



HOUSE OF LORDS

## Industry and Regulators Committee

### Corrected oral evidence: Follow up: Ofwat, the water industry and the role of the Government

Tuesday 4 July 2023

4.05 pm

Watch the meeting

Members present: Lord Hollick (The Chair); Lord Burns; Viscount Chandos; Lord Cromwell; Lord Gilbert of Panteg; Baroness McGregor-Smith; Lord Reay; Baroness Taylor of Bolton.

Evidence Session No. 4

Heard in Public

Questions 33 - 57

#### Witnesses

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

## Examination of witnesses

David Black and Iain Coucher.

**Q33 The Chair:** Welcome to this meeting of the Industry and Regulators Committee. We are continuing to look into the water industry and we have a particular focus on the role of the Government.

We met both of you and had a good discussion last October. One issue that we were concerned about was the financial stability of the water companies and in particular whether they had the financial firepower to catch up on the infrastructure investment that is needed to stop leaks and to stop poisoning our rivers and the sea. We came away from that meeting thinking that you were taking quite a lot of steps to do that, reducing the level of gearing and being much more proactive—if I can use that word—about setting tasks on behalf of the water companies to make investment and do these things. Indeed, one of them was to deal with the level of gearing, which you felt had zoomed too high and should come back to no more than 60%.

We had a meeting a week after the meeting we had with you, with Sarah Bentley, the then CEO of Thames, who was positive about the prospects with Thames and bullish about the plan she had put forward. Indeed, she maintained that sunny outlook until days before she quit.

The first question we would like to explore with you is when you heard about the position of Thames. When did you realise it was in peril? How were you informed about it? Was it part of the regular monitoring you are doing of the financial health of the water companies, or did it come out of a clear blue sky?

**David Black:** We published our annual monitoring financial resilience report on the sector in about October last year, and Thames Water was one of the companies that we noted required action to address its financial resilience. We considered that its financial resilience was not adequate and we had concerns about it.

At that point in time, the company had plans to raise £1.5 billion of equity from its shareholders, which it set out in June last year. Since then, it has secured £500 million of that from its shareholders, but it still requires further equity from them. We had been engaging in discussions with the company and its investors for some time. We were aware that it needed to raise the equity. It had been publicly transparent about that.

Then it updated us on where it was getting to with its shareholders and the concerns that the business was not turning things around sufficiently fast. It still needs to raise further equity from shareholders, and there are discussions with them about doing so. We are in discussions with the company and its shareholders as well. That is where the issue sits today.

I stress that the company does have around £4 billion of liquidity to draw on. We think that some of the reports about concerns about Thames have been overstated. The company has an ability to weather the present issues.

**Q34 The Chair:** Let us unpack that a bit. When we spoke with you earlier, in October, you were talking about £500 million being put in. That figure has now gone up to £1 billion. As I understand what you said, the shareholders have become rather reluctant to put additional capital in. Is that the case?

**David Black:** To be clear, the plan always was to raise £1.5 billion of new equity from shareholders. The shareholders have put in £500 million. There is still, on that original plan, £1 billion to come in and that is what the company is in discussion with its investors about raising.

It is correct to say that investors have become more concerned about the successful turnaround of the company. From an investor perspective, they are looking to invest in a proposition, and that requires them to have confidence that a turnaround plan is in place. The company is at present revising and developing its turnaround plan. That is where the discussion is between the company and its investors. It will also send a business plan to Ofwat on 2 October this year as part of its PR24 business plan.

**The Chair:** When did it become clear to you that the plan being put forward would not support that additional level of investment or would require even more investment?

**David Black:** The company had updated us some months ago about its engagement with shareholders and where it was getting to with its financial position. We have a strong interest in this, obviously, but it is up to the company to raise that equity from its shareholders. We are here to protect the customers' interests in that process.

**The Chair:** At the moment, you have a shareholders' strike.

**David Black:** No, the company is in discussions with the shareholders about raising that equity.

**The Chair:** How much money is required?

**David Black:** To make a final judgment on that, we need to see the revised business plan. We think it is substantial sums of money.

**The Chair:** To what extent has the failure to hit the plan resulted from increased interest rates or from poorer trading than was expected?

**David Black:** That has exacerbated the position. The company has always been aware that, and has been clear that, it was performing poorly and was not meeting its performance targets in the current price review period. It is conscious that it needs to turn that around and has plans to do so. The impact of inflation and the drought last summer exacerbated those financial issues, but rising interest rates have had a material impact. It also has protection, in that the cost of capital gets adjusted as the cost of new debt rises. It is more about the impact of inflation on its business, but I would also note that inflation is beneficial

to it as well. It increases its underlying capital base, which will reduce pressure on the gearing in the near term.

**The Chair:** The inflation situation was known six months or so ago, and interest rates have been heading north for quite a long time. These matters would have been capable of modelling and predicting some time ago, and what you are saying is that this is relatively recent. In that context, the departure of the chief executive days before it became clear that the roof was in danger of falling in suggests that something rather dramatic happened in the last few days or weeks before her departure.

**Iain Coucher:** May I say a few words? We had been aware of Thames' poor performance for some time, for all the reasons that Ofwat has said in monitoring its performance. We were told about the turnaround programme, and we were—curious is the wrong word, but we wanted to know a lot more about that. David and I and a number of other Ofwat executives went to Thames in November last year [2022]. We wanted a detailed explanation of its transformation programme. We were concerned about the rate of improvement. We further expressed our concern to the Thames board on 22 March [2023]. Again, we said, "We are very concerned about the rate of progress on this turnaround programme. You need to think about ways in which you can accelerate it."

We have known about this struggling company for some time. As the company has got into doing more modelling on how this will unfold in the coming year or so, coupled with increasing energy prices, it has exacerbated the situation and made the injection of equity more acute. We have been aware of this for some time.

**The Chair:** The injection is needed more quickly. Is the quantum larger than you originally thought?

**Iain Coucher:** We have been told that to get through this control period, it needs about £1.5 billion of equity and £0.5 billion has been secured already. There are ongoing conversations about whether the remaining £1 billion is sufficient. It also has in mind what might be required in future control periods. There is a bit of a conversation about the next financial settlement as well.

**David Black:** Looking ahead, the company knows it has to invest further at the next price review period and to back that it will need to raise both debt and equity. To do that it needs a stronger financial position. There are the issues it is currently experiencing in getting through this period, and then there is what it needs to secure for the next period and progressing the degearing of the company.

**The Chair:** Other companies have experienced higher interest rates, very high debt and, of course, inflation. Is this a systemic problem across the water industry or is it a problem only for Thames?

**David Black:** The problem is most acute at Thames because it has persistently poor performance issues and very high gearing. Thames's gearing is higher than any other companies' in the sector and its performance is right at the bottom of the sector. If it was poor performance alone, it could weather this; it is the persistently poor performance combined with a very high level of gearing.

We are pleased to see that other companies that we have raised concerns about are raising equity. Yorkshire Water announced last week that it had secured £500 million from the shareholders. Southern Water has raised equity and is in the process of raising more. I understand that more companies will announce that they have successfully raised equity in the near future. We are seeing the sector successfully raise equity and we do not see the same level of issues at other companies. That said, we are being very public about the need for companies to improve their position and equity. We think that many companies will need to raise equity as they look ahead to the challenges of the next price review and as they finance a much larger investment programme.

**The Chair:** Could you have taken action earlier to avert this situation?

**David Black:** It is very much for Thames and the shareholders to address this issue. As I say, we are here to protect customers' interests. We will use all the tools we have at our disposal. I think you have to go back some years for potential earlier action. We are engaged with Thames, and we will continue to do so as it works through these issues.

