Discussion Paper: The Case for Separation of Powers in Water Regulation

Prepared independently by Martin Hurst for Sustainability First (SF), with support from SF colleagues and peer review from experts in regulation in various sectors.

June 2026

'There is a long-standing assumption, based primarily on the separation of powers doctrine, that law making, investigation and determination of liability should be undertaken by different institutions.' (Garoupa *et al.,* 2011)

Executive Summary

This paper starts from the premise that water regulation should deliver outcomes that secure long-term resilience, improve the water environment, protect drinking water quality, ensure bills offer value for money, provide good service for consumers (including those in vulnerable circumstances), and, as the government has made clear, support economic growth. Against that wider backdrop, it focuses on one specific issue: how regulation should be exercised across this broad range of duties and powers. The author has considerable respect for much that Ofwat does – and while agreeing that a high-level totemic change was required, feels that the political rhetoric around Ofwat probably arises as much from wider frustrations with the sector as the reality of its past performance as an economic regulator.

The new Water Regulator will have a tough job. Alongside its core role of delivering outcomes that matter directly to households, communities, and the wider economy, it must restore trust and build its reputation for fair and impartial regulation.

These outcomes do not only matter as regulatory objectives, but because they impact lives and long-term confidence in the sector. Households need fair, affordable, predictable bills and confidence that regulatory decisions prevent poor behaviour; communities need resilient water systems that respect environmental limits; and investors need regulatory clarity that supports sustained, long-term investment and fair returns. To achieve this, investors need confidence and a reasonable degree of certainty. Effective regulation must therefore balance social needs and expectations and environmental integrity with economic discipline and the need to retain an investible proposition. Getting the institutional design right is not an abstract governance concern, particularly for an essential service such as water, it is a practical safeguard to ensure that regulatory decisions command public legitimacy, meet public need, enable ambitious environmental delivery, and support stable, long-term financing of essential infrastructure.

To do this Ofwat already has (and the new regulator will have even more so) a broad range of instruments at its disposal. For example: the classic tools of economic and environmental regulation, investigative powers, the new concepts of supervisory regulation (building on existing prudential regulation) and constrained discretion, and a formidable array of penalty-based regimes. These include incentive-based regulation, civil penalties up to 10% of a company's turnover, and criminal sanctions. It is important therefore that both Ofwat and the new regulator are and (even more importantly), are seen to be, unbiased in their application of these powers and that potential 'conflicts of interest' are managed through appropriate checks and balances. The temptation for a regulator under fire for its own actions

to deflect blame through being seen to be tough on others may appear to outsiders to be significant. Ironically, the opposite risk – that of capture is also present. Both arise from the 'principal-agent' nature of regulation, where the regulator will never have the full information and knowledge that regulated companies - with different incentives - have, and therefore is always relying on surrogates for full information.

In this context we should note that we have struggled to identify another regulated industry in the GB with a regulator that has such a wide remit without independent checks/key decisions delegated outside the regulator. This breadth of powers places a premium on clarity of role, governance, proportionality, and public confidence in how decisions are taken. It is also the case that while some other economic regulators have broad responsibilities, they have introduced wider internal and external governance to address these concerns. For example, as long ago as 2014, Ofgem set up an Enforcement Decision Panel of external experts to take enforcement decisions, in response to industry and investor concerns about Ofgem acting as legislator, judge (in the broad sense), and jury. Similarly, the Competition and Markets Authority (CMA) operate through independent panels.

Appendix 3 contains relevant quotes to support this viewpoint from Sir John Cunliffe's report. Although he does not tackle the issue around Ofwat's breadth of powers directly, his report does stress that in operating the existing regime, Ofwat and the new regulator need to be careful to avoid what is described as the 'double jeopardy' of incentive-based penalties (which are not fully supported by the customer body, Consumer Council for Water), followed by fines/civil penalties[1]. This is not an argument against strong enforcement, but for enforcement that is clearly anchored in independent judgement and focused on improving outcomes for consumers and the environment.

