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Meg Hillier MP
Chair of the Committee of Public Accounts

By email only

10 September 2020

From Tamara Finkelstein
Permanent Secretary

Dear Chair,

Thank you for your letter of 29 July 2020 about water supply and demand management. I am writing now to respond to the points in that letter, and wanted to do so in the context of the Public Accounts Committee's full report. The Environment Agency has therefore written in parallel to set out its plans to tackle over-abstraction and sewage outflow (the report's recommendation 6), Ofwat's approach to regulating carbon emissions (recommendation 4) is annexed to this letter and, also included, is a letter from Ofwat to clarify parts of the water company evidence provided at the session on 22 July 2020. As required, a Treasury Minute responding to the Committee's report will also be published in due course.

The government, water regulators and the water industry all place a high priority on making further progress on the work required to maintain secure water supplies. The government has pushed for more ambition. In 2018, we wrote¹ with the water regulators to water companies setting out our expectations for further medium- and longer-term improvements in water resources planning for the next round of plans (to be finalised in 2024). To support our expectations, we have developed a national framework for water resources², which was published in March 2020. The framework builds on a shared vision set out in our 25 Year Environment Plan, to leave the environment in a better state than we found it; and improve the nation's resilience to drought.

The national framework brings together industry, regulators, government, water users (including those in agriculture and power generation), environmental non-governmental

¹ <https://www.ofwat.gov.uk/publication/building-resilient-water-supplies-joint-letter-defra-environment-agency-drinking-water-inspectorate-ofwat-water-companies/>

² <https://www.gov.uk/government/publications/meeting-our-future-water-needs-a-national-framework-for-water-resources>

organisations and academia to improve the way we use and look after our water supplies. The framework looks to secure our future water supplies by:

- reducing demand to an average of 110 litres per person per day by 2050;
- improving water efficiency across all sectors;
- working with water companies to halve leakage rates by 2050;
- developing new supplies such as reservoirs;
- making it easier to move water to where it's needed through regional water transfers; and
- reducing the use of drought measures that can have an impact on the environment.

In response to the points raised in your letter:

1. The balance between investment and price in the price review process

You asked for a detailed response about how companies should balance requirements to invest with pressure to reduce consumer bills (recommendation 1). While we must ensure water companies provide secure water supplies, I disagree that the Department should provide more guidance on their levels of investment.

The government and water regulators set out in detailed guidance the outcomes that water companies should deliver to secure water supplies sustainably in the longer term. As well as the national framework, the Environment Agency is consulting on the technical guidance that will form part of a suite of guidelines for the water companies' water resources management plans (WRMP)³. We provide guidance on the methods that the companies should use to justify the optimal level of investment required to deliver these outcomes. We will also work closely with the companies as they develop their plans – indeed the joint regulatory unit, RAPID was set up for this very purpose. It is also why Ofwat is allowing the significant funding for water companies to properly investigate strategic infrastructure to address long-term drought resilience challenges. This should help the water companies make improvements to their water resources management plans, which inform water companies' business plans.

However, the actual level of investment largely depends on the specific needs in water companies' areas for example where the state of infrastructure is poor or there are fewer available water sources. Companies, not government, are best placed to assess and justify the condition of their systems, assets and finances, the key risks they face, and measures to address them.

It is important to note that section 2A of the Water Industry Act 1991 (WIA) provides a power for the Secretary of State to publish a statement setting out strategic priorities and objectives for Ofwat's regulation of the water industry. The statement *must have regard to Ofwat's section 2 WIA duties* with respect to regulation of the water industry and is subject to Parliamentary scrutiny. A statement was last published in 2017⁴ and there are plans to

³ <https://www.gov.uk/government/consultations/water-resources-planning-guideline-proposed-update>

⁴ <https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance>

lay a further statement in Parliament in 2021/2022. The statement sets out the government's priorities including i) securing the long-term resilience of water supplies in a way that offers best value for money for customers and ii) protecting customers, including by continuing to drive fair, affordable bills for all. These priorities help shape Ofwat's decisions throughout the price review process.

