



Industry and Regulators Committee

Corrected oral evidence: The work of Ofwat

Tuesday 19 July 2022

10.35 am

Watch the meeting

Members present: Lord Hollick (The Chair); Lord Agnew of Oulton; Lord Blackwell; Baroness Bowles of Berkhamsted; Lord Burns; Lord Cromwell; Baroness Donaghy; Baroness McGregor-Smith; Lord Reay; Lord Sharkey; Baroness Taylor of Bolton.

Evidence Session No. 6

Heard in Public

Questions 53 - 64

Witnesses

[I](#): Christine McGourty, Chief Executive, Water UK; Stuart Colville, Director of Policy, Water UK.

Examination of witnesses

Christine McGourty and Stuart Colville.

Q53 The Chair: Good morning, and welcome to the sixth evidence session of our inquiry into Ofwat. I am delighted to welcome two witnesses from Water UK, which represents the water industry: Christine McGourty, who is the chief executive, and Stuart Colville, who is the director of policy. Both have a great deal of experience of regulators and the regulatory industry, so we are looking forward to their comments today. The session is being broadcast, and a full transcript will be available shortly for you to scrutinise.

Ofwat has some competing objectives. On one hand, it has to look after the consumer; on the other, it has to make sure that the water industry is viable, investable and kept up to date in terms of infrastructure, which is a topic that we want to look at. Are the statutory objectives clear and appropriate or do they need to be set out more clearly? How well does Ofwat manage trade-offs between its various objectives, particularly in the relationship and tension between long-term investment and customer bills? Are the Government's strategic policy statements adequate? Obviously, the Government are an important part of the oversight of the regulated water industry.

Christine McGourty: Yes, we believe Ofwat's objectives are clear. As you say, the challenge is managing those really tough trade-offs. The key one, much discussed, is that between short-term bill reductions for today's customers and long-term investments. We believe that Ofwat's focus has been weighted somewhat too much to those short-term interests of current consumers. By 2025, bills will have been flat or falling for 15 years [in real terms]. The long-term investment challenge has been recognised far and wide. Ofwat has recognised the need for greater focus on the long term and we certainly welcome that.

There are new strategic threats of a different order to what has been faced in the past: climate change, population growth and the growing expectations around the environment. All these will require that greater long-term focus. We would like to see a greater parliamentary scrutiny role of Ofwat so that it can be held to account and explain how it is performing against the objectives set out from the Government's strategic policy statements.

Stuart Colville: The strategic policy statement has become almost a totemic document that everyone has pointed to. We are going through an unprecedented period of political change with the Environment Act and much increased public interest in the natural environment, particularly given experiences in lockdown where more people were getting out and about, experiencing rivers and so on.

It is important that, while protecting the absolute independence of Ofwat, government continues to be involved in discussions about these very difficult trade-offs: which are the right environmental outcomes to be prioritising, how that fits with the affordability agenda at a time of

pressure on household bills and so on. I would not want to see government think its job is done with the issuing of that very important document, the SPS.

The Chair: You make a rather intriguing comment in your written evidence and suggest that you have some enthusiasm for the idea that Ofwat may have passed the point of "peak regulatory intrusion". Now, it is not unusual for those who are being regulated to suggest that the regulator should have a lighter touch, but this comes as a surprise because we have seen frustration in some of the evidence about the lack of transparency on the financial model of the various water companies. A major public concern is the pollution and sewage that is being put into the water system and damaging our rivers and beaches. The man or woman in the street might say, actually, greater regulation is needed.

Indeed, we saw a comment last week about more ferocious legal challenge to companies if they misbehave. What lies behind your desire to have lighter regulation? What is the reason for it and where would you like to see the regulation reduced?

Christine McGourty: To be absolutely clear, we believe in strong, tough, independent regulation. That is absolutely right for the sector. The point we simply wanted to make was that the regulatory regime has, inevitably perhaps, become more complex over time. Elements get added year after year, and rarely do they get removed. There is a five-year price review process that is almost continuous. Once five years is over and a determination is reached, work begins very soon after on the next price review.

Ofwat itself has talked about the benefits of simplicity, which is what we would like to see. There were moves in that direction in the methodology that was published in the last few weeks, with a couple of phases being merged into one, for example, and fewer bespoke performance commitments. Put simply, there is an opportunity to pull back from the really detailed approach, perhaps with fewer higher-level outcomes to reduce complexity and cost, but no stepping away from the strong regulation, which is absolutely right.

The Chair: Do you understand and have sympathy with those who complain about a lack of transparency?

Christine McGourty: There is more transparency than there has ever been. A huge amount of finely detailed documentation about the finances of the companies is published on the Ofwat website and by the companies themselves. They are very supportive of that transparency, and we have seen more of it over time. I completely understand the questions around that and why people want to see more of it, but the companies are transparent. A vast amount of data is published. It is a really important part of holding the companies to account and we support that.

Q54 **Baroness McGregor-Smith:** Good morning, Christine and Stuart. I draw

your attention to my registered interests, as I am a non-executive director of the Tideway tunnel. How well does Ofwat work with other regulators and authorities to meet shared challenges? For example, do you see any overlap or, in fact, underlap with the Environment Agency that could lead to challenges with water pollution incidents or the commitment to net zero? We are very interested to know how you work with it.

