



Department
for Environment
Food & Rural Affairs

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Defra's strategic policy statement to Ofwat Incorporating social and environmental guidance

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Purpose and Aims of this Guidance

The *Principles for Economic Regulation* establish that independent regulation needs to take place within a framework of duties and policies set by a democratically accountable Parliament and Government. Regulatory frameworks must form a logical part of the Government's broader policy context and be consistent with established priorities.¹ The *Principles* therefore require that Government puts in place a strategic policy statement for each of the economic regulators to provide transparency regarding priorities and desired outcomes. This Guidance to Ofwat sets out the priorities for regulation of the water industry which the Government expects Ofwat to reflect in their decision making.

The water industry supplies goods and services which are essential to health, wellbeing and economic stability. As a result, the decisions taken by Ofwat, the independent economic regulator for the water industry can have significant impacts on the economy, on society and on the environment. In recognition of this, Ofwat has been given clear statutory duties to protect the interests of consumers; whilst ensuring that efficient water companies can carry out and finance their functions; and to exercise its powers in a way best calculated to contribute to the achievement of sustainable development.

Summary of Ofwat's Statutory Duties under section 2 of the Water Industry Act 1991

Ofwat's Primary Duties are to:

- protect the interests of consumers, wherever appropriate by promoting effective competition;
- secure that the functions of each undertaker (i.e. water company) are properly carried out and that they are able to finance their functions, in particular by securing reasonable returns on their capital; and to
- secure that companies with water supply licences (i.e. those selling water to large business customers, known as licensees) properly carry out their functions.

Ofwat's Secondary Duties are to:

- contribute to the achievement of sustainable development;
- 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 consumers' interests are protected where companies sell land;
- ensure that consumers' interests are protected in relation to any unregulated activities of companies; and
- have regard to the principles of best regulatory practice.

Ofwat also have general duties to consider the effect on the environment when exercising their powers.

¹ *Principles for Economic Regulation*, BIS, April 2011

Water and sewerage services in England and Wales are delivered by 32 private companies, all of which are regulated by Ofwat to ensure that consumers receive high standards of service at a fair price. Ofwat sets the economic framework within which the water companies must operate.

Government expects Ofwat to ensure that its regulatory decisions are transparent, accountable and aligned with the Government's policy priorities for the water and sewerage sector. The Government has set out its vision for the water sector in the Water White Paper: *Water for Life*, published in December 2011. This identified the challenge of increased water scarcity due to climate change and demographic trends and highlighted an increased emphasis on resilience, long term planning and customer choice.

This Strategic Policy Statement provides the overarching context for the more detailed *Social and Environmental Guidance* issued to help Ofwat contribute to the Government's wider social and environmental goals as set out in their sustainable development duty. These have been brought together here to provide a single, consolidated source of guidance to Ofwat. This guidance is issued by the Secretary of State for Environment Food and Rural Affairs in accordance with sections 2A, 27(3); and 192B(2)(e) of the Water Industry Act, which enable the Secretary of State to give general directions to Ofwat on issues to which they should give priority and to specify issues on which Ofwat is asked to report, as well as to issue social and environmental guidance. For further detail on the statutory basis for this guidance please see Annex B.

There are ten directions from the Secretary of State on priorities clearly highlighted within the body of this Strategic Policy Statement. They are not intended to affect the position of Ofwat as an independent economic regulator, but are designed to identify Government priorities clearly and to provide a strong steer on the outcomes Government wishes Ofwat's activity to contribute to delivering.

This Guidance refers to Ofwat's work in relation to the appointment areas of all water and sewerage undertakers and licensed water suppliers who operate wholly or mainly in England. Ofwat's activities in relation to companies whose areas are wholly or mainly in Wales fall under the jurisdiction of Welsh Ministers.²

In line with the *Principles for Economic Regulation*, this Guidance seeks to provide stability for both the regulator and the industry by providing a long-term view of the Government's overarching priorities. The Secretary of State may revise this Guidance to reflect any substantive changes to the Government's policies or priorities. The *Principles of Economic Regulation* state that such guidance should be revised no more frequently than once a Parliament.

² Ofwat is the economic regulator for all water and sewerage undertakers and licensed water suppliers in England and Wales. This Guidance relates only to Ofwat's activities in relation to undertakers whose areas are wholly or mainly in England and licensed suppliers operating in those undertakers' areas.