Q35 **Lord Cromwell:** You have told us that in October and November last year, you raised concerns about Thames Water. I do not want to talk just about Thames Water today, but inevitably we will talk quite a bit about it. Macquarie bought it in 2006, loaded it up with £14 billion of debt and with PE financial engineering paid out dividends to the parent companies. Why did it take so long to get concerned?

**David Black:** On the question about financial resilience, those problems have become more acute in recent years due to its poor performance and the falling cost of capital. While it raised debt in earlier periods, its financial resilience was not as stretched as it is now, but it underlines the case for our view that the sector should reduce gearing. As part of the 2019 price review, we introduced a financial incentive for companies to reduce gearing. Interestingly, on appeal to the CMA it rejected that mechanism. We have been trying, use all the tools at our disposal, to encourage companies to bring down gearing. That is certainly an issue in their current financial predicament.

**Lord Cromwell:** You are saying to us that you could not have seen this earlier and you did everything you could?

**David Black:** Going back to 2006, I think we should have stepped in at that point to stop companies gearing up; I think that is right. We have changed companies' licences, so that we have the powers to stop it happening, but at the time we did not have those powers. We received

new powers from the Government in 2021, and we have used those. We have new licence conditions in place to protect customers in the future, but at that time, going back to the early 2000s, regulators across all sectors took a relatively hands-off approach to companies gearing up. That happened in the energy sector and the transport sector. We are very clear that we think companies need to have a prudent financing structure and that some of the legacy financing structures need to be brought up to date.

**Iain Coucher:** We were aware of Thames' problems before that. I was particularly talking about the turnaround programme that we were concerned about in October and November, and it sort of works like this. It was performing so badly that we were concerned for the customers in London about leakage, service recovery and things like that.

**Lord Cromwell:** When was this?

**Iain Coucher:** All throughout last year. Because it was performing so badly, we wanted to see the turnaround programme pushed faster, and while turning it around it has had reduced income because the income from customers has been depressed. The way to support the business throughout that period was further injections of equity. We were very nervous and wanted to see answers to, "What are you going to do to support the business during the turnaround programme?" It was beginning to crystallise then, and that is when we get into the letters of support for equity injection. It has been on our radar for a long time, but we could not really intervene because at that stage it had commitments from shareholders to inject equity to address the shortfalls.

**Lord Cromwell:** I have the benefit of hindsight here, of course, and that is always a wonderful thing, but you are still only taking us back a year and this had been going on since 2006. I am just trying to understand. You get very detailed financial information. Was it just, as you say, that a light-touch approach was being taken, or did people not understand the PE engineering model?

**David Black:** From about 2015 onwards we introduced a new financial monitoring regime, partly because we were concerned about getting early insight on companies with financial issues. We published reports. Last year we drew attention to Thames' issues but if you go back to previous reports, we had identified it as having insufficient financial resilience. We have been clear for some time there were issues. In the 2019 price review, which goes back to 2018, we introduced the back in balance proposals. We were clear that the sector needed to turn this round. We have been talking to the sector about this since at least 2015. Certainly, this process has been in motion for some years. If I go back to earlier periods, in the pre-2007 period, there was a more relaxed approach to companies raising levels of debt. At that time, levels of debt were much lower but since then the approach has been tightened.

**Lord Cromwell:** I am glad we are less relaxed, I think, than we were.

**David Black:** We are very much of the view that companies need to bring down their level of gearing to reasonable levels. As I say, we have faced huge resistance from investors and companies to doing so, so this is us taking action to change the way the sector is funded.

Q36 **Lord Cromwell:** Let us look forward now. Are your new licence conditions enough to prevent repeats of what we are going through with Thames Water? Do you have enough to work with there? Specifically, what further actions will you be taking to hold down or even reduce debt in other companies?

**David Black:** The primary thing is stopping dividends going out of the company, so that locks cash into the company. We have raised the minimum level of investment credit rating before the cash lock-up provisions apply. We are also using a financial monitoring framework to highlight where we have concerns with companies, and we are engaging with companies privately and publicly to address our concerns. All the companies we have been concerned about have plans to raise equity, and I am pleased to say that they are raising equity.

The other issue for Thames is its size and scale. Raising £500 million for Thames means much less when you have a £14 billion debt pile. Raising £500 million for Yorkshire Water obviously has considerably more impact. We feel that the sector is making progress on this but there is more work to be done, particularly because the sector needs to finance its large investment programme.

**Lord Cromwell:** Are you confident that this situation that has arisen with Thames Water will not arise again the future?

**David Black:** I think that we have the safeguards to stop the cash moving out of companies. Clearly, we have companies in financial positions that require injections of equity, so there is still the legacy of those past issues to address, but we are working with the companies to make that happen.

**Lord Cromwell:** If you do pile in and start telling companies that they have to reduce their level of debt, will that frighten off the investors and increase their costs, so that the whole business does not really make sense any more? You have been very careful in what you are saying not to frighten the horses, if I can put it that way, but if you start interfering at this level and saying, "£14 billion: you have to get it down to £5 billion", or whatever figure you want to pick, how will investors react?

**David Black:** On the licence change proposals, the credit rating agencies were clear that they saw it as positive from a debt market perspective, but it is a potential negative from an equity investment perspective. We have listed companies that raise equity with levels of gearing in line with our view about a prudent financial structure, so we think it is certainly possible for this investment model to work. There are issues with current investors in the sector who may not have the appetite to invest further money in water companies, so some of those may have to leave and new

investors may have to come in. That process needs some time, so that is what we are looking to see happen over the next few years.

**Lord Cromwell:** I imagine that that investor flight is one of the things keeping you awake at night at the moment.

**David Black:** I think the sector remains attractive to investors. We are seeing investors buy in and pay premiums for water sector assets. The price of listed companies remains positive in relation to their RCVs, and companies are raising debt at attractive prices in the international market. The sector is attractive to investors. One of the things in its favour is inflation protection. If you look at a world today where inflation risk is quite significant for investors, what the water sector offers is protection against that risk. While returns are low, associated with low-risk investments, it does benefit from inflation protection.

We think that the growth opportunities in the sector make it attractive for investors and we expect it to remain so, but you are absolutely right that we need to get the balance right so that we continue to attract global international capital, which can choose where it goes, into the UK water sector.

**Lord Cromwell:** Time will tell, I guess. Thank you very much.

Q37 **Lord Reay:** Are you confident that £1 billion in equity at Thames Water will be enough? To me, it seems like a sticking plaster on a huge problem. With £14 billion of debt, presumably it is paying 6% to 7%, which is £800 million to £1 billion alone. On your comment about £4 billion of funds, I recall that the press report from Ofwat referred to "committed funds". Do those committed funds include the £1 billion that it is in the process of raising?

**David Black:** No, they do not. We agree that the total equity it needs to raise is larger than the £1 billion. The £1 billion we are talking about is to get it through the current financial period. If you look to the future, it will need to raise further equity to degear the business and further equity to address any remaining issues with its performance and turnaround.

**Lord Reay:** Can you explain to the committee how the special administration process works—the mechanics—and to what extent would special administration lead to cost for the taxpayer?