Regulators also need (as Sir John Cunliffe set out) to enable recovering companies to rebuild capacity and financial resilience. And they must avoid any perception that by imposing penalties they are responding to public criticism - possibly in which their own past decisions could be implicated - rather than operating fairly and proportionately[2]. The author has argued elsewhere that previously regimes at Ofwat were part of an implicit concord with ministers, companies and consumer bodies to put difficult (and costly) decisions off in the interests of lower bills and good returns to investors – most notably during the long period of over a decade when the cost of capital was systematically falling. For an essential service like water where customers cannot switch provider, it is especially important to avoid outcomes where households face higher costs or delayed environmental improvement as a result of compounded regulatory penalties.

This paper suggests that the legal concept of 'separation of powers' which underpins the distinct roles of the legislature, the executive, and the judiciary, and also appears in fora as diverse as policing and social housing, has merit in how the water regulators should do their job. This was also a conclusion the Organisation for Economic Co-operation and Development (OECD) came to (see a summary in Appendix 1). The implications of this are that the regulators must take great care when: defining required outcomes; setting limits on company spend; investigating breaches of regulation/licence

[1] Note: In their penalty policy, Ofwat say explicitly that in setting penalties they will take account of any incentives - so in principle it is covered in part (direct communication with Author).
[2] The author does not suggest this has happened, but perception can be as important as reality. See e.g. https://sustainabilityfirst.org.uk/blog/walking-the-talk-what-might-a-sustainable-licence-to-operate-look-like-for-water-and-energy/

condition; and then levying civil penalties (and arguably also seeking criminal penalties, though there is at least a third-party role through the courts).

This approach is supported by the guidance produced by the OECD, summarised in Appendix 1, which stresses the need for a central principle: clearly distinguished roles and responsibilities.

The current position of Ofwat goes beyond simply being what Cunliffe refers to as 'judge and jury'; in many cases it sets the outcomes and the rules as well. The problem will be made even more pronounced by the inclusion in the new regulator of the Drinking Water Inspectorate (DWI) and parts of the Environment Agency's (EA) water function. This means that even more of the outcomes, spend, investigation, levying of civil penalties, and prosecution under criminal law will all in effect fall to one body.

The existing regulator, Ofwat, faces nearly all these challenges. The even wider powers for the new regulator present a still stronger challenge to devise appropriate separation of powers within that regulator.

We don't suggest the new regulator should be broken up before it is even created. **But there is a very powerful argument for conscious design solutions to ensure that there is clear separation of responsibilities, governance, and decision making within the new body, and within Ofwat at present**. We set out a range of options to achieve this: from strong Chinese walls within both Ofwat and the new regulator - at executive and board level - with those who set outcomes and price controls being strictly separated from those who enforce; to greater external input and oversight, including perhaps from Parliament.

We also set out a range of examples where the case for separation is already accepted.

The current position

Broadly speaking, Ofwat's current role could be described in three parts:

Economic regulation: Acting on input from the DWI on required drinking water outcomes/investment, from EA on environmental investment, and from regional water groups and its own Regulators' Alliance for Progressing Infrastructure Development (RAPID) process on requirements for major water resource infrastructure, Ofwat considers proposals from companies for expenditure etc in their price review business plans and then determines allowed bill increases and required spend. In doing this it will consider reasonable efficiencies and the relevant cost of capital. It determines spend in three categories: totex (operational and capital spend required to run the day-to-day business), capital maintenance, and 'enhancement spend' (for delivery of new projects).

Prudential regulation: Checking that water companies are going concerns and are not taking unnecessary risks.

Enforcement: Following the setting of licence conditions and other requirements and then, after a series of tests, applying controls such as limiting senior executive bonuses and levying civil penalties of up to 10% of turnover where such conditions/requirements are breached. Many of these requirements are set out in legal duties.

In undertaking these roles Ofwat must comply with statutory duties, which Ofwat describes as follows (Ofwat, n.d.):

‘Under section 2 of the amended Water Industry Act 1991 (WIA91), we must carry out most of our work as an economic regulator in the way we consider will be best to:

- further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition
- secure that water companies (meaning water and sewerage undertakers) properly carry out their statutory functions
- secure that water companies can (in particular through securing reasonable returns on their capital) finance the proper carrying out of their statutory functions
- secure that water supply licensees and sewerage licensees properly carry out their licensed activities and statutory functions
- further the resilience objective to secure the long-term resilience of water companies’ water supply and wastewater systems; and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services’.

