



HOUSE OF LORDS

Industry and Regulators Committee

Corrected oral evidence: The work of Ofwat

Tuesday 25 October 2022

10.30 am

Watch the meeting

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

Evidence Session No. 11

Heard in Public

Questions 119 - 130

Witnesses

[I](#): David Black, Chief Executive Officer, Ofwat; Iain Coucher, Chair, Ofwat.

Examination of witnesses

David Black and Iain Coucher.

Q119 **The Chair:** Good morning, ladies and gentlemen. I welcome our two witnesses to today's meeting, which is the 12th meeting of the 2022-23 session. We are delighted to have with us the chairman of Ofwat, Iain Coucher, and his chief executive, David Black.

Gentlemen, you have probably been following our inquiry. I guess that it will come as no surprise to you that there is some dismay at what is seen as a lack of regulatory toughness in challenging the water companies over the last five to seven years. A couple of weeks ago we had a discussion with the Environment Agency, which came in for a similar level of criticism. What we want to do today is to understand how we have ended up where we are and what your plans are to move things forward in a more acceptable way that, hopefully, will recover the public's support for the water industry and its regulation. That is our agenda for today.

I start with a question about your remit. Are your powers adequate for the task? In particular, do you have in mind taking on some extra powers so that you can take a more active, direct and, perhaps, forcible role in ensuring that the environmental problems that we have—leakages and things like that, which are inherent in the system—can actually be resolved? It is an invitation to you to name any further powers that you think are needed and appropriate.

David, let me start with you. Iain is a new boy and can give us his initial reflection, but you have been around for quite a while. Do you feel that the remit and the way the regulatory system works is satisfactory and up to doing the task that it should be doing?

David Black: First, thank you for the opportunity to appear this morning. At the most recent price review, we set the ambition of seeing transformation in the sector's performance. We did not think that the sector was in a good place at that point in time. More importantly, we did not see it as being fit to face the challenges of the future. We took steps at that point to set expectations of much higher performance from companies. To date, we have seen some improvement, but we are still some way off the challenges that were set at that point in time, and they will only grow further.

You ask about the remit of Ofwat. As you heard from the Environment Agency last week, three regulators work in conjunction in the sector: the Environment Agency, the Drinking Water Inspectorate and Ofwat. We think that there are significant opportunities to improve the co-ordination of the planning process in future, particularly around environmental investment. The committee is very familiar with the issue of sewage discharges. That is an area that was not monitored until quite recently, but there are clear indications of the scale and size of the problem, which requires major investment and a major performance improvement from the sector.

With regard to specific powers, the Government have significantly enhanced our ability to change licences. That came into effect in 2021. We are in the process of using those powers. We are strengthening our ability to regulate financial structures in the sector and the payment of dividends, and will look at customer protection as our next step. That is quite significant.

We are looking at the powers to fine. We have the ability to fine companies 10% of their turnover for enforcement breaches. That is quite substantial, but these are asset-intensive businesses, so we think there may be further scope for change. There are also some issues with the price review appeals process, which the Government are looking at. It needs to be streamlined, with more focus given to customers in that process. I will stop there.

The Chair: Do you feel that the Government are sufficiently involved in the arrangements around the price review? Should the Government become more involved? Was it essentially a political decision? Are you in the uncomfortable position of having to take what is essentially a political decision about a trade-off between, say, price and investment levels? You have talked about getting involved very much in intervening on dividends and pay. Is that something that the regulator should be doing or something that the Government should be doing?

David Black: One thing to appreciate about the environmental decision-making process is that there is already substantial involvement via the Environment Agency. At the last price review, PR19, the direction was set not just by the strategic policy statement but, as you heard from the Environment Agency, by the water industry national environment programme. That set out 11,000 schemes that were put to Ofwat as part of the business plan.

There is an argument about balance. We are looking for the Government to set out the outcomes they want to see from the sector, and we are starting to see that in the form of the national environment plan and the storm overflows plan that they have set out. It is very much about having clarity on outcomes that are expected from companies and then greater flexibility in the system to get the best value means of delivery. That would be helpful. There is a balance to be struck, but I think that the role of the Government in the process is more intrusive than it looks from the outside, if you look just at the SPS and Ofwat's role. Every environmental investment scheme that was put forward at PR19 was designed and developed by companies and the Environment Agency. That is the way the process works.

The Chair: And signed off by the Government.

David Black: The sign-off process is a matter for the Environment Agency, but there is the ability for the Government to sign that off, if they choose.

The Chair: Iain, as a new arrival, how do you find the relationship with,

on one hand, the Government and, on the other hand, the Environment Agency? Is there adequate clarity?

Iain Coucher: It is right that society and consumers expect the regulatory community to work together very closely. That applies not just to us and the EA, but to the Drinking Water Inspectorate and everybody else. It is right to expect that that is integrated and joined up.

As David said, there are good working relationships with the EA. The process by which all environmental schemes are discussed between the water companies and the EA is the way in which priorities are set. Ofwat's role is to make sure that those schemes, having been signed off by the EA and the Government, are delivered cost effectively and efficiently by the organisations. It is not our role to challenge whether they are necessarily the right or wrong things to do; they have been through that process.

I am technically on day 50 but, as far as I can tell, the process seems to work very well. I have spoken to the EA several times already to try to ensure that we are aligned, particularly as we look to the future, because the future will see significantly more investment in the environment. That may well cause the Government to get involved in decision-making or balancing between investment and bill payers. So far, it has not been the case. We absolutely need to be aligned to make sure that people understand the relative prices of those things. That is what we will do.

The Chair: Sticking with powers, when we talked to the Environment Agency, there was a degree of recognition that the ability to take away a licence if there was persistent bad behaviour—underinvestment and overpollution—might need to be revisited. In the mists of time, that was a power that regulators had, but they do not have it now. Do you have a reaction to that?

David Black: To clarify, there is the power to invoke special administration. It requires the approval of the Secretary of State and the High Court. There is a process. The burden—or barrier—of proof is high, but that process is there.

We have come close to looking at the need to do that. It is no secret that the case of Southern Water and its particularly poor performance on pollution and misreporting saw fines and penalties from Ofwat of over £127 million and £90 million from the courts from Environment Agency action. As a result of those actions, we looked to the company to turn itself around and to enter a transformation process. One aspect of that was support from shareholders. The existing shareholders were not willing or able to put in extra funding. Ultimately, they exited as controlling shareholders and a new shareholder has entered.

The power of special administration gives the right to change owners, which could lead to changes in management, but there are a number of ways to achieve it. The point you have to come back to is that you must

still solve the fundamental issues facing the company on behalf of its customers.

The Chair: Do you think that the powers currently in place are sufficient deterrent to the companies against persistent bad behaviour?

David Black: As I said, we are seeing very serious challenge to companies and their investors from the penalties that are being imposed by both Ofwat and the Environment Agency. It is now getting very painful for shareholders. We are seeing changes, and I think that we are now seeing arrangements that impose significant costs on shareholders, loss of value and, ultimately, the ability to exit shareholders and enter new investors.

Q120 **Lord Reay:** Thank you for hosting some members of the committee in Birmingham earlier this year.

We have heard quite a bit of evidence that, in the past, Ofwat has tended to prioritise keeping bills low, which has been achieved relatively successfully, but at the expense of adequate investment in the sector's infrastructure assets. How do you respond to that comment? Do you accept that the balance will have to be remedied at the next price review in order to deliver environmental improvements and increase future water supplies?

David Black: I do not think that it is right to characterise Ofwat's focus as being on low bills. I can point to the 2019 price review. We did not reject a single scheme on the grounds of affordability. As discussed, in the environmental investment process the need for investment is decided by the Environment Agency, rather than Ofwat.

Bills have fallen in recent price reviews. That has been due to the fall in the allowed returns, with lower returns for shareholders. We think that is absolutely right, but it was not at the expense of investment.

The outcome of the price review process very much depends on the business plans that are put to us, the scale of the environmental investment specified by the Environment Agency and the business plans that are put together by the companies themselves. At recent price reviews, there has not been a need to constrain investment plans for affordability or other reasons. It may be that, looking ahead, significant increases in investment will be required. I do not think that that is any secret when we look at the work that is being done by, say, the Storm Overflows Taskforce. Substantial new investment is required, which may well impact on bills, depending on the other elements of the package.

It is wrong to characterise Ofwat as holding back bill increases in previous price reviews. We have challenged companies to be more efficient, and rightly so. We have demanded better performance from the costs that customers are funding, but we have not pushed back on major investment propositions. In fact, we take very seriously the duty to future customers. At the last price review, for example, we provided extra funding for companies to prepare and develop new water resource

schemes because we looked ahead and saw the need for those schemes, and we did not see them in company business plans.

Lord Reay: Iain, would you like to add anything to that?

Iain Coucher: I have looked at the process by which we determine the regulatory framework. The companies submit their business plans. On a steady-state basis, these companies are operating and maintaining assets, and the costs associated with that are very predictable. We can understand how much investment is required to replace exhausted and tired assets to maintain the base as a whole. As David said, we challenge people to be more efficient and we expect incremental improvements in performance and efficiencies.

That is relatively straightforward. We can do that quite accurately, and we can look at the underlying expenditure. Then we look at all the incremental investments that have come forward, either through the environmental schemes or through specific schemes to improve resilience or capability. We add it all together and then produce what the bill expenditure would be to support that.

As David said, we have not refused any requests to fund. A couple of times we have said, "We think you can do it more efficiently; you can slow it down slightly or bring it forward". We can juggle it around, but we have never said, "You should not invest". The focus on bills has come down for two reasons. First, we have required greater efficiency from the water companies, which they have delivered. Secondly, the better financing arrangements that we put in place over the last periodic review meant that bills have come down. It is wrong to characterise it as a focus on bills. The outcome has been bills being held, but it is not the case that we have held back investment.

Lord Reay: I appreciate that it is early days, but what percentage increase in investment do you think we will see at the price review, relative to the last price review, in order to rectify the problems caused by lack of historical investment in infrastructure?

David Black: I do not think that we can say at the moment what the scale of investment will be. The Government's storm overflows plan talks about £54 billion over 25 years. That would in itself be a doubling, roughly, of the level of environmental spend, but that is certainly not the limit of environmental spend. There will be more on top of that because it is only one of the environmental issues facing the sector. That is new spending that needs to be addressed and which will be addressed, as set out in the Government's storm overflows plan.

