Briefing paper

Sustainability first

Defra's Strategic Policy Statement for Ofwat

Summary

The new Defra Strategic Policy Statement (SPS) to Ofwat is to be welcomed. But there are caveats. The real test will be how much it changes things in practice: Sustainability First has consistently argued that 1) **continued evolutionary change will not suffice in key areas** given the magnitude of the challenges and the tendency to focus on the short-term politics around lower bills, rather than wider and long-term societal needs: notably on the environment. This means that 2) **trade-offs need to become more explicit, and there needs to be a societal debate around these**.

There is a real need not only for regulatory translation of the SPS, but equally 3) **there is a need for a wider culture change within regulators and the industry** (in particular, to increase flexibility to challenges such as climate change and biodiversity and to shift emphasis towards outcomes from process). This will need to address fixed mindsets and behaviours which have grown up over decades.(1) 4) **This in turn requires moves: from the national towards the local; from customers to include also citizens and communities; from communication to co-invention; and from short term bills to long term solutions**. The last of these has seen some welcome progress in recent months.

Perhaps the main challenge will be in translating the positive words about the aquatic environment (shorthand for rivers, lakes estuaries and the coast) in the SPS into real change on the ground. 5) **There is an urgent need for a controlling mind overseeing the increasingly complex and messy set of grants, funding, policies and delivery arrangements impacting the aquatic environment – and rebalancing from national prescription to enablement of local action**. The subsequent publication of the draft water targets under the Environment Act seems to have missed an opportunity here.

To facilitate this, **there is much to be gained from launching an open conversation about the water environment and the value of water**.

The Strategic Policy Statement

The recent publication of Defra's SPS to Ofwat is an important staging post on the path to PR24 – the next 5-year price review for water companies. The requirement for a SPS is set out in the Water Industry Act 1991 (with subsequent amendments). It aims to do what it says on the tin: set out Government's strategic priorities for Ofwat, the independent economic regulator of the water industry.

This kind of document is always a compromise between clear strategic steers without limiting Ofwat's freedom to manoeuvre, between short term politics (for which read lower bills) and optimal long-term investment, and between political messaging and clear policy.

This author previously oversaw an early ancestor of the SPS. The experience there was of a document which is carefully negotiated – within Whitehall/Defra, and with Ofwat, the Environment Agency and the DWI. All the signs are that this SPS has been through some of the same processes.

It was further complicated by the fact that some of the policy is still in progress – for example on the water targets which sit under the recent Environment Act (now published in draft – but on a quick read giving a different message to the SPS on catchment approaches), and for the meat on the bone of environmental principles also set out in the Act.

The recent high political profile around sewage discharges and Environment Agency water regulation is also relevant: such high political profile for an issue, coupled with significant media coverage, seldom leads to good strategic policy making. And Ofwat are also in transition awaiting a change in chair and with an acting CEO.

Given all of that, the document is pretty good. It is much clearer and better structured than the previous SPS, five years ago. It recognises work done by Slaughter and May for Sustainability First, which argued that the biggest need for economic regulators is not legislative change, but rather political cover/interpretation. It rebalances Ofwat's

[1] This issue is being addressed in Sustainability First's current Sustainability Principles project https://www.sustainabilityfirst.org.uk/sustainability-principles

agenda towards the long term and aquatic biodiversity and introduces the concept of adaptive planning (2).

It does not hesitate to outline political expectations of the water industry and the Environment Agency – despite Defra having no formal powers on at least the first of these. And, in a significant advance on the draft SPS, it prioritises the aquatic environment and catchment approaches.

In line with Sustainability First thinking, it contains good material on data and on digitalisation.

As important, given some of the history of Defra/Ofwat relations, are the signs that both Defra and Ofwat are moving in a similar direction and are acting like grown-ups.

Ofwat's PR24 (the next 5-yearly water price review and the first opportunity to give practical effect to the SPS guidance) documents, most recently their draft guidance on the new water company long term strategic plans, have shown as much commitment as the SPS to long term thinking, adaptive planning and intergenerational equity – Ofgem please take note.

The gaps

And yet we in Sustainability First would not be doing our job if we didn't identify some areas where we would have liked to see more.

For all the welcome steers on the aquatic environment, the document still avoids a number of the trade-offs/choices – most specifically, the inevitable crunch between bills, (particularly for poorer customers facing a cost-of-living crisis,) and long-term outcomes.