Defra's Strategic Policy Statement to Ofwat

Executive Summary

1. Background: Strategic Policy Statement to Ofwat

- i. The Government is committed to stable and predictable regulatory frameworks to protect consumers, facilitate efficient investment and contribute to sustainable growth. To support this, strategic policy statements are designed to ensure clarity about the respective roles of Government and the economic regulators by providing context and guidance on priorities and desired outcomes.
- ii. As the independent economic regulator for the water industry, the decisions taken by Ofwat can have significant impacts on the economy, society and the environment. In recognition of this, Ofwat has been given clear statutory duties to protect the interests of consumers; whilst ensuring that efficient water companies can carry out and finance their functions; and to exercise its powers in a way best calculated to contribute to the achievement of sustainable development.
- iii. It is the Government's responsibility to set the strategic framework and policy priorities within which economic regulators such as Ofwat operate. This guidance sets out the priorities which Ofwat should keep under review and requires them to report on the steps they have taken in response to this steer.
- iv. The principle underpinning this guidance is that high-level decisions involving political judgement are taken by the Government; whilst day-to-day regulatory decisions are undertaken independently by Ofwat. This guidance is designed to support Ofwat's regulatory independence and has been developed within the context of Ofwat's statutory duties and functions.
- v. The Government's vision for the water sector is set out in the Water White Paper: *Water for Life*. This identified the challenge of increased water scarcity due to climate change and demographic trends and highlighted an increased emphasis on resilience, long term planning and customer choice. We expect Ofwat's regulatory decision-making to support this vision by contributing to an innovative, sustainable, resilient; and customer-focused water sector.

2. An innovative water sector in a transparent and predictable regulatory regime

i. A Transparent and Predictable Regulatory Regime [p. 9]

This section sets out the Government's priorities for Ofwat in relation to:

- Ensuring that the water sector remains an attractive investment prospect.
- Taking appropriate account of investor views on the impact of the existing regulatory framework and any proposals for reform.
- Recognising that regulatory approaches will need to continue to evolve if they are to remain relevant to the changing needs of the sector.

ii. Supporting Economic Growth [p. 11]

This section sets out the Government's priorities for Ofwat in relation to:

- Contributing to the drive for growth; in the context of their statutory duties to protect consumers and ensure that efficient companies can finance their functions.
- Enabling infrastructure investment in the sector; and driving efficiencies in order to keep costs down for both household and business customers.
- Championing a proportionate regulatory approach which minimises burdens and costs for business.
- Working with the water sector to review the impact of the regulatory regime on investment cycles.

iii. Effective Engagement [p. 13]

This section sets out the Government's priorities for Ofwat in relation to:

- Recognising the full range of interests in managing our water resources, including: improvements to water quality, environmental restoration and protection, planning for development and flood risk management.
- Engaging proactively with other regulators and stakeholders; with a particular emphasis on clear processes for consultation.

3. A sustainable and resilient water sector

i. Ofwat's Sustainability Duty [p. 15]

This section sets out the Government's priorities for Ofwat in relation to:

- Looking beyond the short-term and taking decisions in the long-term interests of our economy, our society and the environment.
- Setting out clearly how decisions have taken account of the three 'pillars' of sustainable development, in order to reflect the long-term challenges facing the industry.

ii. Intergenerational Equity: long term vs. short term investment [p.16]

This section sets out the Government's priorities for Ofwat in relation to:

- Using its regulatory powers to deliver the longer-term imperatives set out in the Water White Paper, looking beyond the immediate five year planning period as a matter of course.
- Maintaining an appropriate balance between ensuring that bills remain affordable in the short-term; and that companies are investing now to meet long-term pressures.

iii. Ecosystems Services [p.17]

This section sets out the Government's priorities for Ofwat in relation to:

- Recognising the Government's commitment to the catchment-based approach which is at the heart of our drive to improve environmental water quality.
- Ensuring Ofwat's regulatory framework can enable water companies to pursue payments for ecosystems services schemes or other such investments in natural infrastructure where they deliver a cost beneficial outcome for their customers.

iv. Managing Water Resources Effectively [p.18]

This section sets out the Government's priorities for Ofwat in relation to:

- Managing future supply and demand and reducing the pressure on the environment from the water we abstract from rivers and other water sources.
- The need to be smarter in using the supplies we have, to develop new ways of capturing, storing and sharing water, and to reduce the amount of water we waste.
- Taking action where too much water is being abstracted from catchments; and reforming our approach to abstraction to reduce future risks.

