Centre City Tower, 7 Hill Street, Birmingham B5 4UA
21 Bloomsbury Street, London WC1B 3HF

Meg Hillier MP
Chair, Public Accounts Committee
House of Commons
London SW1A 0AA

10 September 2020

Dear Chair

Re: PAC evidence session on water supply and demand management.

I promised to write to you with a more detailed response on some of the key points the water companies raised with you at the recent evidence session the Committee held on water supply and demand management. Specifically, I wanted to set out our serious concerns with their explanation of how Ofwat regulates the sector and our approach to the latest price review (PR19).

Our overall approach to investment, resilience, and bills

Water companies' evidence to the Committee suggested that the regulatory system prioritises bill reductions over investment in long term resilience. This is not the case. At PR19 we placed a clear emphasis on increasing long term resilience. Of a total funding package of £51 billion, £13 billion will be invested in new and improved services and in tackling environmental challenges, this is over and above the spending required to fund day-to-day services. We have also challenged water companies to set stretching but achievable performance commitments, with associated financial and reputational incentives. Meeting these commitments mean that customers will benefit from better day-to-day services and better maintained infrastructure. Moreover, at PR19 we challenged companies to adopt a truly long term approach and to provide us with substantive assurance that their plans addressed long term challenges, and to set out performance commitments that cover the period to 2035.

Rachel Fletcher t. 0121 644 7818 e. Rachel.Fletcher@ofwat.gov.uk

Our assessment of the need for investment is built on the business plans presented by the companies, with Ofwat providing a reasonable efficiency challenge to their costs for delivering those plans. We do not take a top-down view of bills by reference to a certain level of bills. The significant package of investment and service improvements agreed in PR19 will be delivered alongside affordable bills for customers, something that is more important than ever given the pressures on the economy brought about by the Covid 19 pandemic. But the 12% reduction in bills (before inflation impacts are taken into account) is achieved principally by reducing returns to shareholders, and this takes place alongside increased investment in networks and water resources. This is also reflected in our intervention to provide almost £1 billion of additional funding – not asked for by companies – for the development of new and much needed long term strategic water supply solutions, to secure long term resilience to water supplies in North East London and to stimulate the level of transformational innovation required to meet the challenges of current and future generations.

Total cost of regulation

It was suggested in the companies' evidence that the regulatory process adds £15-16 a year to each customer's bill. We understand this estimate to include all the regulatory costs which companies face from each of the regulatory bodies (including the Environment Agency, Drinking Water Inspectorate and Consumer Council for Water) they interact with, and would also include the costs of environmental licences and other requirements essential to running a water company safely. By contrast, the total cost of all Ofwat's activities in 2020/21 as published in our Forward Programme for the year is £1.20 per customer.

Thames Water business plans

We welcome Thames Water taking steps to write to the Committee to correct the evidence they gave during their oral session. As the company's letter explains, Ofwat allowed customer funding to Thames Water for the vast majority of the plan they submitted and has made extra funding available for the company for further investment in schemes going beyond that included by Thames Water in their plan.

Funding improved leakage performance

Our regulatory approach at PR19 has driven up the level of ambition on leakage performance following a long period of flat or declining performance. So we are concerned that Yorkshire Water indicated in its evidence that it had been forced, by Ofwat, to scale back its ambition on leakage. This is not correct. Under our performance commitment system if Yorkshire exceeds the 15% performance commitment set for leakage it will receive outperformance incentive payments. The funding for these payments come from customers and can be used to fund further leakage reductions to the level of ambition Yorkshire Water believes is achievable. This way customers will pay when Yorkshire Water delivers.

I hope that these points help to clarify how Ofwat seeks to regulate the sector in the best long-term interests of customers, the environment and society and addresses some of the statements made by companies during your evidence session. If you or members of the Committee would appreciate further information on any of the issues the companies raised, or our overall regulatory approach, we would be very happy to provide you with further evidence or to meet to discuss.

Yours sincerely

Rachel Fletcher

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Chief Executive