



Department  
for Environment  
Food & Rural Affairs

# **The government's strategic priorities and objectives for Ofwat**

**Draft for consultation**

**March 2017**



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# Introduction

1. People, businesses and the environment all depend on excellent water and wastewater services. We want a water industry that works for everyone: one that is resilient, efficient and innovative and which drives forward the objectives of our industrial strategy.
2. This statement sets out our strategic priorities and objectives for Ofwat, the independent economic regulator of the water industry. This is a draft for consultation, as required by the Water Act 2014 (see below).
3. This statement complements Ofwat's existing duties, which are summarised in an appendix to this statement, and places emphasis on areas where we expect Ofwat to lead a shift in the water industry's strategic direction.
4. The first chapter describes our priorities for Ofwat and the water industry in pursuit of an industry that works for everyone:
  - **Securing long-term resilience:** Customers expect resilient services, now and in the future – but some regions are exposed to substantial risks from service failures, for example due to drought.
  - **Protecting customers:** Every home and business depends on a resilient water industry – but not everyone can afford their water bill.

The second chapter translates what this means for the evolution of markets in the water sector, including our expectation that future reforms seek to address these priorities.

## The legislative framework

The independent economic regulation of the water industry is essential to protect customers, facilitate efficient investment and unleash growth. To support this, the government needs to set out a clear strategic context in which independent economic regulators, customers and investors can take informed decisions.

The Water Act 2014 created new powers under which the Secretary of State may publish a statement setting out strategic priorities and objectives for Ofwat to reflect in the way it regulates

water services in England<sup>1</sup>. In formulating this statement, the Secretary of State must have regard to Ofwat's duties under section 2 of the Water Industry Act 1991 (as amended; see appendix), social and environmental matters, and any other matters the Secretary of State thinks fit.

The Secretary of State is required to consult Ofwat, the Consumer Council for Water, relevant undertakers, licensees, the Environment Agency, Welsh Ministers and Natural Resources Wales on a draft of the guidance. Prior to final publication, a draft of the statement must be laid before Parliament for a period of 40 days.

5. Throughout this statement, we describe what we expect of the water industry. Ofwat should have regard to these expectations in carrying out relevant functions, save where a more explicit steer is provided about the role we expect Ofwat to play. We expect Ofwat to have a robust framework to hold companies to account within its statutory remit.
6. We expect that Ofwat will embed our priorities and objectives throughout the organisation. It should:
  - set out how activity across its forward work programme will deliver against the government's strategic priorities and objectives;
  - explain what information it will use to measure its success in furthering these priorities and objectives;
  - explain clearly how major decisions support delivery of our strategic priorities and objectives, for example when establishing the methodology for price reviews or publishing draft and final determinations; and
  - report on its progress to its Board and transparently through its annual report and accounts.
7. We expect that the regulated water industry will reflect our priorities and objectives in its strategic direction. We want to see a transparent, accountable sector which rises to the challenges set out in this statement and measures its performance by how it addresses these.

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<sup>1</sup> Under current legislation, the statement sets strategic priorities and objectives for Ofwat's regulation of water services in relation to appointment areas wholly or mainly in England. The Wales Act 2017 introduced powers to amend this and other legislation such that it would relate only to Ofwat's regulation of water services in England.

# A water industry for the future

## Securing long-term resilience

8. Climate change, population growth and changes in consumer behaviour are putting increasing pressure on the water sector in England<sup>i</sup>. The sector needs to innovate and adapt to ensure that it can continue to meet the needs of people, businesses and the environment – and the regulatory framework needs to adapt too.

**Priority:** Ofwat should challenge the water sector to plan and invest to meet the needs of current and future customers, in a way which offers best value for money over the long term.

9. We expect companies to take account of the full range of pressures on water and wastewater systems and services and develop an excellent understanding of long-term needs. We expect companies to consider a broad, innovative selection of options to meet these needs, including collaboration with other water companies, local authorities and partners who use or have an impact on water and wastewater systems. We expect companies to select options with a view to delivering the best value for money over the long term, considering the wider costs and benefits to the economy, society and the environment.
10. We expect companies to carry out meaningful and effective engagement with their customers and to demonstrate customer acceptability for their plans overall. Where residual risks remain to long-term resilience, we expect companies to describe these transparently and ensure that they are acceptable to current and future customers. Where Ofwat does not have assurance that companies are planning and investing appropriately as part of a strategy to achieve long-term resilience, we expect that it will step in to secure that the needs of current and future customers will be met efficiently.