4. A customer focused water sector

i. A fair deal for customers [p. 21]

This section sets out the Government's priorities for Ofwat in relation to:

- Ofwat's core role in regulating the prices that water companies can charge their customers. Managing the challenging tradeoffs between ensuring a fair deal on customer bills by continuing to drive efficiency in the sector, whilst also ensuring companies can raise the revenue they need to fund management of their assets, investment in resilience and improvements in services.

ii. Extra support for vulnerable customers and those that struggle to pay [p. 21]

This section sets out the Government's priorities for Ofwat in relation to:

- Protecting and supporting vulnerable groups. Alongside its general duty to protect the interests of all consumers, Ofwat has particular responsibilities towards certain groups in society; including the disabled or chronically sick, pensioners, individuals with low incomes and those in rural areas.
- Ensuring that there are no barriers in place for companies wishing to bring forward a social tariff to support customers at risk of affordability problems.

iii. Customers: Increasing Choice, Improving Service [p. 22]

This section sets out the Government's priorities for Ofwat in relation to:

- Influencing the development of the water industry so that companies become more sharply focused on the needs of all their customers.
- Ensuring that its approach to promoting competition in the water sector continues to reflect the clear scope and aims set out in the Water White Paper.
- Assessing the effectiveness of the 2014 price determination against priority outcomes for customers and other stakeholders.

Defra's Strategic Policy Statement to Ofwat: providing context and guidance about priorities and desired outcomes

1. Background and context

1.1 Ofwat exists to ensure that water and sewerage companies provide household and business consumers with a good quality service and value for money. Because the water industry is made up largely of regional monopolies and only a small proportion of consumers can choose their water supplier, the role of the economic regulator is essential in protecting customers and ensuring the sector remains sustainable.

1.2 The Government is committed to stable and predictable regulatory frameworks to facilitate efficient investment, promote sustainable growth and protect consumers. As part of this, we have made a commitment to provide clarity about the respective roles of Government and the economic regulators. The Government has made it clear that economic regulation needs to take place within the framework of policies set by Government and that the decisions regulators take must be consistent with these priorities. The first Commitment of the BIS *Principles for Economic Regulation* states that “*the guiding principle is that high level decisions that involve political judgement are taken by the Government; whilst day-to-day regulatory decisions are undertaken independently by the regulators*”.³

1.3 In order to ensure clarity regarding this division of responsibilities, the Government has committed to put in place strategic policy statements for each of the economic regulators providing context and guidance on priorities and desired outcomes.

Role and Responsibilities

The Role of Government

1.4 It is the Government's responsibility to establish the strategic framework and policy priorities within which economic regulators such as Ofwat operate. To support this, the *Principles for Economic Regulation* require that Government puts in place a strategic policy statement for each of the economic regulators.

1.5 This Strategic Policy Statement is designed to support Ofwat's regulatory independence and has been developed within the context of Ofwat's statutory duties and functions. It sets out the policy priorities that Ofwat has a particularly important role in delivering; and against which Ofwat will be held to account in respect of its independent regulatory decisions.

³ BIS *Principles for Economic Regulation*, Commitment 1, P.6

1.6 This guidance establishes priorities which Ofwat should keep under review and requires them to report on the steps they have taken in response to this steer. It does not constrain Ofwat's regulatory independence or in any way limit their freedom to adopt what they consider to be the most appropriate regulatory approach to delivering outcomes in the light of these priorities.

The Role of Ofwat

1.7 The Water Services Regulation Authority (Ofwat) is a Non-ministerial Government Department. Ofwat's board takes decisions independently of Ministers and are directly accountable to Parliament.

1.8 Ofwat sets the framework of economic regulation within which the water and sewerage companies must operate. Business decisions about investment and operations are for the companies to make. Ofwat influences those decisions by setting incentives, penalties and efficiency goals and by taking enforcement action where necessary.

1.9 The Government expects Ofwat have regard to the strategic priorities set out in this guidance when carrying out their regulatory functions. It is for Ofwat to decide how to best to contribute to the delivery of these priorities.

