Water UK's submission to the NAO review of regulation in the water sector

September 2024

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Contents

1 Introduction

1.1 Background and objectives

1.1.1 This document sets out Water UK's response to the National Audit Office (NAO)'s review of water regulation. Water UK is the trade association for the UK's water industry and includes all regulated water and wastewater companies in England, Northern Ireland, Scotland and Wales.

1.1.2 We strongly welcome the NAO's review. It is timely. The sector faces an unprecedented degree of challenge in meeting the country's needs – from the availability of water for new homes, data centres and economic growth; to delivering environmental improvements; to meeting the challenges of climate change and population growth.

1.1.3 At the same time, much of the existing infrastructure is nearing the end of its life. There is a significant backlog of work to fix this, reflecting that necessary investment has been blocked in previous price reviews. There are also particular issues in enabling investment in asset health and replacement, which is an important contributing factor to the current levels of leakage and pollution incidents. This is despite previous interventions from the National Infrastructure Commission[1] and others.

1.1.4 In 2023, the House of Lords Industry and Regulators Committee found that, "*Ofwat has failed to ensure companies invest sufficiently in water infrastructure, choosing to keep bills low at the expense of investment.*"[2] As a result of this, there is a huge need for 'catch up' investment at a time when new and further investment requirements are simultaneously, though rightly, being introduced.

1.1.5 Based on analysis by Moody's, water companies in England and Wales are expected to spend around £272bn of capital investment from 2025 to 2050. This investment is in addition to the costs of continuing to operate and maintain their existing assets.[3]

1.1.6 Together, these factors steeply increase the need for investment and, as a consequence, customer bills over coming decades – beyond the price increases currently under discussion for 2025-30. Just as we saw investment increase steeply following privatisation (see Figure 1) we are facing a 'second wave' of increased long-term ambition and spend.

1.1.7 It is therefore more important than ever for regulation to be effective in incentivising investment in the water sector to meet the challenges we face now and in the future.

1.1.8 However, the current system of regulation is ill-equipped to meet these challenges. We do not think the system, unless it changes, will enable the level of investment required or secure the best outcomes for customers or the environment. The last decade of decisions demonstrate that the framework heavily prioritises achieving small and diminishing efficiency gains and suppressing bills below inflation[4] over other more pressing public policy outcomes – including security of supply, adaptation to climate change and public outrage over the environment.

1.1.9 Ofwat's draft determinations for the 2024 price review (or PR24), which will set the funding, outcomes and return for five years from 2025, risk exacerbating these issues. For illustration,

[1] For a more comprehensive discussion of this, and the potential continuation of problems into PR24, see: https://www.water.org.uk/sites/default/files/2024-08/20240828_Reckon_Asset%20health%20for%20PR24.pdf

[2] https://committees.parliament.uk/publications/34458/documents/189872/default/

[3] https://dkf1ato8y5dsg.cloudfront.net/uploads/52/504/uk-water-enhancement-spend-to-rise-16-oct-2023-pbc1380409.pdf

[4] In particular, had the sector's revenues been allowed to keep pace with inflation, the sector would have had £11bn of additional investment since 2015.

it has proposed cutting investment in cyber security by 48%, despite the government advising that the threat to critical national infrastructure is high and rising[5], with a number of serious real-world incidents occurring recently in the UK and allied countries.

1.1.10 The result is that, without change, the country is currently exposed to an unnecessarily high level of risk, customers will receive less for their money and there is a reduced likelihood of meeting either statutory obligations or the public's legitimate expectations.

1.2 Review of water sector regulation

1.2.1 When it announced its review of water regulation, the NAO said that it will "*examine the effectiveness of regulatory frameworks in incentivising investment in the water sector and achieving the outcomes set for the sector.*" The NAO said it will look at whether:

(a) government and regulators are clear what outcomes the water industry needs to achieve and the investment needed
(b) regulation is successfully incentivising investment and meeting desired outcomes and targets
(c) regulators can respond to the current investment challenges."

1.2.2 In addition, the NAO wrote to water companies on 11 August 2024, seeking written submissions on the following questions:

1. *Your working relationship with Defra, Ofwat, the Environment Agency and the Drinking Water Inspectorate.*

    a. *How well they communicate their expectations for your company, and in particular the clarity and consistency of messaging between the different organisations.*
    b. *How the different organisations support you in understanding your regulatory requirements.*

2. *How regulation is working currently*

    a. *Your views on the Price Review process (including the appeals process via the Competition and Markets Authority).*
    b. *The costs associated with regulatory reporting and price review, if you have an estimate.*
    c. *Your views on output delivery incentives (ODIs) as incentives to improve performance.*
    d. *Your experience of any enforcement action, up to and including criminal action, and the impact this has on the business.*
    e. *The impact of regulation on the sector's reputation and investment.*

3. *The key challenges you see for investors/investment in the sector in the medium- and long-term.*

4. *Changes to the regulatory environment for water that you would like to bring forward, and the extent to which you are consulted on regulatory changes.*

5. *Any wider issues or problems you face in engaging with government, outside of the organisations we are specifically examining.*

[5] https://www.ncsc.gov.uk/blog-post/legislation-help-counter-cyber-threat-cni#:~:text=For%20the%20NCSC%2C%20the%20cyber,these%20vital%20services%20is%20rising.

6. *What are the issues in the sector that only industry can fix, and not the regulatory framework.*

1.2.3 The NAO also stated that it was happy to receive any wider comments or evidence that may be relevant.

1.2.4 The NAO rightly focuses on whether regulatory frameworks in the water sector are effective at incentivising investment and achieving the outcomes set for the sector. This is critical because **only through a regulatory framework that supports sustainable investment at the right level and at the right time can we deliver for current and future customers and the environment, now and over the long term**. For this reason, we have focused our response on outlining the key issues as we see them, guided by the NAO's overarching questions on incentivising investment. For certain issues, such as on enforcement and working relationships with regulators, we leave our individual members to address these in their respective responses.

1.2.5 The NAO has also clarified that its review will cover Ofwat's work across both England and Wales, but not the actions of the Welsh Government or Natural Resources Wales (whose work is audited by the Auditor General for Wales). As such, this response discusses the water sector in both England and Wales – though in chapter two, where we address the overarching structure of regulation as overseen by Defra, we focus on activities in England. We note that the response from Dŵr Cymru covers in more detail the contrast between the arrangements in England (where it also operates) and Wales.

1.3 The water sector's achievements to date

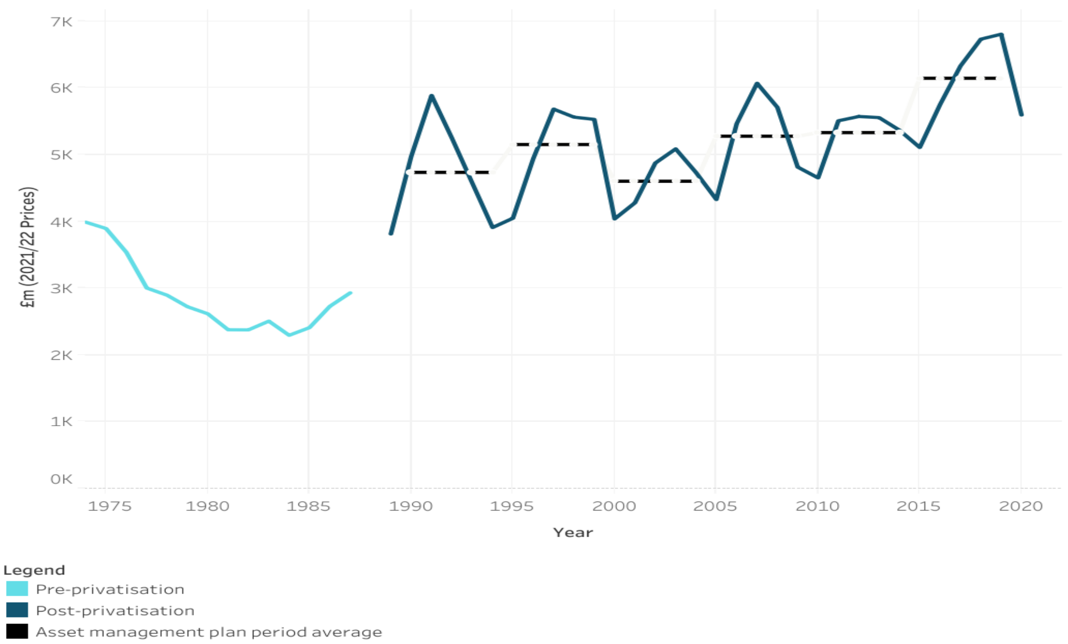
1.3.1 Before we focus on how the regulatory framework is holding back necessary investment, it is worth reflecting on what has been delivered since the water sector was privatised in 1989.