## Water supply

11. Parts of the country face unacceptable levels of risk from drought, while neighbouring regions have surplus water. There is a 12% risk that we will see a drought in the next 25 years that would lead to emergency restrictions such as standpipes in place for at least 2-3 months<sup>ii</sup>. Historically, there has been insufficient investment to secure long-term resilience in some regions.

**Objective:** Ofwat should further a reduction in the long-term risk to water supply resilience from drought and other factors, including through new supply solutions, demand management and increased water trading.

12. Water companies currently determine how to balance supply and demand over a minimum of 25 years through the water resources management planning process. This

requires companies to identify all the options that are available to them to meet demand over the long term and show how they have decided which options to pursue. As part of this process, companies engage with their customers to determine the frequency with which they plan to use supply restrictions to reduce demand during droughts (the 'level of service' that they will provide).

13. We expect Ofwat to recognise the need for investment to balance supply and demand and achieve the level of service that is set out in final water resources management plans – while continuing to challenge companies to meet that need in a way which represents the best value for money over the long term, including through the price review. Ofwat should collaborate closely with the Environment Agency and use its role as a statutory consultee on water resources management plans to enable it to recognise future investment needs, in line with its statutory duties.
14. A 'twin track' approach to improving the resilience of our water supplies is required, with investment in new supplies complementing measures to reduce the demand for water. We will develop a National Policy Statement that sets out the need for nationally significant water supply infrastructure projects, with the aim of accelerating the process of providing development consent. We expect that Ofwat will keep under review the impact of its regulatory framework on the progress of nationally significant water supply infrastructure projects. We also expect that Ofwat will have regard to National Infrastructure Commission recommendations that are endorsed by the government.
15. Measures that can help reduce demand for water are an important part of the solution to meeting future water supply needs. We expect companies to cut leakage – which resulted in average losses of 121 litres of water per property per day in 2015-16 – and help customers use water efficiently, including through metering. Customers in England and Wales used 139 litres of water per person per day in 2015-16, in contrast with 121 litres of water per person per day used by customers in Germany. We expect Ofwat to promote ambitious action to reduce leakage and per capita consumption, where this represents best value for money over the long term.
16. Many options for meeting future water supply needs are complex, requiring co-ordination across water companies, regulators and even sectors. In many cases, there are systemic barriers to water trading across company boundaries (including cascades involving multiple companies, regional cooperation and development of new interconnections or connected water grids), development of shared water resources and effluent reuse schemes. We expect that Ofwat will promote greater collaboration to enable such options to be taken forward where they represent best value for money over the long term. This could include encouraging companies to release surplus water or enable cascades of water through their networks.

## **Wastewater**

17. In contrast with the public water supply, companies are not required to plan their long-term wastewater needs transparently. Partly as a result, we do not have assurance that

companies are planning and investing strategically in a way that will manage pressures from climate change, population growth, changes in consumer behaviour and ageing infrastructure – with risks of pollution, flooding or spikes in future bills. In some areas, the wastewater network is already underachieving. In 2015, there were 1,734 pollution incidents caused by unexpected failures and 4,344 properties which suffered sewage flooding within the home.

**Objective:** Ofwat should challenge companies to improve planning and investment to meet the wastewater needs of current and future customers.

The lack of transparent, integrated planning means that customers are less engaged in decision-making. Opportunities to work with partners who use or have an impact on wastewater systems (such as local authorities) can be missed.

18. As elsewhere, we expect that Ofwat will continue to challenge and incentivise companies to develop an innovative and strategic mix of solutions to meet current and future needs, which offer best value for money over the long term. This could include promoting, adopting or maintaining sustainable drainage systems or co-investing in flood risk management as a means of effectually draining their area. As elsewhere, this will require Ofwat to keep its regulatory framework under review, to ensure that solutions which offer best value for money over the long term are incentivised.

## Resilience against flooding and wider risks

19. Risks to resilience run much wider than the long-term pressures from climate change, population growth and changes in consumer behaviour. The water sector needs to be able to respond effectively to immediate and medium-term challenges to service provision, such as flooding of water and wastewater infrastructure, burst water mains or other infrastructure failures, and including physical and cyber security.

**Objective:** Ofwat should work with water companies to ensure that they assess the resilience of their system and infrastructure against the full range of potential hazards and threats and take proportionate steps to improve resilience where required.