Summary of Roles and Responsibilities

Ofwat does not work alone but has an important role in ensuring that others deliver their responsibilities as well as delivering its own statutory duties:

- Water companies are independently run and managed businesses. They are directly accountable to their customers and their shareholders. They are subject to economic regulation and must comply with their statutory duties and all relevant legislation. Their focus should be on customer service: providing value for money and operational security. They should seek to minimise their environmental impact and, where possible, provide wider environmental benefits.
- It is for the regulators of the sector, in particular Ofwat, the Environment Agency, the Drinking Water Inspectorate and Natural England to work together to achieve a comprehensive and appropriate regulatory regime.

The regulatory framework must form a logical part of the Government's broader policy context, and remain consistent with established priorities.

Reporting Requirements

1.10 The requirement to report on a regular basis to the Secretary of State on how Ofwat has reflected these priorities in its regulatory decisions is designed to improve accountability and transparency. A reporting timetable will be agreed between the Chair of Ofwat and the Secretary of State and will be reviewed on an annual basis.

1.11 In their annual report for each year Ofwat will summarise what action they have taken to support the delivery of the priorities set out in this guidance. In their forward work plan, they will summarise the steps they propose to take in order to further the delivery of the policy priorities set out in this guidance.

The Government's priorities

1.12 The White Paper: *Water for Life* describes a vision for future water management in which the water sector is resilient for the long-term, in which water companies are more efficient and customer focused, and in which water is valued as the precious resource it is. This *Strategic Policy Statement* provides guidance to Ofwat on their role in supporting the delivery of these priorities. The policy priorities which we expect Ofwat's regulatory decision-making to reinforce are, therefore:

- an innovative water sector;
- a sustainable and resilient water sector;
- a customer focused water sector.

1.13 To support the achievement of these overarching policy priorities, there are ten detailed priorities highlighted within the body of this guidance. These are not presented in any particular order or hierarchy and each is equally important. In their role as independent economic regulator, Ofwat will be expected to manage any tensions or tradeoffs between these priorities and to provide feedback on these as part of the periodic reporting process.

2. An innovative water sector within a transparent and predictable regulatory regime

A Transparent and Predictable Regulatory Regime

2.1 Economic regulation plays a significant role in establishing the terms under which investment is made. Efficient investment is an important part of promoting the long-term interests of consumers. It is important that regulatory frameworks avoid adding undue uncertainty to the business environment. Ofwat's primary duties require them to protect the interests of consumers at the same time as ensuring that efficiently run water companies are able to finance their functions.

2.2 Since privatisation in 1989, the stable regulatory framework for the water sector has enabled companies to attract over £108 billion in low cost investment to upgrade water and sewerage infrastructure, improve customer service and environmental standards. The level of investment required in the coming decades will continue to be significant, and the market for capital is becoming increasingly competitive. Ensuring that the sector remains

an attractive investment prospect is essential if water companies are to continue to deliver efficient investment at a cost that keeps bills at an acceptable level.

2.3 The Government's *Principles for Economic Regulation* emphasise the importance of stable and predictable frameworks to enable economic regulation to deliver investment in the regulated sectors. However, they also recognise that, if it is to remain relevant, the framework for economic regulation must continue to evolve to reflect changing circumstances and ensure a good deal for customers. The Government therefore expects Ofwat to deliver a transparent and predictable regulatory framework to support a water sector that is able to attract efficient investment at attractive rates that keep bills to customers low. We recognise that the regulatory framework for the water sector will need to continue to evolve.

2.4 The Water White Paper set out a clear evidence-based case for change to ensure that we plan now to protect the resilience of our future water supplies, taking account of climate change, population growth and patterns of demand. In order to ensure that regulation remains consistent with Government policy, it also set clear limits to the scope and extent of regulatory change the Government considers appropriate at the present time. These limits reflect the success of the existing regulatory model and the importance of predictable regulatory frameworks in sustaining efficient investment in the right solutions.

2.5 Where Ofwat introduces reforms to its regulatory framework, Government expects these to deliver clear benefits to customers. Reform should be well signalled, based on solid evidence and introduced at a measured pace. This should not anticipate or pre-empt policy decisions that are properly for Government to take, nor introduce unnecessary uncertainty, but should build on the recognised strengths of the existing regime.