Christine McGourty: There is more to do on this. We would love to see a tighter join-up between the economic and environment regulators. There have been some really good steps forward. In strategic water resources, for example, we have seen RAPID created, which has brought big benefits, but not the same everywhere. There is no question that, for example, a joint water quality programme between water regulators could bring real benefits.

In the way the system works now, there are risks, for example, of the Environment Agency specifying outputs without the economic regulator having said whether they are financeable. We would like to see timelines joined up so that guidance comes from one regulator to fit the timelines for another. That could get to a much more efficient process with benefits all round.

At a more strategic level, there could be a stronger duty on all the regulators around carbon emissions, for example, so that you do not find one regulator prescribing carbon-intensive and chemical-intensive solutions that then impact on the industry's ability to meet its net-zero targets. These are some of the areas where we would love to see change and in which there is more work to do.

Stuart Colville: It is better than it was. The problems we tend to see are very practical ones where documents are coming out at the wrong time and so on. That is a function of both the complexity of the issues—many of the challenges we face involve very complicated systems—and the sheer number of public bodies that have some kind of involvement with the water sector. We have talked about Ofwat and the Environment Agency. Of course, there is the Drinking Water Inspectorate, CCW—the consumer body—Natural England, which plays a huge role in habitats and so on, the Health and Safety Executive and others. Defra plays a really important role as well in statutory targets and so on.

The complexity of our system is very difficult to deal with on a day-to-day basis. A better-structured approach to water quality would be for everyone to get around the table, with a single timeline and a clear sense of what we are all trying to achieve, to overcome those co-ordination issues and day-to-day things. It sounds like an administrative problem, but that translates into real-world issues.

If you do not give yourself enough time to design a scheme, you will be driven down a concrete route because they are more familiar, you can model them and so on, rather than a nature-based route, which is where we should be going in the long term. They are harder to design, take

longer and involve more landowners. Getting that administration right will improve the real-world outcomes we are all striving for.

Q55 Lord Cromwell: Good morning. I want to ask you a couple of questions about outputs versus outcomes. In your written evidence, you call for greater clarity, specific goals and prioritisation. This morning, you have talked to us about complexity and the need for simplicity. As part of the approach in your evidence, you say that Ofwat needs to take a long-term view, look at problems in the round, draw in other sectors and organisations, seek best-value solutions along with nature-based solutions, and encourage innovation, all of this without additional powers or resources.

My question is in two parts. You acknowledge that outcomes-focused approaches should be cross-sectoral, cross-organisational and, presumably, multi-departmental. Can you give us a bit of explanation about what that would actually look like? However well intentioned, might it not end up as a bit of a fuzzy muddle? I will ask my second question in a moment. Let us tackle that one first.

Christine McGourty: I will make a few comments and then bring my colleague Stuart in on this one. There is a real opportunity here. Everyone recognises that you can achieve a lot more, better value for money and for nature, if you focus on the outcome you want to achieve and not how you want to do it. We have seen good examples of that, and we want to see a really decisive shift in that direction to support and enable those nature-based solutions.

The advantages are not just that every pound could go further but that you move away from those concrete and chemical solutions, and there is more room for innovation and partnership working with community groups, the Rivers Trust, farmers and other sectors. We know that Ofwat is supportive of this direction. Environmental regulation needs to move in that direction too.

Stuart Colville: It is a very good question that gets to the heart of our thinking about the long-term direction of the sector. In order to try to reconcile the tensions you describe, ideally, you would set some top-level goals nationally that describe the level of ambition that society has, in this case, for the environment, but you would then translate that down on a catchment-by-catchment basis, to reflect local pressures on a river and local opportunities and enable different solutions to come forward depending on whether the catchment is on the outskirts of a city or in the middle of Cumbria, where the opportunity will be different.

I will perhaps give you one example of where it could work really well. One of the biggest environmental pressures we deal with is nutrients, particularly phosphorous, into rivers. The performance of the water industry on phosphorous has been pretty good. If you look at where we were as a baseline in 1995 and where we expect to be in 2027, we will have reduced phosphorous by about 90%, but clearly there is more to do

because it is a major part of nitrification, algal growth and all these other things in rivers that we need to deal with. What do we do about that?

We would love a plan for each catchment that says, "Here's the specific problem with nutrients in that catchment; therefore, this is the outcome that we're trying to achieve in response", which might be an X% reduction in phosphorous, nitrates or anything else. The point is that the regulators would then target that reduction and not necessarily prescribe the means by which we would deliver it, which would allow us, for example, to work with landowners, food and drink manufacturers, and the owners of septic tanks, in order to deal with that particular pressure in a way that delivered other benefits. We might build reed beds or other sorts of natural schemes that deliver benefits for birds and habitats, or we might just work with landowners, which might be cheaper, faster, more impactful and more reliable than a concrete solution.

The bit that we need to get right is not necessarily a question of statutory powers. Actually, the statutory powers are sufficient. It is a question of architecture, so it is joining up a top-level goal, which the Government set, which describes society's ambition and then allows a translation into that local catchment, accompanied by robust monitoring, enforcement and accreditation in order to make sure that we get to the outcome we have defined. Does that help answer your question?

