Making partnerships work

Yorkshire Water position statement

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YorkshireWater

Summary

Water companies have a unique relationship with the regions they serve and the environment in the areas in which they operate. As water companies manage these relationships, they share priorities and objectives with other organisations, such as local authorities and the Environment Agency.

This is becoming particularly true as the effects of climate change are felt locally in ways that span different organisations' responsibilities. Flooding is a prominent example of this – with responsibilities for preventing and responding to flooding incidents sitting across water companies, local authorities and the Environment Agency.

However, although responsibility is nominally separated according to the nature of the flooding risk, for example surface water flooding verses sewer flooding, in practice investments to protect against one form of flooding are likely to mitigate the effect of another type. Over the long-run, measures which change the movement of the water cycle can significantly alter all kinds of flood risk in a river's catchment area, meaning there is a large degree of interdependence between different organisations' responsibilities. Partnerships are often the most logical way of achieving the best outcomes.

There is hence a significant opportunity – and, indeed, need – for partnership working in the water sector, as recognised by the Department for Environment, Food and Rural Affairs (Defra) in its draft strategic policy statement (SPS) published in July 2021[1]:

> *"Water companies can achieve more for customers and for the environment through collaboration and partnerships. Solutions to many of the water sector challenges need strong local engagement and will require partnership working across catchments and regions."*

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[1] The government's strategic priorities and objectives for Ofwat (publishing.service.gov.uk); The government's strategic priorities for Ofwat: draft for consultation (defra.gov.uk)

Unfortunately, partnership working in the water sector is limited in both breadth and depth, and this is (in part) a result of the incentives inherent in the regulatory regime. Although partnerships are often the best solution to a particular problem, getting regulatory approval often means they are also the most difficult.

This paper explores the main obstacles to partnerships in the regulation of the water sector and proposes 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.

If these changes are made to overcome the obstacles to partnership working in the water sector, wider benefits to communities and the environment could be unlocked, helping meet local and national government objectives around sustainability and resilience.

Moreover, since effective partnership working can often be cheaper than traditional engineering solutions, these changes will allow water companies to overcome increasing environmental challenges, without unduly increasing the costs faced by customers.

In Yorkshire we have a well established partnership, Living with Water, which brings together Hull City Council, East Riding of Yorkshire Council, the Environment Agency and ourselves in a shared strategy for flooding and resilience and are developing a similar approach in South Yorkshire. This collaborative working could be just the beginning and with barriers addressed we could go further, leveraging funding to improve and maintain infrastructure and jointly employ workforces to pool expertise and more efficiently deliver programmes of work. This would allow us to meet the National Infrastructure Strategy's objectives of getting better alignment between public and private infrastructure investment.

There will be further detail – beyond the proposals for change we set out – for Ofwat to work through as it prepares its methodology for the next price control.

Yet, without any fundamental changes to the regulatory framework, our proposed tweaks to Ofwat's focus and assessment when evaluating partnership funding requests (and accounting for them in their regulatory model) could effectively unlock partnership and collaborative working in the water sector. This would help maximise the public value created and deliver government priorities for the sector.

Introduction

Water companies share responsibility for some areas of their business - for example water quality and flooding - with other organisations. As a consequence, companies do, or could, work with those organisations to achieve shared and overlapping objectives. These partners tend to be public sector organisations, such as local authorities and the Environment Agency.

As Ofwat and Defra have already identified, working in partnership with other organisations who share similar or overlapping responsibilities or objectives can encourage innovation, reducing the cost of improving service levels in the water sector, helping companies deliver new outputs, and improving the effect of water companies' activities on the environment and customers' lives.

A particularly prominent example of an existing partnership in the sector is Yorkshire's own Living with Water partnership, where the company works with two local authorities and the Environment Agency to manage flood risks in the Hull region. The partnership has involved a variety of specific investments and innovative programmes, including community education, aimed at addressing flood risks in the Hull region caused by sewer flooding (the responsibility of the water company) as well as surface water and coastal flooding risks (the responsibility of partner organisations).

While some water companies already work in partnership with other organisations to deliver shared objectives, these partnerships are relatively limited in their nature and working in partnership with other organisations represents an exception to the standard way of working in the industry despite it often being the most logical approach.

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.