2.6 The Water White Paper made it clear that we will not take risks with this successful regulatory model, particularly given the challenges we face in building the future resilience of the sector. It was in this context that we took the decision on the scope of our approach to market reform, and decided not to require legal separation of companies' retail operations. Ofwat proposes to set separate price caps for retail and wholesale activities and to regulate to ensure a level playing field in order to complement the proportionate market reforms set out in the Water White Paper. This is a decision for them to take in their role as independent economic regulator. However, decisions regarding changes to the fundamental structure of the water sector will continue to rest with Ministers and with Parliament. We therefore expect that the regulatory regime will continue to enable efficient, integrated companies to achieve an appropriate return on their assets.

2.7 When considering the longer term direction of reform and assessing the impacts of any specific changes to their regulatory approach Ofwat should give particular consideration to the potential impacts on investment in the sector, including the impact on investor confidence in the regulatory framework. Where proposed changes are sufficiently substantive, Ofwat will be expected to provide a thorough assessment of the impact of their proposals on both consumers and investors, including evidence of the costs and benefits.

2.8 Government expects Ofwat to pursue reforms to its regulatory framework which encourage the increased levels of innovation and dynamism that the water and sewerage sector will require to meet future challenges and deliver benefits to customers in line with the policies set out in the Water White Paper. Government does not expect Ofwat to specify approaches water companies should take to delivering agreed outcomes, but instead to put in place a framework that offers both the incentive and freedom to try novel approaches and encourages greater risk taking.

2.9 Regulatory tools include both penalties and positive incentives and Ofwat is responsible for making judgements about which particular tools are most appropriate to the outcome sought. The *Review of Ofwat and Consumer Representation in the Water Industry* undertaken by David Gray found that: “*the balance of risk and reward is tilted too far towards [. . .] penalties for failure, with relatively limited rewards for outperformance or innovation*”.⁴ In enabling the use of more innovative approaches, Ofwat’s emphasis should be on rewarding success rather than penalising failure. Ensuring capital projects are not more financially attractive than operational spend must be part of this reorientation of the incentive structure. Areas where there may be benefits from a new approach, for example through payment for ecosystem services, are covered elsewhere in this guidance.

Priority I: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review the impacts of any changes to the regulatory framework on investment prospects for the water industry; seeking to avoid regulatory uncertainty wherever possible; taking appropriate account of investor views on the impact of the existing regulatory framework and any proposals for reform. Where proposed changes are sufficiently substantive, Ofwat will be expected to provide a thorough assessment of the impact of their proposals on both consumers and investors, including evidence of the costs and benefits.

Ofwat will report regularly to the Secretary of State on investment prospects for the water sector in the context of Ofwat’s primary duties to ensure that efficient companies can finance their functions and protect consumers.

Supporting Economic Growth

2.10 Economic growth is the Government’s top priority. Water is essential for growth; to thrive, the economy requires a sustainable, resilient, affordable water supply. An energised, innovative, competitive water industry has a central role in meeting the needs of industry and in enabling the development required to support sustainable economic growth and to meet the housing needs of a growing population.

⁴ *Review of Ofwat and consumer representation in the water sector*, David Gray, June 2011

2.11 The Government expects Ofwat to support growth through their approach to enabling infrastructure investment in the sector, including by making it attractive and financeable. The regulator also has a crucial role in driving efficiency throughout the water industry in order to keep costs down for both business and household customers.

2.12 Ofwat is expected, like all parts of Government, to consider their contribution to the drive for growth; placing this in the context of their statutory duties to protect consumers and ensure that efficient companies can finance their functions. Ofwat's duty to contribute to sustainable development (covered in further detail in section four below) requires them to act in accordance with the Government's vision for the long term interests of our economy. In practice, this means encouraging companies to develop business plans and invest in outcomes that support growth, whilst continuing to ensure they meet the needs of their current and future customers. In line with the principles of better regulation, we expect Ofwat to adopt a proportionate regulatory approach which minimises burdens and reduces costs for business.

Priority II: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review the proportionality of its regulatory framework and the actions they have taken to minimise burdens and reduce costs for business.

Ofwat will report regularly to the Secretary of State on this matter taking account of the relevant recommendations of the Ofwat Review and their response to this.

