Sustainability first

11th February 2021

Dear Ofwat

Ofwat December 2020 consultations: PR19 lessons learnt report; PR24 launch document; and public value discussion document

General comments

Sustainability First is pleased to offer our preliminary input into these three related documents. We recognise that not all are formal consultations and that where relevant the dates of requested responses differ. But we judge it important to offer a coherent response, because in our view the theme of public purpose should run through all three.

Our forthcoming major Fair for the Future Project Report, *The implications for regulation and policy of public purpose in utilities*, will offer more substantive input. This will be published in early March and the Ofwat team have had sight of an early draft.

We will also submit a separate response to the Ofwat consultation on the role of **customer and stakeholder engagement** in utilities and will in addition publish a substantial separate Discussion Paper on this. In summary, we consider that the engagement approach in the sector needs to go beyond customer research – and needs to engage people as citizens not just customers. Engagement outcomes will differ depending on the approach taken. We also consider that Ofwat needs to carry out its own research to complement that done by companies, particularly in areas such as citizen issues, resilience, trade-offs between current and future needs etc. And again, thinking on engagement also needs to link in with Ofwat's thinking on public purpose.

There is much to welcome in the PR24 launch document and public value discussion documents. There seems some recognition that traditional price review approaches to long term issues such as climate change, biodiversity and net zero will not, alone suffice – something we welcome and note is borne out by Ofwat's approach to RAPID and to the regional water resource centres. There is also some good (albeit variable) recognition of the importance of culture with regard to public purpose: something we have consistently flagged as central to the agenda – we would encourage Ofwat to talk more in the language of ethical regulation. There appears an improved commitment to inter agency working, something we have also witnessed in for example the new work on WINEP. And there is some recognition that PR19 did not work as well for elements of the natural environment as it could have done.

We welcome Ofwat's 12 major questions, and the issue of how to include public value as one of these. We hope our forthcoming Fair for the Future Report will address many of these questions and would be happy to provide a more detailed response to the questions once that Report is published. We would add three further questions:

- how to ensure equity between current and future generations, and secure a voice for the latter;

- how to approach issues where the public benefits are considerable but hard to monetise (and the costs often relatively small), without trying to shoehorn these into comparative competition/econometric approaches and outcome delivery incentives; and
- (relatedly) how to rebalance away from a presumption of central regulatory oversight towards third party assurance and community assurance, negotiation and co-creation mechanisms (and how to rebalance from consumer to citizen/community interests). Some of the thinking in PR19 around bespoke ODIs helps here, but the inclusion in baseline totex of issues such as community and catchment engagement did not.

Finally, we are concerned that there does not appear to be a common vision underpinning these three documents.

Detailed comments on PR19 lessons learnt

- **The process**: From an engagement point of view, the timetable was less clear and the request to scrutinise outputs came quite late in the day.
- **England and Wales:** There may be a case for Wales adopting a similar approach to Scotland with its negotiated settlement given the different contexts – socially, culturally, politically and structures in place.
- **The initial assessment of plans (IAP):** The IAP was a useful incentive, in particular the ranking and we think continuing some kind of competitive element would be useful (though there also needs to be incentives for water companies to collaborate in the right places e.g. consumer vulnerability, resilience). While we recognise that some companies argue that the use of the terms 'slow track' and 'significant scrutiny' had a negative PR impact on trust in the industry as a whole, we support the comparative approach and think it appropriate that the headings reflect the quality of the plans and reputationally are an incentive to get the plans right first time. We also support the stretching category despite the fact that none reached it. Setting a high-quality bar is useful and wards against complacency. That said, an alternative ranking from the best to the worst for all WASCs/WOCs could be particularly useful at focussing companies' attention on getting it right first time. More transparency around the assessment criteria and weighting within each IAP e.g. for engagement would have been beneficial. While Ofwat identified some examples of good practice it was unclear why and how it had reached its assessments in some areas.
- **Complexity of the control:** Simplicity is, as Ofwat acknowledges, not an end in itself. We support in particular the number of bespoke ODIs which did allow companies to reflect local needs and views. This is a real positive that should not be lost in the quest to reduce complexity.
- **Service levels and efficiency:** It's important that Ofwat properly understands customers *and communities'* views in setting the methodology service levels. In particular to provide legitimacy that the common performance commitments set and the targets arrived at do genuinely reflect customers and impacted stakeholders views and not what the regulator thinks they should value.
- **Resilience:** We'd suggest that Ofwat does not sufficiently understand the value that customers place on resilience, and how to legitimately balance current and future consumer costs in relation to this. Going forward Ofwat's modelling needs to consider all six capitals including wider social value. This will involve a significant shift from a lowest cost plan mentality to a best value plan mentality.
- **What are the right incentives:** Some competitive element**,** with company ranking is very powerful. No company will want to be at the bottom. Perhaps rank them within water only, and WASCs from 1 to the bottom. On engagement, those that perform well could have been

allowed to co-develop in a negotiated settlement type approach, certain aspects of their plan next time.