Lord Reay: Clearly, it will be difficult to increase water bills to pay for future investment during a cost of living crisis. Is more support needed for water company customers? Should there be a single social tariff or water affordability scheme? It is difficult to draw the line for who should receive support. Is it fair to ask other customers to bear the cost of such support?

David Black: This is a real issue. All our research suggests that customers are facing a very tough time, and this was prior to the impacts of the most recent cost of living increases. Customers are struggling to pay bills. Something like 50% of customers we surveyed were struggling to pay a bill. I am talking not just about water bills, but bills across the board.

As regards help for customers, all companies have social tariffs. That has been an important step forward. We think that more can be done in this space. Along with the chief executive of CCWater, the consumer body in the sector, I have written a letter asking companies to think about how they can provide further assistance as the next annual bill comes out in April next year. More needs to be done. We welcome the fact that some companies have put shareholder funding into this—that helps. You are right that the social tariffs are funded, effectively, by one group of customers subsidising another. That is where the Government have a key role to play. They have set guidance for companies on the amount of cross-subsidy that is available for social tariffs. That is the steer we are looking to.

You asked about a single social tariff. We think that there would be significant gains from standardisation across companies. Each company has its own social tariffs. Each of them varies in the way the assistance is provided to customers. That assistance is not well known, so many customers are unaware of it. We think that there would be considerable gains from standardisation.

A single social tariff implies transfers between companies, across company boundaries. Rightly, that is a call for the Government to make. It is my understanding that their intent is to have a single social tariff from 2025. If that is the case, we will implement it as part of the next price review.

Iain Coucher: We are acutely aware of the impact on consumers and bills. This is a really difficult time for all consumers. As we look forward to the next price review, which takes effect from 2025, we cannot necessarily hope for an abatement to the cost of living crisis. It is going to be there for a while.

As we look at our investment plans in discussions with a company, we are very aware that some of the environmental improvements that we want would have an upward impact on bills. We do not want to get to this time next year, having scaled up all these things, only to say, "It's unaffordable". We need early conversations with people as to the scale of ambition when it comes to environmental investment and what that will do to consumer bills.

We have the ability to sculpt things, to move things around and to push them towards the back end of the 2029 or 2030 timescale, to ease the early years or to push things into future years, but it is a real issue for the sector at the moment. There is a lot of incremental environmental expenditure coming through. Last time it was £10 billion. It is going to be

more than that. It will add pressure. We want to have a conversation now, rather than at the back end of next year.

Lord Eatwell: David, can I follow up on something you said? Maybe I did not catch it right. You were asked about the level of investment and you said, "We are not sure what the level of investment will be". That sounds a remarkably passive position. Do you not have a view on what the volume of investment should be? After all, this is an industry that has been characterised by significant underinvestment. That has got us into the mess we are in right now. Is it that you do not have the powers to say what the level of investment should be, or is it that you are simply not doing that?

David Black: First, I would disagree with the contention that there has been significant underinvestment historically. Upon privatisation, one of the first steps in the regulatory regime was to step up the level of investment to ensure that assets were—

Lord Eatwell: That is because in the previous five years it had been artificially low. Everybody knows that. In the previous five years it was artificially low, and then you had this sudden up-step.

David Black: No. Let me go back a bit. Companies are responsible for putting together their business plans. It is their responsibility to develop a business plan that they think reflects—

Lord Eatwell: With no signals from you?

David Black: We ask them to address issues. We are focused on outcomes for customers. In this case, we are talking about improving the environment. The Government have set out their storm overflows plan, so that will set the direction in that space. As we have discussed, the environmental investment flows through from a process set by the Environment Agency. Then you have a residual array of expenditure in areas such as improving resilience of networks. We provide guidance to companies on our expectations of what they are going to look at in their business plan.

The reason why I say that we do not know what the level of investment will be is that, although we have some idea of the work that is being done in the environment space, as we have seen draft national environment plans being put together by companies, we do not have the whole picture yet. We have not seen a business plan from a company. That will tell us the scale of the investment.

On the point about underinvestment, it is the case that there was not a plan to improve the operation of storm overflows. There was investment made at PR19 on that basis, but clearly there was not sufficient investment. That is ultimately the responsibility of companies to put together and to put to us. Companies operate their assets and make their investment plans. It is our role either to improve or to amend those plans.

Iain Coucher: I share your concern, Lord Eatwell. I have been asking the very same questions about investment in the sector. Immediately post privatisation, there was big investment in the core infrastructure. There may well have been underinvestment before that, but there was certainly a higher level of renewals activity in the core asset in the early years. That may have been to catch up on what had happened before, but it went up.

Over the last five or 10 years, that has normalised back to where we would expect to see the underlying investment in the core asset. For mains renewals, it should be around 0.6% by volume. That is a bit lower than the European median, but in part that is because we had a big push in the early part of privatisation. We feel comfortable that renewals of about 0.5% or 0.6% are about the right level. We have funded them on that basis.

To your earlier point that we should have some idea, we have some very good ideas about what investment plans will be going forward. We know the underlying investment in the asset. We can quantify quite precisely what we believe the outturn investment cost will be for the schemes that are under discussion, but those are our estimates. Really, we want the water companies to come forward and say, "This is what we believe the cost of a new reservoir or a new connection would be, or what the cost of addressing our share of the storm overflows will be". We have some numbers and can be quite clear about them, but they are only our good estimates. We want the water companies to come forward. We are acutely conscious that some of the increased environmental expenditure will affect some water companies much more significantly than others. Those are the areas we are particularly concerned about.

Lord Burns: My question is similar to that of Lord Eatwell. I cannot quite understand this: you said that you have not turned down any investment projects, yet almost everybody thinks that, in hindsight, there has been underinvestment in the water industry. How can we put those two conflicting views together? Is it something to do with the whole set-up, the time horizons over which the price reviews and the regulatory arrangements are taking place? Is it because somehow an atmosphere is being created about the relative priorities of investment versus bills?

There seems to be general agreement that the problem with storm overflows is a very long-term problem and that it will take a great deal of money to resolve over a period of time. How does one set that alongside the fact that you then say, "There hasn't been underinvestment"? Everyone we have seen and who has come before us has implied that there is a long-term problem of investment in the industry and that, ideally, we would not be starting from where we are today. How do you get consistency between that view and your view that you have not turned down any projects? Is it just the regulatory environment that is creating this inconsistency?

David Black: One answer is that the investment had not been identified and proposed before. You are right to say that investment needs to step

up to address the storm overflows issue. That is an area that is not disputed. We would also say that, setting it alongside other environmental issues, it will mean a significant step-up in investment. The question is whether those investments should have been made before. There were no proposals to make that level of investment historically. The focus was on targeted improvements, and improvements were made.

Lord Burns: Why do you think that was?

David Black: Because there was not the data. The monitoring was rolled out from 2014. I think the sector has been very slow to identify the early signs that more investment needs to be made. That was the key missing information. The sector did not have information on the extent of the use of overflows. That has revealed that there is a need for a major step-up in investments, which will now take place.

Before that, at previous price reviews, it would have been quite difficult, without that information, to design an effective system of mitigation for storm overflows. Companies could have come with proposals. Work was definitely done, but work on the scale that is being talked about now was not scoped and designed. It required information, and monitoring had to be installed before we got to that point.

Does that help? We agree that there needs to be a major step-up in investment and that that was not scoped in the past, but it was not because Ofwat looked at an investment proposition and said, "No, don't do that". It was because the investment proposition was not sent.

Lord Burns: You are now throwing all the burden back on to the absence of monitoring, but monitoring itself was an investment. I know that doing it was a very expensive process. That is the only way I can understand that. Why was this monitoring not put in place at an earlier stage? The technology existed; it was not that there was an absence of technology.

David Black: In some senses, the technology has developed, which has enabled the monitoring to take place. There are 15,000 sites, some of them quite remote. I am not sure that the technology existed many decades ago; it is relatively recent.

It was not seen as a priority, which is a concern and rightly so. This may be a bit simplified, but if you look at the priorities for investment as I would characterise them, you see that the investment post privatisation was very much about reducing nutrients going into rivers from wastewater treatment works, where quite major reductions were made, and about bathing waters, with a focus on beaches. That is where the improvements were made. There was relatively little focus on rivers. That is very clearly where the focus is now.

Lord Cromwell: In sum, you are saying that priorities have changed and, therefore, investment proposals were not coming forward in the previous period when the emphasis was not on the environmental aspect.

You may wish to comment on that, but my question to you is: were the water companies and Ofwat really not aware that there were pollution issues before the monitoring was put in place?

David Black: Environmental investment was made. What I am saying is that, as I read it, looking back at what was done in historical price reviews, the focus of environmental investment was not on addressing storm overflows issues but on improving output at wastewater treatment works, where there were very serious issues—and there are still serious issues; it is not something that can or should be ignored. The other focus was on coastal areas.

The issue of storm overflows was known about, but the extent of the issue was not known. Clearly, there were concerns about it. That resulted in the rollout of monitors back in 2014. There has been targeted work on the issue, improving the capacity of wastewater treatment works and improving storage. That funding has continued over time, but clearly it is not enough to address the issue.

Lord Cromwell: Who called out the need for this monitoring? Was it Ofwat? Was it the water companies? Was it the NGO sector? It is just a bit surprising that there was nothing for so long and then, suddenly, “Oh, we’d better monitor this”.

David Black: If you go further back, the Thames Tideway project, for example, was designed to address concerns about storm overflows. That was an issue where, ultimately, a very large-scale investment of £4.5 billion was set in motion to address the issues about storm overflows. The Government were making the calls in that space. Ultimately, it was a government decision.

On the decision to roll out the monitoring of overflows, I would have to check, to be honest but, as I understood it, there was a government direction to the companies to do that. We supported it. The EA was also part of the process. I think it was at the initiative of the Government, the EA and Ofwat at the time.

The Chair: I want to move on. Baroness Bowles will explore this further.

Q121 **Baroness Bowles of Berkhamsted:** People have been mining the questions I wanted to ask. I was going to ask whether the price review adequately takes account of the long-term needs of the water system. The answers coming forward are that it probably does not, because certain things get deprioritised and have to come back again, or certain things are not put forward so you have not imposed them.