2.13 The Government is seeking to mitigate the impacts of cyclical infrastructure investment; reducing costs to consumers and promoting growth and sustainability in the supply chain. The stop-start cycle within the water sector supply chain can lead to lean periods, loss of productivity, redundancies and an environment of uncertainty in which small and medium enterprises are particularly badly affected.⁵ The second *National Infrastructure Plan* set out how the supply chain can benefit from the continued need for investment in water and other utilities. The Government welcomes the work that Ofwat has undertaken, in partnership with Infrastructure UK and a number of water companies to identify the reasons for cyclicity in investment, which concluded that action by both the water companies and regulator would be needed to deliver change and reduce costs. Government expects Ofwat to take forward the recommendations for changes to its approach to address the impact of investment cycles in the water sector in reducing the productivity of infrastructure delivery.

Priority III: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review whether its regulatory framework has an impact on the profile of investment in the water and sewerage

⁵ *Smoothing Investment Cycles in the Water Sector*, HMT, July 2012

sector.

Ofwat will report regularly to the Secretary of State on the issue of cyclical investment in the water sector, building on its previous work in partnership with Infrastructure UK.

Effective Engagement

2.14 The *Principles for Economic Regulation* set out the need for economic regulators to work within the framework of duties and policies set by Government and to take decisions in a transparent manner which is subject to appropriate scrutiny and challenge. Key stakeholders for Ofwat include the quality regulators, consumers and their representative bodies (particularly the Consumer Council for Water), water companies and their investors. The relationship between Ofwat and their key stakeholders was picked up in the Ofwat review which called for more “joined up” efforts between the various regulators and the Consumer Council for Water (CCWater) to achieve clarity of approach and minimise the disruptive effects of the regulatory process on the companies, especially in the context of the Price Review.

2.15 As the economic regulator of the water industry Ofwat works particularly closely with the other industry regulators: the Environment Agency and the Drinking Water Inspectorate. Each of these organisations acts independently but within the policy and strategic context set by Government. These complementary roles require a close working relationship built upon mutual respect and trust. The Ofwat review found that whilst “the system works and is not fundamentally flawed”, there were a number of ways in which relationships between the regulators could be improved. These are addressed below.

2.16 The 2011 independent review of the water resources management plans (WRMP) process⁶ recommended that improved joint working both between regulators and between regulators and the water companies was required. To address this, Ofwat and the Environment Agency have produced a new joint guideline for the water resource management planning process to strengthen their working relationships and provide clearer signals to the companies on the outcomes they are expected to deliver.⁷ This sets out how Ofwat and the Environment Agency will share information and hold joint discussions, using a risk-based approach to decide the level of scrutiny applied to each plan.

2.17 The Government expects Ofwat to use its role as a statutory consultee to identify at an early stage any proposals within a WRMP that would be inconsistent with its approach to the price determination process. Similarly, Ofwat is expected to recognise the

⁶ *Review of Water Resources Management Plan Process: Final Report*, IHP, June 2011

⁷ *Water resources planning guideline: The technical methods and instructions*, Environment Agency, Ofwat, Defra, Welsh Government, June 2012

requirements placed upon the Environment Agency by Defra's revised River Basin Management Planning Guidance to the Environment Agency (due to be issued during 2013) and the role that they have in working with water companies to deliver this.

2.18 More broadly, the Government expects that Ofwat will engage proactively with the other regulators and take their views into account in formulating its thinking. Memoranda of Understanding (MoUs) exist between Ofwat and Defra and between Ofwat and each of the quality regulators. These should be kept under review and revised where necessary to meet the recommendations from the Ofwat review.

2.19 In the light of their primary duty to protect the interests of consumers, Ofwat has a particular responsibility to work effectively with consumer representative organisations. Key amongst these is the Consumer Council for Water (CCWater), the body which currently provides advice to water company customers, handles their complaints, and represents their views to Government, Ofwat and the other regulators. The Government expects Ofwat to work in close partnership with CCWater and to proactively seek their input in formulating thinking and taking decisions which relate to the protection of water consumers.

2.20 The Government is undertaking work to streamline the institutional landscape for consumer representation in order to strengthen the effectiveness of consumer enforcement and deliver more cost efficient consumer protection, closer to the consumer front line. Ofwat's work on consumer protection needs to be delivered within that framework, recognising the Government's role in providing policy direction.