The document is conspicuously silent on cross sector resilience – something that looks particularly odd given the recent letter to regulators from Kwasi Kwarteng.(3)

We have long argued that the language of utilities needs to shift from customers to citizens and communities, and to the public value agenda – this is conspicuously lacking in the SPS (as indeed is much reference at all to consumer awareness and behaviour change – the latter now partly remedied by the new statutory target of reducing per capita consumption). However, the absence of reference to public value is at least partly remedied by Ofwat's own subsequent publication on this.

We can't see enough of a steer about the need for appropriate risk taking by Ofwat and companies: real innovation and learning requires some failures. We would like to see more encouragement of 'earned autonomy' for companies and less bureaucracy. With the NAO and the PAC ready to pounce we fear that risk aversion and regulatory gaming may remain the norm.

In a month where the long-awaited Levelling-up White paper has finally emerged there could have been more on the place-based agenda and local autonomy.

And finally, (see below) while talking a good game, the SPS fails to navigate or join up between the labyrinthine funding structures and initiatives on the aquatic environment.

However, some of the above would have been a big ask of any political document in the current climate. Our focus in this briefing and going forwards is how to make the best of the SPS, and to ensure it leads to genuine change. Given what we would argue has been a systematic undervaluation of the long term/future generations, and under-delivery on aspirations for the water environment, evolutionary change is not enough. We have argued elsewhere(4) that we need a fundamental change in culture and process, by regulators and regulated.

How to translate the SPS into action within the aquatic environment

With this in mind, in February Sustainability First held a roundtable to explore some of the issues.

We looked particularly at the aquatic environment, partly because this is a new high priority in the SPS and also reflects a number of the themes we would have liked to see more of. But, also, because the aquatic environment has an important political profile and is part of a complex landscape. Our diagnosis is that the water resources landscape looks much clearer and more stable than the water water/aquatic environment one.

In more detail:

- The SPS now explicitly asks Ofwat to prioritise the aquatic environment and stresses the need for a catchment-based approach.

- The Environment Act not only requires targets for water (among other things), but (perhaps less noticed by the water world) also suggests a quite radical approach and commitment to biodiversity: among other things establishing the legislative cover for biodiversity net gain and the creation of new local nature recovery strategies.

[2] https://www.sustainabilityfirst.org.uk/blog/360-adaptive-regulation-and-planning-in-utility-regulation

[3] https://www.gov.uk/government/speeches/strategic-priorities-and-cross-sectoral-opportunities-for-the-utilities-sectors-open-letter-to-regulators

[4] https://www.sustainabilityfirst.org.uk/images/publications/fair_for_the_future/Regulation_for_the_future_the_implications_of_public_purpose_for_policy_and_regulation_in_utilities.pdf

The last of these even makes a slightly incongruous appearance in the Levelling Up White Paper (perhaps reflecting Michael Gove's past as Defra Secretary of State).

- But on targets there is still a hangover from Brexit, with the Water Framework Directive objectives around 'good ecological quality' (on which the UK has systematically underdelivered) subsequently revised towards phosphorous and nitrogen deposition (which are not outcome targets and could easily cut against catchment solutions), and the Habitats Directive also potentially up for change. However, all of this is a very technocratic exercise at present. There is an urgent need for outreach and co-invention with civil society.

- It is clear that the Environment Agency's regulation and monitoring of discharges to the aquatic environment has been increasingly underfunded and under-prioritised, both by the Treasury but also within Defra and to some extent the Environment Agency. The resultant media and pressure group attacks make it harder for the organisation to take risks and think strategically. The Environment Agency have our sympathies here, this is far from entirely self- inflicted.

- Less defensibly, the Environment Agency have in the past over-prioritised end of pipe investments relative to catchment approaches and land management. Ironically this had the connivance both of some in the industry anxious to grow their RCV and of an Ofwat approach which has been overly focused on demonstrable direct benefits to water customers – and seems to be reinforced by the new water targets just as there is finally a wider acceptance of the need to change). The WINEP (the Water Industry National Environment Programme: the Environment Agency's tool for prioritising investments) has needed major reform; the jury remains out on whether this will happen.

- The media/stakeholder campaign on sewage discharges has struck a political chord. While some of the practice (and regulation) has been indefensible, the discharges reflect in part the nature of infrastructure decisions made 50-150 years ago. In some catchments at least, the problem has moved on: from 'acute' end of pipe pollution to 'chronic' diffuse pollution, largely from agriculture. There is a real danger that political pressure on Combined Sewer Overflows will dominate over (or prevent) a more optimal outcome and catchment-based approach. Ofwat have published their preliminary investigation into this area, but there is clearly more to come.

