Sustainability *First*

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Ofwat's emerging strategy: Join the conversation

Sustainability First is a charity and think tank that works in the energy, water and waste sectors. We have significant experience of consumer and public interest issues, regulation and the demand side (see www.sustainabilityfirst.org.uk).

General comments

- We warmly welcome Ofwat's emerging strategy and the recognition of the need to address both today's challenges *and* long-term issues, though we note that the strategy may underplay the extent of environmental challenges today.
- We encourage Ofwat to be more ambitious in terms of its plans to work across sectors. We consider this is particularly important in terms of facilitating joined-up approaches to: a) vulnerability; b) resilience; c) data; and d) circular and integrated delivery of low carbon and sustainable services – including with regard to 'place' and the built environment. The consumer / citizen lived experience and environmental well-being are circular, cross-cutting and fluid. The strategy is an opportunity to help move regulation from being siloed, cyclical and focused on the so-called 'average' consumer to recognise this more dynamic landscape.
- We would also suggest that more supporting work could be undertaken to identify options for: a) avoiding overreliance on the 'square peg' of fixed term price reviews in the 'round hole' of an rapidly evolving and disrupted world; and b) a taxonomy of innovation to address the different issues and incentives which relate to short- and long-term innovation.

Response to specific questions

Based on the draft in our discussion document, what do you think should be included in a shared vision for the sector? What are the collective aspirations it needs to achieve?

We broadly support the **shared vision**. However, we consider that for each of the three aspirations (excellence, value and stewardship), there is a need to think through what this means at an individual consumer / citizen, community and systems (environmental but also social) level. As currently drafted, the 'everyday excellence' aspiration in particular is drafted relatively narrowly at an individual customer level.

In our view, the strategy would benefit from a strengthened focus on **local, community and decentralised approaches. 'Place'** is likely to play an increasing role in service delivery – including in terms of 'everyday excellence.' This may well lead to more variation in approaches which should be welcomed – but they will clearly need to meet existing or

sensible future licence conditions. New ways of dealing with the added complexity of how regulation addresses questions of 'place' in a transparent way will need to be found.

While this is more immediately obvious for energy, where energy storage could transform local supply, in water there are also highly significant local elements which are underexploited in the current approach: for example, the higher localised impact of much drainage and waste water discharge, and local initiatives on water saving. Anglian Water's work in Wisbech also suggests a radical new approach to community, which could echo findings from the WOCs that customers may prefer suppliers with a genuinely local feel. Finally, the interaction between water and housing development arguably needs modernising in a climate change world with ambitious targets for local housing growth, and also against the backdrop of regional or interregional water resources approaches (e.g. WRSE, WRE).

In terms of the **challenges for achieving the vision**, we note that there is relatively little on **data** in the strategy, both in terms of that held by companies (on customers, assets, etc.) but also that held by Ofwat. Regulating in a world of granular and real time data and predictive analytics is likely to present new challenges and opportunities. Ofwat will need to do more around what approaches to data it wants to encourage from companies (e.g. data strategies to facilitate integrated data mapping, etc.), but also to develop its own data strategy in order to plan how it continues to access the data it needs for effective 'future-facing' sector oversight, and to understand the algorithms that may increasingly be used in an efficient and effective way.

Ofwat will wish to look across to current initiatives on 'smart data' elsewhere in government and also at evolving approaches in other regulated sectors. For example, the BEIS Energy Data Task Force has sought to scope what a modern digitalised energy system could look like and proposes a 'presumed open' approach to energy market data. For building blocks, the task force advocates a national energy 'data catalogue' to create visibility of energy-system data-sets, an asset registration strategy – designed to simply cut across the current multiple 'entry points' for asset registration – plus a digital system map capable of starting the journey towards a full digital model of the energy system.

We are pleased to see that Ofwat recognises the need to **align its strategy within the broader policy context**. This should help facilitate a **more coherent approach across government and other regulatory bodies**, particularly in areas such as vulnerability, resilience, the delivery of integrated and circular low carbon and sustainable services, and the government's green growth and housing strategies. It would be helpful if the strategy set out Ofwat's commitments to work more closely with other economic regulators at a *strategic* level in these areas.