- **Vulnerability and affordability:** We agree that Ofwat needs a continued focus on consumer vulnerability and affordability. Covid has resulted for example in new kinds of non-financial vulnerability e.g. shielding, and the exacerbation of existing vulnerability risk factors e.g. lack of internet access; and increased prevalence of others e.g. mental health problems. On affordability, a debate is needed as to what the role of water companies should be, and where the boundaries of the company starts and finishes in relation to the state and other parties. In addition, on the current cross subsidy, willingness to pay related approach. CCW's independent review for Government should inform Ofwat's approach. There is clearly a need in PR24 for Ofwat to incentivise companies to a) share insight and learning on affordability and vulnerability – engaging these groups can be particularly expensive. Those that share and lead should be given extra credit b) work **cross sector** in delivering consumer vulnerability solutions; c) For water and sewerage companies especially those serving the same areas to work collaboratively to create common baseline offerings; and d) Carry out joint horizon scanning work.
- **Environmental approach:** We strongly support moves to get a more flexible approach to increase the impact for customers and the environment, eg by working with the Environment Agency, Defra and other stakeholders through the WINEP taskforce. We would have questions around the potential for the use of environmental scorecards, new metrics etc.

While recognising that the PR19 document is backward looking and of necessity quite technical, we would argue that an appraisal of such an important milestone should have been informed by a stronger relationship to the outcomes and cultures which Ofwat seek to secure in future.

In our view, a comprehensive, independent and balanced assessment of the challenges that accompanied and followed PR19 would be beneficial for all sides.

Comments on the PR24 and Public Value documents

Given that these documents are intended to launch thinking about PR24, there is a relative lack of focus on how alternative wider mechanisms can achieve many of the outcomes which are currently the focus of price reviews. Such mechanisms could eliminate much of the highly unproductive tension between the regulator and the companies – which we judge as highly inimical to the sector's ability to meet the long-term challenges of net zero, climate change, biodiversity and fairness. We would strongly urge the next price review to concentrate only on those issues of economic regulation which Ofwat cannot achieve through other means.

We are, therefore, concerned that thinking may already be predestined to be too narrow: we would stress that a suite of measures will be needed, and that we doubt that evolutionary change will suffice – we need a fundamental shift toward public value and cultures. These cannot be a 'bolt on' for PR24 but need to drive the entire regulatory design and approach and to be integrated into mainstream price review decisions. We consider that Ofwat needs to adopt a new set of 'sustainability principles'[i] if it is to create and foster the behaviours and norms necessary for the sector to fully focus on public value. We are launching a new project on this topic in 2021 and would be delighted to involve Ofwat in this.

Building Ofwat's own evidence base of how the wider social and environmental context is changing can help demonstrate the need for a different approach and enable you to anticipate shifts in public requirements and expectations. Working out what level of information is 'good enough' is a critical

part of this. Socio-political scenarios can help here,[ii] as can Ofwat carrying out its own stakeholder engagement.

Having a better 'big picture' view of the landscape can assist Ofwat in identifying the 'glide-path' it plans to follow to help the sector deliver public value up to 2040. Working backwards from where you want to be to the present should help you decide how to balance current consumer interests with the interests of future generations - and to manage some of the trade-offs that are implicit in the existing Strategic Policy Statement. It can also help you identify the partners you will need to work with to deliver this, including other regulators, public bodies and civil society groups.[iii]

We warmly welcome the new Future Ideas Lab. However, we are concerned that this will not on its own achieve the step change in collaboration needed nor create a genuinely safe space for industry / regulator engagement on the long-term issues for the sector and the environment, noting that PR19, for all that it was kicked off with a similar 'portfolio of evidence', has left a legacy of distrust. We need government, the regulator and the industry to jointly form safe spaces for discussion and to consciously model the behaviours and cultures which this requires. The new WINEP group is an important starting point.

We hope that these comments are helpful and would be delighted to discuss further.

Best regards

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[i] A question of principle? Economic policy makers and regulators need to adopt a set of sustainability principles if we are to survive and thrive in the disrupted world

[ii] Policy and regulatory risk in public utilities: Two exercises for resilience

[iii] See, for example, this analysis of evidence sources in the energy sector which may also be relevant in water, https://www.instituteforgovernment.org.uk/sites/default/files/publications/evidence-energy-policy-making.pdf