1.3.2 As the National Infrastructure Commission observes, annual capital investment by the water industry in England and Wales has been significantly higher than at any point under the previous Regional Water Authorities.[6] According to data from Ofwat, water companies have invested £236bn of capital investment since 1989, an average of £6.7bn per year, a near doubling of previous annual levels. In recent years, this has increased even further, with average annual capital investment of £7.7bn since 2020 – and a record £9.2bn in 2023-24, the highest ever delivered in a single year. The UK water sector invests more than anywhere else in Europe, with England and Wales making up much the greatest part of that investment.[7]

[6] https://nic.org.uk/data/all-data/historic-water-datasets/#tab-historic-water-capex

[7] https://www.eureau.org/resources/publications/eureau-publications/5824-europe-s-water-in-figures-2021/file, p.8.

Figure 1: Capital expenditure by the water industry in England and Wales



Source: Historic Water Datasets – National Infrastructure Commission

1.3.3 Customers and the environment have experienced the benefits of this significant investment. The improvements delivered since the 1990s have been significant:

(a) Unplanned interruptions to water supply are five times less likely for customers.[8]

(b) Drinking water quality compliance is the highest it has ever been, up from 98-99% in the 1990s to close to 100% in recent years.[9]

(c) Leakage is at the lowest level ever recorded, down more than a third since the 1990s.[10]

(d) 96% of bathing waters now meet minimum standards, compared with 46% in 1995.[11] Furthermore, two-thirds of beaches now achieve the highest environmental standard, compared to just 10% in the early 1990s.[12]

(e) Serious pollution incidents caused by the water industry have fallen by 90% since the 1990s, with the impact of pollution from sewage works cut by around 50% for 'BOD' (the indicator used for organic pollutants), 80% for ammonia and two-thirds for phosphorus.[13]

1.3.4 The water sector in England and Wales has also performed better than those in France, Ireland, Italy and Spain since 1990 in terms of the most important service indicators. Performance levels are similar to those in Germany, but at a lower cost.[14]

1.3.5 These improvements have been enabled through the sector's funding model that is designed to provide investors with the trust and confidence to provide upfront funding for improvements. This investment is added to the value of the company's asset base (the

[8] https://www.discoverwater.co.uk/loss-of-supply
[9] https://www.water.org.uk/sites/default/files/wp/2018/12/GWI-International-sector-performance-comparisons.pdf
[10] https://www.water.org.uk/water-supply/leakage
[11] https://environmentagency.blog.gov.uk/2023/12/01/bathing-waters-annual-classifications-2023/
[12] https://www.water.org.uk/protecting-environment/bathing-waters
[13] https://committees.parliament.uk/writtenevidence/130299/pdf/
[14] https://www.water.org.uk/wp-content/uploads/2018/12/GWI-International-sector-performance-comparisons.pdf

regulatory capital value) and then paid back by customers over time, with investors receiving a return based on the value of the regulatory capital value. As evidenced by a report from Frontier Economics for Water UK in 2017, the investment delivered through this model has largely enabled the sector to deliver more for less, unlocking significant efficiencies alongside those service and environmental improvements and materially outperforming comparator sectors in the decades after privatisation.[15]

1.3.6 However, as the last few years have shown, overall performance in the water sector is not where it should be. Last year, water companies apologised for not acting fast enough on storm overflows – and put forward a plan to put it right.[16]

1.3.7 Furthermore, the rising risk of drought, and the wider pressures created by climate change and population growth, increase the urgency with which we need to act to secure our future water supplies.

1.3.8 To meet these challenges, and in contrast to recent years, the sector will need to attract record levels of new equity investment. Ofwat expects the sector to require £7bn of new equity by 2030[17] and large equity requirements are expected to persist up to at least 2050.[18] The water sector will be in competition with significant demands for private investment across the wider economy; the National Infrastructure Commission estimates private infrastructure investment in England and Wales will need to increase from around £20-30 billion per year over the last decade to up to £50 billion by the 2040s.[19] It is, therefore, more important than ever that the sector's regulation is effective in incentivising investment to meet the challenges we face, now and in the future.

1.4 Issues with the regulatory framework

1.4.1 Substantial improvements are required for the regulatory framework to deliver for customers, the economy and the environment. In our assessment, and based on the scope of the NAO's review of regulation, **we think there are critical problems at two levels**:

(a) **issues with the overarching structure of regulation**, and

(b) **issues with the price control framework**.

1.4.2 We consider each of these issues, and put forward suggestions for how the framework could change to address them, in turn. Whilst these suggestions would require further consideration, we have sought to put forward ideas that are pragmatic and can be implemented reasonably easily.

1.4.3 We note that this submission falls in between Ofwat's draft and final determinations for PR24. While we focus mainly on more fundamental framework issues, rather than issues specific to this price review, we include some supporting case studies and evidence from PR24 (some of which we discuss in our response to Ofwat's consultation on the draft determinations).[20] However, this evidence could change in the final determinations and we therefore recommend that the NAO collects further evidence after the final determinations are published.

[15] https://www.water.org.uk/wp-content/uploads/2018/11/Water-UK-Frontier-Productivity.pdf
[16] https://www.water.org.uk/news-views-publications/news/water-and-sewage-companies-england-apologise-sewage-spills-and-launch
[17] https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-Aligning-Risk-and-Return-Appendix-1.pdf, pp62-63.
[18] https://www.water.org.uk/sites/default/files/2024-08/20240828_Oxera_Investability%20report%20for%20Water%20UK_FINAL_0.pdf, p20.
[19] https://nic.org.uk/app/uploads/Final-NIA-2-Full-Document.pdf
[20] https://www.water.org.uk/news-views-publications/news/response-draft-determinations

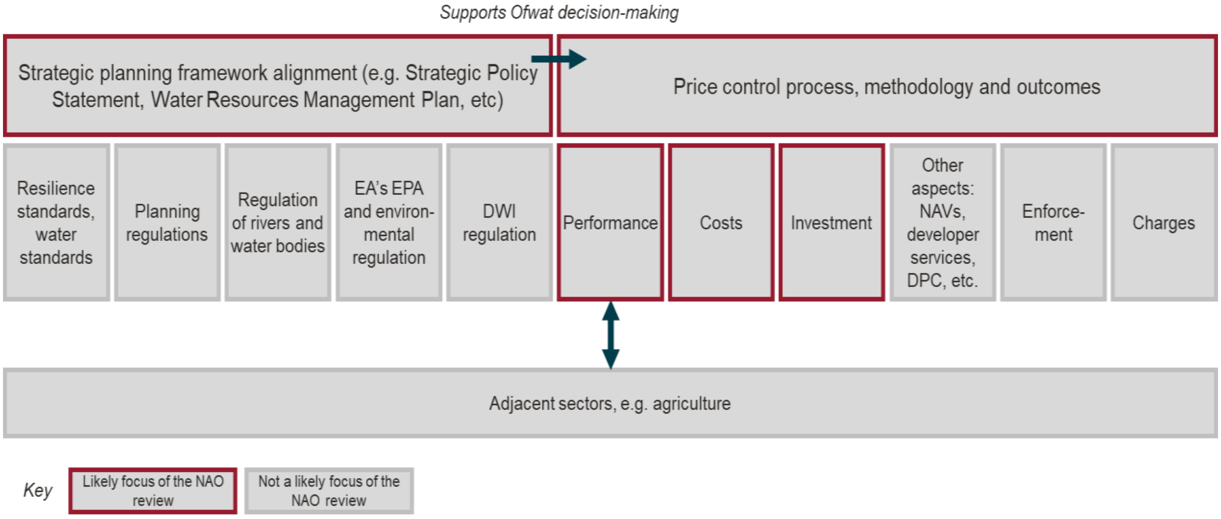
1.5 Wider issues with the framework

1.5.1 Before discussing specifics, it is worth noting that there are also a wide range of other, wider issues with the framework that, based on our understanding, are likely to fall outside the scope of the NAO's review but which are important and may interact with or otherwise affect the specific topics that the NAO is interested in.

1.5.2 For example, the process for how new enhancements (e.g. reservoirs) secure planning approval is often slow and expensive. On the health of our rivers and water bodies, water companies are (rightly) accountable, though the regime fails to reflect the role other sectors such as agriculture and road play (e.g. there are 18,000 road outflows into streams and rivers that are unpermitted, unmonitored and have no funded plans for remediation[21]). Figure 2 illustrates our current understanding of the wider issues, as well as those areas we understand the NAO is likely to be most focused on.

1.5.3 We recognise that the Government will shortly announce the terms of its own review to, "*reform the entire water system to resolve… very deep-rooted and complex problems*" and to "*shape further legislation that will fundamentally transform how our entire water system works*".[22] Reflecting this, there is scope to look more widely at the full range of issues, as well as the potential ways in which they could be addressed. As such, we expect to consider more material changes to the structure and regulation of the sector over the coming months. Given that the findings of the NAO review are likely to be a helpful input into the Government's review, we are happy to engage further on this as we develop our thinking.