20. In 2016, the Government published the National Flood Resilience Review. Working with the Environment Agency, the Met Office and other leading scientists from the research community, the Review improved our understanding of the potential for 'black swan' rainfall events which are plausible in our current climate. The 'black swan' work has revealed that existing rainfall records could be exceeded by 20-30%.
21. As part of this wider work on resilience, Ofwat should ensure that water companies assess the extent to which their major water treatment works and sewage treatment plants are appropriately resilient against extreme flood events (as described in the National Flood Resilience Review) and include provision for additional resilience where required. Water companies should prioritise resilience upgrades on the basis of risk, delivering necessary improvements to high-risk sites first.



## The environment

22. Environmental resilience is an integral part of our vision for a resilient water sector. We expect companies to further the resilience of ecosystems that underpin water and wastewater systems and services, where this delivers best value for money over the long term. For example, investing in the natural resilience of catchments can increase the availability and quality of water that can be taken without posing unacceptable pressures on the environment – avoiding the need for more costly infrastructure solutions.
23. Shortly, we will set out the framework for our 25-year environment plan. We want our country to be the healthiest and most beautiful place to live, work and bring up a family and intend to be the first generation to leave the environment in a better state than we found it. Our ambition is for the water environment to be cleaner and healthier and managed in a way that is more resilient to floods and drought to support people, wildlife and the economy. We expect the water industry to play its part.
24. Ofwat should have regard to the government's forthcoming 25-year environment plan. We expect companies to plan and invest with a view to delivering the best value for money for customers over the long term. This includes considering where water and wastewater systems could be used to provide wider benefits to the economy, society and the environment without having adverse impacts on costs or services, for example by using reservoirs to help alleviate flood risks where appropriate. This also includes considering where it may be appropriate to collaborate with other catchment partners who use or have an impact on water and wastewater systems, in pursuit of the best outcomes for customers.

**Objective:** Ofwat should encourage the sustainable use of natural capital by water companies – that is, our natural assets such as rivers and groundwater – by encouraging water companies to have appropriate regard to the wider costs and benefits to the economy, society and the environment.

25. While we expect that companies will seek to deliver best value for money throughout their business, in many cases companies have strict obligations to protect health and the environment (such as those deriving from the Water Framework Directive). Later this year, the Drinking Water Inspectorate, the Environment Agency and Natural England will write to companies to remind them of statutory obligations for the sector. Ofwat should secure formal assurance from companies that they are planning and investing appropriately to enable them to meet these obligations, in line with its duties to secure that companies properly carry out their functions and are able to finance these.
26. As companies develop their business plans for the next price review, the UK will be making preparations to exit the European Union (EU). Until exit negotiations are concluded, the UK remains a full member of the EU and all the rights and obligations of EU membership remain in force. During this period, the government will continue to negotiate, implement and apply EU legislation. The outcome of these negotiations will

determine what arrangements apply in relation to EU legislation in future once the UK has left the EU. Ofwat should consider how its regulatory approach will help companies to manage future change to statutory obligations, in line with its duties to protect the interests of customers and to secure that companies are able to finance their functions and its general environmental duties (see appendix).

## Housing

27. A resilient water sector must meet the needs of a growing population. The government is undertaking radical, lasting reform that will get more homes built right now and for many years to come. We expect that companies will play their part by ensuring timely connections of new developments to water and wastewater systems so that this does not hold up getting homes built. Companies have signed up to a set of service standards and the timeliness of developer connections is improving. Ofwat should keep under review what can be done to ensure that company planning and delivery keeps pace with housebuilding and supports development across the country.

## Protecting customers

28. Securing a fair deal for everyone is at the core of Ofwat's role. But not everyone is able to access quality services at a price they can afford. In 2015-16, 12 per cent of customers said that they were struggling to pay their water bills. The sector needs to go further to address the needs of customers who are unable to afford their bills. Ofwat should continue to drive fair, affordable bills for all.

**Priority:** Ofwat should challenge the water sector to go further to identify and meet the needs of customers who are struggling to afford their charges.

29. In the previous section, we explained how the sector needs to innovate and adapt to ensure that it can continue to meet the needs of people and businesses. This applies to companies' retail services as well as their water and wastewater systems. Ofwat should continue to challenge companies to keep pace with customer expectations.