To move on, what impact will Ofwat’s proposed long-term delivery plans for the next price review have on water companies’ planning in practice, and will that allow for a shift to genuinely long-term thinking and investment rather than just incremental improvement over five-year periods? Given some of the things that you have already said about shifting investments to the end of a five-year period because of the current cost of living crisis and all that kind of thing, does that mean that

you therefore get progressively onward incremental shifting in time and away from getting things done? If it is shifted towards the end of a period, the companies will presumably come begging, saying, "We couldn't raise the prices, so this now has to go further into the future". You will be on a bit of a never-never there.

What changes would make sure that you look to the long term, including at things that you sort of know are wrong but maybe have not got round to measuring? If you do not put those in, it will for ever be a catch-up.

Iain Coucher: I will ask David to answer that because it is a very good question. I want to pick up on one very specific thing. I was not suggesting for a moment that you defer investment to the back end of the next price control period. It was a suggestion that the increase in bills could be deferred. You still do the work, but you can soften the blow to consumers in the early parts of the period through funding. It is not the investment that is delayed, just the impact on bills.

Baroness Bowles of Berkhamsted: In connection with that, I must say that one of the things you have not said is, "How about the water companies chipping in and not paying out quite so much to shareholders?" Where does that come into it?

David Black: On the long-term plans, the ambition of the long-term planning process is very much to get companies to position their five-year business plan in a much longer-term strategy. The future is uncertain, but the sector is a very long-term business. It is really important that each five-year price review builds to a long-term delivery. The sector faces very challenging circumstances but, none the less, it ought to be the ambition of companies in the sector to have transformational improvement over that timeframe. It is entirely reasonable to expect that to happen.

What we would very much like to see in this long-term delivery strategy is how companies are making prioritisation decisions about what gets done in this five years, what gets done in the next five years and how you build towards long-term outcomes. The danger, as you have just touched on, is that each five-year price review just looks at five years.

There are longer-term planning processes in the sector. The water resource management planning process looks 25 years out, and more than that at times. The new drainage management plans also look 25 years out. We want to see companies bringing that together and setting out the plan for their area, looking ahead but also anticipating that the world is uncertain. Things will change. It is not about locking companies into a straitjacket and saying that this will happen in 2028 and this will happen in 2032. When I look back, there have been some quite remarkable changes, even in the current price review period. That indicates the need to have resets, which we think work well enough on a five-year basis, but this needs to build to a much longer-term plan.

Baroness Bowles of Berkhamsted: It still sounds a lot like "companies ought", whereas we would quite like to hear that you will be enforcing

some of this upon the companies. The companies have privileges in the way they do not end up responsible for damages and so on. In return they should be pushed not to pocket the value of that but to invest it.

David Black: I completely agree. At the last price review, we pushed companies sufficiently hard that four of them appealed our determination, which had never happened before. I am very keen that we push companies to address the issues. Where they have fallen short, it should be their shareholders who fund the improvements. Where they go above and beyond what are industry standards now, that should fall to the customers. I certainly share the ambition to push the sector; I think it is capable of doing much more than it can do.

An illustration is on storm overflows. I wrote to company chief executives earlier this year. As a result of that and the voluntary commitments, they have so far committed to 25% improvements and reductions in storm overflows by 2025. That is without additional funding coming in from customers. It is absolutely right that we expect companies to do more, and I am confident that we can push the sector harder in this area.

Iain Coucher: These are great questions. When I look at the sector, it absolutely needs longer-term planning. We can monitor the performance of a water company on operating and maintenance very precisely over five-year periods, but for some of these large-scale investment schemes tackling storm overflows, which are multi-billion pound and multi-AMP and multi-periodic reviews and timescales, the investment in new reservoirs, water management schemes and drainage plans are all things that will take more than five years and cover multiple control periods. We need the water companies to deliver those and to be adaptable to things that may change, and have some flexibility in their programmes.

The regulator needs to be able to fund those to give them certainty and stability in the long term, but that will need a change to how the water companies do their business. It needs a change to how we regulate things and how we work with the Environment Agency. This is going to be a step change in doing things differently in the future, which we have not had to do in the past.

They are great questions. The water management plans and the water drainage plans are all fundamental parts of that. They have been out to the communities and have identified the schemes that can be addressed, working with the Environment Agency, to bring those back into the periodic review process. We fund those for the next five years in anticipation that it will carry on for several years. They are the relevant questions of the moment.

Baroness Bowles of Berkhamsted: Does that mean that the strategic significant infrastructure project should run on a timeline that is outside the price review process? Should it be running along in parallel, with both having to be fulfilled? Is that what you are saying you will be doing?

David Black: The answer is, yes, that may well be the approach. At the last price review, for example, we set a 10-year price control for the new Havant Thicket reservoir. We also set in place what we call the direct procurement for customer process, which will set a 25-year contract for the building of a £1 billion new aqueduct from the Lake District to Manchester.

We have options to do that. One of our requests to the Government is to free up the vehicle used to take Thames Tideway forward, so that could be used more widely as well. At the last price review we set up a process to provide early funding ahead of the next price review for Southern Water, for much-needed new water resources there. The process certainly exists now, and we will see more of it in the future.

One point that Iain has particularly picked up since coming into the sector is that we are going to see a major step-up into what we call major infrastructure projects. Even though there have been significant investments made in previous price reviews, most of those investments are relatively smaller-scale projects: £10 million, £20 million or £50 million. There have been some multiple hundred million pound projects, but they tend to be rarer.

Looking ahead, there will be projects that are billions of pounds, which will require new skills and new capacity to manage. We need to ensure that companies are set up to manage those. We have to have the right structures in place and make sure that we ourselves, as a regulator, are geared up to address those issues. They will raise different issues as a regulator. We have touched on some of them already, but there will be a step-up in scale and volume on that and it will impact on our work. We will need to be resourced to deliver against that.

Baroness Bowles of Berkhamsted: There will be continual pressure on these things. It is not just a five-year cycle. Everything cannot just come down to a five-year plan.

David Black: We agree with that.

Baroness Bowles of Berkhamsted: But as well as its being long term, there needs to be almost day-to-day pressure to get things done.

David Black: Yes, we agree. Indeed, one challenge that we face is getting companies to take action on the commitments they have agreed. We have some experience. In the most recent price review, some of the progress on new infrastructure has been slower than we would have liked to see.

Baroness McGregor-Smith: For the register of interests, I am a non-executive director of Thames Tideway, so I understand the project really well.

Last week, when we listened to three of the CEOs in the water sector, they talked extensively about their turnaround plans. Thames Water alone talked about an eight-year turnaround plan. How can any of them

take on huge, major projects over the next few years if their entire focus is on basic turnaround? Given their resourcing and what they are trying to do, you talk about urging the Government to look at different models like Tideway, but maybe there is a thought that there should be a completely different stepped approach to how these are done in the future, learning from what the companies are currently capable of in the sector.

David Black: We think the Thames Tideway model is a good one. You are absolutely right. If you look at Thames and the challenges it is facing—the turnaround it is facing—it would be reasonable to suppose that, if this had been taken forward by Thames, as was the original plan, it would have been less effective and less successful.

We think that setting up special purpose vehicles to do that is the right way to go. The other aspect is, of course, that major infrastructure schemes present new management challenges. Managing a portfolio, even if it is a large portfolio, of smaller-scale projects is very different from one very large project. That is why we have developed what we call the direct procurement model. That is a model we can administer, but we are keen to see the expansion of the Thames Tideway model, which has a licence that can then be applied to the new investment. That allows us to intervene as a regulator more effectively.

We think that is a space that needs further work, but at least we have several different models or several different approaches. You are quite right that a lot of this will probably happen outside the existing company boundaries. It is important to note that there will be, as with Thames Tideway, interfaces with the companies. It is important that those work well. It still requires an investment by companies. It still requires good management to make sure that the process works.

Iain Coucher: I have a couple of things to add. First, I am looking forward to seeing Thames Tideway—I am going out with a team tomorrow. I am very acutely aware of the financing model, which we would like to see used elsewhere.

Thames Water is a hugely important organisation for London. We do not want to see it fail. We are wholly supportive of Thames's turnaround programme. I have looked at it. It is going to take a bit of time, but it is primarily in three areas.

It is about operational performance and really getting boots on the ground and responding quickly to incidents and tracking down leakages. It is about having a really good operational focus—they can do that today, and they will do that. It is about changing its contracting model for the delivery of large-scale renewals activities in some of the medium-sized schemes. From what I have seen, it is very sensible; it is what I would do. It will take a bit of time to flush through the system. The old contracting model was poor. What it intends to do is right. There are some bigger schemes that we would like to see taken out of the control mechanism—Abingdon reservoir and things like that—and delivered

through different mechanisms. It should enable Thames to continue to focus on doing the basics really well.

Ofwat will hold these companies to account for poor performance. Equally, we will help Thames be successful. It has to succeed. We will be there as a critical friend holding the companies to account when they fall short, but let us try to make them succeed. We really do not want them to fail because it will have too much impact on so many people.

Q122 Lord Eatwell: It falls to me to talk about sewage. I think you will agree, or perhaps you will not, that the situation we have seen this year and over the past couple of years has undermined the position of Ofwat and the idea that Ofwat has the ability to hold water companies to account. It really has raised concerns about that.

As you would expect with the controversy around the fact that on one weekend almost all beaches in Kent were closed, the Government have produced a plan—the storm overflows discharge reduction plan. What is your view of that? Are the targets sufficiently ambitious and deliverable? What role are you going to play in the delivery of the plan?

David Black: We welcome the Government's storm overflows plan. It is a very large investment programme. It is targeted, first, on addressing the overflows with high ecological impact, which are the overflows that impact on bathing waters, and then making sure that the whole system is in reasonable working order.

In terms of our role, companies will reflect those plans in their business plans. They will engage with the Environment Agency as part of the water industry national environment programme, which is where the storm overflows plan will fit in. That will then come to Ofwat. We will look to see the value from the proposals. There are a number of different ways of meeting the Government's plans. We will be looking to see companies develop proposals that deliver best value for customers and the environment.

Recently, companies submitted their draft drainage and wastewater management plans to us. We are not happy with what we have seen so far. Many companies still have not adequately reflected the Government's overflows plan in their planning process. Therefore, it was very difficult for us to be satisfied that they had looked at an appropriate range of options or that they really had a grip on those issues.

We have sent that feedback to companies. We have extended the timeframe by three months to get better plans in. When those plans land in the companies' business plans, we expect to see well-developed plans taking the first steps forward to addressing the storm overflows plan.