Figure 2: Aspects of the framework for the water sector framework and our understanding of the scope of the NAO's review



Source: Water UK

[21] https://committees.parliament.uk/oralevidence/2434/pdf/

[22] https://www.gov.uk/government/speeches/steve-reed-speech-on-the-water-special-measures-bill

2 Overarching structure of regulation

2.1.1 This section addresses questions from the NAO relating to how clearly Defra, Ofwat, the Environment Agency and the Drinking Water Inspectorate communicate their expectations to the water sector, as well as the overarching structure of regulation. Reflecting the scope of the NAO's review, we have focused on the arrangements between Defra and others in England only, though we also explain below how the arrangements work in Wales.

2.1.2 In this section we provide:

(a) an overview of current arrangements,

(b) issues with the overarching structure of regulation, and

(c) suggestions for improvements.

2.2 Overview of current arrangements

2.2.1 Water companies are regulated by a number of different regulators with responsibilities over different aspects of the water industry. In England, they are overseen by the Department for Environment, Food and Rural Affairs (Defra), which sets the overall water and sewerage policy framework in England. In Wales, they are overseen by the Welsh Government.

2.2.2 In England, water companies are primarily regulated by:

(a) **The Water Services Regulation Authority (Ofwat)**, which is the economic regulator. Water and sewerage infrastructure is a natural monopoly and Ofwat has a duty to make sure that customers are protected from monopoly prices and service levels. At the same time, Ofwat must also make sure that companies are able to carry out their statutory functions, finance themselves and secure long-term resilience. Ofwat primarily enables investment through five-yearly price reviews (also called the periodic review process), which we consider in more detail later in this document.

(b) **The Environment Agency**, which is the environmental regulator for England. It is responsible for maintaining and improving the quality of raw water as well as issuing abstraction licences and discharge permits, overseeing water companies' drought management plans and reducing flood risks, including through their own activities.[23] The Environment Agency imposes statutory and regulatory requirements on water companies using:

(i) the Water Industry National Environment Programme (WINEP), which is a programme of actions that water companies are required to undertake to improve the environment, reflecting their statutory obligations. It is published periodically by the Environment Agency which identifies the expenditures and investments companies must make based on the Water Industry Strategic Environmental Requirements (WISER), which is jointly produced by the Environment Agency and Natural England.

(ii) Water resources management plans (WRMPs), which are produced by companies under guidance provided by the Environment Agency, setting out how they will

[23] Abstraction licenses are required for individuals or businesses to legally remove more than 20 cubic meters of water a day from rivers, lakes or groundwater sources. Discharge permits are required for individuals or companies that discharge liquid effluent or wastewater into surface waters, into or on the ground.

manage and develop water resources over a 25-year period to achieve a secure supply of water for their customers and a protected and enhanced environment. They are approved by the Secretary of State.

(iii) Drainage and wastewater management plans (DWMPs), which are produced by water companies, currently on a non-statutory basis, and outline their 25-year plan for managing wastewater and ensuring effective drainage in the land and properties they supply.

(c) **Natural England**, which is responsible for ensuring that the environment is protected and improved by overseeing companies' activities where they might affect biodiversity and habitats. Along with the Environment Agency, Natural England issues the Water Industry Strategic Environmental Requirements to provide strategic steers to water companies on the environment, resilience and their flood risk obligations.

(d) **the Drinking Water Inspectorate (or DWI),** which oversees the quality of drinking water supplied by each water company in both England and Wales. It conducts technical audits of water companies covering the operating practices of water companies as well as assessment of water company sampling programmes and incidents potentially affecting drinking water quality or sufficiency. The Drinking Water Inspectorate also provides inputs on water companies' programmes for improving drinking water quality during Ofwat's price review, as well as investigating consumer complaints about drinking water quality. The Drinking Water Inspectorate is also responsible for the regulation of the Security and Emergency Measures (Water and Sewerage Undertakers and Water Supply Licensees) Direction (SEMD) for companies. They ensure that companies maintain a water supply and/or sewerage system in the interests of national security, as well as mitigating the effects of any civil emergency that may occur, including cyber threats.

(e) Defra, which issues a Strategic Policy Statement that in effect sets out the priorities for the water sector. Ofwat is required to act in accordance with the strategic policy statement. Defra publishes policy objectives that do not carry a statutory status (such as the targets in the Storm Overflow Discharge Reduction Plan[24]) and, through Parliament, sets direct legal requirements for water companies through legislation, such as the Environment Act 2021.

2.2.3 In Wales, water companies are regulated by Ofwat and the Drinking Water Inspectorate (both of which have equivalent roles as they do in England). They are also regulated by Natural Resources Wales which, in managing water resources in Wales, produces the National Environment Plan (NEP – for Wales) that sets out the improvements water companies need to make to comply with new or amended environmental legislation.

2.3 Issues with the overarching structure of regulation

2.3.1 There are a number of different policymakers and regulatory bodies in the water sector, each with its own duties and objectives. They have different powers to set requirements, frameworks and strategic guidance for companies. However, their decisions are inevitably interlinked given that they regulate the same set of companies.

[24] See here: https://assets.publishing.service.gov.uk/media/6537e1c55e47a50014989910/Expanded_Storm_Overflows_Discharge_Reduction_Plan.pdf

2.3.2 There have been attempts to better align and co-ordinate requirements and relationships within the water sector in recent years, such as:

(a) RAPID (the Regulators' Alliance for Progressing Infrastructure Development), which includes Ofwat, the Environment Agency and Drinking Water Inspectorate and is intended to help facilitate large scale investment in water supply options – regulators working together on strategic schemes is a clear step forward.[25]

(b) The joint review of the Water Industry National Environment Programme by Ofwat, the Environment Agency and Defra – a joint working group, which was a step in the right direction, though did not ultimately create a sufficiently outcomes-focused approach to the Water Industry National Environment Programme for PR24.

2.3.3 However, there remain substantial issues, which we discuss below.

Lack of clarity

2.3.4 Defra's current strategic policy statement lacks clear direction. It sets out a wide range of 59 different expectations on Ofwat, with no clear prioritisation between them.[26] By setting so many equally weighted expectations, Ofwat has significant latitude to make its own prioritisation decisions about the importance of different outcomes. It also breaks the link between clear strategic direction for the water sector, which must ultimately be set by government, and the delivery of the government's priorities. This leaves Ofwat (and to an extent companies) to attempt to prioritise these strategic issues, some of which can contradict each other, creating risks around legitimacy, efficiency, responsiveness and clarity.

2.3.5 While politically salient issues may, to some extent, be protected in this prioritisation, vital long-term questions that are likely to receive less attention (such as resilience or capital maintenance) tend not to be.

2.3.6 For example, as the National Infrastructure Commission has identified in a recent report[27], 'resilience standards' in the water sector are few in number and quite fragmented, which means water companies lack clarity on the investment required to secure a desired level of resilience. This means industry frequently struggles to have robust investment cases approved by Ofwat.

2.3.7 To illustrate this: as part of the PR24 funding process, and following incidents in 2022 where existing stores ran out in a period of high demand, South East Water requested £242m for a range of resilience investment. This included investment towards a number of treated water storage and water treatment works improvements, as well as additional network connectivity to increase its production and distribution resilience. However, Ofwat recently cut this requested spend by 68%.

2.3.8 In the absence of clear outcomes, or sufficient expression or treatment of customer risk, the narrow range of tools that are used to determine expenditure tend to overlook the importance of issues like resilience. For example, during appeals to the Competition and Markets Authority following the last price review, PR19 (which set the funding, outputs and

[25] https://www.ofwat.gov.uk/regulated-companies/rapid/

[26] February 2022: The government's strategic priorities for Ofwat - GOV.UK (www.gov.uk). For example, the expectations relate to areas such as challenging water companies to improve on serious pollution, to plan for long-term water resource needs and to meet the needs of strategic drainage planning, as well requirements on Ofwat to encourage retailers to support non-household customers who are behind on debt, to support housing supply and to promote the bioresources market.

[27] https://nic.org.uk/app/uploads/NIC-Resilience-Standards-Report-Final-190924.pdf

returns for 2020-25), funding for various resilience measures had to be restored after they had been rejected through the PR19 process.

2.3.9 Perhaps reflecting the difficulty of assessing the benefits of risk management in the absence of a clear standard, the Competition and Markets Authority (CMA) noted that:

"*by their nature, resilience projects are forward-looking and can generally be delayed, but this results in customers continuing to be exposed to the identified risk*".