Appendix 4 of this document sets out the relevant enforcement legislation.

Lessons from other regulated sectors

Many sectors, including some facing near monopoly conditions, have deliberately separated funding, regulation, and enforcement to protect credibility, for example:

- Environmental governance, where independent bodies hold government to account;
- Social housing, where regulation, funding, and rent-setting sit in different institutions;
- Transport, telecoms, and aviation, where government funds/oversees at least parts of the infrastructure, but independent regulators oversee performance.

Across these sectors, three consistent types of safeguards emerge:

1. Funding decisions and enforcement sit in different institutions (e.g. for social housing, Homes England provides investment funding, the government sets the cap on rents, and regulation sits with the regulator for social housing; for transport, the Department for Transport sets strategy and provides capital and revenue funding, HM Treasury agrees overall spending envelopes, with safety, economic and performance regulation carried out by independent bodies such as the Office of Rail and Road and traffic commissioners).
2. Regulators do not financially benefit from penalties (fines flow to the Treasury or courts, not regulators)[3]. With the water side of the Environment Agency moving into the new regulator, care will be needed to ensure that the relatively new (and broadly welcome) earmarking of some penalties for environmental works does not create perverse incentives.
3. Independent scrutiny is available through Parliament or courts (appeals, judicial review[4], select committees).

[3] Note: This does also apply in water.
[4] Note: Judicial review is available to companies where civil penalties are levied, but the burden of proof/the evidential test on the regulator is significantly less than for criminal penalties and the key test is on whether the process was followed rather than the merits of the case.

These models are designed to avoid situations where the body that constrained investment is the same body that later punishes the consequences. These models show that separation is feasible and improves confidence in regulatory fairness. See Appendix 2 for further detail on how other sectors achieve this separation.

Reform options for Ofwat

We have identified a range of possible models for reform, with the caveat that deciding how far to go would require more careful analysis of any increased costs or loss of economies of scale, and how to ensure clarity of roles and avoidance of overlaps.

Option A: Formal internal separation ("Chinese walls")

Establish clearly delineated, firewalled functions within Ofwat/the new regulator for price control determination and enforcement. This would involve a degree of separate leadership, distinct evidence bases (with defined evidence-sharing protocols), publication duties, and board-level oversight. A similar separation could be applied between investigation and decision-making.

At each price review, the regulator would publish transparent decision logs documenting the trade-offs made (affordability, resilience, service). Whether an enforcement action accepts the consequences of those trade-offs would then become a legitimate question for judicial review.

Impact: Reduces perceived conflicts of interest without requiring structural reform of the sector.

Example: Ofgem and Ofcom operate separate teams for enforcement, with final penalty decisions taken independently from the investigating team. Ofwat already has elements of this model.

Option B: Enhanced external scrutiny for enforcement linked to funding

Where alleged failures plausibly arise in part from past spending settlements, introduce an automatic right of appeal (e.g., to a tribunal or court) on the funding-performance link. Each major penalty decision would be accompanied by a published "funding linkage" assessment. There is also a case for a broader merits-based appeal across all enforcement decisions.

Impact: Inserts an independent arbiter precisely where the potential conflict arises.

Example: Ofcom's enforcement decisions can be appealed to the Competition Appeal Tribunal (CAT).

Option C: Partial externalisation of funding determination

Shift responsibility for setting long-term or strategic requirements (e.g., resilience, climate adaptation) outside Ofwat's direct remit; for example, to ministers, Treasury-set parameters, or an independent commissioning body. Ofwat would retain economic and consumer regulation, alongside enforcement.

We have argued elsewhere that Defra's strategic policy statements have been notably silent on the trade-offs between long-term requirements and affordability, and weak on quantified long-term targets. If this reflects limitations in Ofwat's founding legislation, the forthcoming water bill provides an opportunity to address it.

Impact: Separates decisions about *what* needs to be delivered from the regulator's role in ensuring efficient delivery and robust enforcement.

Example: The National Energy Systems Operator (NESO) sets strategic requirements for network investment to inform Ofgem's price controls; similar models exist in transport and communications.

