

The government's strategic priorities for Ofwat

Yorkshire Water response to the Department for
Environment, Food and Rural Affairs consultation

September 2021



YorkshireWater

The Government's strategic policy statement (SPS) for Ofwat comes at a critical moment for both the water industry and the country as a whole. The UK is facing significant new social, environmental, and economic challenges, many of which require action to be taken now in order to avoid even more severe consequences in the future.

Climate change is already causing more extreme weather events, increasing flooding incidents and droughts. Population growth will put further pressure on current infrastructure, increasing the need to invest to build a resilient water sector. We also face wider economic challenges arising from the Covid pandemic, exacerbating inequalities within our communities and putting a major burden on the next generation.

The water sector is both impacted by these challenges and well-positioned to help tackle them. Water companies are on the front line in the fight against climate change and we are feeling first-hand the effects of changing weather patterns. However, whilst we face into the challenges of a changing climate, the decisions we take in how we invest in resilience and adapt to these changes can play a big role in supporting and shaping the communities we serve.

As such, the SPS is a critical opportunity for the Government to ensure that Ofwat, regulators and the industry are addressing these challenges in ways which are aligned with the Government's priorities.

We broadly welcome the Government's approach as outlined in the SPS and we are supportive of the ambition to ensure that the water sector is delivering outcomes that support the 25 Year Environment Plan. The priorities identified by government echo our own priorities, and those of the regional customers and stakeholders that help to shape our plans.

However, given the scale and urgency of the challenges that we are facing, we believe there are areas in which the SPS could go further to ensure that regulators and industry are able to play their part as effectively as possible.

The changes we propose do not require fundamental changes to the system of independent regulation of the industry, which has on the whole

worked effectively to ensure that investment is delivered, and customers are protected. Instead, we propose straightforward changes in four areas which would help companies and regulators better deliver government priorities, improve transparency and accountability and unlock the power of public-private partnerships.

1. Balancing priorities

The current draft of the SPS lists a number of priorities that Ofwat is expected to deliver alongside its existing 15 plus duties. The priorities include:

- protecting and enhancing the environment
- delivering a resilient water sector
- serving and protecting customers
- driving markets to deliver for customers where appropriate.

In addition to the priorities identified by government, we believe there needs to be greater recognition and guidance within the SPS on the challenges around drinking water quality. Currently there is only a single line in the SPS on this, yet investment driven by the Drinking Water Inspectorate on lead removal could be on an equivalent scale to the Water Industry Natural Environment Programme.

Whilst we are supportive of the priorities identified within the SPS, there is a lack of clarity from government about how it expects Ofwat to balance the SPS priorities (and its duties) against each other, particularly when they conflict.

The absence of prioritisation creates ambiguity around the future regulatory direction and uncertainty for the sector, acting as a barrier to long-term investment.

2. Delivering accountability

The SPS process provides a way for government to shape how regulators and the water industry face up to the challenges ahead. It also provides a mechanism to set out clearly how regulatory process should be used to help deliver the Government's policy objectives. However, once the SPS

has been published, there is little in the way of follow up to ensure that the priorities set in the SPS are being delivered.

Ofwat's current obligations to report on how it is delivering the SPS essentially result in Ofwat marking its own homework and focusing only on the decisions and activities that support the SPS. There is little external interrogation of Ofwat's assessment; select committee scrutiny of regulators, whilst impactful, is currently ad hoc and infrequent.

This is not unique to the water sector. A similar picture can be drawn across the English regulatory regime, resulting in a democratic deficit as it is difficult for customers, taxpayers and elected representatives to see a full picture of regulators compliance with, and delivery of, government priorities and effectively hold them to account.

There are many similarities between this draft SPS and the previous one. However, there is a question as to whether the outcomes that resulted from the last price review met the objectives set in the SPS. This reinforces the need for better accountability.

3. Partnership working

Both the draft SPS and indeed the Government's 25 Year Environment Plan are clear that the sector can achieve more for its customers through partnership working.

The increasingly complex nature of the challenges we face means that looking at water bills alone is no longer an adequate measure of the economic impact on customers. The costs of climate change, biodiversity loss and health inequality will show up not only through water bills, but through taxation, lost economic potential and other costs for this generation and many more to come.

We strongly support the Government's view on partnership working and there are a number of examples of how partnerships between water companies, local authorities, government and NGOs have delivered more than could have been achieved alone.

An example of this can be seen in the Living with Water partnership, which brings together Yorkshire Water, Hull City Council, East Riding of Yorkshire Council and the Environment Agency for an internationally recognised partnership to tackle the second biggest flood risk in the country.

Unfortunately, this kind of partnership working remains the exception, rather than the norm. This is (in part) a result of the incentives inherent in the regulatory regime which can disincentivise working with others on innovative solutions. Although partnerships are often the best solution to a particular problem, getting regulatory approval often means they are also the most difficult.

4. Streamlining regulation

Regulation of the water industry is complex. There are multiple different regulators, with different responsibilities and statutory planning processes. The price control process, led by Ofwat, has become a four-year long process that consumes significant management and regulatory time and resource and has become inaccessible to non-regulatory experts.

This level of complexity has implications for public confidence in the water sector, the accountability of the regulatory regime and for the sector's ability to deliver solutions that tackle local and national challenges.

Ofwat has itself begun to explore how it can streamline the next price control in its early thinking around the PR24 methodology. At the same time the Government - in both the Department for Business, Energy and Industrial Strategy (BEIS) and HM Treasury - is considering how to reform regulatory frameworks more generally to ensure that they deliver the Government's ambitions.