2.3.10 Commenting as they restored funding for one scheme, the CMA used a richer "*exercise of judgment*" to determine judgment, and expressed concern:

"*… about an assessment framework which required customer harm to occur before accepting this as evidence of the need for additional intervention. Such a reactive approach would expose customers to unnecessary harms and does not reflect the way that a responsible company would be expected to operate*".[28]

2.3.11 Clearer standards and prioritisation across resilience and other issues would avoid some of these debates and remedy government's current limited guidance on direction.

Inefficient decisions

2.3.12 In recent years, the water sector has been faced with a range of new and material statutory requirements to improve the environment. These requirements have been introduced both by Defra (e.g. on reducing the activation of storm overflows or reducing nutrients from the discharges of treated effluent) and by the Environment Agency (via the Water Industry National Environment Programme). There are two issues with these new requirements:

(a) Requirements are not consistently subject to sufficient cost-benefit tests, either because they are not required to pass such a test, or because the analysis is not implemented properly or it is ignored, or because they are undertaken by different organisations. For example, companies are required to upgrade sewerage works to operate at the technically achievable limit for discharges, without having tested whether the same achievable limits in the immediate environment surrounding the discharges could have been delivered in another way, such as through other sectors. This creates a risk that that new requirements are not of consistent value for money for customers or the environment.

(b) Requirements are often set in a way that dictates the manner in which they must be delivered.[29] As a result, companies are often unable to produce the same outcome in ways that are cheaper, more environmentally beneficial and/or more innovative. This is despite an important part of the rationale for our current model being its ability to drive innovation, and major features of Ofwat's system (such as ODIs) supposedly existing to likewise encourage companies to innovate.[30] In this way different parts of the regulatory system pull against each other.

[28] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf p.489

[29] Examples include the specific granular outputs of the Water Industry National Environment Programme and Price Control Deliverables, the output targets set by the Environment Act and the effective closing-off of innovative solutions by setting 'lowest common denominator' cost allowances.

[30] For example, Appendix 8 of Ofwat's Final Methodology for PR24 makes clear the importance attached by Ofwat to the link between ODIs and innovation.

Lack of co-ordination and aligned timing

2.3.13 Regulatory bodies and policymakers do not co-ordinate with each other sufficiently. As a result, their requirements are not properly aligned and tend to be reasonably specific to their area of responsibilities. Currently, the objectives placed on the Drinking Water Inspectorate and the Environment Agency do not include the obligation to consider the broad economic implications and potential delivery challenges of the new requirements that they introduce. This leads to a number of problems:

(a) Defra, the Environment Agency and the Drinking Water Inspectorate impose new requirements – which are likely to have an additional cost – on companies mid-price control. However, Ofwat does not have suitably flexible funding mechanisms that enable companies to seek additional efficient expenditure to fund these requirements. This either risks costs being cut elsewhere to deliver these new requirements or delays the delivery of improvements for customers and the environment. For example, the Environment Agency has twice increased the price of permit (e.g. relating to discharges) mid control period, with no ability for companies to recover the additional costs until the subsequent control period begins.[31]

(b) The same requirements can (and very often are) monitored by Ofwat and either the Environment Agency or the Drinking Water Inspectorate, with differing standards and different approaches to enforcement action. The result can be excessive regulatory burdens and conflicting incentives and decisions. There can also be overlapping enforcement regulations and incentive regimes by more than one regulator. For example, Ofwat has recently adopted a different interpretation of the compliance standards relating to wastewater (as set out in the Urban Wast Water Treatment (England and Wales) Regulations 1994) compared with the standards Defra has been reporting against for several years.

(c) Regulators use inconsistent planning requirements and assumptions, which creates unnecessary inconsistency and complexity. For example, companies are often required to use different assumptions on population estimates when providing strategic plans to regulators.

2.3.14 Ultimately, this lack of coordination between regulators risks creating funding gaps and delays so **that customers and the environment are faced with lower performance and potentially higher costs in the long term.**

2.4 Suggestions for improving the overarching structure of regulation

Clear strategic policy guidance on priorities

2.4.1 As discussed above, the Government' long list of expectations on Ofwat, as set out in the Strategic Policy Statement, does not include any guidance on how Ofwat should make trade-offs. As a result, a laudable desire to keep water bills as low as possible can and often does come at the direct expense of companies being able to make the necessary investments to

[31] There are several other examples. The Drinking Water Inspectorate imposed additional requirements on water companies concerning the need to reduce certain chemicals (Per- and polyfluoroalkyl substances, or PFAS, commonly known as forever chemicals) in the water supply in August 2024, during the PR24 process and some ten months after companies submitted their initial business plans to Ofwat. Similarly, the final Water Industry National Environment Programme and the final Water Resources Management Plan need to be reflected in business plans and price review determinations so companies have sufficient funding to deliver the statutory requirements contained in them. However, the timetables are not aligned and companies have had to revise plans late in the process to reflect the latest statutory requirements.

deliver government's demands concerning the provision of plentiful and high-quality drinking water and the management of the effects of wastewater on the environment. This is a crucial policy question for which there is currently no clarity.

2.4.2 One possible route to address this is **to provide much clearer guidance through Defra's Strategic Policy Statement on the prioritisation of objectives** (rather than simply providing a long list without acknowledgement or guidance on trade-offs). Ensuring policy steer comes from the Government, which is elected and has direct accountability to the public (and so customers), would help strengthen the legitimacy of the sector's activities and any associated bill impacts.

Single set of requirements

2.4.3 As discussed above, requirements on companies come from different regulators and are often not sufficiently coordinated with each other. They also tend to be very specific. Instead**, there would be merit in government and regulators having a single set of requirements that align the sector's long-term strategic planning frameworks**. This would enable companies to develop plans and secure funding to deliver those requirements in an orderly and consistent process.

2.4.4 We consider this could be based on two recent proposals:

(a) **new resilience standards set by the government**, as has been proposed by the National Infrastructure Commission, which would enable water companies and regulators to cost and work towards delivering them as part of the underpinning strategic planning and price review processes.[32]

(b) **a holistic assessment of infrastructure needs**, as has been proposed by the Department for Business and Trade in its 'smarter regulation' programme, which would enable an assessment of interdependencies between sectors (such as telecoms, energy and water) as well as a review of the conditions of assets in the water and wastewater sector, and whether they are sufficiently resilient to future risks.[33]

2.4.5 Policymakers and regulators in the water sector could also take inspiration from the idea of 'mission-driven' government.[34] The new Government has identified five ambitious, measurable and long-term objectives. The intention is to break down silos within government to ensure joined-up delivery of these objectives. A similar approach could be adopted in the water sector, based on benefits to be delivered that are relevant for the sector. The water sector could also take inspiration from the energy sector, where very clear and legally-binding targets relating to carbon (i.e. to reduce carbon emissions by 80% by 2050 compared with 1990 levels) have informed decisions on allowed investment in a clear and transparent way.

Alignment between regulators

2.4.6 As discussed above, different regulators impose different requirements on companies (e.g. via the strategic planning frameworks such as the Water Industry National Environment Programme, the Water Resources Management Plan, the Drainage and Wastewater Management Plans, other requirements imposed from time-to-time) that do not align with Ofwat's price control process that determines companies' funding.

[32] https://nic.org.uk/app/uploads/NIC-Resilience-Standards-Report-Final-190924.pdf

[33] https://assets.publishing.service.gov.uk/media/664c8e09b7249a4c6e9d38a3/smarter-regulation-delivering-a-regulatory-environment-for-innovation-investment-and-growth.pdf

[34] https://www.instituteforgovernment.org.uk/publication/mission-driven-approach-government

2.4.7 To address this, **there is merit in aligning the different regulators' planning processes so that new requirements can be considered at the same time**. Water companies would then develop detailed options and plans using consistent and integrated requirements about what they need to deliver. This would enable best value assessments, effective delivery and clear accountability. However, we recognise that alignment of decisions to price controls may not always be possible, particularly where additional requirements need to be introduced quickly. In these cases, Ofwat could make greater use of 'uncertainty mechanisms' that would provide much needed flexibility to the price review process.[35] Ofwat could also consider more agile investment rounds within its price control to create the flexibility to provide additional funding if necessary. This could be similar to the 'green recovery' process in 2021, which enabled companies to request additional funding through a targeted and proportionate process, with a particularly focus on new and innovative investments.[36] This would help avoid costly delays in delivering improvements, or funds being redirected from other important activities.

2.4.8 **Better communication is also needed between policymakers and regulators as part of the decision-making process**. This would help to ensure that policymakers are aware of the cost impact of their decisions, and that Ofwat can plan price controls appropriately to reflect upcoming changes in requirements. This would also help to ensure that policymakers and regulators are all working towards a consistent set of objectives, and avoid issues such as overlapping or inconsistent requirements.