As our Fair for the Future project is exploring, as we go through disruptive environmental, societal and technological change, there are likely to be an increasing number of '**boundary' issues in terms of roles and responsibilities between decision makers**. We would encourage Ofwat to develop transparent and robust mechanisms to 'call these out' and address them in a strategic way. In approaching this, the strategy will need to consider what Ofwat's role *will be*, not *where it is against the current parameters.* Our 'Circling the

Square' Discussion Paper has proposed a set of criteria that can be used when considering regulatory redesign.

We understand the need to retain and evolve key elements of existing processes. However, we would note:

- **Outcome based incentives and innovation rewards reset every five years**: It is important to think through what needs to be treated on a five-year cycle and what may be more appropriately dealt with separately as a strategic issue.

- **Board leadership**: We are very supportive of Ofwat's work in this area. We would note that the next stage of this work is likely to be ensuring that commitments made in terms of public purpose now need to be embedded in company culture, behaviours and values. This may require developing a deeper level of trust between companies, regulators and policy makers and a different approach to regulation that recognises and builds on other accreditation systems etc. On board membership, there may also be a need for independent directors who can credibly play 'champion' roles on environment and society.

- **Legitimacy**: This is clearly a vital issue for companies in the sector. This goes to the heart of concerns around a 'democratic deficit' in the sector and how people need to be engaged in decisions. However, we would note that Ofwat also needs to consider its own 'regulatory licence to operate'.

- **Customer engagement**: We consider that Ofwat has in many ways 'led the way' in this area. However, we would encourage the regulator to think more ambitiously about this and to not think of engagement purely in individual customer terms. There needs to be a continuum of engagement from consumers to citizens to communities and wider stakeholders (including the environment) to help companies address both short- and long-term issues – and deal with the legitimacy challenge. Forward-looking companies are already doing this (e.g. by engaging stakeholders on values), but we consider there is still significant scope for this type of engagement to be developed further, including approaches to direct engagement by the regulator. There is also a need to consider future as well as current customers.

Do you think long term aspirations and targets will be effective in driving the sector forwards? What should they cover and how should they work in practice?

We broadly support the three shifts identified in the emerging strategy document.

We consider that long-term aspirations are important to **signal to all stakeholders** – including incumbents, new actors and third parties – what the strategic direction of travel needs to be. Absent this, it can be challenging to attract new innovative ideas and investment and to get sufficient focus for partnership working.

We would note that there is likely to be a piece of work to do to **map out how long-term expectations and the long-term water supply framework** are going to **align with five-year price reviews** to ensure consistency and simplicity of messages.

Do you think we're focusing on the right areas in which to drive transformational change, as we've set out on pages 26-29? E.g. innovation, the natural environment, customer relationships.

We broadly support these areas but see a clearly articulated data strategy to be a helpful enabler.

Innovation

In our view, **transformational innovation**, particularly that which may span price control periods, where the benefits may only be felt long-term (e.g. on water resources) and where scale is an important issue, is likely require specific funding mechanisms and space for collaborative approaches. Our thoughts on innovation in regulated utilities are set out in more detail both in our response to the recent HMT consultation and in this New-Pin Discussion Paper.

For innovation that is **incremental and shorter term**, getting a culture in place where fast failure is possible is important. Here regulatory sandboxes, waivers, etc. may be sufficient. However, there is still an issue with how quickly such innovative practice is shared and disseminated within price control periods – when it provides public and systems benefits.

How innovation is best embedded in a business and across a sector will in large part depend on the type of innovation in question (long-/short-term, technical/process/institutional, etc.). While Ofwat's leakage target is an example of a clear attempt to incentivise longer term innovation, we consider that success in this area will also require some strong consideration to the balance between competition and collaboration, and the ability to retain and exploit any generated intellectual property. The following schema highlights some of the ways innovation may be embedded.