The current BEIS consultation 'Reforming the Framework for Better Regulation' sets out five principles for the future of regulation:

- A sovereign approach
- Leading from the front
- Proportionality

- Recognising what works
- Setting high standards at home and globally

Whilst we recognise that this work is ongoing and the consultation has not yet closed, the SPS provides additional issues for Ofwat to consider, but does not provide any guidance on how Ofwat should design the price review process to incorporate these additional issues, whilst remaining in line with the Government's principles, particularly around proportionality.

Proposed solutions

By addressing the challenges outlined above the Government can ensure that the billions of pounds spent by the water industry every year are focused on delivering the Government's priorities as effectively as possible. Outlined below are four ways in which the SPS and wider regulatory regime can be strengthened to ensure that the sector is strongly positioned to increase resilience against future uncertainty, support a thriving environment and ensure our customers understand how and where their money is being spent.

These are:

1. Providing clarity on how Ofwat should manage trade-offs between competing priorities and its duties.

We believe the Government should take explicit steps to provide water companies with the stability needed to invest and innovate to deliver government objectives and tackle national challenges.

In particular, we believe the Government should provide an explicit steer on how Ofwat should prioritise the objectives set out in the SPS, particularly around balancing investment with bills.

There is precedent for Government providing guidance on how priorities should be balanced. For example, the Department for Culture, Media and Sport's SPS to Ofcom states that "the Government's view is that promoting investment should be prioritised over interventions to further reduce retail prices in the near term."

2. Introducing additional accountability, including a stronger and more frequent role for Parliament.

Ofwat, as an independent regulator, is ultimately accountable to Parliament. We believe the Environment, Food and Rural Affairs Select Committee should have a larger role in assessing Ofwat's delivery of the SPS and ensuring it is prioritising in accordance with government priorities.

The Committee could hold an annual evidence session scrutinising Ofwat's delivery of the SPS and how it has balanced priorities. To further resolve Ofwat's democratic deficit, this session could be informed by evidence from relevant stakeholders (including customer groups and local authorities given the regional nature of water companies) offering an external perspective on how Ofwat is delivering against the SPS.

Increasing the accountability of Ofwat to bodies that represent the public is more important than ever as the current direction of travel appears to be taking away the regional customer voice in favour of a centralised process.

To support this, we also propose that the SPS should include measurable targets for Ofwat, on which Ofwat should report in its annual report. We also propose that there should be stronger roles for the National Audit Office, the Public Accounts Committee in holding Ofwat to account and an explicit role for the new Office for Environmental Protection in the price control process.

3. Straightforward regulatory changes which could support partnership working as the norm, rather than the exception.

To support the ambitions in the SPS around partnership working, we propose five refinements to Ofwat's application of the regulatory framework to overcome the barriers and unlock the full potential of partnerships in the water sector.

First, greater weight should be given to wider social benefits in Ofwat's initial evaluation of investment proposals and whether they are needed. This should ensure Ofwat's scrutiny of the benefit case does not lead it to favour schemes which meet narrow objectives over those which deliver wider benefits.

Second, Ofwat should reflect the differences in the profile of costs and benefits of different investments over time when it conducts its assessment of the efficiency of proposed partnership investments. It should ensure it does not disincentivise investments in innovative partnership projects which may pay back over a different period of time compared to traditional assets.

Third, when Ofwat considers the efficiency of ongoing running costs for partnerships established in a previous price control, it should take steps to ensure that partnership-related costs do not distort its assessment of any company's proposed base costs.

Fourth, Ofwat should provide greater certainty around the treatment of partnership investments in company's regulatory asset bases. Ofwat must ensure that its regulatory accounting treatment does not disincentive investment in partnerships where they deliver benefits to customers and/or allow a water company to meet its objectives at lower cost.

Finally, recognising the challenges created by misaligned funding cycles of different organisations, Ofwat could make in-period determinations or grant companies conditional allowances that would allow them to negotiate partnerships with third parties in the time-period when the partners are most able to commit funds.

4. Streamlining the regulatory process for water in order to increase public confidence and allow the sector to deliver more innovative solutions.

To ensure that the regulatory process does not continue to become increasingly complex we would like to see the SPS include a steer from government on how Ofwat should seek to apply the key principles which underpin the Government's proposed new Framework for Better Regulation. This would help set the general direction of regulation and halt the continual march of increasing complexity.

In addition to this and to ensure the price review process meets with the principles set out by government we would like to see five key changes

to the regulatory process. Some of these can be delivered through the SPS, whilst others go beyond its scope and require broader change.

The changes we propose are:

Within the SPS

- Ofwat's visibility in the regions should be increased.
- The number of performance commitments should be reduced and incentives at PR24 should be simplified.

Broader changes

- A single independent body should be established to decide the cost of capital for each regulated sector.
- Timeframes for the statutory plans that water companies are required to prepare and deliver should be aligned.
- Ofwat should consider adopting a negotiated settlement approach for large, long-term new investment projects.

To support each of these recommendations we have developed a series of detailed policy papers.

These are available at <https://www.yorkshirewater.com/about-us/public-affairs/policy-positions/>

For more information contact:

Paul Carter

Head of Corporate Affairs

paul.carter@yorkshirewater.co.uk

[@yorkshirewater](#)

facebook.com/yorkshirewater

yorkshirewater.com