Robust cost-benefit tests for new requirements

2.4.9 As discussed above, new requirements imposed on the sector are not consistently subject to sufficient cost-benefit tests, either because they are not required to pass such a test, or because the analysis is not implemented properly or it is ignored.

2.4.10 To address this, **new requirements set by government should consistently be informed by cost-benefit analysis, including in a way that takes account its strategic priorities.** The need for investment should be tested in a consistent way across all regulators and government so that the value delivered relative to the cost of meeting requirements is understood and compared across different types of environmental improvements to identify the ones that deliver most impact for customers and the environment. But ultimately, this should be a decision for government.

2.4.11 One example of how this could work is the Storm Overflows Evidence Project, which took place in 2021. Overseen by a taskforce led by Defra, the Environment Agency, Ofwat, the Consumer Council for Water, Blueprint for Water (a representative group for environmental organisations) and Water UK, the project assessed high-level options for addressing the issue of storm overflows. Undertaken by Stantec, an environment and engineering consultancy, the report identified a range of approaches to address the issue, including complete separation of wastewater and stormwater systems that would cost up to £600bn.[37]

2.4.12 Under this approach, government would make strategic choices and ensure that resilience standards are set through high-level cost assessment and optioneering. The strategic planning frameworks, business planning and price review processes would follow, to help establish the methods for delivering those strategic priorities and outcomes. To ensure

[35] We set out further details on this in our position paper on uncertainty mechanisms, published in August 2024: 20240828 Water UK Position Paper - A Common Framework for Uncertainty Mechanisms at PR24_0.pdf

[36] https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/green-recovery/

[37] https://www.gov.uk/government/publications/storm-overflows-evidence-project

maximum flexibility, there could also be an opportunity for additional investment rounds based on new or emerging priorities.

Define requirements in a way that enables innovation

2.4.13 As discussed above, requirements are often set in a way that dictates the manner in which they must be delivered, inhibiting companies from progressing cheaper, more environmentally beneficial and/or more innovative approaches.

2.4.14 To address this, **statutory environmental requirements should be defined in a way that allows companies to choose the approach that delivers the change or benefit at the lowest cost for their customers**. Doing so should give companies, who have the on-the-ground expertise, the flexibility to find the route that delivers best value for customers. This could include, for example, using catchment management solutions or green solutions instead of traditional asset-based approaches.[38] This would, in turn, enable Ofwat's price control framework to incentivise the most efficient way of delivering those benefits for the environment.

[38] This topic is discussed in detail in 'Outcome-Based Environmental Regulation', a report from Frontier Economics commissioned by Wessex Water, https://corporate.wessexwater.co.uk/media/e05cim0k/outcome-based-environmental-regulation-report-2021.pdf.

3 Price control framework

3.1.1 This section addresses questions from the NAO relating to the price review, namely the outcome delivery incentives framework, the price review process (including appeals to the Competition and Markets Authority) and costs associated with regulatory reporting and price reviews.

3.1.2 For each of these issues, we provide:

(a) an overview of current arrangements,

(b) issues with the price control framework, and

(c) suggestions for improvements.

3.2 Overview of current arrangements

3.2.1 The price control process that is used in water is fairly standard for regulated sectors in the UK. In each price review, the regulator sets the intended outcomes, revenues and allowed returns for each company for a set period of time (the 'price control').[39] In water, each price review covers a five-year period, similar to the current approach for gas and electricity networks in Great Britain.

3.2.2 The most important aspects of the price review in the water sector for England and Wales, which we consider in turn in the next section, are:

(a) cost assessment, which relates to the amount of funding that Ofwat allows water companies to recover from their customers to spend on running their businesses, maintaining their assets and investing in new infrastructure,

(b) outcomes, which relates to the performance framework that water companies operate under, where they can receive rewards for going beyond their performance targets and incur penalties for not meeting them,

(c) investability, which is impacted by allowed returns and the balance of risk and reward in the price control, and

(d) the price review process, including business plan incentives, regulatory reporting requirements and regulatory appeals.

3.2.1 Cost assessment

3.2.3 Cost assessment is a critical aspect of incentive regulation, helping to identify the efficient but sustainable costs of delivery. Cost allowances are, in large part, fixed at the start of the price control period and Ofwat allows companies to retain a proportion of the cost savings that they deliver during the price control period (usually between 40% and 60%). Fixed allowances incentivise companies to make efficiency improvements during the price control period, and these savings can then be passed onto customers at the next price control period. Similarly, overspend risk is shared between customers and companies.

3.2.4 The cost assessment process that is used in water splits out:

[39] While we use the term 'price review' here as a singular, in practice, Ofwat sets five separate price controls for water and sewerage companies and three price controls for water-only companies as the value chain is broken down into household retail, water network plus, wastewater network plus, bioresources and water resources.

(a) 'base costs', which include routine year-on-year operational and capital maintenance expenditure, and

(b) 'enhancement costs', which include expenditure for the purpose of enhancing the capacity or quality of services beyond current levels.

3.2.5 The efficient level of base cost for each company is estimated using cross-company econometric models in order to 'benchmark' or compare companies' costs against one another. These models draw on historical expenditure data from water companies and 'cost drivers' identified by Ofwat as factors influencing legitimate differences in expenditure between companies and over time. The modelled base costs at different levels of aggregation are then triangulated to estimate wholesale modelled base costs. Ofwat then uses the upper quartile as the efficient benchmark. Companies can ask Ofwat for company-specific cost adjustments that reflect factors that are not included in the modelling.

3.2.6 Meanwhile, when assessing enhancement requests, Ofwat considers:

(a) Is the investment needed?

(b) Is the level of cost that has been requested efficient?

3.2.7 For enhancement requests that are driven by statutory requirements, Ofwat moves straight to benchmarking the efficiency of the proposed expenditure. Enhancement costs are benchmarked using a range of different approaches including unit costs comparisons, simple econometric models and 'deep dives' (in areas where comparisons between companies are difficult).

3.2.8 An additional, forward-looking 'frontier shift' challenge is applied to base costs and enhancement costs to account for expected future productivity improvements. Ofwat also applies an adjustment to account for price inflation of specific inputs such as labour costs and energy costs (where these differ from general consumer price inflation) – this is known as 'real price effects'.

3.2.2 Outcomes

3.2.9 At the PR19, companies made performance commitments about the service levels they would meet. Every performance commitment has an associated ODI which provides financial (as well as reputational) consequences for companies outperforming or underperforming their performance commitment. At PR19 there were performance commitments in 21 areas, covering areas such as per capita water consumption, leakage, pollution incidents, bathing water quality and business demand. For some performance commitments, Ofwat has set penalty-only ODIs.

3.2.10 This framework was first introduced at PR14 and the original idea was to reflect customers' preferences through the ODI rates (which determine the level of associated financial reward or penalty) so that companies would deliver improvements in performance where marginal benefits to customers exceed the marginal costs of delivery.

3.2.11 At PR24, the framework has evolved as follows:

- **Performance commitments:** First, Ofwat has assumed for the draft determinations that all companies achieve the end of PR19 targets even (though this is clearly not the case, as set out in Ofwat's latest annual performance report).[40] Only three companies are in net reward territory for 2023-24 and most companies are facing significant net penalties

[40] https://www.ofwat.gov.uk/wp-content/uploads/2023/09/Water-Company-Performance-Report-2022-23.pdf

as a result of their ODI performance as they have not been able to achieve the target levels set at PR19. Ofwat then sets performance commitments for the next five years based on its consideration of the performance that companies have forecast in their business plans and historical information. Some ODIs have targets that are common for every company, while others have company-specific targets.

- **ODI rates**: ODI rates are multiplied by every unit of performance away from a performance target to create rewards or penalties based on a company's performance. In previous price reviews, Ofwat largely set ODI rates based on customer research. For PR24, Ofwat is departing from this to use a 'top-down' methodology which puts a certain amount of money at risk for the company. Ofwat does this by allocating a certain percentage of regulatory equity to each ODI, and dividing this by a likely range of performance. Informed by customer research and strategic priorities, Ofwat can put more risk on the most important ODIs. For the draft determinations, Ofwat generally set a consistent ODI rate for every company.

- **Risk protections**: Ofwat limits the size of very large rewards or penalties. This can either be through individual 'caps' on performance measures, which disable additional rewards beyond a certain level of performance, or 'collars' which apply for underperformance. At an aggregate level, Ofwat is proposing to set 'aggregate sharing thresholds' to reduce aggregate risk for very high levels of outperformance or underperformance.

3.2.3 Investability

3.2.12 Investment is crucial to an asset-heavy sector such as water – both retaining existing investment and attracting new investment. Ofwat carries out a 'financeability' assessment during its price reviews, to determine whether companies can achieve a target credit rating of Baa1/BBB+, given the base allowed return and the assumptions that Ofwat has made about the notional company (such as the levels of gearing, equity injections and dividends).