**David Black:** The special administration process is there to protect customers' interests and to ensure that service continues to be provided to customers. We have not had to use it at a regulated company level since privatisation, but the way it works is that either Ofwat with the consent of the Secretary of State, or the Secretary of State, applies to the High Court. If the court gives permission and a special administrator is appointed, it is its job to turn around the business and find new owners. There is a number of different ways it might do that but ultimately, its role is to sell the business to a new set of owners. It transfers it from an existing set of owners who are unable to continue to finance the business. If there is any debt restructuring required, the

special administrator can address those issues as well, and then the business moves on under new ownership and continues to provide services to customers. That is the gist of it.

**Lord Reay:** How involved is Ofwat in the special administration process?

**David Black:** It could be involved in the appointment of the special administrator, but it is with the consent of the Secretary of State. Then the company is run by the special administrator. We would have a role as the regulator, but we are not the special administrator and we are not running the company.

**Lord Reay:** No, but you told us when you replied to our report that, "Where appropriate Ofwat would proactively consider using this tool, where it best enables us to fulfil our various duties".

**The Chair:** Hold the answer to this question because we have a pause now while we go and vote; we will be back in about five minutes.

*The committee suspended for a Division in the House.*

**The Chair:** Welcome back. I think when we hit the pause button you were about to respond to a question from Lord Reay. Do you want him to repeat the question so that we can all remember? Not everybody will have remembered in the five-minute gap, including me. Start again.

**Lord Reay:** I was asking about the special administration process and to what extent Ofwat gets involved, because you told us in your reply to our report, "Where appropriate Ofwat would proactively consider using this tool, where it best enables us to fulfil our various duties". Is that how you stand on that?

**David Black:** Yes. There are two grounds for special administration. One is financial—insolvency, inability to pay debts—and the other is where a company is clearly unable to fulfil its duties. That is more a performance-based measure. There is a high bar for both forms of special administration, understandably, but it is a potential remedy that we would consider employing if the circumstances warranted it.

**Lord Reay:** I was going to ask you about confidence in finding a new owner for Thames Water if it has to go through the regime, but I think you answered that in responding to Lord Cromwell.

Our committee also called for Ofwat to use its special administration regime more proactively to change the ownership of poor performance in the sector. Is there a case for intervening earlier to avoid a company's situation deteriorating to this extent?

**David Black:** It is reasonable that there is a high bar for the employment of special administration. It is a very significant intervention in the affairs of a company and its owners, so it is right that we do that on a basis where there is a strong case to do so. Also, new ownership does not necessarily change the situation facing a company. New owners can

provide finance but if the existing owners are willing to provide finance, if a company has a suitable transformation plan and if it is committed to turning round its performance—what we care about is the ability to deliver service for customers in the present and the future. That is the lens we look through. If we thought that the owners were not able to provide the backing or the resources to support the turnaround, clearly, there would be a case for the use of that tool. It is a high bar, so it requires the permission of the High Court. We would have to get the approval of the Secretary of State as well, so it is not something that would be done lightly.

**Lord Reay:** The appointment of a new interim CEO at Thames, a former Ofwat head, is another example of what appears to a cosy revolving door between the water companies and the regulator. Are you concerned that the perception this creates might not be positive for an industry struggling with a lot of issues at the moment?

**David Black:** As I understand it, Cathryn Ross is co-chief executive with the chief financial officer Al Cochran. We obviously employ good people at Ofwat, so sometimes when they leave they will work in the sector. To be clear, Cathryn did not leave Ofwat and go to Thames Water. She went to BT and spent at least three years there before she turned up at Thames Water. People raise questions and have perceptions but, to be absolutely clear, we are fully independent of the sector. At the last price review we were appealed by four companies. I think the sector see us as being challenging and that is absolutely right. We are and we will be.

I do not see that staff going from Ofwat to companies in any way changes that. They see Ofwat people of high calibre and I can understand why they may want to recruit them, but we draw people from a variety of sources. They stay with Ofwat and have good careers but ultimately, most people will choose to leave at some point in their career. We are a relatively small organisation. They will go to various sectors and that includes the water sector, but I do not think there is any suggestion that somehow or other this undermines the process. I do not follow the argument, in the sense that it is not that Ofwat is employing people from water companies, but the reverse. If anything, companies are exposed to the idea they are captured by Ofwat people, but I will leave that for them to judge.

Q38 **Viscount Chandos:** May I go back to the question of a special administration regime? Is it really needed in this case? Surely the licence should enable you to protect the interests of customers. Should not the various holders of the different levels of capital have to be made to sort it out, as occurs in unregulated industries and other regulated industries?

**David Black:** Special administration on the grounds of insolvency applies as with other sectors. If a company fails, there has to be a resolution of the issues. The difference in the water sector is that it is a monopoly service: customers cannot choose it or change their service provider. Therefore, it is vital that those interests are protected, and customers need to know that the water will keep flowing and services will keep

being provided, and that is what special administration is there to do. You are right that the best answer is for investors to deal with the issues with the company and to resolve them. If they fail to do so, we will consider intervening with special administration.

**Viscount Chandos:** Without going into administration and therefore into talking about the special administration regime, are you not taking pressure off the existing owners of capital—the debt holders as well as the equity holders—to sort it out?

**David Black:** I think the reverse; we are increasing the pressure on them to meet their obligations.

Q39 **Baroness Taylor of Bolton:** We had a lot of evidence when we were doing our main report that things have been very bad in the past—the water companies had not lived up to the investment they promised and so on, that Ofwat has not been as strong as perhaps it should have been—but that all was going to be well in the future. I am sure you followed that in the evidence sessions that we had. We also heard evidence from Thames Water and that evidence was very similar: that things had been bad in the past but everything was going to be all right in the future. What do you think of the evidence we were given by Thames Water? I am not asking you to say that we were deliberately misled, but do you feel that the committee got a full and fair picture of the situation that you have been outlining this afternoon?

**David Black:** I think we have been clear that the sector faces quite deep-seated challenges. Leaving aside the position of Thames and its finances for the moment, there are issues that you have highlighted around addressing storm overflows and plenty of other environmental issues in front of it: the need to improve customer service, upgrade assets and face the challenge of climate change, and to improve drought resilience. There is a whole set of challenges in front of it.

It is also very clear that the performance in the sector today is unsatisfactory. In our last annual performance report, I think we singled out seven companies as lagging behind. Given that there are only 17 companies in the sector, performance is clearly not where we would like it to be and not where customers expect it to be. Companies are seen to have let down the environment. I think we have enforcement actions against six major companies. There is a lot that is not right, and I would not want to leave any impression that we think that the status quo is satisfactory. We do not and we are determined to change it.

I am sure that companies were sincere in their aspirations to improve and to change, and I know that the leadership at Thames were. It is just a question of whether they have been successful in executing those changes and turning things around, in what is clearly a huge task for that company and for some of the other companies, and for performance improvement plans. I think the scale of the challenges were understood by the company and the aspirations to improve are very clear, but there is a big job to turn those aspirations into reality.

**Q40 Lord Gilbert of Panteg:** Thank you for the evidence. Shall we move on from Thames to the wider industry and in particular can we look at dividends and executive pay, starting with dividends? You have told us that you have introduced new controls to link dividends to performance. Can you tell us a little bit about how that will work? In particular, will these controls apply across the water companies' entire structures? Are you confident the companies will not be able to put in place complicated financial structures to avoid your controls?

**David Black:** The provisions that we are applying apply to the regulated entity. In the case of Thames Water, that is Thames Water. A number of companies have holding company structures. Some of them have rather complex financial structures. We are introducing controls that will prevent cash leaving the regulated business, so that is where the customers' money goes into, and that is the business we are focused on. There may well be issues with holding company structures and it will be for the companies to address those. If we control the cash leaving the regulated company, we are protecting the customers' interests and that is the focus.