Option D: Court-anchored enforcement for systemic failures

For high-materiality or systemic cases, require judicial confirmation of liability and penalty. Ofwat would investigate and bring cases, while courts determine sanctions like the Office for Environmental Protection's (OEP) model.

Impact: Maximises independence and public confidence in the most contentious cases.

Option E: Structural separation of funding and enforcement functions

Create a separate funding or commissioning body (or ministerial framework) to set the investment envelope, with Ofwat focused on monitoring, consumer outcomes, and enforcement.

Impact: Provides the strongest safeguard against conflicts of interest and aligns with the Regulator for Social Housing/Homes England model.

Considerations: Would require primary legislation and a carefully managed transition.

Possible Phased Approach

Begin with governance and transparency measures (Options A and B), which do not require primary legislation, and assess their impact on stakeholder confidence. Pilot partial externalisation (Option C) for strategic programmes such as drought resilience. Only then consider full structural separation (Option E). Appeal thresholds should be designed to avoid excessive litigation while ensuring independence where funding and performance are closely linked.

Option F: Structural Separation of Funding, Standards, and Enforcement

Although likely inconsistent with the intention to maintain a single regulator, a more radical model would separate the setting of price caps and long-term outcomes from monitoring and enforcement.

Under this approach, the regulator would set the end-customer cost of water and the long-term outcomes to be achieved. Companies would have discretion over how to deliver those outcomes, enabling flexibility, innovation, and ownership. Outcomes would be negotiated with customers, citizens, and communities at a regional or catchment level, building trust and ensuring they reflect local needs and maximise public value.

A separate regulator would oversee delivery and enforcement. Penalties would flow into a redress fund to support consumers, including those in vulnerable circumstances or directly affected by failures.

Conclusion

Taken together, the evidence in this discussion paper points to a clear conclusion: as water regulation is expanded and strengthened, the case for separating key powers within the regulatory system becomes more compelling, not less. The paper has shown that Ofwat already combines a wide range of functions, including setting outcomes, constraining expenditure, supervising company behaviour, investigating breaches and imposing penalties, and that this concentration of roles risks undermining both perceived fairness and public confidence. It has also shown that other regulated sectors have recognised similar risks and introduced safeguards, whether through institutional separation, independent panels, court-based oversight or clearer distinctions between funding, standard-setting and enforcement. The central argument is therefore not against strong regulation, nor against the creation of a more capable single water regulator, but for deliberate governance design that ensures decisions are taken with appropriate independence, transparency and accountability. If the new regulatory framework is to command trust, support investment, protect customers and deliver better

environmental outcomes, separation of powers must be treated as a practical design principle at the heart of reform, rather than as an optional constitutional ideal.

Appendices

Appendix 1: International evidence to support separation of powers in water

a) OECD Principles on Water Governance (OECD(a), 2015)

The OECD Ministerial Decision on Water Governance explicitly calls for a clear separation between water policymaking, financing, operational management and regulation, warning that governance failures often arise when roles are blurred and conflicts of interest go unchecked. The OECD argues that regulators should not combine responsibility for funding decisions, performance judgement and enforcement, as this undermines accountability and public trust. These principles are now being used by stakeholders to support reform of water regulation so that regulators are not required to penalise outcomes shaped by their own prior decisions - avoiding a "judge and jury" model that the OECD identifies as a governance risk in capital intensive monopoly sectors.

b) The Governance of Water Regulators (OECD(b), 2015)

The OECD's Governance of Water Regulators report argues that effective and trusted water regulation depends on a clear institutional separation between policymaking, funding decisions, regulatory supervision and enforcement, warning that public confidence and accountability are undermined when regulators are required to judge failures that are shaped by their own prior decisions. Drawing on international experience, the OECD emphasises that regulators should have a clearly defined mandate, independence from political and financial influence, and governance arrangements that minimise conflicts of interest - particularly in monopoly, capital-intensive sectors like water. It highlights the risk that combining price setting, investment allowances, performance assessment and penalties in a single body can create a perception that regulators are "marking their own homework", even where decisions are technically justified. To counter this, the OECD recommends structural safeguards such as separating funding and policy functions from enforcement, routing penalties away from regulators, and strengthening external scrutiny through courts, appeal bodies or legislatures, so that ultimate judgement does not rest with the same authority that designed or constrained the regulatory framework in the first place.