3.2.13 However, it is important to distinguish between water companies' financeability, or their ability to finance their functions, and their investability, which refers to their ability to attract and retain the equity capital needed to deliver the desired investment.[41]

3.2.14 In the energy sector, Ofgem has acknowledged the need for growth in investment, and formally introduced the concept of 'investability' for its RIIO-2 price review. Ofwat has considered similar issues but has not facilitated a discussion on 'investability' in the same way as Ofgem. In fact, there is no mention of investability in the entirety of Ofwat's published draft determinations, though it has recognised the concept separately and in discussions following the publication of the draft determinations in July 2024.[42]

3.2.4 Process

3.2.15 A high-level description of the price review process is as follows:

- Ofwat usually conducts a review of the previous price review to identify lessons learned and areas for improvement.

- Ofwat then develops a draft methodology for consultation and subsequently publishes the final methodology. The final methodology sets out in detail how Ofwat intends to regulate each area of the price control and provides guidance for companies on what

[41] The concept of 'investability' is discussed in detail in Oxera's report for Water UK on the investability of the PR24 draft determinations, Our Standard Report template (water.org.uk).

[42] https://www.ofwat.gov.uk/wp-content/uploads/2024/07/City-Briefing-%E2%80%93-PR24-draft-determinations-transcript.pdf

they need to cover in their business plans. Ofwat will take into account its statutory duties, and the Strategic Policy Statement (as discussed above), in developing its methodology and throughout the price review.

- Each company then prepares a business plan based on Ofwat's final methodology.
- Ofwat assesses the business plans and publishes its draft decisions in a set of draft determinations for each company.
- Companies respond to the draft determinations, challenging Ofwat's view where they consider it necessary.
- Ofwat considers company submissions and sets the final set of outcomes, allowed revenues and returns in final determinations.
- If a company wishes to challenge the final determinations, it can ask Ofwat to refer the decision to the Competition and Markets Authority.

3.2.16 The Competition and Markets Authority then 'redetermines' the price control for a company that has appealed. In contrast with the energy sector, the water sector does not have a focused appeal regime where companies can only appeal on narrow grounds and can pick specific elements of the regulator's decision. In the water sector, the Competition and Markets Authority is required to conduct a re-determination of the whole price control, though in doing so it can focus on particular areas of contention.

3.3 Issues with the price control framework

3.3.1 Cost assessment

3.3.2 We broadly support Ofwat's use of benchmarking to inform company allowances. Cost benchmarking can be an effective way of overcoming information asymmetry between companies and regulators. By comparing companies' costs, regulators can use the more efficient companies in a sector to identify achievable cost efficiencies, and thereby set more efficient cost allowances for less efficient companies. However, benchmarking needs to be conducted robustly and with a clear understanding of its risks and limitations. There are issues from over-relying on it as a single tool or interpreting the results too narrowly and literally. There are also circumstances where benchmarking is not appropriate (for example where costs are novel, lumpy over time, or influenced by a company's unique circumstances).

3.3.3 As noted above, the House of Lords Industry and Regulators' Committee recently found that Ofwat has focused too heavily on short-term bill reductions in recent price controls.[43] As a result, its cost assessment process has led to underfunding, in particular underinvestment in capital maintenance (replacement and maintenance of assets in order to maintain asset health), which is exacerbated by historical investment being too low. This has created a backlog of investment that needs to be addressed at PR24. Despite a large increase in the level of enhancement expenditure at PR24, we are concerned that Ofwat's approach to cost assessment is not addressing the issues identified with past investment. We discuss the issues with base costs and enhancement costs separately.

Base costs

3.3.4 There are important issues with Ofwat's approach to assessing base costs:

[43] https://committees.parliament.uk/publications/34458/documents/189872/default/

(a) **Locks in underinvestment**. Ofwat's approach to setting base cost allowances for companies is based on a backward-looking approach that risks locking-in any under-investment that may have happened in the past. This situation arises due to Ofwat's use of low-spending companies as benchmarks for the industry as a whole. Some of those companies may have appeared to have been efficient when their low expenditure is actually only the result of lower or postponed investment in areas without statutory obligations, such as maintenance. Such underinvestment is further exacerbated by Ofwat's tendency to approve only a very limited number of 'cost adjustment claims' to reflect companies' individual circumstances. As a result, companies receive less investment funding than they should and can be then be forced to cut back on less urgent improvements that are nevertheless important for the long term.

(b) **Lacks focus on asset health and capital maintenance**. The current regulatory regime does not sufficiently monitor or capture investment in asset health in its benchmarking of company costs, nor does it carry out any separate modelling of capital maintenance costs, despite these costs representing approximately £22 billion in company plans at PR24.[44] While Ofwat has proposed a late change of approach for mains renewals in the PR24 draft determinations, we are concerned that it is not providing enough funding for companies (reflecting that, for some companies, it is providing no additional funding). The proposed approach is also only focused on one type of water asset (water mains), with no intervention or funding for any sewerage assets, despite Ofwat identifying specific risks to rising sewer mains in its draft determinations.

(c) **Insufficiently addresses future risks**. Ofwat's backwards-looking approach to cost assessment makes it unlikely that base expenditure allowances based on historical data will be sufficient to address future challenges, such as population growth and climate change which is rapidly placing new stress on infrastructure in ways not expected even as recently as five years ago and certainly not when almost all of the infrastructure was first designed and built. This situation is exacerbated given that companies have already overspent their total expenditure allowances by £4.4bn (or 12%) in the first four years of PR19. As we set out in our response to the draft determinations, Ofwat's 'climate resilience' allowance is inadequate, severely underfunding companies for known risks.

3.3.5 Underfunding of base expenditure leads to future performance risks to customers and the environment. Poor and deteriorating asset health can lead to insufficient resilience to unexpected incidents and extreme conditions. Future customers may need to pay more, particularly if companies have to adopt higher-cost responses in the future if performance issues arise from past underinvestment.

Enhancement costs

3.3.6 As a result of material increases in statutory requirements, companies proposed enhancement expenditure of £46bn in their business plans for 2025-30. However, Ofwat has proposed to cut this by 25%, to £34.6bn.[45] We are concerned that the size of this cut will make those statutory requirements undeliverable. This issue is driven by design choices within Ofwat's approach to enhancement expenditure:

(a) **Simplistic models**. Where Ofwat has used benchmarking, it has relied on new models that take insufficient account of regional factors and appears to have ignored the

[44] These issues are set out in detail by Reckon as part of the 'infrastructure health' project which brings together water companies, regulators and government to consider improvements to the treatment of capital maintenance in time for PR29. See here: https://www.water.org.uk/investing-future/infrastructure-health

[45] https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/draft-determinations/

evidence provided by companies about the real costs that they face. Given the size of the capital programmes, the models used are simplistic (in some cases only using one or two variables) and risk underfunding companies given the unique circumstances that they are in. A better approach would be to undertake more detailed engineering assessments, especially where there are material risks to customers or the environment.

(b) **Excessive challenges**. Even where Ofwat has undertaken 'deep dive' engineering assessments, the depth of the analysis is questionable. Ofwat's written assessments are often lacking in detail and have led to 'efficiency challenge' reductions of up to 30%, including for statutory programmes. In some cases, the 'needs assessment' has led to a reductions in expenditure of up to 70%. This is highly likely to make individual enhancement programmes undeliverable.

3.3.2 Outcomes

3.3.7 Our view is that the ODI framework is generally a good approach to achieving service improvements. However, in practice, there are significant implementation issues which means that the framework may not deliver what it intends:

(a) **Undeliverable targets**. We can now see that the performance commitments set at PR19 were not achievable. Recent data shows that the majority of companies have been unable to meet the performance targets set by Ofwat despite strong financial and reputation incentives to do so. The sector has, on average, received significant penalties over the first four years of PR19.[46] Ofwat's PR24 draft determinations perpetuate this issue, by using PR19 targets as the starting point for PR24. Even if companies were to deliver their PR24 forecast business plan levels of service (which is an overly optimistic scenario given Ofwat has also cut allowed expenditure by 16%), under the PR24 draft determinations companies would face net penalties of £2.4bn, or an impact on returns on regulatory equity of -1%.[47] As well as creating performance issues, undeliverable targets can also create the perception of a failing sector – even if, in reality, performance has improved over time. Indeed, it is notable that, in contrast to its approach of using historical expenditure to inform future allowed costs, Ofwat's approach in setting targets is not based on the sector's actual performance (nor is it based on any customer research on the relative importance of the outcomes to be delivered).

(b) **Unstable incentives**. The level of change in ODI rates both between PR19 and PR24, and during the PR24 process itself,[48] risks undermining decision-making in long-life assets as companies cannot be confident about future financial rewards or penalties beyond the next price control. This also continues to stretch the link between customer preferences and incentives on company performance. This lack of stability is in contrast to the approaches taken by other regulators, such as the CAA and Ofgem, which typically uplift ODI rates with inflation (either explicitly or by linking rates to revenue) and signal a review of ODI rates from time to time.