To maximise the benefits offered by collaboration and partnership working, the sector could both increase the number of partnership projects and deepen existing partnerships by, for example:

- **Water companies jointly owning infrastructure or assets with third parties.** Shared infrastructure projects which address complementary objectives may help reduce costs to customers (and taxpayers). Joint ownership of that infrastructure can help leverage third party funding to improve and maintain infrastructure, and ensure all partners are able to exercise their specific responsibilities in relation to the asset going forward.

- **Jointly employing workforces**. This could involve companies and partners sharing staff to plan and operationalise projects. Such an approach could help companies work more efficiently to deliver programmes and pool expertise to help identify new and innovative solutions to shared challenges.

- **Establishing full joint ventures** to manage assets or deliver shared activities as a separate entity. Joint ventures could overcome institutional frictions that might prevent voluntary partnerships from making decisions and investments efficiently, streamline processes for establishing legal responsibility for asset ownership, and help partnerships access third party funding that may not be available to them as individual entities.

For example, in Yorkshire we are currently exploring the potential to develop partnerships to address challenges faced by other parts of the region. For example, we are making good progress with a partnership in South Yorkshire to ensure a strategic approach is taken to flooding and resilience in the Don Valley. This includes the local authorities in Barnsley, Sheffield, Rotherham and Doncaster as well as the Mayoral Combined Authority. Most areas in this catchment have suffered from significant flooding and there is a sense that investment in traditional civil engineering in one area has often merely shifted the problem downstream.

Yet there are some significant regulatory obstacles to unlocking the full potential of partnership working in the water sector.

Overcoming regulatory barriers to partnerships

We have identified five main regulatory barriers, which may prevent partnerships from working effectively, and may inhibit water companies from pursuing partnerships in the first place. We have also identified how

Ofwat could refine its regulatory methods so as to avoid discouraging efficient partnerships, concerning its:

1. Assessment of wider social benefits associated with partnership projects.
2. Consideration of whole-life costs of partnerships.
3. Treatment of partnership costs in benchmarking.
4. Approach to accounting for partnership assets in the Regulatory Capital Value (RCV, also known as Regulatory Asset Base).
5. Approach to within-period funding.

Although the barriers we set out are not absolute – as Living in Water demonstrates – they tend to disincentivise partnership approaches. They deter investment that could generate wider public value, particularly environmental benefit, as well as efficiency savings.

Our recommendations will help the sector realise the potential of partnerships and could also help drive up innovative investment non-traditional assets such as nature-based solutions.

1. Place greater weight on wider social benefits when assessing investment proposals

Quantifying costs and benefits is a challenging and often contentious element of any investment proposal. When Ofwat assesses companies' expenditure proposals, it rightly seeks to ensure that companies are delivering the right output (by implication, that the asset being built is the right one) at the lowest possible cost.

As a result, Ofwat requires water companies to carry out comprehensive cost benefit analyses in order to assess the efficiency of costs in light of the analysis of the benefits that the investment will deliver (including wider social and environmental impact).

However, it is difficult to quantify the wider social and environmental benefits that could be created by investment proposals, particularly where the proposal is for a new and innovative project/approach (such as a partnership). The extent to which investment delivers water companies' core statutory functions is more reliably quantified. This means it can be more difficult for companies to secure Ofwat support for costs that help deliver wider social benefits, creating uncertainty in the business planning process that may deter companies from adopting partnership approaches that deliver wider benefits.

In its initial view of the framework for PR24, Ofwat sets out that, consistent with PR19, companies can go beyond minimum standards, and deliver positive social and environmental impacts, where justified by customer valuation research, "*allow[ing] customers to fund improvements which they support*".[2] This is encouraging. However, in the same document, Ofwat suggests that water companies should not fund any share of the wider benefits delivered by partnerships, stating "*water customers can only be expected to fund activities consistent with a water company's statutory functions*".[3]

In some cases, partnership funding can only be justified by reference to the wider social benefits delivered by shared investments, but the uncertainty around Ofwat's assessment of wider benefits (and who should pay for them) and its starting position that "customers can only be expected to fund

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[2] Ofwat also argues that at PR19 "we *were also able to take into account wider social and environmental impacts when deep diving proposals to identify the best value whole life solution*".
Ofwat (May 2021), PR24 and beyond: Creating tomorrow, together, p. 104.
[3] Ofwat (May 2021), PR24 and beyond: Creating tomorrow, together, p.105.

activities consistent with a water company's statutory functions" may prevent water companies from taking part in partnerships.