Lord Eatwell: Out of this, are we going to have usable open data in real time, or near real time?

David Black: Yes. That is also a part of the Government's plan. More broadly, we have been pushing open data in the sector. We recently held

a round table with senior company executives on open data. We brought in Sir Nigel Shadbolt, one of the leading exponents of open data, from the Open Data Institute. We think it has a powerful role to play in the sector. It is a great way of holding companies to account, as well as advising on public health impacts from the discharges.

Iain Coucher: The water industry's use of storm overflows is clearly wrong. We have been allowing water companies to use this overflow mechanism for many years, polluting rivers. There is a plan to put in place. You asked if it is ambitious enough and does it go fast enough. We think so, but there is a limit to what can be done quickly.

If we go too fast, I worry that we will spend inefficiently. It is basically about getting the water companies to process all the run-off wastewater coming off land, buildings and roads. It comes to the water companies. We would like to slow the water down and to use other mechanisms to deal with the influx of water when it rains. It may be sensible to slow some of it down. We do not want to spend a huge amount on big concrete container tanks; it is not possible in some locations anyway. There are a lot of planning processes.

We have looked hard as to what the scope can be. It is a lengthy programme. We are focusing on the things that are the priority first. Equally, we want to make sure that water companies are doing the right things rather than simply spending huge sums of bill payers' money and other people's money to contain it.

Water companies are the recipient of all this water. We would also like to look at the people that produce all the water. Are there other ways of slowing it down? We think it is about right. Once we have it in place, we will continue to challenge water companies to go faster. Today, this week, we are talking to the water companies about what we can start early and bring forward. Let us not wait until 2025 to get on and do that. We want to bring things forward because it is supercritical.

Q123 **Baroness Donaghy:** My questions are related to crime and punishment. Before I ask them, I echo what Lord Reay said earlier and thank you for our very useful visit to the Ofwat headquarters to meet the dedicated staff of that organisation. Thank you.

Some witnesses have suggested that criminal fines are seen by water companies as a normal part of their business rather than a real disincentive. Do regulatory penalties and fines truly change compliance, particularly in relation to pollution, which we have just been talking about? How would you respond to the Environment Agency's calls for potential prison sentences for chief executives and board members of companies that are responsible for serious and deliberate pollution incidents?

David Black: There are two issues. There is considerable frustration at the level of court-imposed fines on environmental infringements—the idea that a fine of £500,000 or £1 million fine does not mean much for

companies that have billions of pounds of assets. I think that is understandable frustration.

We do not impose criminal fines. We operate a process where we try to set the scene for companies to improve. There is both an up and a downside. One of our key driving principles over recent price reviews is to increase the level of return that goes to shareholders from operational performance. If I was to make a criticism of the regime in earlier periods, it would be that there was not enough money at stake in delivering good environmental performance and good customer service.

We have changed that. There is much more at risk now for companies. Certainly, we think the level of penalties that we can impose is quite substantial. We have imposed around £250 million of penalties on Southern and Thames alone in the last five years. As I mentioned, that caused genuine financial pain for Southern shareholders, so the bill shot home to them.

From Ofwat's perspective, we largely have the ingredients. We have much greater flexibility to design the regime for that and have taken steps to do just that. There is still a question, particularly for the Environment Agency, on the imposition of criminal fines. That said, the Southern Water case where the court produced a fine of £90 million was certainly a welcome change. That is a serious fine for a company of that scale.

Iain Coucher: I am not going to say much on this. As David said, it is more about criminal fines associated with environmental pollution, and that is not our remit or responsibility. There have been calls for prison sentences and things like that. Our view is that we would like to see greater powers to debar directors from companies that are egregiously and continually poorly performing. We should not allow them to be company directors any more. That is probably the limit to what I would suggest. It is not really something we have considered.

Baroness Donaghy: The Government are thinking of levying a larger amount—£250 million—in fines. Will that help to reduce delays in holding water company managers to account and reducing the incidence of companies being sanctioned after those with responsibilities have departed?

David Black: We welcome that. It is more a question for the Environment Agency as to how it uses that power, but it should give it more flexibility to get more rapid resolution of issues. One of the frustrations has been that the criminal process produces outcomes and the EA wins its cases, but it takes too long, so there may well have been a change in the company from when the process started. It looks very helpful but it is more a question for the Environment Agency. We certainly agree that we want a strong Environment Agency with the ability to challenge and police company behaviour.

Baroness Donaghy: This is a question that was asked. It is not just a

question of time but of resources to get the level of proof in a criminal case, which is probably an issue about whether there are sufficient resources.

Should you be more proactive in using special administration powers to change the ownership of water companies that fail the environment? Rather than being granted in perpetuity, should water companies be forced to compete for licences over a certain period in order to drive improved performance?

David Black: We think the special administration powers, which I referred to earlier, are part of the toolkit. They have a high bar for Ofwat to apply. It requires proof from the Secretary of State and the courts, so they will not be used lightly. We have certainly used the threat of those powers to achieve changes at companies. We will use those powers if we see the need to do so.

On the second question about competition for licences, it is certainly an idea worth considering. There are upsides and downsides. There is a problem with monopoly companies not facing sufficient challenge. It is very hard to replicate some of the disciplines that a competitive market would bring to the behaviour of companies. That is an issue.

That said, if the licences were expiring and there was a bidding process, it might be difficult to get that longer-term focus on companies as they get to the back end of a licence process. If you knew that your licence was going to be up for bid again in five years' time, would you be making the provisions for the longer term that you ought to be making? We think there are some strengths in the existing model, but it is about making sure that there are much more powerful incentives on companies and that there is a holding to account. Something you may come on to is making sure that there is enough backing in the company from shareholders, so that should things turn out badly we can hold shareholders to account. We think that all those have important elements.

Lord Sharkey: I would like to follow up on the issue of ownership of the water companies. Macquarie was a highly unsatisfactory owner of Thames Water and is now a dramatically underperforming owner of Southern. Can you explain why Macquarie was awarded the Southern franchise?

David Black: It was a transaction that was a sale from the old owners to Macquarie. They chose who purchased the company. The reason why we were not uncomfortable with the proposal was that we have changed the regime since Macquarie owned Thames. We think we have built additional protections into the regime to stop the kind of behaviour that we saw at Thames and the poor performance there.

As part of the deal, Macquarie has injected £1 billion into Southern Water, which is needed to allow the transformation of the company. There are two parts to the answer. The actual decision about that was a

choice for the existing owners, and Ofwat does not have powers to veto or veto a future owner coming into the sector.

Lord Sharkey: I have two questions. First, do you think you should have those powers? Secondly, of the £1 billion you talk about, can you tell the committee how much of that was used for investment and how much was used to repay debt throughout the financial structure?

David Black: Of the £1 billion, £500 million went into the regulated company and £500 million into the holding company to restructure its finances. I think around £280 million has been used in the company's transformation plan. Macquarie is up for whatever it takes to turn round the organisation, which requires serious transformation. We will hold it to account should it fail to do so.

The £1 billion is in the company, and it was sorely needed. Whether it needs more than that will be a matter for it to sort out in the months to come. There is a transformation process that is very much work in progress. It is no secret that we are very unhappy with the performance of Southern. It is failing on most of its performance commitments. It is also failing to invest at the pace that we would like to see to provide for the future. It is a company in serious difficulties, and it requires very serious work to turn that organisation round.

Lord Sharkey: Would you, at Ofwat, want the power ideally to intervene in these transfers of ownership?

David Black: It could be a useful addition to our toolkit. Equally, it puts you in the position of trying to veto potential poor owners and it may well be that, as a regulator, that is quite difficult to do if owners come forward that have not invested in the sector before. How might you decide whether or not they were fit and proper?

Lord Sharkey: You probably understand that it seems very strange that such a dramatically underperforming owner of Thames Water can arrange things so that it becomes a dramatically underperforming owner of Southern Water.

David Black: There might be some poetic justice in this, in the sense that—

Lord Sharkey: Not for the consumers.

David Black: There will be if, as I say, it is putting in money. It has injected money into the company. It is on the hook to achieve the transformation. If it does not, it will bear the consequences. Its returns are directly linked to its success on the turnaround of the company. This is one reason why we do not think the regime should depend on choosing good owners. We think our regime should hold owners to account, and we have made changes to do just that.

Q124 **Baroness Taylor of Bolton:** Can we come back to the basic regulation of the whole industry? As you have said, it does not just involve you. It

involves the Drinking Water Inspectorate, which we have not mentioned much today, and obviously the Environment Agency.

Earlier, you sort of blamed the Environment Agency for the fact that things had not been monitored and that things had got out of control. You said earlier that in the early days of privatisation there had been a lot of investment in bathing water, yet we have seen the problems that we have had and that my colleague referred to earlier.

Is it the fault of others who have not told you what was going on? You said the Environment Agency was very late in monitoring, and that information has only become available recently. That seems a bit strange when there were clearly very obvious signs. How do you get on with those other agencies at the moment and co-operate with them? Iain, you mentioned earlier that you are going to have to change the way you work with the Environment Agency. If you could give us some idea of how you see that developing, it would be quite useful.

David Black: First, on the Environment Agency, we are not in any way suggesting that they were slow to do that. I am saying that as a sector we did not have the monitoring in place and, therefore, the full extent of the issues was not known.

Baroness Taylor of Bolton: Could you not have insisted on more information being available? Clearly, monitoring is pretty straightforward in many respects; it is measuring outputs and things of that kind. Analysis is possible.

David Black: Certainly, much more needs to be done in that space. Technology holds a lot of promising opportunities. Some of the changes that have been made recently in the Environment Agency—putting monitoring into sewage treatment works—are taking advantage of new opportunities that were there. I think they talked to you about the monitoring approach at the last hearing. I do not think I can elaborate further on that.

To pick up on working with the Environment Agency, we work very well with it. It has expertise in what is going on in the local environment that we do not have within Ofwat, so we draw heavily on that.

Equally, pointing to new ways of working, on water resources we have established RAPID, which is a joint venture with the Environment Agency, the Drinking Water Inspectorate and Ofwat. The idea is to work collaboratively together to make sure that there are no regulatory barriers to the major new infrastructure that needs to come forward, and to make sure that we are working together as effectively as we can. We think there may be benefits from looking at that kind of approach in the wastewater space, appreciating that there is a different set of issues and a role for local government in that space as well. We think that the effective working together of the Environment Agency and Ofwat means that there are opportunities to explore new ways of working and push that further.

