilience, and setting a minimal 0.7% base allowance enhancement uplift, Ofwat discourages companies from seeking additional funding for climate-specific challenges. This is in stark contrast to the Climate Change Committee's recommendation of £0.5bn to £1bn per year for public supply resilience and flood protection[69], indicating a significant underestimation of the required investment by Ofwat.

To address this issue, we ask that:

- **Ofwat carefully reviews companies' submissions in response to the draft determination and make all necessary efforts to understand individual company needs in opposition to the current approach of the 0.7% uplift of the base allowance.**

Security and emergency measures

Under the Water Industry Act, Section 208, the English and Welsh governments can give water companies directions regarding national security matters or to mitigate the effect of a civil emergency. As part of their business plans, 12 water companies requested £750 million in funding to enhance resilience under the Security and Emergency Measures Direction (SEMD), maintain the security of Critical National Infrastructure (CNI) and National Infrastructure (NI). However, in its draft determinations, Ofwat has only allowed £228m (a cut of 70%).

We recognise that the overall cut in SEMD is disproportionately affected by the significant cut seen by one particular company (£443 million) but we are concerned that:

- Ofwat's approach fails to account for additional security requirements that have very recently been introduced by DWI, which pose additional costs to companies but have not been reflected in the business plans (e.g. the change of CNI threshold and including technology-based enhancements for physical security across all sites). Furthermore, in Autumn 2023 the government widened the scope of the Critical National Infrastructure estate which increased the number of company assets falling under this definition. However, giving the timings, companies have had no opportunity to apply compliant protections to the newly designated assets and/or to consider the cost implications as part of their business plans.
- We are also concerned with this level of cut given that the increasingly volatile environment (for example, the increased geopolitical threat against UK assets) which means restricting physical security expenditure is far more likely to affect customers and the environment.

To address this, we recommend that:

- **Ofwat reconsider the impact of budget cuts to water and wastewater asset security and make every effort to understand individual company positions (e.g. PR24 was for some companies the first time they proposed additional security enhancement requests in 10 years).**

[69] 'Investment for a well-adapted UK, Climate Change Committee', January 2023, p15.

Finally, water companies have attempted over the current period to increase their internal tanker fleets, power generation and alternative water resources, making them more resilient when responding to emergencies by reducing reliance on third-party support. However, we are also concerned that Ofwat has not considered the ongoing work between water companies and government in enhancing security and emergency measures even further. This work covers the need to respond to national emergencies that could possibly last for a number of days and potentially impact multiple water companies simultaneously affecting a large part of the population.

To ensure the industry is adequately prepared and funded for any future requirements in time, **we ask that:**

- **Ofwat considers the scope for an uncertainty mechanism to apply to security-related provisions to reflect the ongoing uncertainty around future requirements.** Alongside this submission, Water UK is submitting a position paper on an approach towards uncertainty mechanisms for PR24 which should be used for solving these issues.

Investigations

The water and wastewater investigations programmes are crucial in determining efficient and effective investments in future AMPs. Water Framework Directive 'Reasons for Not Achieving Good Status' and 'Reasons for Deterioration' must be properly characterised in order to determine the right investment.

Ofwat's proposed cuts (£69m in the water WINEP and £189m in wastewater) represent false economies, as they risk forcing companies to deliver less effective, more expensive solutions in future AMPs due to a lack of proper understanding of the true reasons for any failure.

While we cannot quantify the effects, we know of several examples where investigations have shown that expensive capital investment could be deferred in favour of lower cost catchment interventions. A robust investigation programme is essential to an efficient investment programme that maximises benefit to the environment, and the proposed scale of cuts is likely to cost customers more in the long run.

To address this, we ask that:

- **Ofwat revisits each companies' case for investigations** and makes sure that allowances are sufficient to drive efficient investment programmes in the future.