Lord Cromwell: It does to an extent. I just wish you joy in getting all these bodies to sit round the table and come up with concrete solutions, if you would pardon the pun, rather than very fuzzy objectives. Anecdotally, I tried getting a catchment project together as a pre-runner of the ELMS work, which I am sure you are aware of. Somebody in the system, and I will not tell you which agency it was, said to me, "This is really all far too complicated. You don't want to bother with this". I think that is possibly what you are up against.

I come to my second question. Outputs tend to be measurable and operational, and the regulator to date, for better or worse, has some pretty clear ones about the quantity, quality and affordability of water as well as the infrastructure to provide it. Outcomes—and we are back to "fuzzy" again, I am afraid—are much more difficult to measure and feel to me more like national policy. Is this co-ordination of multiple actors, sectors, departments and organisations, and the prioritisation of the issues within that, something that government should be doing rather than foisting it on the regulator, Christine?

Christine McGourty: I will hand that one to Stuart. Stuart has been leading all our work on outcome-based regulation, and we published a vision 2050 for the sector in England, which featured this heavily.

Stuart Colville: It is a fair criticism to say, "You need something concrete to aim at", if you will forgive the pun. You need a specific number or thing that is measurable and precise in order to know whether you are winning or losing. The way to do that is to give an indication at that top level, national level, about your overall ambition and then

translate that into a number at that local level as well. This is the means by which you avoid this fuzzy ambiguousness: "Can't you just invest in habitats?" That would be too imprecise, so you need metrics and robustly monitored, accredited solutions that you know will deliver against that metric.

The role of national policy is not to say in every single river catchment, "This is the specific thing I want you to do, sitting here in Whitehall", because, often, that will completely miss the opportunities, constraints, circumstances and so on that exist in different parts of the country. I see the two things as compatible, but it is also a fair criticism to say we are not there yet. Everyone wants to move in this direction. To be fair, I hear this from Ofwat as well. It requires a certain creativity in the process that moves beyond where we have been historically.

Lord Cromwell: I am all for creativity. I worry how it matches up with metrics, but I have had my questions. Thank you very much.

Q56 **Lord Reay:** Good morning. The environmental issues that the water sector faces will require considerable investment, as we know. How much do you think this might cost, and will the private sector be able to finance this without public funding? Do you think that too much pressure is being put on the water sector in this respect? Is a more co-ordinated approach needed involving agriculture and housing, for instance?

Christine McGourty: You are correct: significant sums are going to be needed for the long term, looking at the National Infrastructure Commission's numbers in multiple billions for future resilience, for example. We do not have the exact sum; it will depend on the level of ambition. There has been a lot of talk about storm overflows, for example, which alone could be tens of billions of pounds. But the private sector has shown that it can deliver. Over £160 billion of investment has been delivered since privatisation. That model works and we do not foresee any call on the public purse.

However, what will be helpful is the interaction with policy. For example, if you want to make a big difference to the impact of storm overflows as quickly as possible, the best approach is not necessarily going to be throwing billions at concrete, but getting surface water out of sewers. Rainwater getting into the network is single biggest issue for overflows. I just make that point to show that, to your answer, we do not have an exact figure. The private sector stands ready, has delivered and intends to do so.

The amounts that will need to be spent can be minimised by the right public policy interventions and the right interaction with other areas of public spend, for example, on ELMS.

Stuart Colville: It is true that we do not need taxpayer money to duplicate what the water sector has shown itself to be very capable of delivering, raising huge amounts of cheap investment to push into resilience, environmental outcomes and so on. It is very important,

though, that where the taxpayer is funding a particular scheme or grant, and ELMS in the agriculture sector is the one that springs to mind, we design those policies in a way that complements the other sources of funding that are going into the environment.

In the case of agriculture, we do not want insufficient policy around the use of pesticides, for example, which leads to the use of pesticides in raw water sources that billpayers in the water industry then have to spend money cleaning up. Again, it is a question of joining up where there is taxpayer money going into the natural environment, and making sure that those policies are designed in a way that complements the large investment programme that the water sector itself is pushing forward.

Lord Reay: Christine, you laid out some scenarios. How ambitious should Ofwat and the Government be on this?

Christine McGourty: That is a really tough question and, ultimately, will be down to policymakers. The backdrop we are working against is one of acute affordability challenges at the moment. Everybody recognises that, so, really, it is for policymakers to set the ambition. We will work to that in the most cost-efficient way possible.

Lord Agnew: I wanted to challenge Christine's idea that the storm overflows might cost tens of billions of pounds, because I am interested to know what work they have done with the agricultural sector. For example, a farmer could easily offer up land from the middle of September until the beginning of March that could become a storm overflow reservoir for those few months, to take pressure off at that time of year. We are being encouraged to go for overwintering of stubbles and not planting autumn crops. It would be a great source of revenues to farmers, who are all losing their BPS, and would cost a fraction of the sort of numbers that Christine is talking about. Could you just expand on that a bit?