**Lord Gilbert of Panteg:** Are you comfortable that your controls will hit the mark?

**David Black:** We have only just introduced the provisions, in March/April this year. We have yet to test them in anger and apply them. At this point, we are confident that we can exercise control. We want to get companies to take responsibility, to get boards to take responsibility to make decisions, to link dividends to performance—something that they have committed to in words. We want to have the ability to use the licence to hold them to account if they fall short on that, but the real action for us is to change company behaviour. It is not so much about taking enforcement action. We will do that if we need to, and that will test whether these provisions work in anger or not.

**Lord Gilbert of Panteg:** If companies do enter into complicated financial engineering, will you call it out?

**David Black:** Yes, we can do but, as I say, we can use the protections that we have to target. It is where the customers' money is that, ultimately, we are most concerned with. If we can exercise control over that entity, there is then the question about transparency. I am very aware, for example, with Penmon's recent dividend that it did not explain very well where the money was coming from in relation to South West Water and the water companies versus their parent company. We have been clear that companies need to improve in this space. I think there is quite a long way for some of them to go in explaining clearly where customers' money goes and what proportion is going back to shareholders as part of the returns.

**Lord Gilbert of Panteg:** Thank you. You have also published plans to tighten scrutiny of executive pay and some water company bosses have started waiving bonuses, so maybe they are getting there. Do you think

company bosses are getting there? Do you think they understand the issue and are taking the right action? If they do not take responsibility, will you take the recommendation of this committee and seek powers to ban bonuses from companies that are responsible in particular for serious pollution incidents?

**David Black:** We would like to see companies taking responsibility in linking executive pay to performance. We have introduced new provisions to do that, which will mean that we can stop companies recovering the costs of bonuses from customers where they do not link the bonuses to performance. We are trying to get company board remuneration committees to make responsible decisions, to set challenging benchmarks and challenging targets, and then to follow through and link executive pay to performance. Iain and I have met with the chairs of the remuneration committees of all the companies over recent months to make clear our dissatisfaction with their approach.

I am pleased to see that all of the large wastewater companies have announced that they are either not taking bonuses or their customers will not be paying for them. I think we are seeing signs of progress, and we welcome that, but there is still a job to be done looking ahead. We will test these new provisions; we will see whether they work and we will reflect further at that point. I am hopeful that these new provisions that protect customers' interests will be sufficient. We want to change the conduct of boards to link it to what the public would expect a responsible customer-focused water company to be doing.

**Lord Gilbert of Panteg:** You have not closed your mind to seeking new powers if they do not behave in the way you are hoping they will.

**David Black:** I think the first challenge is to use the powers that we have, so that would be the first test. But if at that point we are not satisfied that we are getting the action we would like, we will clearly look at the case for taking further action.

Q41 **Lord Gilbert of Panteg:** Responding to our report, you told us that Ofwat can apply for directors to be disqualified for breaches of competition law or if their conduct makes them unfit, and that the Environment Agency can apply for disqualification following convictions for pollution offences. Are these powers sufficient and do you think you will be using them more frequently in the future?

**David Black:** We think that it is right for colleagues in the Environment Agency to address the issue of environmental offences. We are reflecting on the role that company directors play, the role of company management versus boards and shareholders, and the potential benefits from holding individuals to account. We will look at that and we will use the powers we have if we see company directors breaching the Competition Act or their duties.

**Lord Gilbert of Panteg:** You are looking at boardrooms working in the way you would want them to; you are not looking for new powers. You

have talked about how you will deploy your existing powers, and the new measures you are taking. Your assessment of these issues is broadly that boardrooms are behaving responsibly and incorporating these.

**David Black:** No. We have had real concerns about the conduct of boards. We have introduced board leadership and governance principles and licence changes to get boards up to the game in this space. I think we are seeing some progress with the decisions that we have taken. We are engaging, as I say, with boards and chairs of committees in this space. I do not think we are there yet. We have real questions about the governance processes and the decision-making processes. We think it right as a regulator that we pay attention in this space, but we are seeing some improvements and we hope to see continued improvements. We will look at what else we need to do if we do not see further improvements.

**Lord Gilbert of Panteg:** Will you be naming and calling out where you are not satisfied with the progress that is being made, even if it does not involve immediate enforcement?

**David Black:** The power to call out poor performance is important. I think you have seen recently with South East Water that we have called the board in. Where we see issues that look to us to be unsatisfactory, we will not hesitate to call in companies and to make clear publicly our concerns where they are falling short for customers and the environment.

Q42 **The Chair:** I think you are painting a picture whereby the problems largely happened 10 years ago, and you are catching up and you have good plans. We were told by Thames that it had very good plans but now we know that those plans did not work. The people who ransacked the company 10 years ago have all scarpered, so there is no money left in the till. Your previous chairman explained to us that in the case of Southern Water, there was a virtual special administration by changing its ownership in 2021, the previous owners having lost a very large share of their investment. Would not something along those lines—special measures involving administration, keeping the assets working effectively and well, a much lower level of debt and a plan that takes into account the current position on costs, inflation and interest rates—be a cleaner and better outcome?

**David Black:** Are you referring to Thames Water?

**The Chair:** Yes.

**David Black:** Clearly, that is an option that could be a resolution for Thames Water. Effectively, Southern Water raised new equity that was through the direct contribution of new shareholders into the business. That is a potential option for raising funding for Thames Water, so I would not rule that out. Equally, there is clearly a number of options on the table for addressing those issues for the existing shareholders raising that capital. But it may well be that new shareholders need to be brought

in, and then there will be a discussion between the outgoing shareholders and the new shareholders as to the value of the existing Thames.

**The Chair:** Let us return to sewage.

Q43 **Lord Cromwell:** In May, Water UK apologised on behalf of the water companies and pledged that £10 billion of this £56 billion that has been talked about would be brought forward to invest in this decade. We took a while to clarify that it was not new money; it was out of the £56 billion. Is that going to be enough to meet the government targets that have been put forward?

**David Black:** We will consider that question as part of the 2024 price review. Companies will set out their business plans to us on 2 October. As I understand it, that number is based on the draft water industry national environmental programme that will be agreed with the Environment Agency. It will reflect the Environment Agency's view about the measures that need to be taken to deliver on the government targets. I understand from the companies that they are confident that they will deliver against the government targets, but we have yet to reach an assessment on that.

**Lord Cromwell:** I will take that as a maybe, I guess.

**David Black:** Yes.

**Lord Cromwell:** Either way, it looks like you are going to be faced with approving some pretty chunky investments coming down the track towards you. Do you feel that the Government have given you enough of a steer on how to strike the right balance between water bills and the wider environmental issues that are now very much in people's minds?

**David Black:** I think the answer is yes. As I tried to explain to the committee in the past, a lot of what comes through in the price review is part of the statutory environmental investment programme, which is required by the EA in England and by Natural Resources Wales in Wales. Therefore, it is part of the business plan and we do not have discretion to disallow that. I think you are right about the stormwater revised plan, but it is not just the stormwater revised plan. That will not be even half the level of investment that they are going to make. It will be a very substantial level of investment coming through at the 2024 price review, so decisions are being made on that at present by the Environment Agency and the Government. That will get reflected in business plans and then there will be a question about the impact on bills.

With the SPS but also with the statutory drives that go into those programmes, that will define a lot of what companies have to do in the 2024 price review. Then there is a question about balancing the affordability of that. Another question that has been exercising us recently is the deliverability of the programme: can the companies turn the money into assets on the ground?

