

3 February 2022

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## Summary

Water UK is the representative body and policy organisation for water and wastewater service providers across the UK. We welcome the opportunity to respond to Ofwat's paper on Assessing base costs at PR24<sup>1</sup>. This response represents the considered and consolidated views of Water UK's members. We note that many of the issues considered in the discussion document are highly technical and we do not respond to those specific elements here; companies will respond to those technical arguments specifically in their individual responses.

We share Ofwat's view – as expressed in the Executive Summary of the document – that the water sector in England and Wales faces a series of long-term challenges. However, we have a number of concerns that, in combination, the proposals in the consultation do not go far enough to address these long-term challenges.

We are though pleased that Ofwat has in this consultation recognised explicitly and placed greater weight upon the CMA water redetermination decisions. As we have set out in responses to other consultations these decisions set important precedents to be followed and greater weight should be placed on the water redeterminations.

As Ofwat acknowledges, base costs represent the vast majority of expenditure, i.e. 80%. It is therefore fair to say that the extent to which base costs are funded can be expected to be an important determinant of what the sector can, and cannot, be expected to achieve in the period 2025-30. It follows that it is very important to get this aspect of PR24 right, and also to better understand and take account of links between base costs and enhancement.

We provide below a number of observations about the approach set out in the document, and would encourage Ofwat to take these into account as it develops its draft methodology for PR24. In addition to that, we would encourage Ofwat to take into account four further important factors:

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<sup>1</sup> <https://www.ofwat.gov.uk/consultation/assessing-base-costs-at-pr24/>

- **first**, the Governments' Strategic Objectives for Ofwat – under the terms of the Water Industry Act 1991, in making determinations under PR24, Ofwat must act in accordance with the objectives set by the UK and Welsh Governments. As the objectives set by the UK Government were not published<sup>2</sup> until yesterday, and those to be set by the Welsh Government are awaited, it is understandable that the proposals set out in the consultation document are not related back to them.
- But – given the importance of base expenditure allowances to their achievement – we would strongly encourage Ofwat to ensure that the finalised Strategic Policy Statements are fully taken into account before developing its PR24 methodology in respect of base costs. In particular, we note that the UK Government's Strategic Policy Statement highlights the importance of taking a strategic and long-term approach to asset health that provides for resilient services taking account of growing pressures, including climate change and population growth, and the needs of a healthy environment, and provides value to customers and wider society in the longer-term.
- **second**, we would counsel Ofwat's Board to take time to understand and reflect on the effects of setting base expenditure allowances more or less entirely with reference to past levels of expenditure, including past levels of spending on capital maintenance and the low costs associated with the disposal of biosolids to land. This approach leads to an assessment of base cost that is increasingly squeezed, with the implicit assumption of increasingly deferred rates of asset replacement – it is difficult to envisage this approach being sustainable.
- We would urge Ofwat to consider whether this approach really is sufficient to support the industry's requirements to maintain adequate resilience and asset health, and this will be further exacerbated by the future impacts of climate change and population growth. This concern was also explicitly raised by the CMA in the recent water redeterminations and we are pleased to see the consultation recognising and considering this point and the important precedent it sets. We also welcome that Ofwat is considering capturing evidence (through asset health measures) that could help demonstrate forward-looking cost requirements;
- **third**, we would encourage Ofwat to consider the implications of the Environment Audit Committee's recent findings on how it goes about setting allowances for base expenditure in PR24. Among a long list of criticisms of the entire sector – including many directed at companies and other regulators – the report noted that: "*Ofwat's regulatory approach to date appears to have placed insufficient emphasis on facilitating the investment necessary to ensure that the sewerage system in England is fit for the challenges of the 21st century ...*". It also went on to state that "*investment must be accelerated ...*", a position which was subsequently endorsed by

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<sup>2</sup> <https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance>

the Prime Minister.<sup>3</sup> As it develops its draft methodology, we would encourage Ofwat to reflect on whether its approach to determining base expenditure allowances is, in any way, leading to an increasing risk in this area and, if so, what changes might be made to its approach in the light of that analysis

- **finally**, we would ask that when Ofwat develops its future PR24 cost assessment approach, it takes further the recent discussions (most notably in the recent CMA redeterminations) on establishing the appropriate link between costs and service – and ensures that the PR24 approach is robust to the economics of service changes over the long-term time horizon expected in the development by companies of long-term delivery strategies in line with customers' expectations.