Christine McGourty: Yes, absolutely. I will bring in Stuart here, because Stuart has been a member of the taskforce looking at this whole area. You are right that working with other sectors—and farming is absolutely key, but others are too, such as developers—is going to be key to tackling this issue, which everybody wants to do. The water companies cannot do it alone. It is going to require working with those other sectors and some innovative thinking, and everybody will be up to that. It is really important to achieve the maximum at the lowest cost as quickly as possible. Everyone is very keen to do that.

Stuart Colville: Lord Agnew, you have given a really good demonstration or case study of why setting an outcome is much better than getting into the weeds of how something should be done. The setting aside of land to absorb rainfall, whether it is done at the level of the home by sustainable drainage or on a larger scale, is exactly the sort of thinking we need precisely in order to reduce those costs and have a faster impact.

Rather than going through the rigmarole of planning permission, giant storm tanks and concrete solutions, some of these sorts of schemes can be delivered more cheaply, quickly and potentially effectively than traditional solutions. This is exactly the sort of thing that we should be thinking about and is another reflection of that outcome-based thinking, rather than people in Whitehall trying to prescribe that we should build this precise storm tank in order to deal with the problem. It is exactly the sort of thinking we need.

Lord Cromwell: Do you have any numbers on whether all these nature-based solutions, farmers flooding their fields, blocking up their ditches and so on, are going to have a significant impact on the problem of overflows? I am rather dubious, I have to say.

Stuart Colville: I supported a piece of work with the Government to look at how we would radically reduce the use and impact of storm overflows. We considered the use of sustainable, nature-based solutions, in addition to traditional concrete and steel. We found that they could have a really important impact. In some cases, they will not be appropriate because, actually, they will push up cost, so there will be some locations where they just will not be the right solution. However, there is potential to do something at scale, which has never been tried in any country before at national level, to really make them part of the solution.

They will only ever be a proportion of the solution. Any environmental outcome that we care about, including storm overflows, will always require an element of investment in hard assets.

Lord Cromwell: I am sorry; that is exactly my question. Sustainable and all that sounds very nice and cuddly. Really, what proportion of the problem can you solve with reed beds and the like?

Stuart Colville: It is hard to give a definitive figure at national level because to do so would require you to model thousands of individual schemes. We have done work examining the potential to use sustainable solutions for 50% of the problem, which we found to be not necessarily the right figure because it seemed to push up cost. To be honest, you would be talking about a scale of effort that has never been attempted before, so all of our numbers on this are guesses extrapolating from individual examples. There is probably more work to be done to narrow the parameters around a precise role.

Often, that will not be possible until you get to regional level. You are looking at individual plans then for an individual river, and that is the level where you can identify the particular solutions that will be appropriate.

Q57 **Lord Burns:** Ofwat has published its draft methodology for the next price review, PR24. Could you outline for us the main changes from the previous price review? It is a very long document, and it is a very brave person who seeks to make their way through the whole of it, so it would be very nice to know from your point of view the main changes it is

proposing this time compared to the previous occasion.

Christine McGourty: I am not an expert in regulatory economics, so I will not try to summarise the whole 900 pages, but I can make a few high-level points that may be helpful. It was published only in the last few weeks and will take time to digest. Some early thoughts would be that it looks tough. It looks stretching. That is what you would expect. There are some things in there that are very good to see. There is support for the net-zero transition and nature-based schemes, which we have talked about, and an overall focus on the long term.

Beyond that, it is difficult to say what it will really deliver. Is it going to deliver the right level of investment in resilience and in maintaining healthy assets that we need for the long term? Will it deliver a package that maintains the confidence of investors, which we need to meet the challenges ahead that we have talked about? It is too early to answer on that.

Stuart Colville: Final business plans depend on more than just the methodology. If you look at the previous price control, PR19, the methodology is one thing, but you need the sort of decisions within that architecture to be pro long-term investment, pro long-term outcomes and so on. It takes you so far to make sure that the scaffolding is right, but we need to maintain sufficient momentum behind these objectives around long-term outcomes for society and the environment because the methodology on its own is not enough. It is necessary but not sufficient.

Lord Burns: My concern with it was that it talks about a number of key objectives, and, if I have interpreted it correctly, it tries to say that they are equally important and interdependent, and it does not really wish to prioritise them. Much of our discussion has been about trade-offs and the decisions that have to be made. Surely, there is no escaping trade-offs and, at some point, one has to make some decisions about where the emphasis comes. Do you think the outcome of this will be a change of emphasis away from bills and more towards these environmental issues?

Christine McGourty: That is what we would like to see, but I am not sure yet whether we are going to get that, so we will just have to wait and see. As my colleague Stuart said, it will be about not just what is in the documents but the decisions made in the coming years. There is a lot of rhetoric, as we have talked about, around the long term. Let us just see whether that turns into reality because, without it, there are going to be some enormous challenges ahead and increasing costs for future customers to bear.

Lord Burns: Stuart, do you want to add to that?

Stuart Colville: That summarises it well, actually.

Q58 **Lord Sharkey:** I would like to ask about social tariffs. We know that every company has a social tariff, but it is called different things by different companies and is calculated differently. Apparently, 75% of customers have no idea whether water companies will offer support with

bills, with the over-55s, perhaps not unexpectedly, being the least aware of this.