To address this problem, Ofwat needs to ensure that the scrutiny it places on companies' estimates of wider social and environmental benefits does not lead it systematically to mark down investment proposals which deliver wider benefits compared to those which do not.

Ofwat should also ensure its approach does not discriminate between traditional and non-traditional methods used to deliver wider social and environmental outcomes. As an example, there is a risk that Ofwat might routinely favour investment directly targeted at reducing greenhouse emissions from a wastewater treatment plant over investment which, as a secondary benefit, removes greenhouse gasses from the air as part of a partnership-funded, nature-based flooding solution.

If Ofwat remains concerned about the quality of the justification or valuation evidence provided for wider social benefits, it should provide additional guidance to firms ahead of the next price review, allowing them to submit evidence that meet's Ofwat's requirements. Alternatively, Ofwat should adjust its process when assessing companies' business plan proposals, to give it more time or resources to engage with companies and their partner organisations so that it understands the wider benefits delivered by shared investments.

2. ***Ensure Ofwat assesses partnership investments on a whole-life basis***

Ofwat relies upon a number of tools to assess the cost of and need for enhancement investment proposals (such as the cost associated with a new partnership scheme). It appraises the different options companies identified to address the same objective, or In other words as part of their cost benefit analysis, and it compares the costs of a proposed scheme against the costs (and benefits) of schemes proposed by other firms, and those which have previously been built.

Different investment options for addressing similar objectives may have different pay-back periods to one another. Therefore, it is important to compare the costs and benefits of investments over their whole life, since schemes which appear most expensive in the short-run may be cheaper to operate over their lifetime; and some schemes may last longer than others (meaning they continue to deliver benefits for a longer period).

Innovative partnership schemes may have longer payback periods to other investments. As an example, investment in a nature-based drainage scheme, that reduces the rate at which rainwater enters sewers, may have a higher initial cost than a traditional engineering solution, but be significantly cheaper over the long run. Such nature-based solutions may also take longer to establish - for example since vegetation needs time to grow - meaning they start to pay-back later than a more immediate solution.

Ofwat should therefore ensure that it does not compare partnership investments unfavourably against traditional investments due to differences in the profile of costs and benefits over the lifetime of the partnership investment. It should make sure to account for cost savings and avoided costs over the lifetime of the asset (or scheme), and reflect all benefits delivered to customers over the long-run, and not just in the upcoming price control period. This refinement of its approach to assessing funding requests would be aligned with Ofwat's objective of ensuring that its PR24 decision is more focussed on the long-term outcomes delivered for customers, and consistent with the government's long-term ambitions.

3. ***Account for ongoing partnership costs separately in benchmarking***

Ofwat sets allowances for base costs (such as companies' ongoing operating costs) based on benchmarking between companies.[4] Ofwat tends to rely on models which compare companies' costs over the next price control period with one another, while taking account of key factors which lead costs to be different, such as scale and population density.
While upfront costs associated with a partnership investment tend not to be included in this assessment, ongoing costs *incurred in future price controls* associated with a partnership initiated in a previous control will

[4] Since PR14, Ofwat has tended to exclude enhancement expenditure from its benchmarking assessment, focusing the assessment only on base expenditure which is more likely to be comparable between companies at any point in time.

tend to be assessed as base costs and subject to Ofwat's benchmarking process.

At PR24 and subsequent price controls, Ofwat must ensure that it does not rule efficient ongoing partnership expenditure (from existing partnerships) as inefficient when it carries out cost benchmarking. Likewise, it should also avoid any scenario where companies which avoid long-term costs through a partnership arrangement – for example, because the company funds upfront investment whereas the partner commits to maintenance costs - appear artificially efficient in benchmarking and distort the benchmarks for other companies.

Ofwat has two main options for overcoming this problem. Firstly, it can exclude ongoing partnership costs from its benchmarking models and assess them separately, as it did for the majority of enhancement costs at PR19. This approach allows it to assess the efficiency of a company's proposed costs (and the water company's contribution to a partnership) on a case-by-case basis, reflecting that each partnership offers a different set of outputs, meaning they cannot easily be compared with one another.

Secondly, if Ofwat does include ongoing partnership costs in its benchmarking models, it needs to ensure that it captures the drivers of partnership expenditure or accounts for the outputs that are delivered. Since this is near impossible for bespoke partnership arrangements, Ofwat should consider mechanisms for adjusting allowances set as part of the benchmarking process, such as making pre-model or post-model adjustments to account for differences in the extent of partnership working between different companies.