**Lord Cromwell:** Are you clear on what they are likely to be? What are you going to get for your £10 billion?

**David Black:** We ask the question of companies in their business plans as to what they are doing to deliver against that, so we expect we will get a very long list of specified schemes. I am hoping to see some innovative proposals come through, using nature-based solutions, catchment management as well, but we would also expect to see some of the more traditional solutions, which is large tanks, stormwater overflows. That will come through business plans. Then, the challenge we have identified in the letter we sent to you is that we need to step up our role in monitoring the delivery of that and holding companies to account to deliver.

If we think about a programme, which I think at the last price review was about 11,000 environmental schemes, this price review might be multiples of that. Clearly, there will be a high level of public interest in the speed at which companies are delivering against that, their success in the delivery of that, and the cost of the delivery. We think we will need to resource up to deal with that. I am pleased to say that we have agreed with HM Treasury an increase in our funding for the next two years to start to move into that state. We need to be much more active in overseeing delivery of that.

**Lord Cromwell:** We are letting Iain off the hook a bit here. He has been nodding or shaking his head, depending on what you are saying.

**Iain Coucher:** I agree with everything.

Q44 **Lord Cromwell:** Are rates of return in the water industry enough to drive the increased investment that will be needed? I am asking Iain that one.

**Iain Coucher:** To David's point, when you look at the volume of the work that is required over the next five years and beyond—the £10 billion and the £56 billion is roughly £2 billion a year for 25 years—there are many other schemes in there. There are things like neutral reductions, net zero, increased resilience to deal with less abstraction. The quantum of money is huge. As David has already said, we are very concerned about the impact on bills, the deliverability and fundability of that, and we have been out there testing that with all the water companies because we want to deliver this work as quickly as we can. We understand and accept the deliverability issue—that there might not be a supply chain to do that. We will challenge companies to do it as fast as they can. We do not want to see it just slowing down for other reasons.

We know that this will need a significant amount of new money. We are sensitive to the issue. We know that we have to make this attractive, but not too attractive, for international and national investors, so that they get a rate of return that reflects the risk they are taking, which is a slightly different risk profile, and we can get the triangulation right between the needs of customers, the environment and shareholders, in order to square the circle. As you can imagine, at this point in the cycle we get lots of people saying to us, "We would like to see the returns go up" but they always say that.

We will listen to what they are saying because we need to make it attractive, but that is not to suggest that we are going to throw money at it. It is about going through the process.

**Lord Cromwell:** But can the circle be squared: is there enough return there to attract investment? That is my fundamental question.

**Iain Coucher:** To David's earlier point, we are seeing water investments coming in; equity investments in Northumbrian, Southern—all round the place. We are seeing it, so it still remains attractive. There are still multiples on the RCV. We think it can be squared but we have to go through the process. It is quite a lengthy process, but so far we are confident.

Q45 **Lord Cromwell:** A final question from me. Do you both believe there is a role for private equity in the water industry? Is Ofwat now a bit more cute about how to manage that relationship?

**David Black:** Yes, I think it is a source of funding. It is an important source of funding in the sector. We need to see long-term investors; we need to see investors that are committed to the long term and to sound, prudent structures, and that want to see environmental improvements. We need to see investors that are engaged in the company. We have created a regime whereby, as Thames investors have discovered, if a company does not perform, they experience the downside consequences of that. They need to be engaged.

We are looking for investors that can help turn around and transform the companies that need to do that. Private equity sometimes offers that: people with real hands-on experience in company turnarounds that can secure people on company boards to assist with that. Equally, we are aware of some of the issues with and pitfalls of the model you have referenced in your discussion. We have the protections from the customer perspective to address that.

**Iain Coucher:** The nature of the investments has changed. This is not necessarily true for all companies, because there are some listed plcs out there with different models, but the pension funds that have invested in these companies were quite happy to invest in low-risk, steady returns. They knew that there would be some retention of dividends to reinvest in the business, and that was fine. Now, the demand for further investment means that you cannot just invest and forget. You have to invest with the expectation that in future periods, you have to reinvest as well. That is a slightly different type of investment fund. It is certainly a role for private equity, for pension funds and for everybody, but we are seeing the nature of investments change slightly because of this continual need to invest over multiple five-year periods.

**Lord Cromwell:** Very interesting. Thank you.

Q46 **Baroness McGregor-Smith:** I note that, as listed in my register of interests, I am a non-executive director of the Thames Tideway Tunnel.

Going back to the additional £10 billion of investment needed, how much of that do you expect to be funded by increased customer bills? You obviously have a price review coming up. By how much do you expect bills to go up at that price review, particularly given the additional investment required in the sector?

**David Black:** On bill increases, we have yet to see company business plans, which will be coming to us on 2 October. That will set out company plans for their requests for a bill increase. We understand from companies talking about plans and from their customer engagement that all companies are looking at requesting a bill increase. I think most companies are looking at quite significant bill increases, but we have yet to see the maths worked out. Secondly, there is a set of questions about allowed returns and efficiency challenge that we will impose on companies. We will know more about how all that comes together during 2024.

On the question of whether customers would pay for the £10 billion, we will examine that as part of the price review. Companies will put forward their business case. Where companies are catching up on their current obligations—issues that they should have already addressed—that is for them and their shareholders to fund. Where they are going above and beyond existing standards, which the Government's plan requires, that will be for customers to fund, ultimately. Investors pay up front and it is recovered from customers over time.

**Baroness McGregor-Smith:** Do you think it will be easy to understand what the companies have got right in their obligations, as opposed to what the additional investment could be for customer bills? Will that be quite easy to see within the range of company plans?

**David Black:** I think it will be challenging. We will expect companies to demonstrate that in their business plan and we have live enforcement actions under way at present, which will shed light on this issue as well. One of the key challenges for the 2024 price review is landing on that position and being able to communicate and articulate, as a regulator, why we have reached that view. I fully expect other people to differ in their views on this. Our processes will be transparent and open, and we will publish the decision but also the reason why we have reached the decision. There are appeal rights for companies in the process if they wish to disagree with us.

Q47 **Lord Burns:** Following on from the previous question, when you talked about the maths of this, you have an ambition to get the debt average down to 60% or so. Does this mean that for this very large increase in investment, companies will have to find from equity and retained earnings 40%, at least, of what is being looked for? Is that how the maths work?

**David Black:** At price reviews we use something called a notional cost of capital. We set, effectively, a target for gearing, which was 60% in the current review period. We are lowering it to 55% in the future review

period. Companies will still make choices as to how they gear their business. I think we are expecting to see companies bring down their level of gearing—but not all of them will—to 60% or 55% in the next period. That is not so much the issue from our perspective. The issue is whether they have sufficient financial resources to weather the challenges that will come their way, and variability in their performance.

I think what you are touching on is that if investments are increasing, that needs to be financed and in some cases companies—Thames, for example—will need to bring their gearing down. That amounts to quite significant sums of money. On the other hand, they have certainty, once they have got through the price review process. There is a very clear set of parameters—their revenues, their asset base growing over the next five years, and a fair amount of certainty beyond that—to address that issue.

**Lord Burns:** I understand the attraction of the way it works, partly, but the issue just struck me, given that we were discussing earlier the need to get more equity into this industry. At the moment, the companies have not been generating very much in the way of retained earnings, but this indicates that the pressure on raising more equity in the next period will also be quite intense.