The government's expectation is that Ofwat – in its capacity as an expert, technical and independent regulator – challenges water companies on the cost efficiency of achieving these outcomes. It is on this basis that the government will not be providing additional guidance to water companies on their levels of investment to meet the wide range of outcomes the government expects to be delivered, so as not to undermine those responsibilities. Indeed, in a context where companies are best placed, by reference to their specific circumstances, to decide on the level of investment, and given Ofwat's role, further intervention beyond the policy context set by the government, would risk undermining Ofwat's ability to carry out its responsibilities independently. In the same vein, while the government seeks to further the consumer objective, the government does not give directions to water companies on whether consumer bills should be lower or higher.

2. Leakage, 3. Metering and 6. Reducing water consumption

The Committee has made several useful observations on reducing demand for water. A full response to the 2019 government consultation on water efficiency will be published this Autumn and will set out the policy direction on the areas raised by the committee, including: customer supply pipe leaks, smart metering, water efficiency communications (part of recommendation 3), product labelling and building regulations (recommendation 5).

Water company data on leakage and *per capita* water consumption is available to the public on Discover Water⁵ (recommendation 2 and part of recommendation 3). The Committee suggested that Ofwat should review its incentive and penalty regime to ensure there are no perverse incentives which could undermine leakage reduction. I am grateful to Ofwat for providing detail on its regime, which is set out in section 1 of the annex.

Overall, we know that we need to see reductions in water use to protect the environment and respond to climate change. The government and water regulators welcome the water company leakage improvements of a 7% reduction seen in 2019/20 and we fully expect companies to achieve the ambitious leakage reductions they are committed to. In August 2020 the Department published a paper⁶ outlining proposed targets to be introduced using powers in the Environment Bill. This included the proposals for a statutory target on water demand to reduce the volume of water taken from the environment by water companies, encompassing leakage and household and non-household water use. Along with the policies to be confirmed in the consultation response, this will put in place the foundations needed to reduce demand.

⁵ <https://discoverwater.co.uk/>

⁶ <https://www.gov.uk/government/publications/environment-bill-2020/august-2020-environment-bill-environmental-targets>

4. Sewage and 5. Chalk stream abstraction

The Environment Agency has made significant improvements in these areas, including improvements to thousands of storm overflows and returning many billions of litres of water a year to the environment. However, we recognise the problems still facing our water environment, including our internationally important chalk streams, and as explained in the Environment Agency's letter, we are taking the actions required to tackle these problems.

Government's strategic policy statement to Ofwat in 2017 recognised the importance of sustainably managed natural resources and a resilient environment, further emphasised in the 25 Year Environment Plan. Ofwat's final determinations, in 2019, also recognised this. Ofwat has allowed water companies the £4.6 billion required to deliver the Environment Agency's Water Industry National Environment Programme (WINEP) for 2020-2025. The final determinations also include performance commitments that aim to push companies to go even further on important environmental outcomes, such as reducing pollution.

The Environment Bill will place a statutory requirement on water companies to produce drainage and wastewater management plans, currently being produced on a non-statutory basis. This will further help water companies identify opportunities to better manage sewage discharges and tackle future risks. The Environment Bill also includes measures to widen the circumstances in which the Environment Agency can reduce abstraction to sustainable levels without the payment of compensation.

The government and regulators realise we need continued action. We are currently arranging a chalk stream conference in October to agree a chalk stream action plan. We have set up a storm overflows taskforce to develop options for significantly reducing the volumes of sewage discharged into our watercourses. We also wrote to water companies recently, setting out our plans to work with the industry to lift ambitions further, so we see the accelerated environmental progress we all want.

7. Achieving net zero

The government and regulators recognise the magnitude and urgency of the challenges before us – climate change, biodiversity loss and degradation of the natural environment. Since the 2050 net zero target was enshrined in law in 2019, the water industry has set its own Public Interest Commitment (PIC) to achieve net zero operating emissions by 2030. It was the first sector in the UK to make such a commitment and Ofwat is supporting and challenging this work, ensuring that the drive to net zero 2030 is achieved efficiently. Ofwat is also working with the Environment Agency to consider how to maximise environmental value for customers in the WINEP. This includes encouraging further carbon savings. I am again grateful to Ofwat for providing further detail on its incentives and penalties for achieving net zero and its plans to ensure companies take full account of their carbon emissions in their options appraisals as set out in section 2 of the annex.