## Household customers

30. Despite recent reductions in the average water bill, some customers continue to face an affordability challenge. Water companies offer a variety of financial support to their customers and nearly all now offer social tariffs, tailored to local conditions, for their most vulnerable customers. But the sector can go further to help those who cannot afford their bills.

31. We expect companies to provide social tariffs which reach all eligible customers and offer a meaningful discount. There are opportunities to learn lessons from best practice, for example to align approaches in areas where households access different water and sewerage service providers.

**Objective:** Ofwat should challenge companies to improve the availability, quality, promotion and uptake of support to low income and other vulnerable household customers.

32. 'Bad debt' (unrecovered customer debt) pushes up the costs of all customer bills and causes distress to those customers that fall behind on their bill payments because of affordability problems. The cost of uncollected charges has risen from £1.9 billion in 2010 to £2.2 billion in 2014<sup>iii</sup>. We expect that companies will share best practice and take steps to significantly reduce bad debt and that Ofwat's regulatory framework will incentivise this.
33. The predictability of bills is important for many customers and Ofwat should seek to limit undue bill volatility in its regulatory approach. At the same time, Ofwat must uphold the principle of intergenerational equity: that every generation should pay their fair share of the costs of providing water and sewerage services. This will require the industry to demonstrate an excellent understanding of future investment needs, as described earlier, so that costs are not deferred to future generations.

### **Business customers**

34. From April, all businesses, charities and public sector organisations in England will be able to switch from their local monopoly water company to another supplier of retail services in pursuit of the package that best suits their needs. Experience in the energy market has shown that small business customers can be vulnerable users of utilities<sup>iv</sup>.

**Objective:** Ofwat should promote an enhanced focus by water companies on the needs of small business customers that may struggle to access the best deals.

35. As the market develops and Ofwat gains insight into how competition is working, it should explore whether to give small businesses further protections, for example to protect them from mis-selling, ensure more transparent prices and to make switching easier.

## Making markets work

36. Markets are a vital tool in Ofwat's mission to secure a fair deal for everyone. Greater competition can help drive innovation and unlock cost efficiencies. We want to harness the power of competition to help deliver our ambitions. For example, water trading can help balance supply and demand and enable water needs to be met at a price that customers can afford.

**Priority:** Ofwat should promote markets to drive innovation and unlock efficiencies, with the aim of furthering: (i) the long-term resilience of water and wastewater systems and services; and / or (ii) the protection of vulnerable customers.

37. Ofwat should explore the full range of ways in which it can bring competitive pressures to bear in the water market to further these goals, focusing on areas where cost-benefit analysis shows significant potential to improve outcomes overall. We want to see a water industry that works for everyone, not just a subset of customers.

38. Ofwat should ensure that its reforms uphold the excellent public health and environmental standards that customers expect. This includes promoting the effective operation of catchments as a system, in which water companies and others collaborate to deliver public value. It should seek to sustain long-term investor confidence in the sector, with the aim of protecting the consumer interest.

### Retail competition

39. In April, the world's largest retail market for water services to businesses, charities and public sector bodies will open. We expect Ofwat to monitor the development of the market, with the aim of enabling business customers to secure the package that best suits their needs.

40. Last year, Ofwat examined the costs and benefits of extending competition to the household retail market. They identified a range of scenarios, finding potential benefits of up to £2.9 billion. However, further work needs to be done both to ensure that these benefits can be realised, and to understand and mitigate any impacts on vulnerable customers. It is also important that we learn the lessons from the opening of the business market.

41. Ofwat should work with the government to build the evidence base further, in order to enable the government to fully understand the case for extending competition to households. Ministers will then take a decision at the end of the Parliament or early in the next one on whether or not to introduce competition in the household retail market. Moreover, we acknowledge the importance of addressing the issues identified in this analysis, such as high and rising levels of bad debt, and the need for greater innovation in the water sector. Ofwat should continue to consider how it can address these issues

within the current regulatory framework, including through bringing competitive pressures to bear.

## **Upstream competition**

42. From 2020, new markets for water resources and bioresources (sewage sludge) will develop. Businesses will be better able to sell water to water companies, encouraging interconnections in the supply system and development of new sources of supply; while competition to treat and sell on energy and nutrient-rich bioresources will drive innovation and efficiency.
43. Ofwat should promote effective competition in these markets in line with the principles set out above. In relation to water trading, it should seek to support and align with the implementation of the government's abstraction reforms. It should ensure that upstream reforms complement appropriate long-term planning and investment by undertakers to secure the long-term resilience of water and wastewater systems and services.

