28th August 2024

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Dear David,

On behalf of the English and Welsh water companies, Water UK has provided Ofwat with a formal response to its draft determinations (enclosed). I thought it might also be helpful to set out industry's high-level position.

First, let me say that I know you and the team have put a huge amount of work into PR24 to date – a process that is never easy, even without an election to disrupt the timetable. Thank you for that.

As we have discussed before, the companies Ofwat regulates know that, overall, performance is not where it should be. They are working hard to put that right, part of which requires mobilising record levels of investment.

As you examine their plans for that investment, I know how difficult it is for any regulator to distinguish between genuine issues and special pleading, and it is natural for a degree of cynicism to enter into the judgments you must make. That must be even more the case where there has been such variable performance between companies.

Sometimes that cynicism is justified. On other occasions – as we saw with the last offshore wind auction seeking new energy investment – such cynicism is unwarranted and the outcome is failure.

On behalf of the whole sector, I wish to make clear the industry's strong belief that without significant change, Ofwat is currently headed for the second of these possibilities. Unless Ofwat alters its course, there is a very real risk that much-needed economic growth will be constrained and the continued over-abstraction of water from fragile ecosystems will not improve. Without change, new homes could be blocked, the recovery of our rivers will be slower and I see us failing to show anything like the required urgency in dealing with the water shortages we know are coming.

On specifics, without significant changes between draft and final determinations, it is the industry's strong view that:

1. **Ofwat's draft decisions, taken together, would likely make it impossible for the water sector to attract the level of investment that it needs and will reduce the UK's attractiveness to international investment**. As Oxera's independent report into the investability of the water sector shows, investors – who are being asked to contribute billions in new equity to support investment programmes – have nothing like the confidence needed to provide that much of their own finance. We have also seen a steep loss of confidence among debt investors. This view is widely shared, with Moody's recently noting that, "…if the draft is adopted unchanged we could lower our view of the regulatory framework's stability, predictability and

supportiveness."[1] That would ultimately mean companies will not be able to deliver for their customers and the environment or play their role in driving much-needed growth in the economy.

2. **Companies face the largest ever cut to proposed investment – coupled with the most punitive targets ever. Together, this will mean insufficient funds to deliver the ambitious programme of investment that we both want to see.** Ofwat's cuts to proposed plans risks delaying improvements that would reduce leaks, sewage discharges and service failures. With some regions facing much larger cuts than others, it would also exacerbate regional inequalities - despite no clear basis for some parts of the country being disproportionately affected by reductions to vital programmes such as those improving storm overflows. Alongside this record-breaking cut to proposed spending Ofwat has set the most demanding performance targets in history. This combination cannot be delivered. It is surely perverse that penalties will be issued even if significant improvements are made each and every year. Ofwat must stop repeatedly cutting investment plans to the point they are no longer viable while, at the same time, holding companies to increasingly unachievable targets that set the sector (and Ofwat) up to fail.

3. **Ofwat's approach stores up problems and costs for future generations.** Ofwat's cuts to proposed investment risks leaving companies insufficiently funded to maintain their assets and, over the longer-term, they risk finding themselves unable to meet statutory targets to deliver environmental improvements. This is despite evidence that shows that current investment needs cannot be deferred to future periods. In addition, Ofwat is also extending the time period over which companies can recover the costs from customers of investment projects beyond their 'natural' lifecycle, which means customers will be paying for longer. This creates issues of intergenerational fairness.

4. **Ofwat is focussed on the wrong risks, micromanaging very specific decisions and stifling accountability, innovation, collaboration and efficiency**. It is right for Ofwat to seek to push the sector to innovate and deliver improved outcomes for customers and the environment. However, Ofwat's approach to managing delivery risk duplicates existing statutory requirements and means companies would be unable to adopt cheaper or greener options (for example, by seemingly prohibiting companies from replacing concrete and steel with nature-based improvements to overflows). At the same time, Ofwat deals inadequately with other, arguably more significant, risks such as from cybersecurity, aging infrastructure and the potential for unexpected new costs to emerge from future obligations (e.g. new requirements on drinking water quality).

Ahead of final determinations, we must look again at the continued focus on squeezing costs regardless of the impact on outcomes. Independent experts continue to be surprised that Ofwat promotes the full £6.7bn of investment that it cut out of the last price review as evidence of the value of its work.[2] It is, of course, right that Ofwat challenges companies hard on efficiency and value for money. However, with the benefit of hindsight, it is our view, and the view of many independent

[1] 'Regulated Water Utilities—UK: Ofwat's draft determination increases sector risk', Moody's, 14 August 2024.
[2] See 'Measuring-Ofwats-Impact.pdf', Ofwat, November 2023, page 4.

experts, that these cuts to plans went too far. Indeed, the sector now expects to overspend by something approaching that same amount by 2025.

Companies cannot sustain a situation in which they keep spending more to run their equipment and services than they can take in through bills - while a better alternative to underfunding improvements would have been to reallocate that money to projects Ofwat could have supported. The Competition and Markets Authority, in its last examination of these issues in 2021, made important observations about the previous round of cuts and provided pointers that would be useful to revisit before final determinations are concluded.

I know you share industry's understanding of how important it is to reach the right final decisions on these issues. Those decisions will either set the country on a path of sound environmental stewardship and economic growth, or they will again store up problems for the future.

With that in mind, it is vital that Ofwat take the time it needs to study carefully the individual issues raised in this and company submissions, particularly given the reduced opportunities for engagement to date compared with previous price reviews (and concerns from companies that each settlement does not appear to have been assessed as an overall package).

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 you to enter into more meaningful engagement and arrive at a better settlement for customers and the environment. This would need to include working with you on overcoming any practical barriers to agree specific charging arrangements, as well as managing any supply chain issues.

In what I hope will be felt to be constructive, **Water UK has offered other specific recommendations for how decisions might be improved in time for the final determinations** – we include this in our main response and accompanying consultancy papers and reports. These changes could significantly reduce the risk of the process running on through 2025 and help companies to hit the ground running from April. In addition, given the struggles faced by many families we have offered a suggestion for better targeting support for those struggling to pay.

Water UK is eager to share further evidence on our views (including from engagement with investors) and is willing to facilitate improved engagement and an approach that is focused on successfully concluding PR24. I look forward to working with you as part of this.

I am copying this letter to the Rt Hon Steve Reed MP, Huw Irranca-Davies MS, Philip Duffy, Marcus Rink and Mike Keil.

Yours sincerely,

David Henderson

Chief Executive Officer
Water UK