Recognising the role the sector could play in the green economic recovery, in July 2020, the Department, Ofwat, Environment Agency, Drinking Water Inspectorate and Consumer Council for Water wrote⁷ to water companies, inviting them to submit proposals to, among other things, implement new innovative ideas to benefit future or current customers, specifically including net zero improvements. Companies were encouraged to arrange meetings with the government and regulators, and these are expected to take place from September 2020.

Thank you once again for the Committee's report and taking the time to write about these essential issues and I hope I have given you reassurance about the government and water regulators' continued action on these matters.

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'T. Finkelstein', with a long horizontal flourish extending to the right.

TAMARA FINKELSTEIN

CC:

Sir James Bevan, Chief Executive, Environment Agency
Rachel Fletcher, Chief Executive, Ofwat

Annex

1. Ofwat's leakage and penalties incentives

In its letter, the Committee suggested that Ofwat should review its incentive and penalty regime in order ensure that there are no perverse incentives which might undermine leakage reduction. Below is an overview of Ofwat's leakage incentives and penalty regime.

During the companies' oral session, it was suggested that some companies felt 'penalised for carrying out mains repairs because the need for repairs is viewed as an indication of poor asset maintenance rather than as an important means of reducing leakage'. The number of mains repairs conducted by a company is a long standing measure and an important indicator of the health of a water company's assets. Equally, an increase in the number of mains repairs over time can indicate a deterioration in the health of the network and underinvestment in (or poor targeting of) mains replacement and renewal.

Furthermore, active leakage control, including 'find and fix' activities, can contribute to a higher volume of mains repairs. However, there are many alternative leakage reduction solutions (such as pressure management, transient event identification and removal, targeted mains replacement and renewal, communication and customer side leakage activity). There are also other emerging capabilities (such as smart networks, 'calm networks' and innovative repair techniques) which could prove to be highly beneficial in reducing leakage.

Moreover, proactive mains repairs (detected by the company) reduce the need for reactive repairs (customer reported). As the mains repairs metric includes both of these, the impact on companies' mains repairs performance overall is muted. At PR19, several companies proposed to improve their leakage performance without increasing mains repairs. In the last year, companies report having reduced leakage and mains repairs substantially, illustrating that the relationship between leakage and mains repairs is not straightforward. Therefore, having considered the evidence submitted by companies, Ofwat's Final Determinations in PR19 afforded companies more flexibility in the early years of the period, to deliver a step change in leakage by conducting additional proactive mains repairs as part of a holistic strategy to address leakage.

As part of developing its approach for the next price review, Ofwat will consider the balance of incentives and penalties and their effects on achieving customer outcomes, including future leakage reduction.

2. Ofwat's approach to net zero – options appraisal and net zero penalties and incentives

In its July 2020 report, the Committee asked for detail on how Ofwat will ensure water companies take full account of carbon emissions in appraising the options available to them. In its 29 July letter, the Committee invited Ofwat and the Government to demonstrate that the incentives and penalties in places are sufficiently strong to move towards achieving net zero.

In response, the below sets out Ofwat's approach to net zero with specific regard to price reviews, water resources management plans (WRMP), and for strategic schemes in the Regulators' Alliance to Progress Infrastructure Delivery (RAPID) programme. It also outlines the opportunities for reducing emissions through the development of the bio-resources market and through Ofwat's collaborative work with the Government, other regulators and water companies.

Price Reviews

At the 2014 price review (PR14), Ofwat required companies to report on their annual progress in reducing overall greenhouse gas emissions (GHG) from their regulated activities. At both PR14 and PR19, several companies proposed bespoke carbon/GHG emissions performance commitments, with a mixture of financial and reputational incentives attached to those commitments. Ofwat monitors companies' progress in achieving these commitments. Ofwat will consider whether, in line with its outcome delivery incentive regime, any outperformance or underperformance payments, for companies' performance against their performance commitments, should be made.