## **Competition for the market**

44. There are significant barriers to entry in the remaining parts of the regulated water sector (water treatment and distribution; wastewater collection and treatment). To promote efficiency and innovation, the existing regulatory regime enables new companies to be appointed as water or sewerage undertaker in an area of appointment and, in some cases, new infrastructure providers to be appointed to develop infrastructure projects. Ofwat is also developing incentives for undertakers to enable competition for the financing, design, build and operation of large projects ('direct procurement'), with the aim of generating savings in project costs and cheaper financing.
45. Ofwat should promote competition in these markets in line with the principles set out above. It should ensure that these support the long-term resilience of water and wastewater systems and services and have particular regard to impacts on the operation of systems as a whole. Where Ofwat incentivises the delivery of undertakers' duties by third parties (for example through 'direct procurement'), it must secure assurance that undertakers' duties will be met to an equivalent or better standard and ensure that the consumer interest is protected and value for money is delivered.

## **Markets for environmental services**

46. Water companies play a vital role in markets for environmental services. For example, the majority of direct abstractors do not have the capacity that water companies have to enhance their resilience, for example to build large-scale water storage or to move water around the network. Some water companies are examining the potential to sell untreated water to these businesses outside the public water supply, transporting it either through rivers or pipes, and to develop new water resources to enable this.

47. Markets are also emerging for pollution reduction – where a buyer meets their environmental obligations by paying a seller to reduce their own discharges – and other environmental services. Such transactions are complex, often spanning both the regulated and unregulated water sector. Ofwat should keep under review any barriers in its regulatory framework to development of markets for environmental services, seeking to enable these markets where possible while ensuring that the consumer interest is protected.

## Appendix: Summary of Ofwat's duties

Sections 2 and 3 of the Water Industry Act 1991 (as amended) place a number of statutory duties on both the Secretary of State and Ofwat.

**Ofwat's primary duties (as set out in section 2) are to carry out its functions in the way it considers best calculated to:**

- further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition;
- secure that the functions of each undertaker (that is, water company) are properly carried out and that they are able to finance their functions, in particular by securing reasonable returns on their capital;
- secure that companies with water supply licences (those selling water to large business customers) properly carry out their functions; and
- further the resilience objective to secure the long-term resilience of undertakers' water supply and wastewater systems and to secure they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services.

**Subject to these, Ofwat has secondary duties to:**

- promote economy and efficiency by companies in their work;
- secure that no undue preference or discrimination is shown by companies in fixing charges;
- secure that no undue preference or discrimination is shown by companies in relation to the provision of services by themselves or other regulated companies;
- secure that consumers' interests are protected where companies sell land;
- ensure that consumers' interests are protected in relation to any unregulated activities of companies;
- contribute to the achievement of sustainable development; and
- have regard to the principles of best regulatory practice and to the interests of consumers in relation to other utilities.

**Ofwat and the water companies also have general environmental and recreational duties in section 3 of the Water Industry Act 1991 (as amended). Subject to the duties in section 2, these are to:**

- further the conservation and enhancement of natural beauty and the conservation of flora, fauna and geological or physiographical features of special interest and to further water conservation;
- have regard to the desirability of protecting and conserving buildings, sites and objects of archaeological, architectural or historic interest;
- take into account any effect which the proposals would have on the beauty or amenity of any rural or urban area or on any such flora, fauna, features, buildings, sites or objects;
- have regard to the desirability of preserving for the public any freedom of access to areas of woodland, mountains, moor, heath, down, cliff or foreshore and other places of natural beauty;
- have regard to the desirability of maintaining the availability to the public of any facility for visiting or inspecting any building, site or object of archaeological, architectural or historic interest; and
- take into account any effect which the proposals would have on any such freedom of access or on the availability of any such facility.



# References

Data on water industry performance can be accessed at [www.discoverwater.co.uk](http://www.discoverwater.co.uk).

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<sup>i</sup> *Enabling resilience in the water sector*. Defra, March 2016.

[www.gov.uk/government/publications/water-sector-improving-long-term-resilience](http://www.gov.uk/government/publications/water-sector-improving-long-term-resilience)

<sup>ii</sup> *Water resources long-term planning framework*. Water UK, September 2016.

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<sup>iii</sup> *Affordability and debt 2014-15*. Ofwat, December 2015.

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<sup>iv</sup> *Energy market investigation: final report*. Competition and Markets Authority, June 2016.

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