Appendix 2: Case studies demonstrating how other UK regulatory models separate funding from enforcement

a) Telecoms (Ofcom)

Ofcom regulates the telecoms sector under the Communications Act 2003, focusing primarily on enforcing conduct rules and maintaining market fairness rather than funding infrastructure. Economic regulation applies mainly to monopoly segments, such as Openreach or firms with significant market power, while the wider sector is subject to lighter-touch regulation due to competition. Ofcom can impose financial penalties for breaches of licence conditions or statutory duties, guided by its published penalty framework, but any fines are paid to the Consolidated Fund rather than retained by the regulator. Investment in telecoms infrastructure is largely privately financed by firms, with limited government support for specific initiatives such as rural broadband rollout, and Ofcom does not set company capital budgets, though it does regulate certain prices, such as capping Openreach's

wholesale charges. Its independence is reinforced through its statutory basis, lack of involvement in funding decisions, and oversight mechanisms including statutory consultation requirements, appeals to the Competition Appeal Tribunal, and parliamentary scrutiny. Overall, the key design feature is a clear separation between regulation and funding, with Ofcom enforcing rules while playing only a limited role in infrastructure investment decisions.

(Communications Act 2003, 2003; Office for Communications, 2024; HM Government, 2024)

b) Aviation (Civil Aviation Authority – CAA)

The Civil Aviation Authority (CAA) acts as the independent regulator for the UK aviation sector, overseeing safety, economic regulation of airports, and consumer protection, while airlines and airports themselves make commercial investment decisions and fund infrastructure privately. The CAA sets price controls for airports with significant market power, such as Heathrow, and can impose financial penalties where licence conditions are breached; however, these penalties do not fund the regulator, and consumer enforcement is often pursued through legally binding undertakings that can be enforced via the courts. Its independence is maintained through a clear separation from both government investment decisions and financial incentives linked to enforcement, with courts and statutory processes playing a key role in determining and enforcing sanctions. Overall, the regulatory model is characterised by a strong separation between regulation, funding, and enforcement outcomes, ensuring that the CAA operates without direct financial interest in penalties or infrastructure investment.

(Civil Aviation Act, 2012; UK Civil Aviation Authority (CAA), n.d.)

c) Roads and Rail (Office of Rail and Road – ORR)

The Office of Rail and Road (ORR) is a non-ministerial department that regulates rail and monitors strategic roads, enforcing performance and safety standards while remaining separate from funding decisions. Rail investment, including funding for Network Rail, is determined by government through Spending Reviews, while road investment is set through Road Investment Strategies agreed by ministers and the Treasury. Within this framework, the ORR regulates Network Rail, monitors National Highways, and can apply enforcement measures and fines, but it does not control how funding is allocated, instead assessing efficiency and delivery within government-set budgets. Its independence is maintained through its institutional separation from ministerial decision-making, with funding determined by government and regulatory enforcement carried out by the ORR under statutory powers that are ultimately subject to oversight by the courts.

(Department for Transport, 2015(a); Department for Transport, 2015(b); ORR, (n.d.))

d) Social Housing

Funding, rent-setting and regulation in the social housing sector are deliberately separated across institutions, with capital funding for new homes provided by Homes England, rent policy set by central government, and oversight carried out by the Regulator of Social Housing (RSH). The RSH monitors governance, financial viability, safety and consumer standards, and has a range of enforcement tools including inspections, regulatory judgements, enforcement notices and, in extreme cases, direct intervention such as replacing board members or arranging transfers of management. The Social Housing (Regulation) Act 2023 has strengthened RSH's inspection and enforcement powers without giving it control over funding, reinforcing this institutional separation. This framework is underpinned by transparency, with the RSH publishing regulatory judgements and enforcement actions, and reflects a

core design principle of maintaining clear checks and balances between funding, price-setting and regulatory functions.

(HM Government, 2023; Social Housing (Regulation) Act, 2023; Regulator of Social Housing (RSH),2024; Regulator of Social Housing (RSH), n.d.)

e) National Crime Agency

The National Crime Agency (NCA) is a UK law enforcement body created under the Crime and Courts Act 2013, whose role is to tackle serious and organised crime. It operates under the Home Secretary's strategic direction but is operationally independent. It is not an economic or sector regulator: it does not set prices, determine investment or funding levels, license industries, or fund the sectors it investigates. Those sectors, such as banking or transport, are financed through wholly separate public or private mechanisms.