How to embed innovation – A possible schema for different types of innovation

Type of innovation	How to get this type of innovation embedded?
Short-term Incremental  **Long-term Transformational**	Revenue / cost pressure – 'No other way' & 'why wouldn't you?'
	Pressure from new staff with different skills / experience – 'Why don't we…?'
	Supply chain pressure – 'This is the new normal'
	Customer / stakeholder pressure – NB scope limited where no competitive pressures
	Communication & dissemination – of lessons learnt within the business and between businesses
	Training in new approaches – changing / normalising 'professional' expectations
	Open culture – space and time to accept failures as learn / refine new approaches
	Test / trial facilities – sandboxes, innovation labs etc. to experiment and build confidence in new approaches
	Risk-reward sharing frameworks for delivering co-benefits – enabling value stacking etc.
	Clear external policy & regulatory signals / goals on outcomes to be delivered - particularly important if there is no immediate obvious financial business benefit (e.g. innovation around vulnerability), where there are externalities, where the benefits extend beyond the company to the wider system in which they operate, etc.
	Incentives / rewards to deliver new approaches – which are aligned with desired outcomes – external (regulatory) & internal (performance and remuneration)
	Changing standards / introducing new standards to mandate new approaches
	Facilitated strategic collaborations – by policy makers, regulators or other third parties
	Funding – clear simple frameworks that bridge the 'valley of death'
	Institutional frameworks that enable cross sectoral collaborations to thrive

Source: Sustainability First. NB – approaches not mutually exclusive.

The natural environment

We would reiterate the need for Ofwat to articulate its 'systems' thinking to work together across environmental regulators and other sectors to encourage and enable the development of more circular and integrated solutions. Some may be largely 'place-based' and some more 'systemic'. We would encourage the use of approaches such as the IIRC's capitals model (adapted by Sustainability First to include data in our 'Sustainable Licence to Operate' strawman). We are not convinced that competition is the best approach to the development of natural capital accounting.

Customer relationships

We consider it important to recognise that vulnerability is dynamic; solutions which are just focused on 'the vulnerable' may miss out other needs.

We are pleased to see commitments to augmenting the customer voice. However, again we consider that this needs to go beyond customers to citizens, communities, etc. Crucially, engagement needs to become an activity which is ongoing and embedded in company

culture – not just something which happens in regulatory cycles as a compliance activity. Engagement needs to extend beyond willingness to pay research to also include values and changing public expectations.

Although we recognise the importance of companies owning their relationships with their customers, we consider that on some issues Ofwat itself may also need to engage directly with customers, citizens and stakeholders – particularly on issues relating to intergenerational fairness and geographical trade-offs. Deliberative techniques such as citizens' juries and assemblies can be used in these tricky areas (indeed, Sustainability First's New-Pin project was a form of deliberative engagement), but to maximise the impact of such initiatives, regulators as well as companies need to feedback the deliberation into their ongoing work. As a regulator of an essential service, we consider that Ofwat should also be working with other regulators to develop leading indicators of vulnerability, etc.

Encouraging private enterprise to deliver public value

Sustainability First's Fair for the Future project is developing the concept of a 'Sustainable Licence to Operate' which is very much focused on the issue of company purpose. We would note that the separation between 'public value' and 'private value' is not always clear-cut (particularly in the case of future consumers). We are currently working with water and energy companies as part of the Fair for the Future project to help them assess how they can embed a 'Sustainable Licence to Operate' approach in their businesses. We are producing 'Talk into action' papers on each of the 'pillars' of our strawman licence which highlight themes, challenges and examples of good practice. The first of these, on purpose and values, can be found here. We also see a valuable role for creation of 'safe spaces' where government, regulators, companies and other stakeholders can consider potential approaches – including radical ones – to meeting long-term national goals on sustainability and fairness.

How do you think we could evolve our approach to price controls, building on the conversation on page 36?

Whilst we recognise the need to deal with some costs and outcomes via **price controls**, it is important to think through what needs to be treated on a five-year cycle and what may be more appropriately dealt with separately as a strategic issue. The current approach can sometimes be 'one size fits all'. For example, this could have the unintended consequence of potentially deterring or delaying important strategic decisions, disincentivising long-term innovation or subjecting more minor issues to a level of scrutiny that may not be appropriate or proportionate.

In terms of the **greater role for markets**, we would note that the current non-domestic market has yet to lead to any significant growth in water efficiency services, etc.

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