(c) **Unreasonable levels of risk**. As well as creating significant downside risk for the sector (as discussed above and illustrated in Figure 3), Ofwat's approach to ODIs for PR24 is

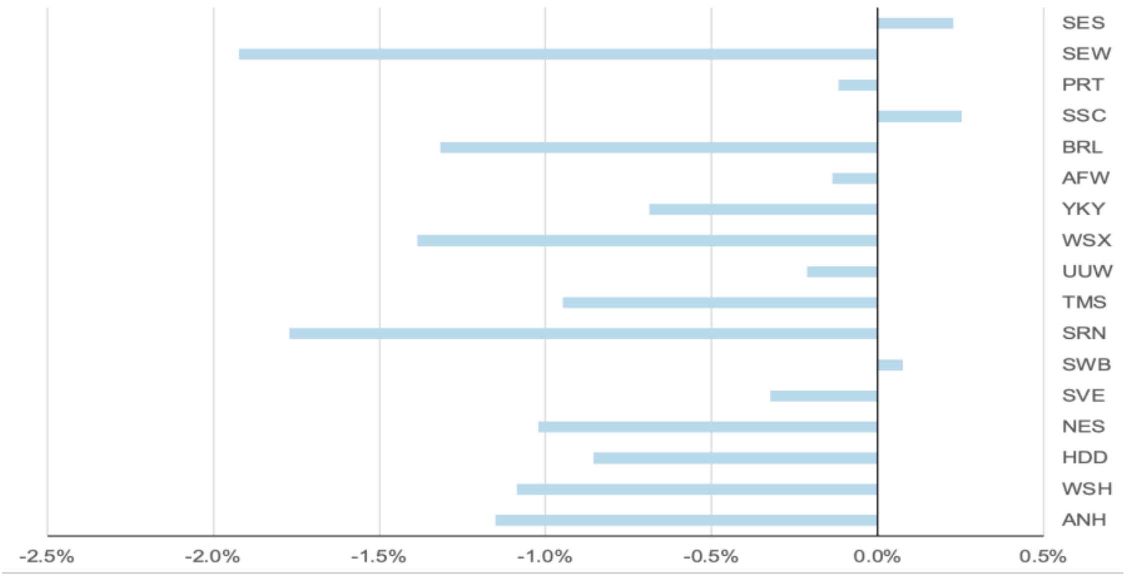
[46] https://www.water.org.uk/sites/default/files/2024-08/20240828_Oxera_Investability%20report%20for%20Water%20UK_FINAL_0.pdf

[47] https://www.water.org.uk/sites/default/files/2024-08/20240828_Oxera_Investability%20report%20for%20Water%20UK_FINAL_0.pdf

[48] https://www.ofwat.gov.uk/wp-content/uploads/2023/08/PR24-Using-collaborative-customer-research-to-set-outcome-delivery-incentive-rates-.pdf

undermining the investability of the sector, putting at risk its ability to deliver the improvements (rightly) demanded by customers and society. This is discussed in further detail below.

Figure 3: Expected net ODI penalty/reward, average annual return on regulatory equity (RoRE) over 2025-30



Source: First Economics for Water UK, August 2024.

3.3.3 Investability

3.3.8 As discussed above, the sector requires significant levels of new investment, which needs to be financed. Ofwat's current approach to setting baseline returns for investors, combined with a wider price control package that does not adequately balance risk and reward, threatens companies' ability to raise equity capital needed to finance the investment required or to retain existing capital. If fresh equity capital cannot be raised, or existing equity retained, then this will hamper the ability of any company to deliver the necessary improvements.

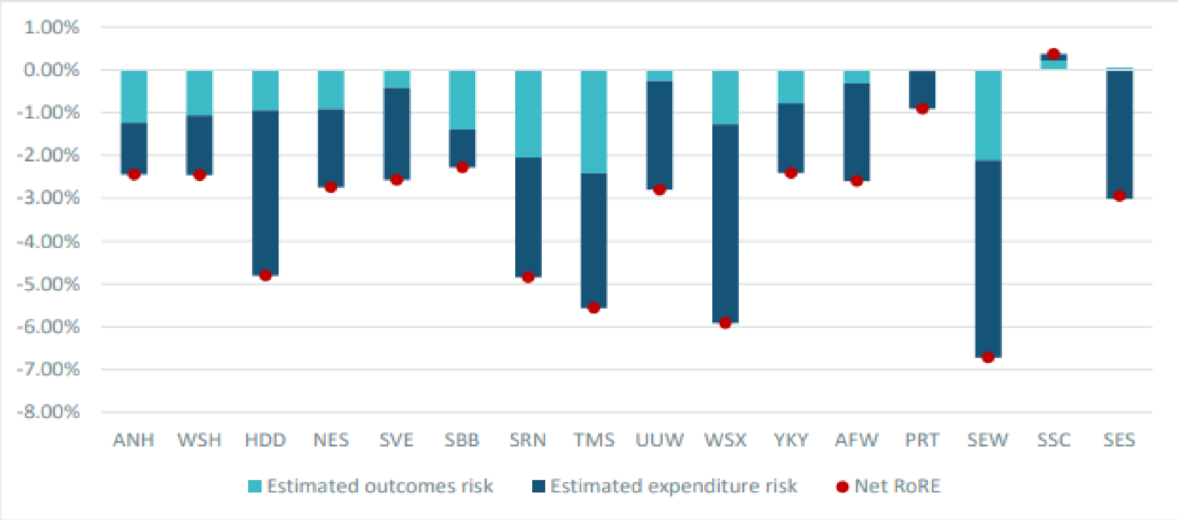
3.3.9 There are a number of specific issues that create this risk:

(a) **Poor calibration of risk and reward**. This means that equity investors face a significant risk of not earning the baseline allowed return on equity. Realised equity returns depend on out/under-performance in various areas of the price control, including whether a company receives rewards or penalties on ODIs, and whether actual expenditure is above or below total expenditure allowances. Current performance reinforces this concern, with nearly every company overspending their allowances and incurring net ODI penalties over 2020-24. Our analysis of Ofwat's PR24 draft determinations (see Figure 4) would mean that, even if companies performed in line with their business plans, all but one company would only be able to earn the baseline allowed returns.[49] In other words, price reviews do not appear to represent a 'fair bet'. Ofwat's own modelling shows that it expects the median company to underperform

[49] https://www.water.org.uk/news-views-publications/news/response-draft-determinations

against total expenditure and ODIs by 20 basis points of RoRE, suggesting that the median company will only be able to earn the base return if it can outperform Ofwat's debt financing assumptions.[50]

Figure 4: Estimated performance risk based on Ofwat's draft determinations and business plan forecasts for PR24, average annual return on regulatory equity (RoRE) over 2025-30



Source: Water UK's response to Ofwat's draft determinations for PR24, August 2024.

(b) **Returns not reflective of market conditions**. Ofwat has not set base allowed returns in a way that is flexible to market conditions, which can be an impediment to attracting necessary financing in a timely manner. This is set out in further detail in our response to the PR24 draft determinations. Furthermore, as Oxera's report on the investability of the draft determinations identifies, Ofwat's proposals to reduce the rate at which companies can recover the cost of enhancement projects ('run off rates'), and to restrict dividends under certain gearing approaches, are unattractive to both existing and potential investors.[51] This implies that, if companies continue to seek finance for investments via low dividends, the water sector may not be able to raise the levels of equity financing needed to fund investment growth in upcoming years.

(c) **Lack of investor confidence**. Investor sentiment towards Ofwat has also deteriorated, as reflected in Ofwat's own 2023 investor survey.[52] The survey shows a significant negative sentiment, with the lowest scores since the survey began in 2016, specifically in important areas such as alignment of the regulatory framework with investor interests, responsiveness to investor concerns, and consistent and sufficient engagement with all types of investment stakeholders. In fact, up to 48% of respondents, and 100% of equity investors, believe Ofwat is not listening to investors, compared to 24% that believe it is. This growing disconnect highlights a deepening lack of confidence in Ofwat's approach among investors, further hindering the investability of the water sector. Ofwat's approach has been addressed by Moody's, the credit rating agency, which suggests that if the draft determinations were adopted, it would increase the risk of cost overruns or future underperformance, as well as the risk of companies incurring penalties. This, Moody's suggest, may "*lower their view of the regulatory framework's stability, predictability and supportiveness*".[53] This could result in a further

[50] https://www.water.org.uk/sites/default/files/2024-08/20240828_Oxera_Investability%20report%20for%20Water%20UK_FINAL_0.pdf
[51] https://www.water.org.uk/sites/default/files/2024-08/20240828_Oxera_Investability%20report%20for%20Water%20UK_FINAL_0.pdf
[52] https://www.ofwat.gov.uk/wp-content/uploads/2024/07/Investor-survey-results-23.pdf
[53] https://www.moodys.com/research/Regulated-Water-Utilities-UK-Ofwats-draft-determination-increases-sector-risk--PBC_1417545

downgrade of Ofwat's regulatory rating, which was already reduced from AAA to AA in 2018.[54]

3.3.10 These factors are likely to have a direct impact on customers as:

(a) they ultimately need to pay more for financing as the regulatory framework itself has increased the regulatory risk of the sector; and

(b) investment in service, resilience and the environment can only happen if companies are investable.