Water UK would – for its part – would be willing to continue working constructively with the Ofwat team – and those in the industry – to help define the changes that might be required.

## Specific observations

We would also like to make a number of more specific observations on the substance of the proposals in the document:

- We are concerned that there is an imbalance in the document between *efficiency* and *sufficiency*. There is much in the document about efficiency (reflecting one of Ofwat's secondary statutory duties). But there is very little in relation to its primary duties to secure that companies can fulfil their licence obligations. We think that imbalance needs addressing. As the current public debate on water quality in rivers reveals, the value that customers and those with a stake in the environment attach to service (defined in the broadest sense to cover reliability and resilience) matters to them at least as much as price. It follows that *sufficiency of activity* matters at least as much – and perhaps more than – the *efficiency* of individual activities. We naturally recognise that appropriate monitoring would be needed to ensure that additional activity is delivered.
- We are also concerned that in setting base expenditure allowances, it will be important for Ofwat to adopt a reasonable assumption regarding the associated level of performance that can be delivered from base expenditure alone, with a greater appreciation of the role of on-going, repeatable costs required to maintain a given level of service, let alone improve it further in future.
- By the same token, we would also expect Ofwat to ensure that its PR24 approach can evidence adequate provision for growth intensity driven expenditure in its models, i.e. being clear that

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<sup>3</sup> See Prime Minister's Questions, 26 January 2022 <https://hansard.parliament.uk/commons/2022-01-26/debates/5F56399B-B223-408A-A8EC-1BA001B62E4A/Engagements> .

population growth intensity is not included in base expenditure, and to adjust for that using reasonable assumptions about the additional costs that result.

- We would also encourage Ofwat to ensure that its modelling contains appropriate assumptions on productivity and real price effects. Adopting assumptions that are demonstrably reasonable in these areas, and areas like them, will be an important part of ensuring the legitimacy of the PR24 settlement, and transparency as to the overall level of company challenge embedded within it. Companies are not shy of rising to tough and challenging settlements. But the risk of applying challenge to all aspects of a price control settlement is that it can have the unintended consequence of driving companies to prioritise shorter term decisions rather than focussing on the longer term which is a central focus of Ofwat's wider PR24 reform.
- The document emphasises the importance of independence in modelling. In practice, this drives Ofwat to set allowances with reference to past expenditure, with the attendant problem that the level of past expenditure is used as the benchmark for expenditure in future. However, it is not clear that adopting such an approach can be expected to lead to outcomes that match the needs and preferences of customers and the environment. For example, it implies that the level of service (defined in the broadest sense to cover reliability and resilience) in the past is what customers and the environment want in future, which is inconsistent with the feedback the sector is currently receiving. It also implies that past levels of capital maintenance, and associated asset replacement rates over that period (and the resulting age and condition of assets<sup>4</sup>) are what society wants and are sustainable in the long term, without impact on asset health and resilience of service delivery.
- Whilst – to the best of our knowledge and barring one or two high profile cases – the industry at all times acted within the legal requirements that applied at the time, it seems clear that maintaining that level of expenditure into the future will be insufficient to meet the long-term requirements of customers and the environment on a sustainable basis, particularly given that the future will present new challenges from the past given the impacts of climate change and population growth. For example, delivering net zero will likely require the replacement of many of the assets with more blue-green infrastructure solutions and delivering ambitious reductions in leakage in the future may require greater replacement of the network which is more in line with other jurisdictions where leakage is lower around the world.
- In places, the document advances claims about the predictive power of Ofwat's suite of modelling. We would caution against attaching too much weight to the predictive power of any econometric model that relies wholly on past costs to predict future costs – this type of approach may help appropriately allocate costs between companies, but cannot predict the efficient level of total cost required by the industry to meet future challenges. This is further

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<sup>4</sup> See <https://www.water.org.uk/wp-content/uploads/2021/03/Developing-a-2050-Vision-for-the-Water-Sector-Discussion-Paper.pdf>, page 12

reinforced by the totex incentive framework – for as long as companies enjoy a short term reward, and are able to spend below allowances (whilst fulfilling their legal obligations), the incentive framework will also encourage companies to spend below allowances.

- We very much welcome Ofwat’s statement that its models are consistent with engineering insight. We look forward to understanding how resulting base expenditure assumptions can better align implied asset replacement rates with established engineering design lives.