We are certainly very grateful for the co-operation we have had from the Environment Agency. We have worked closely with it on the enforcement cases that we have taken against Southern Water, and cases that we are taking against the six wastewater companies that we are investigating now.

Iain Coucher: Let me be very clear. We are not criticising the Environment Agency at all. It has a difficult job. There are tens of thousands of these overflows. I have spent a long time investigating this, and what appears to have happened is that it was not apparent, because there was no measurement mechanism in place to look at the frequency of using what was a legitimate way of discharging water in exceptional circumstances. It was partly designed to do that, but nobody seemed to know how often they were using it or for how long.

Baroness Taylor of Bolton: The water companies must have known.

Iain Coucher: They did not. They knew that there was a mechanism by which, when they got overwhelmed with water for whatever reasons, they were allowed to discharge in exceptional circumstances, but people did not monitor that. That was the wrong thing.

There are a couple of things, Baroness Taylor. They became aware in 2013, and that highlights two things to me. First of all, why did people not know about this? Did the water companies really not understand their assets and their knowledge? If they did not know about this, what else do they not know about?

I am concerned about the extent to which water companies really understand their assets, their performance and how they are using them. There was no requirement to monitor outflows, which is surprising to all of us, so we put in place a programme of work, but that was 2013. You will say, "Now it is 2022, so why is it still not in place?" It will all be completed by 2023, so they are almost there, but it has taken a long time to do that and equip all these things. As they put the programme in, they found more and more instances.

We are very confident that we understand the scale and frequency of it and that the technology exists. There are two things. Did they really understand their assets? It highlights the issue of responsiveness. We absolutely have to get on top of that, to make sure that water companies understand the performance of their assets and respond when things are not going right.

The EA and Ofwat have spoken at length about us needing to work much closer together to make sure that we share information, that the EA knows what we know and we know what the EA knows, and that we pool our information so that we can rely on it and have conversations about it. I do not think that was the case 10 years ago, but it is certainly the case now.

As we go forward, we start to look at these very large schemes such as the £56 billion overflow programme, or whatever it might be. It is in part inspired by the EA's requirement to fix all this. We need it to be delivered. I think the EA and Ofwat have to work closely together to monitor delivery against that programme and to look at ways we can bring it forward. Things will change. Water companies will say, "We would like to do something slightly different" and we will say, "Okay, let's have a conversation about that". In the execution of this plan, and other things, the EA and Ofwat have to work together so that we can look at shared information, shared programmes and holding the water companies collectively to account rather than its being in isolation.

We would not want to criticise the EA. As far as I can tell, relationships between EA and Ofwat have improved dramatically over the last few years. There is a commitment with my counterpart, Alan Lovell, to do more in the future.

Baroness Taylor of Bolton: Let me pick up on one other aspect: local authorities. You mentioned them. They are impacted if there are to be changes in the kinds of things you are talking about, but they are also sometimes frustrated when they are making planning decisions because people do not like change. I have heard that water authorities are not absolutely asked—neither are you or the Environment Agency—about the impact on the water industry, the impact on sewerage or the impact on infrastructure of new developments. They are not statutory consultees. You are nodding, so I think that is correct. Do you think they should be?

David Black: We think that may well help. The Government have committed to reviewing what I understand is called the right to connect, which is very much about responsibilities on new developers. We are looking for better solutions. When developers build new developments, it is about ensuring that they make the most use of sustainable drainage solutions. There is a question about the operation of those solutions once the development goes live, and how that is best handled. As I understand it, the Government are looking at the issue. There are real opportunities to make improvements in the area.

More broadly, there are some really challenging issues around surface water drainage and the role of water companies and local government. It will require partnerships between both of those organisations. One project that we funded as part of the green recovery in 2021 was a development in Mansfield, investing £80 million in sustainable urban drainage. Part of that is to test whether we can use that kind of approach more broadly as a better solution for the impact on local communities than just building more sewerage capacity, so that we can get the water out of the sewers. Will it reach better outcomes? It is better from a local government perspective, and local government is also making a contribution to the cost of that scheme. We are looking at adopting that solution elsewhere.

The Chair: In his evidence to us, your former chairman, Jonson Cox, called for a fast and thorough review of permits by the Environment

Agency to ensure that all storm overflow permits continue to be compliant with appropriate stringent conditions. What is holding that up?

David Black: It is probably a question more for the Environment Agency than us. One point I would make is that the storm overflows plan is going to address this issue at scale.

The Chair: There is something you can do, which is to mandate the companies to provide open data. I noticed on Feargal Sharkey's Twitter feed yesterday that there was a map of the UK. We could see what was happening in the south and in various other parts of the country, but there were a whole lot of areas of the country where you could not see what was happening. That was because those companies do not provide the data. Can you not force them to provide the data? You are nodding. Why not?

Iain Coucher: It was in sympathy with your question. The solution is to have a lot more relevant information for people who use the rivers. For a period of time, until we get all of this fixed—it is going to take a long time—if you can make the public aware of levels of contamination in the river, that will be enormously useful to say—

The Chair: You are right; the public are one of your best allies. You have been slow, frankly, on the monitoring. They are there to help.

Iain Coucher: We want to find ways in which we can get that information and make it publicly available, with an obligation on water companies to do that. That is certainly something I want to challenge them to do. Whether we have the powers to do that, I do not know, but it certainly seems right to me that we should do it.

David Black: We have a work programme on open data. We have a live review of it at the moment in the sector. I am really disappointed that some companies are hiding their data. We have seen companies refusing—

The Chair: When you write to companies about bad behaviour, do you have a website that you put that letter on?

David Black: When I write to companies, the letters are put in the public domain, yes.

The Chair: We look forward to seeing those letters shortly.

Q125 **Baroness McGregor-Smith:** We have heard calls for both Ofwat and the Environment Agency to shift from an output-based approach to an outcomes-based approach so that there is more leeway for the water companies to do what they think is right, particularly around the environment. Clearly, there are endless challenges in the industry at the moment. Do you think that is a model we should move to and, if we did, how long would it take us to do so?

David Black: The answer is yes, in short. The more complicated answer is that we have used an outcomes-based approach elsewhere in our price review but not in the environmental area, and we have seen that giving companies more flexibility allows them to come up with the best solution. You have heard from Sir James Bevan that the Environment Agency is also committed to an outcomes-based approach.

To some extent, they are held back by some of the pre-existing EU legislation that does not permit an outcomes-based approach for some environmental improvements, so there are some restrictions. It comes back to the point that was raised about the level of investment. As a regulator, we would like a very clear government steer as to the outcomes that government wants. We can then translate those into our price review regime and put it to companies to deliver against those. We can then, hopefully, unleash innovation, partnership working and getting the best solutions. Whichever way we look at it, if we are spending £50 billion or £60 billion in the next 25 years to address this issue, it is really important that we get the best value solution. It is not just about spending the money, but fixing the outcome.

We think the outcomes-based approach has considerable merit. That said, there are some caveats. It will not be appropriate all the time in every instance, but it is an opportunity to unleash more innovation, more partnership working and more nature-based solutions that are presently held back by the present outputs-based model.

Iain Coucher: Absolutely. We largely have an outcomes-based regime at the moment. The environment area is one where we do not, but it is largely outcomes. There are roles for outputs. There are times when I would like to understand a bit more about how they have achieved the outcome, because there is always a risk that they have done something that has long-term implications for short-term gain.

Let us take mains renewals, for example. They are not spending at the rate at the moment that we would expect them to. It is considerably below where they should be, yet performance appears to be going in the right direction. You could argue that that is okay. It might be in the short term, but I would like to understand why they are not keeping up with the renewals. There are areas where we might want an output measure as well as an outcome. It is absolutely the right way to go. We agree with the water companies that that is largely a better way of doing things.

Baroness McGregor-Smith: Do you think they are ready to do it?

David Black: Some are and some are not. To be honest, we have talked about concerns on the performance of some companies. They are well behind on their current delivery of outputs. That would raise concerns. Other companies are very keen and are champing at the bit. They have ideas about how it could be done, offering options. They have been experimenting with it, so there is certainly potential to do it.

Another example is the collaboration with the Environment Agency. The good news is that we have been talking to it about these issues. There have been changes to the WINEP process for PR24. We are talking about further changes now to try to get the maximum possible benefits of that approach.

Lord Burns: I want to ask about water supply but, first, I want to go back to the issue of change of ownership. I am slightly surprised by your answer about powers. I was involved 20 years ago in buying out Hyder into Glas Cymru and I had several conversations with your predecessors. I cannot believe that we would have gone ahead without the agreement of the regulator. I had a similar experience in banking, when I was involved in a major banking transaction between Abbey National and Santander. It was inconceivable to either party that we could have gone ahead with that without the agreement of our then regulator.

Do you have those powers in practice? If you do not, why do you not have them and other regulators somehow do?

David Black: On the exercise of informal influence, yes. On our website we published an exchange of correspondence between our then chair, Jonson Cox, and the relevant person at the Macquarie fund that was making the investment. As part of that process we were quite clear about our expectations and the changes that had taken place in the sector. We have put all that in the public domain for the sake of transparency. To confirm, yes, there was engagement with Macquarie ahead of that transaction going ahead.

Q126 **Lord Burns:** Let me go on to the issue of water supply. We have heard that there could be challenges in ensuring future water supply due to climate change. This has been highlighted by the problems of drought this year. Two solutions have been raised in discussions with other people: one was to transfer water between existing water resources and the other was, of course, about building new reservoirs. How do you see the future potential of those two things and what might be involved?

David Black: There is a demand side and a supply side set of solutions required. To look ahead, there will certainly be population growth and climate change, but also the need to reduce abstraction. We have chalk streams that have been overabstracted at present. All those things add up to the need for more water resources in the future.

There is a water resource management planning process. One of my concerns at PR19 was that, when you looked across the plans, there was not sufficient co-ordination across companies. It has been quite a long-standing frustration of Ofwat that we were not seeing conversations happening about potential transfers.