Could you explain to us briefly how social tariffs are decided on and whether you think a single social tariff should be introduced, covering all the water companies in England and in Wales?

Christine McGourty: The sound was a little strange, so I am not sure I caught your last few words, but I definitely caught the gist of your question. You are absolutely right. There is a vast range of schemes currently available to help customers. About 1 million people in all take advantage of them. The companies are required to follow guidance on this. There is guidance that support has to be specific to their local area, and they have to be able to demonstrate that it has the support and buy-in of their customers. That is why the schemes are designed region by region, and, as you say, there are some differences between them.

Now, as you say, the Government have indicated support for the single social tariff and the majority of industry supports that. The design of it is going to be really important. It will need to be carefully targeted and to ensure that the contributions from others to pay for it are reasonable. We have been working closely with the regulators, the Consumer Council for Water, government and others on this. Ultimately, it will be a matter of social policy; policymakers will have to decide what strikes the right balance between helping those who are most vulnerable and most in need, and the cost to other customers. We are hoping to hear more on that shortly.

Stuart Colville: A single approach nationally clearly offers some opportunity, but we also need to tread carefully. If there is to be a shift away from a company-led set of schemes to some kind of national arrangement, our advice to government would be to make sure that any decisions are taken in time for the next price review, PR24, so there are no operational issues, but equally that we tread carefully and do not inadvertently create large numbers of losers. If there is to be a transition, it needs to be a smooth one and we need to proceed with some caution.

Lord Sharkey: Are you in active conversation with the regulator or the Government about how to draw the line and where it should be drawn?

Stuart Colville: Lord Sharkey, you slightly faded out at the end. I think you asked whether we are in conversation with government and regulators about this issue. The answer to that is yes. In fact, we are supporting Defra in the modelling of options and scenarios, looking at how such a scheme might be designed if policymakers wish to proceed.

Lord Sharkey: You are waiting for a steer from the policymaker.

Stuart Colville: Ultimately, it will be a call for them and one they need to make reasonably soon.

Q59 **Baroness Taylor of Bolton:** Can we stay with consumers? I have a general point and then a specific one. Can you outline what you think the

actual state is of the relationship between consumers and water companies? How far are water companies succeeding in informing consumers about their own policies and approach? How far are they good or bad at listening to what consumers are thinking or are concerned about?

Extrapolating that, given the problems we all have in meeting future water demand and stopping damaging behaviours, such as flushing wet wipes, are the water companies expecting consumers to do more while not actually helping with the information? It is a very topical question in a way. Given the current heat and global warming, these issues are going to get more difficult in the future. Can you give us some feel of where you think we are on those issues?

Christine McGourty: Customers are absolutely at the heart of everything the companies do. They take that relationship extremely seriously, both in service delivery on a day-to-day level and in strategic planning for the longer term. They have to put, and they do, customer views at the heart of all their decision-making. Many of them interact in multiple ways. The communications take every form, in particular social media—more and more these days—but every company has its own schemes to highlight water demand. You touched on that.

We have supplemented that by running a national-level campaign, which was introduced a few years ago, as an umbrella and in order to add extra value and a national message to underpin the very tailored regional campaigns. It is called Water's Worth Saving. The reach of that alone this year so far has been of the order of 5 million, so that has been a very welcome new development as a supplement to what the companies already do.

As there is on water demand, there are similar campaigns on, for example, wet wipes. We all know they are responsible for a huge number of problems with the sewer network. Some 90% of these dreaded fatbergs are made up of them, so many of the water and sewerage companies have their own campaigns on exactly that issue. We are going to supplement that with a national campaign which we will launch later this year. The companies are doing a huge amount—more and more. The customer interactions and customer research they do have increased year on year.

With some of the things—we have talked about the water demand and the wet wipes—the companies need help and support from policymakers. When it comes to water demand, for example, we have been pressing for some time to see water efficiency labelling of white goods. We are all used to seeing it in the world of energy where I used to work, but we are not so used to seeing it when it comes to water efficiency and minimum standards on water-using products at home such as showers and taps. The companies are doing a lot and there are additional things that policymakers could help with too.

Stuart Colville: If you look back two or three decades, the water industry was probably quite traditional. With perhaps some exceptions, there was limited interaction—"We'll come and tell you if there's a problem"—on a sustained aggregate basis across companies. That has completely transformed, thanks to both the work of the companies themselves and, to be fair, Ofwat, which has also emphasised this aspect over the last decade or so.

There is now far more engagement and interaction at every level. That applies to the creation of business plans, for example, where there are huge amounts of activity, testing customer views, customers' willingness to fund a particular outcome and how the different outcomes trade off, all the way through to incentives on companies to add those who are in need to their priority service registers and to accurately capture those who might need additional help in the event of supply interruption. At every level, there has been a complete shift. This is now fundamental to how water companies are operating their retail business.

It is fair that we can always provide more information, and clearly that will continue. If you look at international comparators, we fare pretty well on that, but there is more we can do.

Finally, on the behaviour change point, this is a very exciting area where we have been ramping up our activity both at a company or regional level and at a national level. We need to go further still. If you look at the drought challenge that is facing us as we approach mid-century, a third of the new water that we need to find has to come from water efficiency and reduced demand. That is according to the National Infrastructure Commission, so clearly, we need to continue to ramp up those efforts. That is a focus for us as well. I would characterise it as a real shift in recent decades. There is some exciting work going on now, and there is more to do, particularly on that behaviour change side.