**David Black:** Yes. It may be that companies will need to prioritise. It may be that they cannot deliver everything at once and there will be questions about, first, financing the programme and then getting prudent gearing arrangements in place to support the financial resilience of the company. As I say, we have indicated that there are companies that need to take action. I also stress that it is not just about gearing. Some of the financial resilience issues that we see in companies relate to the structure of the debt and the use of swaps, rather than purely the level of gearing. Gearing varies and it can be unhelpful if you focus too tightly on a particular parameter.

**Q48 Lord Burns:** Moving on from the financing of all of this, when it comes to the issue of delivering this substantial increase in investment, is the capacity there within our economy to deliver the scale of investment and the projects that you are looking for? A second question: is there a bigger role in this for special vehicles to do some of this? Do you see increased use of special vehicles at this time?

**David Black:** The short answer is yes. In Ofwat we are setting up a major projects directorate. We are resourcing up in this space. We will see more major projects come through than we have ever seen before in the sector. Traditionally the sector has had relatively few large projects; obviously, there are the Thames Tideway and some major infrastructure investments, but usually it is a lot of small projects. We are expecting to see some big reservoirs, big upgrades going ahead at PR24 and beyond, so that will mean an increase in a whole range of projects. We are expecting to see direct procurement for customers used at scale. We have one scheme in process at the moment with United Utilities, so that is probably a £1 billion-plus water pipeline to go from the Lakes to

Manchester. We will see more projects of that scale. We are also looking at the SIPR regime, which I think you very helpfully highlighted to the Government regarding loosening the legislative constraints on the use of that vehicle. We are expecting to see that used as well.

We are concerned about the ability of the sector on deliverability. All major projects are delivered by the supply chain, ultimately, and it is not just a question for the water sector. We have rail investments, nuclear power stations, energy, the grid transformation. There are some real questions for the country as a whole about where the priorities are and then how we can unlock and unblock the constraints on the supply chain. There are things we can do as a regulator in making sure that the pipeline of investment is there and is visible, but it will require companies to work with the supply chain constructively. We can use the special purpose vehicles as well but there may still be a challenge in delivering the scale of investment that we are talking about.

**Q49 Viscount Chandos:** Our report recommended a greater role for nature-based solutions to water pollution and surface water flooding alongside the more traditional steel and concrete approaches. In our earlier session today we heard further evidence from representatives of the industry. What do you see as the key barriers to the greater adoption of nature-based and catchment-based solutions?

**David Black:** We welcome catchment-based solutions. We have been clear at Ofwat that we would like to see a lot more of these, a lot more at scale. I think the challenges are more about getting confidence that they can deliver for the environmental outcomes that are required, and sometimes there may be legislative constraints on the ability to use a range of options to address solutions. For example, the Government are requiring companies to upgrade wastewater treatment works to technically achievable limits. At the moment that does not seem to open up the scope for nature-based solutions. We would like to see them play a bigger role.

We have changed our approach as a regulator to make sure that there are no barriers resulting from Ofwat's methodology. We think that companies have the scope to use that. We are using our innovation fund to promote nature-based solutions as well, and we are clear that we expect to see them come forward at PR24. We have also worked with the Environment Agency on the design of the international environment programme to make sure that it permits nature-based solutions. Ultimately, companies may require Environment Agency approval for a particular solution, and that is where the bigger challenges lie.

The Environment Agency has a challenge in making sure that it is satisfied that companies can deliver on their promises to improve the environment via nature-based solutions. They will not always be appropriate. There are some situations where nature-based solutions will not work and will not be appropriate, but we think the sector can do more and better. The question for me is whether it stays at the margins of water company plans or we see it play a more prominent role.

**Viscount Chandos:** The feedback and evidence from the water companies is that they see current regulation as unhelpful. Do you think that is fair, or do you think it is them making an excuse for not driving it hard enough?

**Iain Coucher:** In answer to your previous question, there are probably three drivers that are causing the non-adoption of these types of things. The first is the uncertain outcome. Everyone wants to reduce a certain level of pollution, for example. Nature-based solution at scale is not yet proven technology, so you could spend a lot of money and not achieve the outcome. Companies are a little bit nervous about spending lots of money with an uncertain outcome. We can get over that.

The second thing that is causing a bit of reflection is that we just do not have the designers out there who have built these things in the past. There is not a supply chain out there that can design them. Again, that is addressable. The final point, as David touched on, is that, to adopt a nature-based solution you have to get a waiver from the Environment Agency to say, "We are going to do that, but we are not going to do something over there". The law does not quite allow you to do that. Again, we can overcome that.

There is nothing that I or David have seen that suggests that we cannot solve all these things, but there is a bit of going round and making sure that all those things are closed off. It is not particularly a regulatory thing. It is just that things have to change, particularly on the Environment Agency as well.

**Viscount Chandos:** What proportion of nature-based solutions would you like to see in the relevant areas?

**Iain Coucher:** We would like to see as much of them as we possibly can, because it makes a lot of sense. They are good for the environment and they tend to cost much less. There is a bit of land take. I worry slightly that we are solving somebody else's problems on this. If you can provide a big nature-based solution, it allows somebody who is discharging run-off into fields and roads not to treat their stuff. They can just say, "Somebody else will cope with it". But let us put that to one side.

If we have everybody working together and this is the right thing to do, absolutely we should do it, but there is still a little bit of finessing around the edges: what happens in 10 years if it does not work; how is it maintained? These are things we do not know, but this is a much more sensible way than building large concrete tanks.

**Viscount Chandos:** You said that there were instances where nature-based solutions were not the answer. Is that 10%, 30% of what needs to be done in the next 10 years?

**Iain Coucher:** The answer—and David knows this much better than I do—tends to be where you do not have the physical land to capture and hold water processes. Over decades and centuries we have built these

sewage treatment plants and processing areas in places that now have houses all around them, and to find a nature-based catchment area that holds and treats water takes a bit of land. That is what the water companies are saying to us; they cannot always do it, but if they can, great. It does not have to be that. If you can slow water down as it comes off the run-off—we are looking at that as well. We have been very clear with the water companies: if you can find a way of doing this, we will work with you to find a way of getting through the regulatory processes.

**David Black:** We have engaged with companies about what they would like to see, and we have changed our methodology in line with what companies have committed to. We are confident our regime is pro-nature-based solutions. The question is whether companies working with the Environment Agency can deliver on the scale that we would like to see.

Q50 **Viscount Chandos:** The concern is expressed that there are too many players in this, too many different regulators or bodies. You have mentioned the role of the Environment Agency. The National Infrastructure Commission made recommendations on surface water and working with local authorities. Is there something that can be done to simplify and catalyse partnerships?

**David Black:** There are real challenges in this space regarding surface water, sewers and the role of local government and water companies. I think that water companies can do more to work in partnership with local government. We are seeing signs, particularly when there are major events and responding to those, of improved partnership working. I think it is a difficult space. The answer, unfortunately, is that there is not a national model that you can just roll out to every solution. The way of addressing these issues is different in London versus Norfolk versus Northumbria. Companies need to find ways of working with their local stakeholders.

Maybe more could be done. The NIC was talking about the approach to surface water drainage. It is obviously not quite within Ofwat's focus but it is an area where we expect to see companies working effectively with their partners. As Iain said, there are some interesting questions about what water companies should be responsible for and what should be the responsibility of ratepayers or council tax payers. There are some challenging issues in this space. We will do what we can to make sure our framework facilitates what water companies can do, and then there is a question for local government about effective working in this space.

Q51 **Baroness Taylor of Bolton:** Given the multiplicity of players involved—you have mentioned the Environment Agency, local authorities and so on—given the difficulties everybody has in co-ordinating, and given the issues you and colleagues have raised about investment in the industry, when should the ordinary consumer have confidence in their supply of water, and the ordinary swimmer have confidence that they can bathe in the sea?