I am happy to say that I think there has been substantial change. We now have RAPID. We have provided funding for 18 strategic resource schemes, which include transfers and new reservoirs. I expect that a menu of those will probably be required. It might not be either/or but

both will need to go ahead. That will be an outcome that follows from the water resource management process. That is a statutory process, and it is important that it is worked through. We will have to look at the results of that, but our expectation—standing slightly outside the process—is that we will need new water resources coming forward. It is likely to be a mixture of transfers and new reservoirs. There are benefits and options for both.

It will put pressure on the planning process because the last time a major reservoir—the Abingdon reservoir—went to planning process, in 2011, it failed. It did not get planning consent on the grounds that it was not immediately needed. There will be a need to make sure that the planning process can align to the needs as well.

Lord Burns: On transfers, do you expect one water company to pay another water company for transfers between them? Who will settle a price?

David Black: There is what we call a bulk supply framework, which is a framework for both companies to engage in and negotiate. The Havant Thicket new reservoir that Portsmouth is constructing is actually for the benefit of Southern's customers. There has already been a negotiation between Southern Water and Portsmouth as to the price they would pay and the terms and the duration of the contract.

We have been doing some work with the sector to make sure that the framework is fit for purpose and that we are thinking through the issues. There are some quite challenging issues, for example, about sharing water resources in a drought. As to how that process works, we think it can be resolved and we are working through that with the companies. There is a process now and companies already have bulk supplies between each other. There are a number of agreements in place, and there is the ability for them to make new agreements.

Lord Burns: In general, are the companies working well together now on these transfers?

David Black: I see a step change in the working of companies. The Environment Agency established the regional water resource management planning process and the national framework, so there is much better co-ordination at the regional level. I have some concerns that, between regions, there is still some missing co-ordination. With the work that the Environment Agency does and the RAPID national framework, we can address those issues as well.

There has been a real change in that space. I am pleased that we are in a much better place, but I do not underestimate the challenges of getting new resources in place. It is perfectly feasible to come up with a plan, but getting those resources through the planning consent process and making them happen will be challenging.

Iain Coucher: This is one of the changes as we look to the future. We have to see much greater integration and working together between multiple water companies. In the past they have largely been able to do stuff inside their own geographical patch, but when you start to think about water demand in the future, we need reservoirs in some areas that need to supply different areas and move water around. That absolutely needs the industry to work together to develop solutions and to have broad transfer agreements. It requires Ofwat and the Environment Agency to think about how we oversee that and make sure it is effective, and that the consumer and the environment are protected. It is a good example of how things will be different in the future.

Lord Burns: Are there physical problems about the transfers? I well remember, from my days with Welsh Water, that water was transferred from Elan Valley to Birmingham entirely by gravity over 75 miles, or whatever it was. Do most of the schemes work by gravity, or do they require a lot of pumping?

David Black: There is a proposition to use the existing canal infrastructure in some cases and then to install new pipes so that as much as possible we can use gravity because that is the cheapest and the most environmentally efficient way of shifting water.

In terms of resilience propositions, we may need to look at some ability to pump water if transfers are going two ways. It may involve all those elements. There are some quite challenging environmental issues as well. There are concerns about the potential transfer of invasive species. All those issues have to be worked through as well.

Q127 **Lord Sharkey:** We have heard that consumers have a role to play in helping to meet future water demand by reducing their own water usage. Who is responsible for encouraging consumers to cut their demand? What progress has been made and what targets exist?

David Black: That is a good question. We certainly think that there is a really important role for the demand side. There is a role for government in this in setting standards for new homes. We would like to see water-efficient new homes built. It would be a huge shame if they were not being built.

Equally, there is a really important role for companies, which is probably twofold. One part is to roll out metering—that is the easy way. On average, customers save about 15% of water; they use 15% less once a meter is installed, which is obviously a huge help. We have about 55% to 60% of the country metered now. Clearly, there is big scope to take that further forward.

The other part is helping customers to make decisions about using water wisely and offering water-saving tips. Companies do that now. We have set targets to do that. I do not think it is working very well. We need to see a step up in that space, and we are looking at what we can do as a regulator. At the last price review, we established a £200 million

innovation fund to drive innovation in the sector. We are looking at the possibility of establishing a substantial water efficiency fund to drive companies to work together to change customer behaviour.

Companies need to work together collectively. They also need to work at an individual level. There is the need to invest, particularly in smart metering and working with customers. Hopefully, that will produce a much better outcome than we see currently.

Lord Sharkey: Are the companies currently devoting enough resources to it? Are they taking it seriously?

David Black: I do not think they are taking it seriously enough. They are putting resources into it and they are working with customers. Different companies have more effectiveness in the space; there is some interesting work with smart metering and smart technology, but I do not think it has enough leadership. There is not enough common cause across the sector in the space. Again, individual companies are doing some interesting pieces, but we think a lot more work needs to be done. We are looking at how we can work as a regulator to try to promote and enable that to happen.

Lord Sharkey: Do you have conversations with the companies about the targets that they should be setting?

David Black: Yes, we do. At the last price review, we set each company a target on reducing per capita consumption. Regrettably—partly due to the impact of Covid, to be fair to companies—no company is currently on track to reach those targets.

Lord Sharkey: I have a final comment about meters. As you probably know, the rollout of electricity meters has been extremely unsuccessful. There seems to be consumer resistance to all of this, or incompetence on the part of the supply companies. What is the position with meters? What progress is being made?

David Black: The level of metering is currently at 55%, heading towards 60%. Companies do not have the power across the country to impose meters on customers, but in water-stressed areas companies have more ability to install meters. The Government have helpfully extended the areas of the country that are designated as water stressed, so that expands the scope for that.

Some companies are starting to roll out smart meters. Companies are talking to us about ambitious plans for the next price review. One of the points that Iain mentioned was about bringing forward projects in the next price review. We have a process called transition spending to address our concerns. We do not want companies to wait, so we are looking at whether we can use funding in that space to accelerate the rollout of smart meters. We are also thinking about how the sector works together, what common standards we might need and how we get the maximum benefits out of this.

There is considerable benefit from smart metering, not just for customers but in reducing leakage. Obviously, once you have a meter in a customer's house that measures every 15 minutes' consumption, you can spot leaks on the customer's side, and you can spot leaks better in your own network. We think there is real scope in that space. It will probably require some know-how to unlock. That is what we are looking to work with the sector to achieve.

Lord Sharkey: Iain, do you have anything to add?

Iain Coucher: No. Meters are part of the solution. It is a more cost-effective way of reducing consumption. It is difficult to get some of these pieces. There is no compulsion. I have been with several water companies, and they are actively talking to people—certainly at the call centres when someone calls in—irrespective of what they rang in about. "We can see you're not on a water meter. Have you thought about being on a water meter?" They are really promoting the installation of water meters. They do not have the powers at the moment, but I genuinely think that if you can install a water meter, you should.

I also think that the water companies should be out there installing meters ahead of customers signing up for them. I could come to your house and put a water meter in the field near your house. You would still have the choice to be charged by meter or by rateable value, but it provides a huge amount of asset information about water consumption and pressure changes—information that the water companies would find invaluable in balancing water demand as well as, at some future point, turning it on for consumption.

You asked what the target is. I think we are currently at about 140 litres per person per day. The long-term government indication will be that it needs to get down to 110 litres. We have a way to go yet, but it is an important part of meeting future water demand.

Q128 **Lord Cromwell:** To go back to investment, to maintain and increase the water supply and deal with the more overt environmental aspects—the emphasis nowadays—will clearly require a huge scale of investment. You mentioned £54 billion over 25 years as just part of that.

I am a bit uncomfortable. We never seem to get a handle on what the total bill is likely to be. Iain teased us earlier by suggesting that you have some calculations of your own. You may not want to reveal them, so as not to excite or depress those putting business plans together at the water companies. I get that, but when is the big reveal, when everybody knows the solid number, the money that needs to be raised?

David Black: There are a number of ingredients. Company business plans in October 2023 will set out their view about investment and the impact of customer bills. I should note that it will vary quite markedly between companies. That is my expectation. One of the traps is that we have been talking about average bills and the average across the country, but even at the last price review, when bills were going down for

all companies, the difference was minus 3% versus minus 30%. There could be quite significant differences across companies.

We will have some insights earlier than that. Companies are putting together their draft water industry national environment programmes and their draft water resource management programmes. That will provide substantial elements of their business plans, and we should start to see a quantum of investment coming through those processes.

The impact on bills always requires some understanding of what their required rate of return or allowed rate of return will be. For PR24, we will set out an early view on that in December this year. That will be another piece of the puzzle. There is then obviously the question as to what extent the sector becomes more efficient to help to manage bill pressures.

A final element is the speed at which companies recover their existing asset base. Part of the customer bill is the recovery of the historical asset base—you might be surprised to know that it is 35% of it, on average—which is the investments that have historically been made by companies. It is a question of in what time period and how fast do you recover those costs. When those all come together, it will be company business plans that first see that. There will be quite a lot of information on the level of investment coming through the water resource management planning process and the drainage and wastewater management plans.

Lord Cromwell: I understand that those are the different bits. I am still groping for a date when it all comes together. Is Iain prepared to share with us the back of his fag packet?

David Black: October 2023 is the date when the companies put their business plans before us. The final water industry national environment programme goes out in March next year. There is a draft next month, so those are some of the dates.

Iain Coucher: I am happy to share the principles of my fag packet with you, if you like.

Lord Cromwell: I did not know that fag packets had principles, so that is very interesting.

Iain Coucher: There are a couple of things on investment. First, in the last periodic review we spent roughly £10 billion on enhancement schemes. When we are talking about the storm overflows, £54 billion is the estimate of what it will be. If you spread that out, there is also some additional investment in new reservoirs and other bits and pieces, so you can see two or three times that spend level. It will be later in the year, but I am concerned not just about the quantum that will drive consumer bills but about the industry's capacity suddenly to step up from what has traditionally been roughly £2 billion a year across the sector to double that. There is no supply chain in place. We need access, planning and resources. The water companies do not have the resources for it.

Even if we blew the whistle and said, "Away you go", I have some concerns about the capacity inside the supply chain to deliver what are not single schemes but hundreds, if not thousands, of small schemes all over the country in different places. We have to be realistic about how the water companies can deliver it. We do not want to set targets for people to invest and then say, "Oh, by the way, there isn't a supply chain to deliver it for other reasons". We are trying to be sensible about setting expectations, but it is a significant increase. If the committee would like, we can lay out some early thoughts for you, but we would not want to put it in the public domain.