4. ***Provide certainty on the regulatory accounting of jointly owned assets***

Water companies and partners must agree on responsibility for ongoing operating costs and maintenance of assets over their lifetime. Some partners may be unable to commit to long-term agreements to contribute a proportion of operating costs, exposing the water company to higher costs over the lifetime of the asset.

Where an asset is co-owned, or owned by a third party, it is unclear how and whether it should be reflected in a water companies' RCV. Water companies are remunerated for the cost of up-front investment through the depreciation and return they earn on the RCV, but there is no common approach to accounting for capital expenditure on shared assets.

To the extent that uncertainty about the regulatory accounting treatment of capital investment in partnership assets discourages water companies from building partnership assets, water companies may be incentivised to choose more inefficient investments to meet their objectives, or fail to deliver wider benefits for customers.

Regulatory accounting rules should not distort companies' incentives to choose a particular way of working over another, particularly if it forces them to select more expensive options or investments which deliver fewer benefits to customers. Ofwat should therefore take steps to ensure the approach to regulatory accounting of partnerships assets is clear and non-distortionary. This does not require major reform of Ofwat's approach, but clarification of existing arrangements.

If partnerships establish joint ventures to deliver assets, it may be appropriate for partnership investment to be kept separate from the water company's RCV by adopting a RCV-approach similar to the direct procurement models used for large, contestable investments in the water sector, most notably applied to the Thames Tideway Tunnel. Under this model, the joint venture's costs would be capitalised and recovered from customers through a separate RCV over the lifetime of the asset, and Ofwat would set separate rules for the allocation of risks, such as cost overruns, between customers and the joint venture.

While this model may be appropriate for large, one-off capital investments, it is less likely to be appropriate for smaller or recurring investments which may also occur in partnerships. In these cases, water companies' RCVs should broadly reflect assets which water companies have paid for. Therefore, for a partnership where water companies fund part of an asset's cost (with other partners funding the rest), their share of the investment should be reflected in their RCV. Specifically, Ofwat should consider upfront investment in partnerships as capital expenditure when setting the "pay as you go” rate which determines the share of companies’ costs to be capitalised, and the share of costs to be expensed during the price control itself.

5. *Develop a mechanism for within-period funding*

The rigidity of the regulatory framework and companies’ statutory responsibilities may make it difficult to co-ordinate effectively with prospective partners.

Water companies and prospective partners' funding cycles are typically not aligned to one another, meaning that partners can be unwilling (or unable) to commit funding at the point at which water companies are able to do so as part of their 5-yearly price control process. Partners may also require water companies to agree to provide funding for the duration of the partnership, which may require them to make commitments beyond their current regulatory period.

We recognise that it will be challenging to change the funding cycles for other organisations to align with the price controls in the water sector. The funding cycles of other organisations are both well-established and very varied.

However, Ofwat could make in-period determinations or grant water companies conditional allowances, that would allow the companies to negotiate with third parties in the time-period when the partners are most able to commit funds.

Ofwat (and Ofgem) have previously granted conditional allowances and used uncertainty mechanisms to account for changing requirements within the price control. This approach could be extended to support funding for long-term objectives, particularly if working in partnership outside a price control reduces costs compared to commissioning work within the price control framework.

Conclusion

Ofwat's stated objectives around encouraging and facilitating partnerships are broadly aligned with companies' views on their potential value and in customers' interests. Indeed, the value of partnerships is particularly acute as the sector looks to tackle the effects of climate change and environmental deterioration.
The broad mechanisms in the water regulatory framework are designed to provide companies with the flexibility to meet their objectives in the most efficient way possible, to deliver new and additional outputs, and to innovate to find effective ways of working. This is welcome.

However, in practice barriers exist which prevent companies from working flexibly with partners (and prospective partners) to meet common objectives and deliver improved outcomes to the benefit of customers. These barriers tend to concern Ofwat's approach to assessing the benefits of investment proposals, its approach to assessing costs once they have been incurred, its treatment of these investments in the asset base and the practicalities of aligning funding cycles.

As we set out above, Ofwat could address the various barriers without fundamental change to its existing regulatory framework. Our proposed tweaks could effectively unlock partnership and collaborative working in the water sector to maximise the public value created and deliver government priorities for the sector.

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