**David Black:** Regarding the supply of water, there is an extensive water resource management planning process to address that issue, taking long-run projections of both demand and supply. We are clear that we need to see improvements in the demand side, driving down leakage further and helping customers use water wisely. We also need to see some major new water resources coming through, and they will need to be built over the forthcoming decades as well—not just in the next five years, but in the years to come.

**Baroness Taylor of Bolton:** You are talking decades?

**David Black:** The work will take place over decades. Building a reservoir is not a short piece of work. There are questions about the planning processes, and it is very helpful to see the national policy statement on water to bring those new water resources forward. We are confident that companies can and will deliver against this.

On the bathing rivers, there is clearly a huge task to be done on storm overflows and improving the quality of wastewater treatment and wastewater treatment works, and then making information available for bathers and users of water to assess water safety. There is a huge task to be done in that space. The bathing water framework is one for the Environment Agency to lead on, but we are keen to see further progress in that space.

**Baroness Taylor of Bolton:** You have to make sure that the investment goes in so that beaches are actually safe. I will not ask if you would go bathing in many areas.

**David Black:** As I said, there is a huge task to invest to meet the aspirations that the Government set out—the requirements, should I say—in the storm overflows plan. Companies are developing plans to deliver against that. They have taken action; we have pushed them to take action well ahead of the next price review. We are seeing them putting in place measures to reduce storm overflows now and to reduce the harm from wastewater treatment works, but there is a huge task that remains to be done.

**Baroness Taylor of Bolton:** So you would not put dates on this.

**David Black:** The Government's storm overflows plan is a 25-year time horizon, and we would obviously like to see progress accelerated and to go as effectively and as fast as possible. The optimist in me says that early in the process there should be low-hanging fruit whereby companies can make improvements relatively swiftly and at low cost. The pessimist in me tells me that as move along the curve, we will start to face some higher cost solutions. We have the Thames Tideway as an example of a close to £5 billion project to improve the Thames that will be coming into operation in the next couple of years. That is going to be great news from a customer and a water user perspective, but clearly, there are many more to come and much more to be done.

**Iain Coucher:** There was a question before about the £10 billion. We have made it very clear to the water companies that we expect the priority to be the most harmful areas. We do not want to play a numbers game. We do not want to see these things come down. We do not do the easy ones, which are small; we want to focus on those which are producing the most harm in bathing areas and coastal areas. We want to see it prioritised in that way. The first prioritisation that we have been talking about is probably 2030. I think we have spoken about trying to get rid of all those which cause the most harm, but it is going to take a while, unfortunately.

**Baroness Taylor of Bolton:** Do you understand why there is quite a public outcry about this, and the need for public information about what might happen when?

**Iain Coucher:** Absolutely, and I agree. This is going to sound very defensive. We do not mean it to be, but we have this bow wave of investment that is coming towards us, that we have to sculpt to make sure that it is deliverable and affordable and stuff like that. Until we get through this cycle of periodic review, we cannot really publish where the priorities are going to be, because there is so much. We absolutely know that people need to know when and how it is going to be fixed, so that we can hold companies to account for delivering it. We are all over this, I can promise you.

Q52 **Baroness McGregor-Smith:** This goes back to the PR24 issue. I was listening to you talk about some of the complexity that will be coming from the companies this summer. When you think of what we are doing on nature-based solutions, the additional investments needed, the historical underinvestment—the list goes on and on. Within all of that, there will be a priority list. Is it not time to think about a different approach from PR24, to take out some of this historical underinvestment completely and to do it separately?

There have been various rounds of discussions with the water companies over many years and clearly, whatever has happened has happened, but there are still historical challenges for many of them. Is it not time to accept that those challenges are not going to go away unless very significant investment is put in elsewhere?

**David Black:** I think we are going to see an integrated plan. As we have explained, there is a real constraint on the ability of the supply chain to meet that plan, so it is really important that companies prioritise what they need to deliver. It is not just about overflows and nutrient reductions; it is also a question of improving the sector's drought resilience and addressing some of the long-standing asset health issues. We think it would be best to see that in one plan, and for the companies to address those issues. Clearly, there will be questions of prioritisation. We are expecting companies to address those in their plans and to explain to us why they have chosen the plan they have.

**Baroness McGregor-Smith:** Do you think that is the best way to keep

customer bills down? I still look at it and think that surely customers must be aware of some of the historical underinvestment and the challenges the water industry has had. Would it be fairer for them to see that really well-itemised additional investment is going in to support future supply and to make sure that our rivers are cleaner?

**David Black:** We are very clear that companies need to be able to demonstrate where they are going above and beyond the current standards in justifying any new increases in spending. That is part of the business planning process—they all need to be able to demonstrate that. That is probably the best protection that we can offer. Ultimately, we are looking to get to an outcome where we see value for money from a customer perspective. That is not just about the size of the bill; it is about what customers are getting for it and what environmental improvements we see. The big challenge for the sector is demonstrating that there will be value from a society perspective in a sector that has lost the trust of its customers. That is the key challenge for both the sector and us looking ahead.

Q53 **Lord Gilbert of Panteg:** In your reply to Baroness Taylor, you mentioned the plan for water, which sits alongside the national policy statement for water resources infrastructure. Taken together, do you think that these plans provide sufficient clarity and impetus to ensure future water supplies and, in particular, will it make it easier and faster to build reservoirs and water transfer schemes in future?

**David Black:** We certainly welcome the plan for water and the policy statement for water. We are seeing one major reservoir go ahead in the current price review period. All indications are that building new reservoirs, major new water recycling sources and major water transfers are likely to be controversial. There will be people who are impacted by these schemes who will, rightly, look to see the adverse effects impacted and who may be very reluctant to see the schemes go forward.

We think there is a set of issues that are not unique to water infrastructure but are common to other infrastructure projects, which will be challenging for the sector. We worry that companies and the sector have had relatively little experience in taking major projects forward, and the low public standing of some companies may make the process challenging. We are also seeing major structure projects taking longer and longer to deliver. There are a lot of challenges facing the sector in getting the new infrastructure going from concept to delivery. We will work with the sector to try to make sure that we do what we can to make the process happen as swiftly as possible. I am under no illusions about the challenges the sector faces and the need to build its capacity and ability in this space.

**Lord Gilbert of Panteg:** Are there any further powers, any legislation, that would help to speed up this planning process?

**David Black:** Not from an Ofwat perspective. These are classic major project issues which, as I say, are not unique to the water sector. We do

think that there is a question for water companies about gearing themselves up to deliver this, and the use of special project schemes. We have seen the Tideway scheme being very successfully delivered by Thames Tideway, and it has been great to see that go ahead. However, there are clearly lots of pitfalls, which you will be very aware of, in the delivery of major infrastructure. It will be really important that companies understand the risks and that all prudent steps are taken to deliver it. We see that we have the powers as the regulator to play our part, with the exception of the supplementary investment provisions in relation to major investment projects in the water sector. In terms of the general obstacles that need to be overcome, these are issues that the water companies will need to address.

**Lord Gilbert of Panteg:** If planning and measures to increase supply are going to be tortuous, how about demand? Does the plan for water go far enough in reducing demand, and what progress are companies making in increasing water metering? Is there a case for making it compulsory?