Lord Cromwell: I understand that. That segues quite neatly into the next bit of what I am going to ask you. To separate capital expenditure and recurrent, on the capital side whose money should it be? Will the private sector be able to raise these sorts of eye-watering sums, or will the public purse be involved and, if so, in what proportion? I think you have already said that management capacity will be an issue, and that you are thinking of a financing model outside the current water companies. I guess that is partly going to affect how you answer my question. Who is going to pay for it, and in what proportion?

David Black: Ultimately, these costs will be paid for by customers over the next 30 to 50 years. They will be financed by investors. The sector is seen as attractive for investors. There has been no problem to date in raising capital, and I do not think there is an issue with the level of capital that needs to be raised. We are seeing strong signs of keenness for people to invest; they are looking at these projects. We have had days with investors, putting out information, so I think all the signs are positive. From their perspective, investors are looking at the prospects for return and certainty about the level of return. The water sector investment model is seen as offering high levels of certainty. It offers inflation-indexed returns and I think it has the ability to raise this level of capital.

It is right, as Iain said, given the step-up, that we look at all aspects of this, but I do not see a need to bring in public money to finance it. Obviously, the investors' perspective will be, "Will customers ultimately pay for these bills?" That comes back to the affordability question, which I think is where we started.

Lord Cromwell: To take your quick maths of two or three times the £54 billion, if you are looking to raise £200 billion, you are confident that private money will cover it.

David Black: I think Iain meant two or three times the £10 billion every five—

Lord Cromwell: Forgive me, I was getting carried away.

David Black: There are large sums of money being talked about. Equally, there are large markets of capital looking for a home. As I say,

the water sector has successfully competed for capital globally, so we are confident that the model can continue to deliver that.

Lord Cromwell: If we come to the recurrent side of things, water companies have to certify to you at Ofwat that they have the resources to keep up with their maintenance requirements. Our Chair referred to your previous chairman's letter to us, in which I think he said that a third of the storm overflow issues arose from lack of maintenance. If they fail to meet those commitments to Ofwat, who should pick up the bill for that? Ultimately, perhaps the customer does, but should not the water companies be covering that?

David Black: The short answer to that is yes. There has been some work on storm overflows as part of the Storm Overflows Taskforce. It looked at root cause analysis that estimated that around 30% of overflows were due to operational and maintenance issues. That is one of the reasons why I wrote to companies earlier this year and said we need see a step change in performance now.

Iain talked about the profile of costs on customers earlier in the session. We are keen that, if operational solutions are needed, they should happen now and we expect companies to do that. The good news is that companies are making those commitments. They are bringing down the levels of overflows, and are doing so through how they operate their networks and systems. They are more effective at dealing with blockages. There is lots of scope. That is why we should not see this as just an investment issue; it is an operational and performance issue as well. It is a sign that the sector is not performing as it ought to be. We think it is really important that we play our role as a regulator in driving performance to higher standards.

We have signalled to companies in advance of PR24 that we expect them to start at a level of 20 discharges a year. They started the period at, on average, 29 across the sector, so that is quite a significant reduction. This is trying to capture the benefits that we expect to see from operational improvements. Those costs are rightly for companies and the shareholders to bear and not for customers.

Lord Cromwell: Finally, to change gear slightly, there is a range of policies and funding sources. We have heard evidence that they are sometimes contradictory or are not very well co-ordinated, which has led to calls for a national water strategy. Do you think that is worth while or not?

David Black: It certainly may help in bringing things together. When you look beyond the role of water companies and catchments, there are a number of other players. It is quite frustrating for some of the NGOs that work in this space and deal with a water company, the Environment Agency and local government organisations. They are all trying to achieve the same outcomes but not in a co-ordinated fashion. We would welcome action in this space from the Government.

We appreciate that it is a challenging task. It is very easy to stand outside and say, "It would be easier if those two organisations worked together", but it is obviously about making it work better in practice. We think there are big opportunities for more co-ordinated approaches. The link between agriculture policy and water is important. At the moment, the concern is that water customers are, effectively, paying to clean up damage done to waterways from other sources. That is a challenge. If we can get a regulatory framework that works well across all sectors, we can have better outcomes.

Q129 Lord Blackwell: In a minute I want to ask about the good use of Thames Tideway-type projects. Before I do that, for my own benefit, I want to go back to some of the earlier discussion on investment.

A number of us here have experience working with or on the boards of other regulators. What comes across, maybe unfairly, is that Ofwat is a much more passive regulator in the way you describe the investment process. The businesses put forward their plans; you review them, and you have not stopped them investing in anything. What I am missing is the notion that you have a vision of what is required to take the industry forward and that you are pressurising, compelling or requiring the companies to come up with that investment.

I know you cannot just say to them, "We want you to invest umpteen billion", but if I think about, for example, the way the financial regulators have been quite specific over the years on what investment was required to meet the resilience of the industry or cybersecurity, or to deliver particular customer outcomes, they have been highly specific in the year-on-year targets that have to be met. There is Ofcom with broadband and 4G or 5G, et cetera.

Is it that Ofwat has not seen its role as having that vision and setting targets that compel companies to do that, or is it that the Government have not given you a clear enough policy lead? We are in a situation where at the moment, as other people have said, we have clearly had inadequate performance on leakage—environmental and other aspects—which could have been remedied if there had been more investment over the last 10 years when significant capital has been taken out of the industry through financial restructuring. Why was Ofwat not able to set targets that compelled the companies to invest more?

David Black: That is an excellent question. On leakage, I point to the fact that we have done that. I would say that Ofwat was conventionally too willing to let the outcome be a result of the water management planning process. In 2017, we looked at the evidence and we thought that the sector was not doing nearly a good enough job. I would challenge your view that it is about investment. It is about operating your networks properly; it is about installing the right technology and acting quickly when you spot leaks. It is not just about signing off a cheque.

That has had a result. We have seen leakage fall by close to 12% over that five-year period. We have been very clear with the sector over this current five-year period that we are expecting to see a 16% reduction.

We have been willing to play a more active role. I have pointed to the water resource situation, where we stepped in to require companies to develop 18 new strategic resources.

This is where we point to the environmental space. We have been less active in that space, partly because it has been a working arrangement with the Environment Agency—that is not to criticise the Environment Agency by any means. The process for that has been determined by bottom-up work with each company to set particular environmental standards. Our approach has been more about requiring companies to meet the standards as set by the Environment Agency. You can look back and say that, in hindsight, we could have been more actively involved, which is why we are now looking at how we can further deploy the RAPID model. We want to work closely with the Environment Agency. As I say, it has the monitoring expertise in the field, and it is important to look at the broader landscape.

We think there is a more active role that we can play, but I would certainly categorise Ofwat's recent price review as being that we reached and set challenging performance targets right across the business for water supply interruptions, leakage and reducing pollution incidents. We can see that that has had an effect. In the last five-year control period, pollution incidents were reduced by 36% as a result of challenging companies and incentivising them to do that. I am very keen that we do more of that.

Lord Blackwell: My question may be one for Iain. Looking forward, do you see it as Ofwat's responsibility to have a vision for what will be required to deliver the water quantity and quality that the country needs in 10 years' time and to have your own view of what that will require in investment, new reservoirs or water linkages, and to make sure that you are as a regulator structuring the industry to deliver that? Is that your role, or is it a much more passive role?

Iain Coucher: It is our role. We need to stand back and ask ourselves what we are trying to achieve with the water industry. It is true that we have seen improvement in performance in terms of the metrics to which David referred, about pollution incidences, and that has largely been achieved with no incremental investment. When people say that we have not invested, we have invested in schemes, but we have driven performance improvements down without investment.

We need to ask ourselves—not just Ofwat but the water companies and society—what the right level of performance is for leakage. What is the right level of performance for pollution? We can improve it by 20%, but are we getting to the accepted norm, or should we go a lot further, and what is the level we should go down to? What is the best level in the world in terms of leakages or pollution incidences or responsiveness? We should ask ourselves whether we should be aspiring to be a mediocre industry or to be the very best and what the difference is between getting from where we are to where we could be. People will say, "How much is that going to cost me as a consumer?"

When I look at some of the metrics, I think, "Is that really the best that we can do?" It is incumbent upon us to ask the questions and to challenge the water companies, "What do you think consumers will bear? What do they want in terms of all these key metrics?" We must lay that out and say, "Right, that is what we are trying to achieve in the base service for what people expect: high-quality water, reliable, affordable and resilient". It is all those types of metrics. How long should somebody be without water if it goes off? What is the accepted norm? People are pretty forgiving as long as they can see the water companies doing something about it.

I do not think we have ever had a conversation about what we think world-class water distribution should look like, and I think we could. At Ofwat, throughout my conversations and my employment processes I have encouraged people to look at that. Ofwat has a much bigger role to play in the facilitation of dialogue around these much bigger schemes. Who is the organisation? We work with other government agencies. Who is doing the talking about reduction in demand, investment in new reservoirs or the trade-off between new reservoirs and water movement?

Ofwat has a role to play in facilitating that conversation. We are not the arbiters of that. It is a combination of the Government, local authorities, companies and politics, but we should at least be laying out our views about what could be done. That is something I am keen to do. Certainly, in the review process that is under way, we have been pushing the water companies to go further, to be more ambitious, to be bolder and to ask what their customers want. That is something we should continue to do.

Lord Blackwell: I take from what you are saying that to take on those wider responsibilities would be an evolution or a shift in Ofwat's role.

David Black: There are some aspects of that. We have looked at our role in the RAPID process, which I see as a potential guide for what we might do on wastewater, where we have been much more active in the sense of looking at companies' plans and saying, "We don't think there's enough there". We also have work being done on modelling our future water resource demand and looking at how that might be met across the country, looking at what water resources are and trying to spot whether things are missing in that framework.

While the wastewater process is more complex and there are more players involved, we think that model is potentially applicable in that space. That is what we are exploring. It would obviously have impacts for how we work going forward—it would be a change.

Iain Coucher: We discussed this at the board meeting just last week. We are publishing our final methodology for the water companies, which will go out in December. The internal team was very challenged. Are we being challenging enough? We do not want to miss this opportunity to make a step change in performance. Whatever we do now affects the delivery of water companies into 2030. Let's get it right now. We really do not want to shift the industry from an underperforming level to a new

level of mediocrity; we have to be more ambitious than that. Let's get out there. We will go and talk to all the water companies. David and I will lay down our views about ambition and challenge to raise the bar.