The NCA's role is investigative rather than punitive. It does not itself impose financial penalties. Instead, it builds cases and refers them for prosecution, with sanctions such as criminal fines, confiscation orders, or civil recovery imposed by the courts under frameworks including the Proceeds of Crime Act 2002. While the NCA can pursue asset recovery powers, outcomes are ultimately determined through judicial processes rather than by the agency itself.

Accountability and scrutiny are provided through several independent channels. Courts determine guilt, sentencing, and financial penalties; the NCA has no role in setting these. The Crown Prosecution Service generally makes independent decisions on whether to bring charges. The agency is also inspected by HM Inspectorate of Constabulary and Fire & Rescue Services, which reviews its effectiveness and governance, and it is subject to parliamentary scrutiny, particularly by the Home Affairs Select Committee.

(Crime and Courts Act, 2013; National Crime Agency, n.d.)

f) Office for Budget Responsibility

The Office for Budget Responsibility (OBR) is an independent fiscal watchdog established under the Budget Responsibility and National Audit Act 2011. Its role is to provide economic and fiscal forecasts, assess the government's performance against its fiscal targets, and improve transparency in public finances. It is not a regulator and has no powers to enforce decisions, allocate funding, or impose penalties, its function is limited to analysis, assessment, and public reporting.

The OBR is funded through HM Treasury as part of the public spending framework, but its independence is protected in law. While the government can set fiscal policy objectives and the broader framework through the Charter for Budget Responsibility, it cannot direct the OBR's analytical methods, conclusions, or judgements. This legal separation underpins its credibility as an independent body.

Because the OBR has no enforcement powers, accountability operates through transparency and scrutiny rather than sanctions. It reports directly to Parliament, with the Treasury Select Committee playing a central oversight role by examining its forecasts, questioning its leadership, and holding a statutory veto over the appointment of the OBR Chair. The organisation also publishes detailed information underpinning its work; including models, assumptions, and forecast evaluations, allowing external experts to scrutinise and challenge its analysis. In addition, its governance and financial statements are audited by the National Audit Office, and it is subject to periodic independent external reviews by organisations such as the OECD and academic experts.

(The Office for Budget Responsibility Act (Budget Responsibility and National Audit) Act, 2011; HM Treasury, 2024).

g) *Energy (Ofgem)*

Ofgem is an economic regulator setting allowed expenditure through 5 yearly price controls for the gas and electricity networks. The newly established NESO plays a key role in identifying where new infrastructure investment is needed to deliver on the government's net zero ambitions. Ofgem then determines the funding required and sets incentives and wider licence requirements. Ofgem also sets licence requirements and code obligations for the competitive parts of the market (retail and generation / wholesale) to ensure these work in consumers' interests. In terms of enforcement Ofgem has powers to impose penalties up to 10% of turnover for breach of licence. For these decisions, since 2014, Ofgem has (voluntarily) had in place an Enforcement Decision Panel "to allow cases to be decided by dedicated specialists, with an easily visible separation between the investigation and decision-making functions".

Ofgem also has the ability to bring cases under general consumer protection legislation which it currently has to do through the courts. However, in the recent review of Ofgem DESNZ are proposing to give Ofgem the ability to directly enforce general consumer legislation (to speed up the process) and also the power to limit bonuses in the case of breaches of regulation.

(Ofgem, 2023; Institute for Government, 2025; Department for Energy Security and Net Zero (DESNZ), 2026)

h) Office for Environmental Protection (OEP)

The Office for Environmental Protection (OEP) is an independent public body established under the Environment Act 2021 to monitor and enforce compliance with environmental law by public authorities. Its role is investigative and supervisory rather than punitive: it examines potential failures by government departments, regulators and other public bodies, but it does not impose financial penalties. Instead, where serious breaches are identified, it may issue information and decision notices and, if necessary, initiate legal proceedings such as environmental review or judicial review, with any sanctions or remedies ultimately determined by the courts.

