INDUSTRY COMMENT

FLEXIBILITY: A FRIEND

Martin Hurst makes the case for introducing more – and meaningful – flexibility into the PR24 process, and looks at the options.

The size of additional investment ("enhancement spend") and bill increases in this price review, PR24, looks unprecedented over the period since privatisation (though worryingly close to the norm going forwards). This is accompanied by more ongoing changes in draft plans, and – reportedly – in the volume of queries from Ofwat than ever before. There is a risk of appeals to the Competition and Markets Authority. Finally, some of the enhancement spend has been pushed into tightly defined process changes at the expense of wider outcomes, and water supply resilience may in part be dependent on laudable aspirations for reductions in household consumption which may not be realised.

The context is also unusually fluid. We face a post-election administration which may have different priorities and the prospect of telling such an administration they can do little to change things for the next five years may not appeal to Ofwat, Environment Agency (EA) or Defra civil servants. (Although out-with this article, it is also eminently possible that a new administration may consider wider institutional changes, which themselves may have knock on effects on PR24.) We can already see technological and other changes coming along within this period which could both obviate the need for some spend and deliver better multiple outcomes. And Ofwat's new adaptive approach implicitly recognises the need to be able to take on board new information as it becomes available.

This has understandably led some to question whether more flexibility might be allowed in parts of PR24 and if so what mechanisms might best achieve this. Options include:

- *Deferring the final determination of this price review by a year/running instead a 'PR25' with some key changes to requirements including priorities from an incoming administration.*
- *Creating a formal 'reopener mechanism' along the lines used by Ofgem for net zero spend in RIIO2 – perhaps by with-holding some investment out of draft plans.*
- *Enhancing existing 'uncertainty mechanisms'.*
- *Recognising that some of the biggest issues concern wastewater, so increasing flexibility/refocusing on outcomes in the EA's Water Industry National Environment Programme (WINEP).*

This article explores the drivers behind seeking such flexibility and looks in a bit more detail at each of the options. The article is not intended to be the final word on this subject but rather to stimulate a debate. Views to the author are very welcome.

There is quite a lot of flexibility built into company licence conditions so some at least of the options are clearly doable. It will be critical that they don't undermine investor confidence and certainty, and do not increase supply chain costs/delivery risk, but this appears manageable.

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Why do we need greater flexibility?

First, the draft business plans submitted by companies appear to still contain moving parts, reflecting among other things late arriving changes to guidance. The number of queries companies are receiving from Ofwat is reported to be significantly greater than at similar stages in past reviews. There is a risk of mistakes creeping in. The lack of public transparency in what is even in normal times an extremely complex and opaque process is a major concern for public confidence in regulation (particularly given fears that the extra investments being proposed may not make much discernible difference to the health of our rivers and beaches). There may also be a risk of appeals to the CMA, which could add further to uncertainty and undermine confidence.

Second, the scale of proposed spending increases – which themselves derive in the author's view from a combination of decisions ducked in the past, and a political feeding frenzy sparked by Feargal Sharkey's campaigning – pose major delivery challenges. The sector (and its supply chain) has struggled to deliver all its projects in previous price review periods, with a much smaller spend.

Third, many including this author feel that the environmental requirements from EA and government – while containing parts which



are sensible/low regret – have been derived from an excessively inflexible, process-based, approach. Concentrating instead on the actual quality of our rivers and beaches could deliver more, cheaper results. Put another way, for many of the environmental requirements there is little place for considerations such as best value or cost benefit trade-offs and there is little ability to factor in multiple benefits (e.g. reduced flooding risk) or disbenefits (e.g. increased carbon footprint). In addition, the approach belies wording in the Plan for Water about the importance of catchment, nature-based approaches. We therefore risk wasting bill payers' money, undermining moves towards net zero, and setting the capacity building we urgently need in catchment approaches back five years.

Fourth, for an industry which has historically seen slow movement in technologies (not a criticism, simply part of the facts), there is a lot of potential innovation, new evidence and change over the next two to three years. The speed of trialling of machine learning and digital twins could rapidly improve system and plant optimisation and, if properly funded, reduce the medium term need for some increases in spend – something apparently recognised in the new secretary of state's letter to water companies. And ongoing learning (including an Ofwat innovation fund project) about the benefits of nature-based solutions could in a couple of years provide enough evidence for the EA to more widely favour catchment approaches over concrete – something companies, government and regulators all claim to want.

Fifth, there is in some areas a potential gap in water supply if the expected and hoped for reductions in household consumption do not materialise. Furthermore, the long-term delivery strategies which Ofwat has wisely required the companies to produce are explicitly based on the concept of adaptive planning: which may mean that some key decision points are reached before 2029. The public will not tolerate restrictions such as hosepipe bans or worse, or key longer-term decisions being put off, if solutions can be made available with some flexibility.

Finally, of course there is the coincidence of the price review with the election, and in particular an election which may see a change in administration. A new administration might choose to take the credit for improvements in performance while blaming its predecessor for bill increases. But equally, a new administration could well want to be seen to achieve more, potentially for lower bills. Not to allow for this would be shortsighted.

So, what could be done?

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'PR25'

Perhaps the most obvious, but not necessarily most attractive option, would be to put everything back a year. Provision exists in company licence conditions for effectively rolling over the last year of PR24, although this has not been done before in water regulation. Of course, this would delay some of the enhancement spend which most people believe is needed – though Ofwat could make allowances for some uplift in what would have been year one of PR24.