Lord Blackwell: Coming back to the Thames Tideway type of project, as you play out that vision and the potential need for more reservoirs and more linkages, can you see the role of more competitive financing structures—SPVs—in doing that? Is that something you would take a lead in trying to help?

Iain Coucher: Absolutely, and we have done so far. David knows the technicalities of why we struggle to replicate the Thames Tideway model, the SIPR process. That allowed Thames Tideway to be very successful. It is delivering today. We like that as a project, but elsewhere we are doing something called direct procurement for customers. We put out a package of work; it has to be significant—a new reservoir or a new connection. They are billions of pounds and we will create SPVs to create and own those, and to fund them. That is a big part of our programme going forward. We will get new entrants and new competition in there. We think that will be a positive way to deliver more of the Thames Tideway or resource procurements.

Q130 Baroness Bowles of Berkhamsted: I would like to go back to the issue of companies' poor performance and the linkage to the financial side of things. We have heard that they are becoming increasingly leveraged in order to pay out dividends to shareholders. In that context, Lord Sharkey has already probed a bit on Macquarie. They may have put £1 billion in, but three-quarters of that seemed to disappear out again in dividends.

How can high levels of dividends and executive pay be justified when the environmental performance is so poor? I hear what Iain said about the power to disqualify directors. I think that is a very good proposal and something I have long proposed in other areas. Do you actually have that power, or do you have to make a recommendation to the Secretary of State? Have you threatened that at all? What other engagement are you having with RemCos, for example on having malus, clawback and deferral into bonus schemes, which is part of modern remuneration? What follow-up is happening with regard to the letter that you, David, wrote last February to RemCos?

David Black: There are quite a few points to pick up. On what we call financial resilience—the level of gearing in companies—we are concerned. It is not that the gearing has increased in recent years; in fact, it has stabilised, but there were three companies in particular that we had concerns about: Thames Water, Southern Water and Yorkshire Water.

The good news is that we have made some progress. We have seen £1 billion injected into Macquarie. We have seen Thames's investors inject £500 million and promise £1 billion more. With Yorkshire, we recently announced the settlement of an enforcement action against them, where they have agreed to inject £900 million or close to £1 billion into their

business, as well as investing an extra £100 million of shareholder money to fix up rivers.

Progress has been made. None the less, we are concerned that the licence in the sector is still too permissive and that it does not set stringent enough standards of financial resilience. We have consulted on a set of licence changes that would basically give us power to lock money into the company if its credit rating fell to a level that we deemed insufficient for a water company. We also have the power to take enforcement action when companies do not align dividends to their performance. That change has been fiercely resisted by companies. We will see whether they choose to refer those licence conditions to the CMA, but we are in that process with them at present. That is one area.

The other element is making sure that their returns are linked to performance. I come back to that point. It means we have big incentives on operational performance so that when companies fall short, it hits the shareholders. We have seen that with Southern and Thames in the period to date, with them incurring significant penalties on their poor performance so far. Obviously, what we want them to do is improve their performance and not to continue to incur penalties.

On executive pay, I could not agree more. It is really concerning, given the current environment and the storm of criticism that companies faced over the summer, that they have not yet been more responsible in linking executive pay to performance. As you noted, I wrote to remuneration committees earlier this year. We are currently looking at the executive payments and are in the process of engaging with the companies. We need to act in that space.

We are also looking at how we can bolster arrangements. The companies made a commitment as part of PR19 to align executive pay to performance. We may need to look at arrangements to strengthen that. None the less, as a regulator we are quite clear that it is company boards and remuneration committees that need to take responsibility for making those decisions. It is not for us, as a regulator, to micromanage executive pay, but they ought to be able to demonstrate that it is linked to their performance and, to date, they have not done so.

Baroness Bowles of Berkhamsted: Do you have the power to disqualify?

David Black: No, not at present.

Baroness Bowles of Berkhamsted: It would be going through the Secretary of State route.

It fell to me to ask this question, so I ought to declare my interest as a director of the London Stock Exchange. I am not angling for listings; it is just coincidence.

We have heard that private equity is often behind the increasing debt and dividends. Some people have suggested that one way around that would

be to make the licence conditional on all water companies being listed on the Stock Exchange, with at least 25% of shares traded publicly. Of course, that would also introduce additional corporate governance requirements. How would you see that as an extra way to get more public oversight and better governance, and obviously what people thought of them in terms of what happened to the share price and so forth? Would that assist?

David Black: Yes, we think it would have some benefits. The benefits are twofold. You touched on one with the minimum requirements about board governance. The other is the additional scrutiny that analysts bring when a company is listed. That said, we think we can replicate to a large extent the governance benefits by putting requirements on water companies' licences that they adhere to rigorous governance standards. We have done that, and I think we have made some progress in that space, but it requires further attention.

Yes, there are some benefits of listings and there are some costs. It would be wrong to pretend that listed companies are the answer to the problem. South West Water is listed by the Pennon Group, and we have real concerns about their poor environmental performance, so being listed does not guarantee good performance. We have observed, obviously, the concerns we have heard about the highly geared structures that were used in Thames, Southern and Yorkshire, and the flow-on effects on their performance.

We are keen that we put the sector on a good financial footing. We have taken action to do that, and we are seeing real progress in that space. The big challenge is to turn around their operational performance, and that is what we are pursuing right now.

Baroness Bowles of Berkhamsted: Coming back to the Macquarie windmill, do you recognise that it was £1 billion in and three-quarters of a billion out?

David Black: No is probably the short answer. It is on the hook for turning around Southern Water and its returns will depend on its effectiveness in doing that. Southern Water is on penalties now, which will remain in place unless it turns around its performance. It is obviously liable for any enforcement action that is taken if it fails to adhere to its licence conditions. We think we can hold Macquarie to account, and it will be up to it to successfully turn around Southern Water.

Baroness Bowles of Berkhamsted: It sounds as though it paid out the shareholders in advance of having to pay fines.

The Chair: Lord Reay has some follow-up questions.

Lord Reay: I have a couple of questions to ask, if I may? First, there was an article in the *FT* about Yorkshire Water, saying that, if you included pension liabilities and derivatives in its gearing ratio, it reached over 100%, which seems very high. Do you look at the gearing ratio with

those two things in it with all the water companies? My understanding was that you like to keep gearing at 70%, but 100%-plus seems high.

David Black: I agree. It is very high. There were particular issues with Yorkshire Water, with derivatives that it entered into and a very unwise—at least in hindsight—set of swaps back in 2011 which turned out very badly for it and led, when it marketed those transactions, to the additional 30% of gearing. That was one reason why we identified concerns with its financial resilience and one reason why we have been pursuing action against it to strengthen that.

I am pleased with the resolution of the enforcement action that we took against it and that it is injecting £900 million into the company. We are very clear that it needs to address those issues. Yorkshire Water itself thought that it was adequately financially resilient at the time, but accepts that there were problems for the future. It is an example of where a company has entered into arrangements that were quite unwise and quite speculative and has exposed itself to unnecessary risk. That is why we have very much tightened up our approach in this space to prevent that happening again in the future.

Lord Reay: Across the board?

David Black: Yes. That is why we are bringing the licence changes into place. You are absolutely right that it is important not just to look at the headline debt numbers; there are sometimes very complex financial structures sitting behind them. We have to understand what the impacts of those are as well.

Iain Coucher: On your specific point, I think the current sector is about 70% geared, and we would like to see it come down. That is the industry average rather than our goal. We would like to see it at about 60%.

David Black: Yes. We talked about 60% in the current price review period. Clearly, the level of gearing is in itself one factor. As you pointed out, other factors in the financial structure can add to the stresses, but we think that gearing needs to be lower than it is now.

Lord Reay: My second point is on a topic that Iain discussed earlier in terms of Thames Tideway and Thames Water, and how it is important that the project was a success, and that Thames was a success, and that you were there to help Thames if there were issues. If you are vested in the success of the companies you are regulating, how independent would you define yourselves as a regulator?

Iain Coucher: Do not get me wrong. I was not suggesting that we are here as an apologist for the water companies, but it is important for everybody that water companies succeed. We do not want to see anybody fail. We want them to deliver for the consumer and for the environment. We have a degree of support or tolerance because they are in the recovery programme, and it is absolutely critical that they succeed. That will not mean that we let up on holding them to account for their

performance or their delivery of ambitious targets, but we will enter into dialogue with them to understand what is going on.

My goal is not to suggest that we are impartial. Well, we are impartial, but we are not partial to them; we are not embedded in it. We want them to succeed, as we want all our water companies to succeed, because consumers and society expect high-quality service from water companies. I was not suggesting that we were going to give them grace or favour. We know what they are doing. We know they have a recovery plan. It is important that they succeed. Things will happen along the way, and they will talk to us about delivering it. Does that give you reassurance?

Lord Reay: Thank you.

The Chair: Iain, could we come to what keeps you awake at night? Your predecessor explained to us that one of the consequences of indexing the asset base was that there could be significant windfall profits for water companies as a result of the current level of inflation. He said that that kept him awake at night because he did not want to add insult to injury to consumers and he had not yet resolved in his mind how that could be avoided. Have you any thoughts on that?

Iain Coucher: On the indexation, or what keeps me awake at night?

The Chair: The consequences of indexation.

Iain Coucher: It is a challenge. David will articulate this much better than I can. There is an upside that comes from indexation. There are a number of things you can do with that fund. We would like to see that not returned to shareholders—the shareholders are getting the benefit of the indexation inflation—but used either to deleverage the company or for some other customer benefit. They should not benefit from the upside of high inflation. We have views about how we can do that. Jonson was right to say that it is a looming issue. We are aware of it. It is an opportunity for companies to do some good with it.

The Chair: To the extent that, as a result of the formula, there is a windfall profit, would you be able to direct the companies to use that windfall for the benefit of consumers or to increase investment above the current expected rate?

David Black: It is more about encouraging the companies to do that by the changes to the licence regime to potentially prevent them paying out dividends when they ought not to. That would keep the money in the company. I think companies have accepted that that ought to be the case, so I do not think we necessarily face resistance on that. Some companies have gone ahead and are investing the money to benefit customers.

The Chair: When we see the Secretary of State shortly, we will encourage him, or her, to give you full backing to ensure that that is indeed what happens.

Thank you very much indeed for spending a few hours with us. It has been very helpful. We wish you well.