**David Black:** We think there will be a big step-up of metering, with the Government extending the number of water companies in drought and water-challenged areas, so that will ease the rollout of meters. It is not across the whole country. Clearly from a water regulator's perspective, that would be welcome, but we understand that it is a decision for government to take, and there are clearly impacts on a customer level to consider. The rollout of smart metering, going from what are relatively dumb meters now to smart meter technology, offers further opportunities.

There is a massive job to be done to turn around public attitudes to the use of water. Companies have been working on this with customers but not very effectively to date. We have announced as part of the 2024 price review that we will establish a £100 million fund to help drive campaigns to improve the level of water efficiency. There is real scope to make changes. There is a need to drive a national-level change in attitudes. This will not be done in the short term, but it does need to be tackled. We are confident that the sector can tackle it, but it needs sufficient resources to do that.

The other area is obviously leakage. The sector has had some success recently in reducing leakage, but there still needs to be much further progress on this.

**Lord Gilbert of Panteg:** That comes back to investment. Have you modelled the potential impact of smart metering?

**David Black:** We have not, but a number of companies and other entities have.

**Lord Gilbert of Panteg:** And the outcome, the result, is—?

**David Black:** The installation of a meter, whether it is smart or not, for a water customer has been estimated to reduce demand by about 15%, which is quite significant. For a smart meter, they talk about gains or incremental improvements of 2% or 3% beyond that. The real gains are probably in network managements and leakage management. It is one of the challenges with leakage at present that companies do not know where water is being leaked from in the network. Once you have smart technology on your distribution network and smart meters at the customer end, it becomes much easier to tell where the water is going. It will also uncover leakage on the customer side. I do not know if you have had the experience of leaky loos, but they are quite difficult. They are quite innocuous-looking, so smart meters really help customers to understand where the usage is. There is certainly scope to go further once we have the technology in place.

Q54 **Lord Cromwell:** Listening to you very candidly outlining all the opposition and the challenges, perhaps it is late in the afternoon or something but I do end up wondering whether in your heart of hearts you believe that the water companies as they stand will really be able to deliver this £10 billion, quite aside from all the other things they will be doing. Candidly, it does not feel to me that your heart is really in it.

**David Black:** I will have to speak for myself. I think that the sector can do it. It needs to do it and it must do it. The sector has gone through a change curve on this. If you went back even three years ago, there was quite a lot of denial of the problem. It was not really a serious issue, or they could explain it away. We have seen a lot of companies change their attitude. There is still resistance in the sector to facing up to the issue, but certainly the urgency and the need are understood by the sector. This issue is on the front page of the newspaper more than any other for them, so I think they are very gripped by the issue.

**Lord Cromwell:** I am sure that they are gripped, but do they have the capacity to actually deliver these projects and to run them properly?

**Iain Coucher:** It is a good question. It is something that has troubled us, so we have been out with the water companies. We have made it very clear to the water companies that the size and scale of this investment programme is not something they have seen before. When they submit their business plan, we would expect them to be able to demonstrate that they have tested this with the marketplace. We have spoken to the supply chains to see their challenges. We have said to the water companies that if they think this is the status quo, they have got it wrong. If their executive team is saying that it can add a few more projects to the programme, it has got it wrong. This is a wholesale transformation of their business. It is no longer just operating water assets, maintaining them and inspecting them with a little bit of intervention. It will change everything. So unless they are in that mindset, they have it wrong.

Some companies are there. Some companies are engaging their supply chains now and thinking about partnerships and designers. Some people

are internalising capability. Some companies are not there yet, but we will get them there. We want to get to the situation where everybody has confidence that a water company can deliver this programme, that it is not too ambitious but is ambitious enough, and that it is not being slowed down for other deliverable reasons. We will push them really hard, but we want to be able to look in the whites of the eyes of the board to say, "You're standing behind this programme".

It is going to be a challenge, but we think we can get there, absolutely. My heart is in it and so is David's.

**Q55 The Chair:** When do you expect Thames to deliver its revised plan, taking into account the current environment of interest rates and inflation that we are in? When do you expect that plan to be delivered to you? It will have to be investable, because clearly a significant amount of funds has to be raised.

**David Black:** They will submit a business plan to us on 2 October, and we are engaging with the company on their finances.

**The Chair:** In October?

**David Black:** Yes, they will submit a business plan to Ofwat on 2 October—along with every other company.

**The Chair:** Can anything go wrong in the meantime?

**David Black:** We have been very clear that they have the facilities to draw upon. They have cash in the bank.

**The Chair:** You are satisfied that that the taps are not going to run dry.

**David Black:** Yes. I should note that the shareholders' plans as they were, which were to inject equity, would not have seen more equity come into the company before March next year. We are not talking about hours or days or weeks. Fundamentally, the company needs to have a plan to show that it has confidence to turn its business around, and then the equity needs to come in. That is the context.

**Q56 The Chair:** Finally, listening to all your answers and remembering what you said at our previous encounter, there is a very steep amount of investment needed, and we have discussed that today. Clearly, inflation will play into the model. Interest rates are a lot higher than they have been for the last 10 years. It seems to me that the only payer standing is the bill payer. Are there any companies that we can look to to make a contribution to the costs of this?

**David Black:** In terms of water infrastructure, the cost of water will ultimately be paid for by customers. That is how the model works.

In terms of new capital spend, that is paid for up front by investors. It is either debt or equity coming into companies, and it is recovered over time from customers. The benefit of the regulatory model is that these costs are smoothed over time, so the costs of capital are recovered over

25 to 30 years. It is also spread over future bill payers. You are absolutely right to say that if there is a big quantity of new investment coming in, and if it is to deliver improvements in service, not to address the issues that they should have been addressing from the past, that will ultimately fall on customers.

**Q57 The Chair:** As a number of my colleagues have mentioned, customers will be felt rather hard done by with the underinvestment over 10 or 15 years, by sewage pollution, by the losses that are currently being made by the companies and the very large amount of money that has been sucked out of the companies over the last 10 years. It is understandable that there is a great deal of anger on this. It is important, apart from putting forward a viable plan for Thames, that you the regulator, the economic regulator and the Government, who will be meeting in two weeks' time, come forward with a clear plan to say that we can get what we thought we were paying for.

**David Black:** I absolutely agree. To be clear, customers will not pay for past dividends. One of the benefits of the regulatory model is that dividends are zero. It does not change the allowed general capital, so that does not impact on customer's bills.

You referred to underinvestment. I think it is important to say that, on the whole, companies have spent their cost allowances over the last 30 years. There have been instances where they have underspent, and where some companies have underspent. However, on the whole, in the last price review period, companies spent slightly more than they are allowed to, and in the previous price review period they spent slightly less. On the whole, they have spent broadly what they have been allowed for.

The underinvestment that you are talking about is investment that has not been proposed by companies, has not been funded by customers, and obviously has not been delivered. That is the catch-up, so customers have not paid for that and it has not been provided. We are getting very clear signals that people want to see improvements in the space. If they want to see the improvements, there have to be the payments to follow. Where companies are not delivering for customers, where they are falling short, where they are not meeting their current obligations, that will be for company shareholders to fund. We have a variety of tools that we use to ensure that customers' interests are protected and that they are only paying for the incremental improvements in service, but these are quite significant increments that we are referring to.

**The Chair:** I was rather hoping that you were going to tell us that Macquarie was going to make a contribution out of its very considerable carried interest on the profits that it has made over the last decade.

**David Black:** The sort-of good news for you is that it is now interested in Southern Water, and it has injected £500 million into that business. It will inject further money into business to turn it around.

**The Chair:** On that hopeful note, thank you very much indeed this afternoon.

**David Black:** Thank you.