2.21 The Ofwat Review recognised that regulatory decision making is not a process of developing consensus and that "*the regulator must be, and be seen to be, independent and avoid any impression of capture by the companies it regulates or other stakeholders*". However, it also identified a danger that the absence of the necessary confidence between Ofwat and the companies it regulates could undermine the effectiveness of those relationships. The Government expects Ofwat to engage effectively with the companies it regulates; to place a particular emphasis on clear processes for consultation and to be transparent about how these processes have influenced decision-making.

2.22 The water industry is just one of a number of key players involved in managing our water resources. Others include land managers, local authorities and environmental NGOs. These parties can have a range of overlapping interests in the water environment, including improvements to water quality, environmental restoration and protection, planning for development, drainage and flood risk management.

2.23 Joint approaches designed to deliver multiple benefits can often be more cost-effective and deliver better outcomes than silo working. There are many good examples of how this can work in practice, but these approaches can be difficult to get off the ground due to a lack of clarity about responsibilities and concerns about accountability and transparency of the resources invested. Effective partnerships will be increasingly vital if we are to address the long-term challenges set out in the Water White Paper. The Government expects Ofwat to recognise the benefits that can come from joint working and

to regulate companies in such a way that they are able to act in partnership where this will deliver positive outcomes for customers.

3. A sustainable and resilient water sector

Ofwat's Sustainability Duty

3.1 The Government has set out a clear commitment to sustainable development, backed with clear actions to deliver it.⁸ Reflecting this, sustainable development is the core principle informing all sections of this guidance. It is embedded in our priorities for growth and affordability; as well as in our position on managing water resources effectively, planning for the long-term to meet the needs of current and future customers, and supporting ecosystems.

3.2 Sustainable development means making the necessary decisions now to realise our vision of stimulating economic growth and tackling the deficit, maximising wellbeing and protecting our environment, without negatively impacting on the ability of future generations to do the same. It means looking beyond the short-term and taking decisions in the long-term interests of our economy, our society and the environment. This 'horizon-shift' towards taking a longer term view was at the heart of the vision for securing future resilience set out in the Water White Paper and is covered in further detail below.

3.3 The founding principle of sustainable development is that the three 'pillars' of the economy, society and the environment are all interconnected. In the context of the water sector, this makes sustainable development as central to the work of the economic regulator as it is to the work of the environmental and quality regulators. Our long-term economic growth relies on protecting and enhancing the environmental resources that underpin it, and paying due regard to social needs.

3.4 The Ofwat review recognised Ofwat's commitment to delivering sustainable outcomes as efficiently as possible, but concluded that action was needed to carry this through into regulatory policies and decisions. In particular, it identified opportunities for Ofwat to revise its regulatory approach to use incentives more effectively and ensure that its decisions reflect a broader assessment of benefits. In response to this, the Water White Paper set out a commitment to provide a stronger steer to Ofwat on how it should interpret its sustainable development duty.

3.5 Sustainable development is central to everything that Ofwat does and must be fully embedded throughout its regulatory decision making. We welcome the work Ofwat is already doing to deliver better outcomes for customers, the economy and the environment. In line with the Government's commitment to transparency, we wish to see Ofwat setting

⁸ <http://sd.defra.gov.uk/documents/mainstreaming-sustainable-development.pdf>

out more clearly how decisions have taken account of the three ‘pillars’ of sustainable development, in order to reflect the long-term challenges facing the industry.

Priority IV: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review their contribution to the achievement of the Government’s sustainable development objectives.

Ofwat will report annually to the Secretary of State on the outcomes achieved, using the Government’s Sustainable Development Indicators as a guide and publish this alongside their Annual Report.

Intergenerational Equity: long term vs. short term investment

3.6 The Water White Paper set out the Government’s commitment to work with the regulators to reform the aspects of the current system which institutionalise short-term thinking and make it difficult to adopt solutions which would deliver a more joined-up resilient water resources system. It is the Government’s clear expectation that Ofwat will use its regulatory powers to contribute to the delivery of the longer-term imperatives set out in the Water White Paper, with assumptions and funding decisions looking beyond the immediate five year planning period as a matter of course. This will include careful consideration of the appropriate balance between ensuring that bills remain affordable in the short-term and that companies are investing to meet long-term pressures.