- Some in the industry have argued (with justification) that Ofwat's price review process also excessively lumps local investments into 'baseline Totex' which places them at the mercy of econometric models of comparative competition which underestimate hard –to-value environmental outcomes. Put simply, it has been easier to get a big investment on the aquatic environment approved than to do cheaper and more efficient interventions on the ground.

- The industry has committed to producing its first set of drainage and wastewater management plans this year. But they will be of mixed quality; there is a real question as to whether much funding response will await the next versions in 2027 and therefore not start until 2029.

- There is, quite frankly, a mess in funding approaches. The WINEP will be given force for 5 or 10 years in the 2024 price review. The new environmental land management system will probably give fixed period funding, but neither the timing nor the substance is joined up with the WINEP (the system on the ground is also overseen by Natural England who are, under pressure from some NGOs, fixated on the Habitats Directive). And natural flood management, which also looks to use catchment approaches to join up the flood and aquatic environment benefits of catchment management, is set in a 6-year programme starting in 2021 and then 2027.

- So systematically, co benefits – between flood reduction (including surface water flooding issues, which are conspicuous by their absence) land management, and the environment; between water quality and water resources etc. – are at best undervalued and more often ignored. This is even true within different units within The Environment Agency. This is becoming a wider barrier to green finance in this area.

- There is huge goodwill on the ground, and the 'catchment partnerships' run largely by the Rivers' Trusts do a heroic job on little funding to unite players. But it is still struggling to be more than the sum of its parts. It is unclear how these partnerships will work alongside the new local nature recovery strategies.

- Finally, the recent climate change risk assessment identified that the impacts of climate change on biodiversity require a lot more work. There is a real concern that our current approach to enhancing the aquatic environment is seeking to set existing habitats in stone, rather than creating the conditions in which they can adapt. This is true especially on the coast, where the challenge of sea level rise means the concept of 'enhancing' a habitat may be all but meaningless in a dynamic context.

At the roundtable we heard some excellent case studies about local approaches, received an update on work to update the catchment partnerships approach and heard

from a novel initiative to engage communities that face resilience challenges.

The evidence seems to be clearly that the good things are happening despite, rather than because, of the regulatory regime. The fact that even in big water companies there appear to be only one or two of these examples strongly suggests that there are systemic barriers to wider roll out.

How should Environment Agency/Defra/Ofwat now act on the aquatic environment and how can the SPS help?

First, the SPS clearly gives some cover for both nature-based solutions and for catchment approaches. This is good. But there appears to be a need for

a) Much better joined up policy and funding streams – in particular between ELM, natural flood management, WINEP and the sustainability reductions element of water resources. There is a strong case for a single controlling mind close to Defra. There is also a need to invent this jointly with the people who deliver on the ground.
b) Greater transparency behind all the funding streams and regulatory decisions, in particular on prioritisation / how trade-offs are dealt with in practice. Sustainability First has argued elsewhere that clear principles behind these trade-offs would be welcome. It is also important that there is a level playing field between capital investment and local resource spend: the bias at the moment is towards the former: Ofwat's concentrating on outcomes rather than on funding classification would be a good start.
c) New structures to enable better co-ordination and funding of local/place-based solutions and delivery of mutual benefits. We have argued before that a fixed pot for local solutions which is not included in baseline totex, but where spend is allocated by the companies working with local communities would be a win-win all round.
d) A greater tolerance of balanced risk taking (in the Environment Agency as well as companies) is needed. Some local approaches won't work. But overall, they will deliver benefits which central control cannot.
e) c) and d) both need a regulatory culture transformation in Environment Agency and Ofwat.

Open dialogue

However, it is easy to argue that all the problems lie at the centre. Sustainability First strongly believes that culture change is needed in companies and other delivery bodies. The sector needs to become less focused on regulatory facing activity. They need also to engage much more fully with local authorities and city mayors, particularly given the local authority white paper. Companies (and the Environment Agency and Ofwat!) also need to do much more to understand the constraints and business models of the voluntary sector, rather than forcing small charities to conform to their processes.

Finally, with a few examples, companies and regulators are still focused on how to engage customers. Work on how to engage communities is still in its infancy. There is also a tendency to regard communities and customers as homogenous whereas segments of each will have different views.

But to end with a suggestion, there is much to be gained from launching an open conversation about the water environment. There is no one 'truth' and there are a range of legitimate interests, some of which (such as the many of us who walk their dogs by water courses or on the coast) may not even know they have an interest in as yet.

This paper was written by Martin Hurst