Baroness Taylor of Bolton: As a consumer, if I put that hat on, I have to say that I think there is still very limited interaction with many consumers. Certainly from my experience of the water companies, my interaction is getting the bill and paying it, and that is probably the end of it. I hear what you say, Christine, about how consumers are at the heart, but you also want to put water bills up. You have said the balance needs changing, given the backlog of underinvestment, and current consumers have something to pay for that. There is going to be a lot of resistance unless people actually understand what is needed and why it is so vital that this investment takes place. Rather than us all getting our information from the BBC or the documentaries on this, surely the water companies have to have another step change if, as you say, there has been one in the past.

Christine McGourty: I am sure there is a lot in that. As Stuart outlined, they are doing more now than they ever have done. You are right that the challenges are only going to increase. I am sure we will see more of it and more innovative ways of targeting customers with both information and education about their own use of water and the value of water. The

Consumer Council for Water has also expressed an interest in that, and it is doing some work in that area. It is something that all of us—the trade association, companies and the consumer body—can probably work on together.

Q60 Lord Agnew: Christine, we have heard criticism of water companies for increasingly leveraging their balance sheets to pay out to dividends and, indeed, even bonuses, with some suggesting that that money would be better used for investment in the infrastructure, which you have said is needed. What controls are in place on dividends in the water sector? Do you worry that limiting the amount paid in dividends will make the place a less attractive investment proposition?

Christine McGourty: It is worth saying that the model of companies raising that mix of debt and equity finance has delivered benefits. We have seen the £160 billion of investment that has transformed the performance of the sector over the last few decades, and it is the dividends that enable the equity that funds the investment. We need to attract finance from the global capital markets, and that requires a reasonable return, so there is absolutely a balance to strike. Given the challenges ahead, we need to ensure that we can continue in the UK to attract the finance that is needed in future.

Lord Agnew: Are there any useful lessons to be learned from the example of Welsh Water, which is run as a not-for-profit, with the profits wholly reinvested for the benefit of consumers rather than paid out as dividends?

Christine McGourty: Welsh Water is really interesting. At Water UK, we have members from all nations of the UK; we are very pleased to have Welsh Water, Northern Ireland Water and Scottish Water as members, so we are neutral to the model. Welsh Water has clearly made a success of that model. We do not see any particular lessons there for the English model, which has worked successfully. One interesting observation would be that they have good strategic join-up between policymakers, regulators and the company. I am sure that is helpful when it comes to addressing the challenges we have talked about. Those big strategic challenges for the environment, climate change and resilience are the same whatever the model, so they are faced equally in Wales, Scotland and England.

Q61 Baroness Donaghy: Good morning. The committee has heard a lot of evidence about the almost routine use of storm overflows when they are envisaged to be used only in exceptional circumstances. How was this situation allowed to develop, and what share of the blame for the current situation rests with the industry, the regulator and the Government?

Christine McGourty: I will make a few comments and then bring in Stuart, who has been sitting on the government task force looking at this precise issue. These combined sewer overflows are a legacy issue in the UK, in Europe and around the world going back to before the 1970s. They were intended as a safety valve and played an important role there.

When the sewerage network became stretched, having those overflows avoided flooding people's homes with sewage. That is the history.

Everyone wants to see action here. The companies are doing their bit, but they cannot solve it alone. Of the order of £1 billion is being spent in the current five-year period, but certainly there is more to do, and it is a complex problem. I will bring in Stuart, who I am sure will have further to add.

Stuart Colville: It is useful to reflect on that historical point. From, I suppose, the great stink of the 1850s all the way through to 1965, these things were routinely inserted into the construction of sewers, which has left us with this legacy now to deal with. We have around 100,000 kilometres of combined sewer, 15,000 overflows, and over half of today's housing stock has a combined drain that collects rainfall and waste from the home. When you look at the problem, it is worth bearing in mind that scale of challenge in terms of how we deal with it.

Public concern on the issue is very clear. The water industry is under no illusion about the seriousness with which the public take this issue. That is a reflection of both increased environmental awareness and the fact that we are one of the first countries to monitor overflows properly with event duration monitors, which has exposed this issue. There are, I think, 650,000 overflows across Europe, but we are one of the first countries to try to pin down that problem.

With the challenges of climate change, fat, oil and grease, and wet wipes, none of which were necessarily being borne in mind when these things were first designed, clearly, we now need to tackle these issues. The answer to tackling them is new statutory targets, which Defra is consulting on, but also investment on the back of those targets as well as some support from government.

The task force that Christine mentioned has made five specific recommendations about legislative reform, everything from the repair of private drains, for example—most drains are privately owned and not owned by water companies, so we cannot currently get in there to repair these things and they get inundated with water, which then causes overflows—all the way through to right to connect. That is the ability of developers to connect more and more housing to sewers regardless of the degree of loading they already take.

There are some things that the water industry clearly needs to do and some action for government as well. Referring back to a previous question, more support is needed for customers to understand how some of their behaviours, whether around fat, oil and grease or wet wipes, can exacerbate these challenges. There is an obligation on water companies to help explain that and make sure that that is corrected.