There are however limits to the art of the possible: to fully rework the PR24 methodology statement, for companies then to comprehensively rework their draft business plans and then for Ofwat to undertake a draft and then a final determination would take much too long – so a completely new 'PR25' would not be possible, rather Ofwat would have to go for a rebadged PR24 with changes to a select number of key parameters. These parameters might major on the paucity of nature-based solutions in the WINEP and the scope for new technological application. And a new administration might also add a few specific changes (e.g. greater emphasis on vulnerability).

Energy-style reopeners

A major innovation from Ofgem's approach to energy regulation ('RIIO2') was the significant expansion of the use of reopeners. Accepting that government policy and technologies on net zero were uncertain, Ofgem decided not to determine this spend along with final determinations but instead moved as much as a third of enhancement spend into later one-off decisions: the remit and

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'call for' these proposals could only come from themselves.

Some commentators viewed this as a cynical means of hiding price increases, while allowing good headlines in the final determination. But the reasoning had some merit: Ofgem could not yet form a proper judgement of how much spend/ which projects to allow. But neither could the country's drive for net zero wait another five years to start some of the key investment.

The degree of uncertainty in water is less than for net zero investments in energy. But some at least elements of the price review will gain in terms of the evidence base and technologies over the next couple of years – and the concept of reopeners is very much in line with the 'adaptive' approach required by Ofwat and Government.

There would also be a credible case for creating a reopener to allow for the next revision of the Environment Act water targets, which is due before 2029. And a reopener mechanism could allow more time for a new administration to set priorities and change things on the back of these than the supposed 'PR25' option.

The main arguments against are threefold: the extra resource required in Ofwat and in companies; the potential lack of customer transparency and input into reopener spend; and the open-ended uncertainty for investors and the supply chain.

Uncertainty mechanisms

Reopeners are in fact only one type of a wider set of measures known as 'uncertainty mechanisms', some of which are already included by Ofwat in PR24. The most obvious ensures that companies are protected from inflation: in other words, the price review is set in real not cash terms. Other uncertainty mechanisms include changes in tax and 'volume drivers' adjusting for a change in, say, customer numbers.

Companies' licences also allow price limits to be reopened in certain limited circumstances where a materiality threshold has been exceeded – the 'IDOK' regime – and IDOK related changes to licence conditions have featured in past price reviews, albeit with limits on the size of change allowed.

The author is sceptical that the existing uncertainty mechanisms would in practice deliver all of what we might seek, at least without a pretty big change of attitude from Ofwat. But there are some specific issues which could be covered – for example, if the experience some water companies appear to be having with a post covid increase in water demand per head, because of people working from home etc, continues and thereby undermines their ability to meet formal delivery incentive mechanisms.

One has however to ask whether changing the existing system, through PR24, really is the most efficient or sensible approach. If the major problem with PR24 is with the narrow focus of water quality/wastewater, then why use the sledgehammer of a PR25, a new reopener mechanism or an IDOK to crack what is a large but self-contained nut.

WINEP adjustments

So the solution might instead (or perhaps as well) be to tackle the WINEP: the EA's specification for what water companies must do to improve water quality and meet statutory objectives in that area. In any case (see above) it is far from certain that companies will be able to spend all the increases included in the WINEP in this price review and a few are already explicitly arguing for some phasing.

Three immediate options suggest themselves, involving, I would suggest, pragmatic discussion under 'cover' from government between Ofwat and the EA and/or the establishment of tripartite (Ofwat, EA, companies) protocols:

- *The EA could create a 'WINEP reopener' allowing for further increases in the WINEP to fund nature- based solutions as evidence for these approaches builds.*
- *The EA/government could withhold part of the WINEP spending and requirements for the later years of the price review until evidence is clearer on the role which nature-based solutions can play and how machine learning/SUDs/digital twin models can obviate the need for spend based on concrete. Ofwat's role could be expanded to cover best value across alternative approaches, rather than simply holding companies to account to project delivery.*
- *The WINEP could remain as drafted, but the EA could be charged with taking a risk and evidence-based approach to representations from companies for moving specific spend from concrete to other delivery routes.*

These could all also allow for flexibility as statutory reviews of Environment Act targets are concluded.

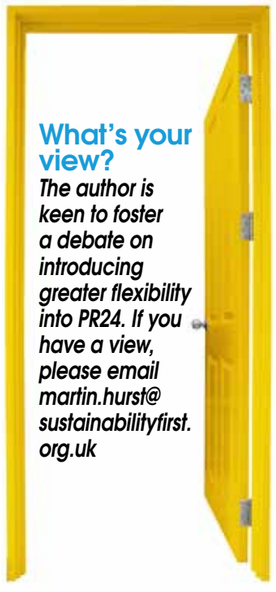
On balance

As mentioned, care will be needed. Investors – already nervous – and the supply chain will look for confidence from requirements over five years. Creating more uncertainty could therefore increase cost from the supply chain and the cost of capital from investors. But conversely, the supply chains are going to be very stretched, and creating opportunities to reduce the pressure on big ticket concrete projects by moving action to other more local delivery chains based on nature-based solutions could even help here. Investors will want certainty, but they also want the industry's reputation to be enhanced, and in any case the uncertainty over companies' ability to spend all the increases in the WINEP may be weighing on their minds.

In a nutshell, this author thinks the benefits of creating more flexibility heavily outweigh the risks. But to optimise this flexibility, it should perhaps follow the adaptive principle in allowing for some limited reopeners together with increasing flexibility in the WINEP, and not just tweak the edges of the existing price review.

By Martin Hurst, who was a senior civil servant on water and environmental issues for 20 years, and is by background a professional economist. This article derives from his work for Indepen and Sustainability First, where he is an associate.

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What's your view?

The author is keen to foster a debate on introducing greater flexibility into PR24. If you have a view, please email martin.hurst@sustainabilityfirst.org.uk