In June 2020, Ofwat launched a consultation on regulatory reporting⁸. The consultation included proposals to gather more information on water companies' GHG emissions and to require annual publication (for inclusion in companies' annual performance reports) of enhanced emissions data, including both operational and embedded emissions. This additional information, alongside data on companies' performance in delivering the PR19 emissions reduction performance commitments, will enhance Ofwat's ability to assess net zero-related investment at the next price review. This all forms part of Ofwat's ongoing work to develop its approach to net zero at future price reviews, including how net zero will feature and in terms of incentives and penalties.

WRMPs

It is a requirement of the WRMP guidelines for companies to account for GHG emissions within their options. It is proposed that for all water resource options for WRMP-2024, companies will be required to set out the carbon costs and mitigation strategies involved. In July 2020, Ofwat, the Environment Agency and Natural Resources Wales issued updated WRMP guidelines for consultation⁹. Once finalised in January 2021, they will be issued to companies and will apply to their next set of WRMPs, due to be finalised in 2024. The guidance states that carbon costs, including both operational and embedded, should be accounted for in WRMPs. The guidelines set a clear expectation that companies capture, in a consistent way, costing (including carbon costing) for options in their WRMPs. Ofwat considers that embedding consistent carbon costing will improve the quality of information provided in WRMPs and Ofwat's ability to assess and provide responses to companies' WRMPs.

⁸ <https://www.ofwat.gov.uk/wp-content/uploads/2020/06/APR-Consultation-2020-21.pdf>

⁹

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/903694/Water_resources_planning_guideline.pdf

RAPID

In relation to the strategic schemes to address long term water resource needs included within the RAPID programme, companies are required to set out the carbon costs and mitigation strategies involved. This will also be required when companies apply for Development Consent Orders, should schemes progress to this stage. RAPID is working with water companies to set up a 'task and finish' group to consider how to assess proposed RAPID schemes against challenging carbon emissions targets. Ofwat is clear that this should include both operational and embedded carbon emissions as part of the 'best value' scheme assessment for RAPID schemes.

Bio-resources market

Another way that Ofwat is encouraging the sector to reduce carbon emissions is through actively promoting the development of the bio-resources market to transform waste into renewable energy. In PR19, we established a separate price control for bio-resources, to help encourage companies to see bio-resources as a viable means of generating revenue and energy.

Joint working

Ofwat's commitment to strengthening the sector's approach to climate change mitigation and adaptation is firmly embedded in its ambitious strategy, 'Time to act, together'¹⁰. This sets out its commitment to join forces with regulators, governments, companies and civil society to deliver its ambition: for the water sector to provide the very best service for customers, improve the environment and improve life through water. Ofwat welcomes the sector's industry-led net zero 2030 target for operational emissions, and has been engaging with Water UK on this work. Ofwat also intends to be on the Advisory Board for this work once set up by Water UK. Ofwat is also part of the UK Regulators Network and its dedicated working group focused on sharing and disseminating learning on approaches to climate change mitigation and risks across regulated sectors. It is also working with the Environment Agency, Government and water companies to consider future approaches to the WINEP process to maximise environmental value for customers and encourage further carbon savings.

Green recovery

Finally, as mentioned above, the Government and water regulators recognise that the economic recovery presents further opportunities for greater ambition and to drive the pace of progress needed to achieve net zero. In July 2020, the Government, Ofwat, Environment Agency, Drinking Water Inspectorate and Consumer Council for Water, wrote to water companies, explaining that supporting the country's green economic recovery is an opportunity for the sector to go further to deliver more. Companies were invited to submit proposals to: accelerate existing plans and environmental priorities within the agreed 2020-25 plans; bring forward 'enhancement investment' proposals from 2025 and

¹⁰ <https://www.ofwat.gov.uk/wp-content/uploads/2019/10/Time-to-act-together-Ofwats-strategy-1.pdf>

beyond; and implement specific new innovative ideas, which would benefit future generations or current customers, including for example net zero improvements.¹¹