3.3.4 Price review process

Approach to price reviews

3.3.11 We have material concerns with Ofwat's latest price review process:

(a) **Damaging incentives**. Ofwat's approach to business plan incentives includes an initial assessment of business plans – the Quality and Ambition Assessment (QAA). Ofwat uses this approach to incentivise companies to reveal efficient costs and service levels. However, in practice, the design of the QAA rewards those companies that submit a low-cost plan with unrealistic performance forecasts. Furthermore, Ofwat's criteria for categorising companies' business plans goes beyond simple 'quality' requirements. For example, companies can be financially penalised for not using assumptions made by Ofwat in its final methodology, such as the appropriate allowed return on capital, even if the company has clear evidence to the contrary. These damaging incentives create an 'honesty tax' on companies, and risks contributing to price review decisions that are unachievable and undeliverable.

(b) **Late changes**. Ofwat has deviated from decisions or added elements to the methodology in its draft determinations in a way that is not transparent or consistent. This makes it difficult for stakeholders to provide their views. For example, rather than using the early methodology stage, Ofwat has made significant changes to the treatment of Price Control Deliverables (PCDs, which allow Ofwat to return money to customers if commitments are not delivered during the control period) and ODI rates. While these changes may be justified, the sheer volume – 205 pages of guidance and 16 different models[55] – and the novelty of the policy proposals that have been put forward at a very late stage, has created challenges for the sector.

3.3.12 The overall result of these issues is a process that takes longer and costs more to implement and may not deliver the outcomes that the framework is trying to deliver.

Regulatory reporting

3.3.13 Some level of complexity is unavoidable. However, aspects of the price review process impose disproportionate cost and burden with limited benefit. The regulatory burden has also increased significantly over time.

3.3.14 For example, for PR24, Ofwat's draft determinations were more than 3,000 pages long across 101 documents, and also included hundreds of models. In contrast, PR04's final determinations constitute a single document of 281 pages. Similar increases can be observed

[54] https://www.moodys.com/research/doc--PBC_1124483
[55] https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/price-control-deliverables/

in the complexity of methodologies and business plans. It is far from clear whether the 1,000% increase over the last twenty years has led to improved outcomes.

3.3.15 That being said, in other cases, it can be appropriate for regulators, and therefore for companies, to put time and effort into properly understanding and addressing complicated issues. For example, given the lack of attention to such an important area, it is likely that the water sector will need to develop additional measures for asset health, aligned to the future risks to customers and the environment, which would help to facilitate discussions and decisions about future investment. This reflects the ongoing work across the sector on 'infrastructure health' to identify potential new metrics for future price reviews.[56]

3.3.16 The result of the current approach to regulatory reporting is a level of regulatory burden and cost that is not targeted in the most effective way, and therefore is unlikely to deliver the best outcomes for customers and the environment.

Appeals process

3.3.17 We strongly support the current regime for appeals, which investors say they consider to be the 'gold standard' in terms of accountability.[57] This is because the Competition and Market Authority provides an important safeguard for both companies and customers. As previous redeterminations in the water sector have shown, the Competition and Markets Authority is able to consider decisions 'in the round' and take all relevant factors into account.

3.3.18 However, it should only be seen as a 'last resort', for example if a company considers the final determination to be undeliverable, as the lengthy appeals process can lead to delays to delivery, additional costs in replanning and uncertainty (including amongst investors).

3.4 Suggestions for improving the price control framework

3.4.1 In line with our overall approach in this response, below we have set out some incremental changes that need to be made in order to remedy the issues we have identified and to achieve more effective regulation that delivers for customers and the environment.

Better calibration of the performance framework

3.4.2 **Performance targets and ODI rates need to be set so they are achievable and deliverable**. They need to reflect the actual costs of delivering service improvements and give greater consideration to company-specific evidence where there are genuine differences between companies in the costs of meeting targets. It should also have regard to customer preferences and wider strategic priorities, ensuring companies are incentivised to deliver the outcomes that matter most.

3.4.3 Alongside a more evidence-based approach to setting targets and ODI rates, Ofwat should carry out high-level sense checks of the calibration of its ODI framework. This could help Ofwat identify and remedy issues such as the fact that the majority of the sector is receiving overall penalties, despite improvements in performance over time, or the fact that the majority of companies are expected to pay penalties even if they perform in line with their business plans.

3.4.4 More broadly, **Ofwat could consider adopting different ways of incentivising improvements, which could include relative targets and incentive mechanisms**.

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

[57] https://www.ofwat.gov.uk/wp-content/uploads/2021/12/GIIA-Risk-and-Return-Response.pdf

Better approach to cost assessment and benchmarking

3.4.5 **Ofwat should implement improvements to its benchmarking approach to emphasise long-term deliverability and intergenerational fairness**.

3.4.6 As a minimum, Ofwat should engage with the proposals put forward for further consideration by Reckon for new approaches for capital maintenance and asset health in future price reviews, which includes approaches taken in the Scottish and Northern Irish water sectors and other regulated sectors.[58]

3.4.7 On enhancement costs, Ofwat needs to engage more proportionately and effectively with companies to properly understand the drivers of cost and reflect these in its modelling. The modelling approach also needs to be scrutinised from a technical perspective to ensure that the method for setting allowances is credible and high quality.

3.4.8 Alongside these improvements, there are other mechanisms that can be used to ensure that funding is made available when needed under specific circumstances:

(a) First (and as discussed above), make more use of uncertainty mechanisms (e.g. targeted reopeners[59]), which would help to release funding when new requirements come into force during a price control period. Ofwat should also consider implementing uncertainty mechanisms in other areas of significant uncertainty, such as 'volume drivers' where volumes of work required are uncertain. This has been implemented by Ofgem.

(b) Second, Ofwat should continue to use gated approaches (e.g. RAPID) to facilitate large, long-term projects. Such approaches ensure that funding is only released when projects reach specific 'gates', and help to enable early work to progress in a timely manner. However, it is important that Ofwat uses such approaches only when appropriate (e.g. because a specific project will span multiple price control periods), and not to impose undue restrictions or control on a large number of projects. Otherwise, this can delay important investment and erode incentives for companies to deliver cost efficiencies through the price control.

Ensuring investability

3.4.9 **Ofwat needs to set baseline allowed returns in a way that reflects recent changes in the macroeconomic environment and broader external pressures (such as increasing competition for capital). This needs to be accompanied by a more balanced regulatory package that makes it realistic for investors to achieve those baseline allowed returns.** This can be done through the approaches discussed above on costs and ODIs that would lead to better calibration of the price control, but also requires better assessment of the balance of risk in the regulatory framework. Ofwat also needs to assess the impact of its price controls as a whole for each company, rather than looking at individual components in isolation.

3.4.10 It is also critical that Ofwat's assessment of its proposed price controls be underpinned by credible assumptions around equity financing. Ofwat should assess the investability of its price controls, to ensure that it:

a) Provides confidence that investors will be able to recover their capital plus a fair return, over the lifetime of the investment; and

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

[59] https://www.water.org.uk/sites/default/files/2024-08/20240828_Water%20UK%20Position%20Paper%20-%20A%20Common%20Framework%20for%20Uncertainty%20Mechanisms%20at%20PR24_0.pdf

b) Provides a profile of expected returns on equity which investors are willing to accept.[60]

3.4.11 Further details are set out in Oxera's investability report. This will help the sector attract the investment it needs to tackle challenges including climate change, population growth, and an ageing asset base, and to improve outcomes for customers and the environment.

[60] https://www.water.org.uk/sites/default/files/2024-08/20240828_Oxera_Investability%20report%20for%20Water%20UK_FINAL_0.pdf

4 Next steps

4.1.1 Water UK is willing to work with any and all stakeholders to facilitate regulatory reform that delivers for customers and the environment and enables the sector to attract the necessary investment to ensure long-term sustainability.

4.1.2 We urge the NAO to review the issues we have highlighted in this document and recommend reforms where necessary to improve the effectiveness of regulation. We look forward to engaging further with the NAO on its review of water regulation.

4.1.3 We also look forward to engaging with the Government and others on the forthcoming review of the wider sector.