The OEP is funded through grant-in-aid from the Department for Environment, Food and Rural Affairs (DEFRA), with its budget set through government spending processes and approved by Parliament rather than by the bodies it investigates.

Institutional independence is a core design feature of the OEP. The Environment Act 2021 establishes it as a distinct body with statutory functions, while governance arrangements ensure it is operationally independent and accountable to Parliament via the Secretary of State. It also has formal reporting duties, including publishing reports that must be laid before Parliament, reinforcing external scrutiny.

Overall, the OEP's model deliberately separates investigation from punishment: it holds public authorities to account and can escalate cases to the courts but does not itself impose fines or sanctions. This ensures that final determinations are made through judicial processes, maintaining independence and procedural safeguards, although it may contribute to slower enforcement compared with administrative penalty regimes

(Environment Act 2021, 2021; Office for Environmental Protection (OEP), n.d.)

Appendix 3: Relevant quotes from the Cunliffe Review (Independent Water Commission, 2025)

'Ofwat's Quality and Ambition Assessment (QAA) provide financial rewards and penalties to incentivise companies to submit business plans close to Ofwat's view (see Box 21). Proposals for additional spend and/or projects beyond Ofwat's criteria are disadvantaged under the QAA. This could have deterred companies from submitting plans for necessary spending on the capital maintenance and/or enhancement of assets in the first place, where this was not in line with Ofwat's view, and even penalised them for simply making the case. Water company CMA redetermination submissions at Price Review 2024 have also criticised QAAs "for encouraging companies to submit undeliverable, low-cost plans". Ofwat assesses the stretch and efficiency, as well as affordability, of companies' base and enhancement expenditure proposals as part of the assessment of ambition in companies' business plans' (p.182)

'The Commission considers that Ofwat has relied too heavily on a data driven, econometric approach, and has not taken sufficient account of company-specific conditions and challenges. The Commission recognises that it is necessary to have objective, industry-wide benchmarking to protect customers from misuse of monopoly power in relation to price or service levels. However, the Commission judges that over-reliance on this approach, and its over-development, have over the years led to sub-optimal outcomes for the sector, for customers, for investors and for the environment. The increasing complexity of the challenges facing water companies – and of the challenges facing the regulator in regulating private monopoly utilities – require a broader, less monolithic and a less desk-based approach to economic regulation and to the oversight of companies' performance against their licences.' (p.193)

'The regulator should consult publicly on and then publish a single overarching document describing its supervisory approach. This should cover:

- the purpose of supervision
- how it expects to supervise including how it uses information that it gathers
- its guiding principles – including principles for engaging with companies and what it expects from companies
- its tools and how it intends to use them
- main aspects of its staffing structure and how this supports the supervision approach • its decision-making framework, and
- how its Board oversees the supervisory approach and its performance, including in relation to its efficiency and the 'burden' it places on companies.' (p.195)

'Use of economic incentives on environmental and water quality performance risks overlap with any potential enforcement action over these areas through separate legal permit requirements – creating a potential for 'double jeopardy' (see Chapter 4)' (p. 212)

'Investors and companies have argued that an increasingly "punitive" regulatory approach by Ofwat has exacerbated existing financial resilience weaknesses. This includes the impact of a larger downside skew in Ofwat's approach to incentives (through ODIs), stronger enforcement penalties, and a more interventionist approach to guidance on financial decision-making. The impact of this may be shown in the widening gap between the best and worst performers and in the increasing number of companies earning returns below the risk-free rate.' (p.336)

'There are a range of levers to support the turnaround of water companies, in line with public interest, which could be considered for inclusion within a turnaround regime:

- 'Forbearance. Water regulators are expected to investigate and enforce against breaches of the regulatory framework. For some regulators and some offences there is a statutory requirement that they must do so. A turnaround regime could provide the water regulator with additional discretion over enforcement in defined circumstances, allowing them to defer or waive fines and penalties where it is in the broader interest of customers. This may include, for example, circumstances where additional fines are likely to hinder the ability of the company to invest in infrastructure improvement. Where forbearance is offered it would need to be contingent on agreed future performance targets being met, be accompanied by measures to prevent moral hazard, and be demonstrably in the public interest.
- Deferral. For companies in turnaround there may be a case for the water regulator to provide flexibility on deadlines by which projects must be delivered, so long as reasonable progress can be demonstrated and deferral is in the public interest. This would ensure, for example, that companies are not fined for non-delivery of projects that they are unable to deliver because of their broader circumstances.
- Settlement. In addition to forbearance, the water regulator may choose to agree settlements with companies – these would be significant financial commitments by water companies made in order to conclude ongoing enforcement investigations. The regulators would have to ensure settlements were an appropriate response and in the public interest. This could include considering, for example, whether a settlement is likely to lead to quicker remediation of harm.
- Reviewing allowances and performance targets. For companies in turnaround, the regulator should be able to take a pragmatic assessment of the current spending priorities and allow investment to be made where it is needed most to bring the company back into compliance. For example, where higher allowances are necessary given a company's unique circumstances, the regulator may wish to consider these. The regulator should also consider whether performance targets and incentives need to be set differently for companies in turnaround.' (p. 343)

'Ofwat cannot currently propose the content of undertakings. With appropriate caveats, reforms could enable the regulator to direct that any penalty money taken from a water company's profits is spent in a particular way to redress harm or to meet priority investment needs. In this way the regulator could choose, for example, to direct that money which may have been spent on penalties is spent on improvements to infrastructure.' (p.344)

'Further, the powers to issue penalties under section 22A of the WIA 1991 have not been delegated to DWI who instead have to recommend penalties to the Secretary of State.' (p. 388)

'Companies have suggested they be replaced through closer and more transparent engagement between companies and the regulator: "Price Control Deliverables are a symptom of a regulatory system that lacks trust, with prescriptive requirements and a proliferation of penalties that duplicate the enforcement regimes of other regulators.' (p.186)

Appendix 4: Relevant legislation on enforcement

a) ***The Water Industry Act 1991*** (Water Industry Act 1991) (as amended), provides for Ofwat to enforce three different kinds of contravention:

- breaches of conditions of an appointment or licence;

- breaches of statutory requirements enforceable under section 18 of the WIA91(the “statutory requirements”); and
- breaches of certain customers service standards known as “guaranteed service standards” or “GSS”).
- The WIA91 also provides Ofwat with the following enforcement related powers:
- the power to issue provisional or final enforcement orders for specified contraventions;
- the power to impose financial penalties; and
- the power to acquire information for enforcement purposes.

‘Having considered the broad level of penalty and appropriate additional factors, the enforcement authority will determine the appropriate overall level of any financial penalty. In doing so, it will ensure that the amount it determines is not more than 10% of the turnover of the undertaker or licensee as required by section 22A (11) of the WIA91. The 10% limit applies to each breach for which a penalty is imposed, rather than representing a cumulative limit for a financial year.’

b) *Water Special Measures Act 2025* (Water (Special Measures) Act 2025)

As the government policy paper explains:

‘The Water (Special Measures) Act (‘the act’) was introduced into Parliament on 4 September 2024 and received Royal Assent on 24 February 2025. The act significantly strengthens the power of the water industry regulators and delivers on the government’s commitment to put failing water companies under special measures.

There is a lack of public trust in the industry and widespread concerns about underinvestment in infrastructure, levels of pollution, and failures to address illegal spills of sewage. In 2022 to 2023, £9.7 million was paid out in executive bonuses and benefits to water and sewage company executives in England and Wales, despite poor performance. In 2023 Dŵr Cymru Welsh Water executives did forego bonuses.

This act is not the full extent of the government’s ambition, with wider transformative change across the whole water sector to follow. This act delivers on the government’s promises by:

- blocking bonuses for executives who pollute our waterways
- bringing criminal charges against persistent law breakers
- enabling automatic and severe penalties for wrongdoing
- and ensuring monitoring of every sewage outlet

Collectively, the measures in the act will ensure water companies are better held to account where they have failed to deliver for the environment and customers and begin to restore trust in the industry.

To enable the implementation of the new measures introduced by the act, the strengthened regulators will consult on how they intend to use their new powers provided by the act, as well as on updates to their guidance and policies where required. The government and the regulators will take into consideration the overall impacts of the policies introduced through the act and ensure that the ability of the sector to attract investment and any impact on customer bills are carefully considered and balanced.’

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