Baroness Donaghy: You said that this is a historical problem throughout Europe. In your written submission, you said current levels of asset replacement are not sustainable and well below the levels in comparable

European countries. The Environment Agency's annual water and sewage companies performance assessment for 2021 found that the performance of the companies fell to the lowest level that we have seen under the environmental performance assessment reporting. What explains this systemic, industry-wide underperformance? Why are we worse than the rest of Europe?

Stuart Colville: The report you mentioned from the Environment Agency, the environment performance assessment, is deeply uncomfortable reading, because there are some statistics in there that are clearly unacceptable. In particular, the total number of serious pollution incidents this year was at a level that it should not be at. In the last few years, we have seen some of the lowest ever serious pollution incident numbers on record, so it was particularly disappointing to see that metric this year.

There are some bright spots. Three of the companies this year scored the highest possible rating, but, overall, it was not where we wanted it to be. I can say for sure, because I have talked to them, that the water companies see this as their most important challenge—to make sure that the trend of recent years, particularly that improving pollution number, continues in future and that we get that back next year.

Christine McGourty: Every company has a pollution action plan. They are all committed to making progress on this area. As Stuart said, zero serious pollution incidents is the challenge for 2025. There has been a lot of progress; the trend over time is positive. Serious pollution incidents are down, I think, 90% since the 1990s, but, as Stuart said, it was really disappointing to see this year's results. Despite those four star performers, it was a drop on last year's when five companies achieved the highest ratings, so companies are now absolutely focused on turning that around for next year.

Baroness Donaghy: What about the European comparators? Is that something you spend time on?

Stuart Colville: The reality is that we tend to monitor far more and are more transparent, across the UK but including England, than some of our European comparators. I sit on the board of the European federation of water industries, and we have these conversations all the time. The challenges are identical, but often the problem is not as visible.

If you look at the Danube or some of the industrialised water bodies in continental Europe, they have plenty of problems with overflows, pollution and so on. They do not necessarily have the same robustness of independent environmental regulation, the same data that is readily accessible to the public or the same strength of civil society. We know that environmental NGOs in this country are particularly strong, which often, rightly, lends light to some of this.

We do compare these things. Because pollution incidents are defined differently in different countries, it is hard. You have an apples-and-

oranges problem, but we do benchmarking studies. Those that we have done suggest that, on leakage, for example, which tends to be easier to compare, we perform pretty well. If you look at investment numbers compared with our continental peers, again, we tend to be up there at the top of the rankings in the amount of investment going in. It is hard to compare, but we do look at that benchmarking. If it would be helpful and of interest to the committee, I would be very happy to provide that data.

Baroness Donaghy: I think it would be interesting.

Q62 **Baroness Bowles of Berkhamsted:** Against the defence of the industry, if I could put it that way, that you have just made to Baroness Donaghy's questions, not all our witnesses would necessarily agree with that because they have suggested that regulatory and criminal fines are seen by water companies as the cost of doing business rather than a real disincentive. Do water companies truly fear the consequences of regulatory action? Is that a fear of the financial consequences or merely a reputational one? In other words, do they change behaviour as well or do they say, "We've still got a plan and we're sticking to it"?

Christine McGourty: They absolutely do fear those fines that you have talked about. The regulators and courts have taken really tough actions against companies in recent years, and the financial impact can be severe. In recent years, we have seen fines of £20 million and then another fine of £90 million. The financial hit of fines such as that is severe. The reputational impact is also severe and long lasting, so nobody wants that. I know that companies and their boards take it extremely seriously. It has been demonstrated, the power that the regulators and courts can wield, and that they are not afraid to use it.

Baroness Bowles of Berkhamsted: It may be the case that they fear them and do not want them, but water companies are a natural monopoly within their areas, so I am not entirely certain what the consequences are. Maybe that kind of thought is in the mind of the Environment Agency, because it is now calling for prison sentences for chief executives and board members whose companies are responsible for the most serious incidents. It has also called for company directors to be struck off so that they cannot move on in their careers after illegal environmental damage.

Yes, they are the most extreme potential consequences, but it must indicate that fines are not necessarily working because things are not being corrected fast enough. Would you agree with that?

Christine McGourty: The level of fine and the sentencing you referred to are matters for the regulator and the court. Here, as the trade association for the industry, we do not have a view on that. The regulators and the courts have extensive powers, and we have seen that they are not afraid to use them.

I can assure you, because I talk to them all the time at every level in a company, right up to boards and chairs, that the issue of the

environment, which we have talked about so much today, is absolutely a number one priority. They take it extremely seriously. It impacts their bottom line. It impacts everything they do, their people, their reputation, their relationships and their ability to do business. They take it extremely seriously, and these regulatory and legal actions are having a very big effect.

Baroness Bowles of Berkhamsted: Have companies lost investors as a consequence of such actions?

Christine McGourty: I do not know the answer to that question. I could try to find out and come back to the committee, but I am not aware.

Baroness Bowles of Berkhamsted: It would be good to know what the consequences are. If it just that the bottom line is affected but the investors put up with it, and there is a red face here and there but nobody has been sacked, that is not a very good effect of a fine. If there are significant knock-on effects, what happens subsequently would be interesting to know.

Christine McGourty: I do not know the answer, but I think that you are talking to the representatives of the investors shortly. I am sure they pay close attention to this issue too.

Stuart Colville: The whole point is to avoid the need for enforcement. There are a few things that companies are doing now that need to continue. That is better management of the network, so we are seeing more data, telemetry, analytics and condition-based maintenance instead of time-based maintenance, which is a more modern way of doing it. That journey probably started about five years ago and will continue, so we need to really crack on with that.

There is this question about investment in ageing assets, which will be a major issue. We clearly need to tackle some of the creaking Victorian infrastructure in PR24, particularly given population growth and climate change. That will be a priority. Then, referring back to a previous question, there is this issue of helping customers understand what is and is not flushable. There are 300,000 blockages every single year, and £100 million is spent cleaning them up. That is a major part of making sure that we have sewers that are operating as they should be.

Yes, there is an enforcement piece, but clearly, we want to avoid getting there. Actually, looking at some of the long-term trends, I am confident that companies are doing the right things in order to avoid getting there in the first place.

Q63 **Lord Blackwell:** I wanted to come back briefly to this question on the scale of investment required. You have laid out huge challenges facing the industry. It is inevitably going to take substantial investment to deal with maintaining the supply, improving wastewater management and the environmental issues. Although, Christine, you did not want to put a number on it, you were confident that the private sector could fund that.

Plucking a number out of the air, given the scale of the Tideway, for example, another infrastructure project, it would not be surprising if you were talking about investment, industry-wide, approaching £100 billion. If the private sector pays for that, it will expect a 9% return, which would be a £9 billion addition to bills. Total industry revenue—you will know, but I would guess—is about £15 billion, so it would be something like a 60% increase. Is the current structure—regulator, government and industry—up to facing the challenge of putting bills up by 60% to pay for what is required?

Christine McGourty: Those are some very big numbers you have outlined, which highlights the scale of the challenge, so it is going to take a lot of work. Industry, regulators, consumer groups and policymakers need to move forward in the right way to ensure that we get the investment that is needed and that what is needed is done in the most efficient way possible. That is going to be absolutely key. If all the stakeholders involved in this proceed together collaboratively and at the right pace, I hope we will reach the right outcomes for customers, communities and the environment.

You are absolutely right. The toughest challenge facing the industry and the sector at the moment is squaring the circle on the affordability crisis and the investment challenge. There are no easy answers.

Lord Blackwell: I just wonder whether this discussion is being faced up to in the conversations you have with the regulator and the Government.

Christine McGourty: Certainly, the rhetoric and the conversations suggest everyone recognises the challenge. We need to move quickly. We do not want to waste the current decade, then have more to do and push the problem out to future generations, so we really need to act now. With the right decisions from regulators and policymakers, and the companies taking the right action, I hope we will make progress.

Q64 **The Chair:** Christine, as a final question, might I come back to your comment about a “reasonable return”? The cost of this will, in part, have to be borne by the consumer. The questioning today has really been about how much more the consumer can take, particularly at this time. Really, the issue is also what a reasonable level of return is. Quite a lot of the evidence we have had has suggested that the returns that have been achieved are somewhat in excess, in some cases far in excess, of the expected rate of return. Obviously, that is a complicated calculation because, as far as I know, expected rates of return are not made public. Perhaps they should be.

The structure of the industry is that, if significant investment is being made—and, by the way, numbers up to £600 billion have actually been mentioned—that becomes part of the regulated asset base on which a level of return is allowed. In some ways, there is an incentive to raise money, invest and get a return on it, particularly in a very safe monopoly structure that exists in this industry. What would you regard as a reasonable rate of return?

Maybe this is a question to Stuart. Having regard to the fact that returns have been seen and judged to be too high, should the industry not recognise that and anticipate a lower level of return for putting up this additional funding in order to get the infrastructure in good working order?

Christine McGourty: I was going to come in with a couple of recent data points. Certainly, to look at a couple of the most recent numbers, they would show that the average industry dividend yield over the last two years is at 3%, so that is not out of line with Ofwat's own PR19 price determinations. In the last year alone, three companies paid no dividends. Of course, that varies from year to year. In the last year, it was something like nine companies either losing money or failing to achieve their base return.

Those data are in the public domain, and I would argue that they show that those rates of return over the last few years are reasonable. As I said, we will need to attract the finance we need from those global markets. We need that in order to address the challenges we have already talked about. That is what I would say on the question of returns.

Stuart Colville: The financial performance of companies over the last couple of years does not quite match some of the stereotyping that you might encounter in the media, for example. I think, in financial year 2020-21, the total return on regulated equity was at 2.3% or something of that order. Now, there will be variation between companies of course, but, as an average, it does not necessarily paint a negative picture.

This issue is clearly of a lot of importance to the regulator as well as the industry. The regulator has been pushing down the cost of capital and effectively the assumed return for companies, pretty much price control by price control, in recent history, so it does not add up to the kind of picture that you might encounter in the media.

The Chair: Thank you very much indeed for that. Thank you for your very clear answers to all these issues and for joining us today.