3.7 In this context, Ofwat’s objectives must be both to ensure that the timing of investments is cost-effective and that the financing system allocates costs fairly between current and future generations. For example, whilst failures of the sewerage network can result in significant environmental impacts and sewer flooding of properties, longer-term planning for sewerage infrastructure has had less focus than that for water supply. The Government expects Ofwat to incentivise more strategic planning for the management of the sewerage network to ensure its long-term serviceability at a reasonable cost to both current and future water and sewerage customers.

3.8 In line with the principles of sustainable development, we expect Ofwat to incentivise companies to think and act long-term, reflecting the broader context of supply challenges through to 2050. Companies should monitor and assess the risks posed by a changing climate to their activities and assets, using the most up-to-date UK climate change projections (currently UKCP09). The water resources planning guideline states that a water company must assess the likely impact of climate change on its plan and report on the implications for their water supplies to both Ofwat and the Environment Agency. Ofwat should view the 25 year planning horizon in WRMPs as a minimum not a maximum and should regulate to incentivise companies to address the long-term pressures on and resilience of their infrastructure and water resources.

3.9 Through the Price Review process and other regulatory tools Ofwat should incentivise the delivery of outcomes designed to increase resilience both now and in the future. We expect Ofwat to use all the tools at their disposal to encourage companies to take a long-term perspective and to explicitly avoid assessment methodologies that could drive companies towards short-termism or discourage innovation.

Priority V: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review the impact of their assessment methodologies, penalties and incentives on activity by water and sewerage sector to prepare for longer-term challenges

Ofwat will report regularly to the Secretary of State on this matter. This should consider the profile of investment in the full range of measures required to ensure the future sustainability of the sector over the long-term, taking account of evidence of future pressures such as the Climate Change Risk Assessment and the Environment Agency's Case for Change work.

Ecosystems Services

3.10 The Natural Environment White Paper: *The Natural Choice*, published in June 2011 set out the Government's commitment to taking an 'ecosystems approach' to environmental management. It highlighted the economic and social benefits that can result from managing environmental activities at a scale capable of taking account of impacts across the landscape (often described as working at a 'landscape scale'). *The Natural Choice* recognised the particular relevance of this approach to management of the water environment across a whole catchment.

3.11 The Government's catchment-based approach announced in March 2011 is at the heart of our drive to improve environmental water quality. Water systems are complex and interconnected with the land that surrounds them. Activity on land affects the quality of the water environment, as well as the quantity of water available for abstraction and the risk that heavy rainfall leads to flooding.

3.12 Reducing water pollution in a catchment can be particularly beneficial to water companies in the drinking water protected areas from which they source their supplies, offering better value to customers than measures to extract the same pollutants downstream. It is an example of an innovative approach that Government expects Ofwat's regulatory framework to facilitate, being fundamental to the long-term resilience of the water sector and its infrastructure and relating directly to the practical application of Ofwat's sustainable development duty.

3.13 Properly targeted, investment of this sort can deliver a wide range of positive social, environmental and economic outcomes. An increasingly common approach to making such investments is through 'payments for ecosystems services' schemes. HM Treasury's Green Book supplementary guidance on accounting for environmental impacts in policy

appraisal recommends use of ecosystem services as a framework for assessing these costs and benefits. The Government expects Ofwat's regulatory framework to enable water companies to pursue payments for ecosystems services schemes or other such investments in natural infrastructure where they deliver a cost beneficial outcome for their customers.

3.14 The framework should also be flexible enough to enable water companies, to work with other stakeholders on such projects if this represents best value to customers and to look for partnership funding, where this will maximise the scope for delivering multiple benefits, including those which should not be funded by water customers.

Priority VI: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review the impact of their regulatory approach on the widespread implementation of innovative approaches, such as catchment management schemes, that offer both good value for customers and the potential to deliver multiple benefits. They should also consider whether the regulatory framework presents any barriers to innovation in this area.

Ofwat will report periodically to the Secretary of State, having reviewed the impact of their regulatory framework on implementation of innovative approaches, such as catchment management.

Managing Water Resources Effectively

3.16 The Water White Paper set out the scale of the challenge we face in delivering secure, sustainable and resilient water in the coming decades. It showed how, if we fail to respond to this challenge, we may face difficulty in meeting projected demand for water by the 2050s. To manage future supply and demand and reduce the pressure on the environment from the water we abstract from rivers and other water sources, we need to be smarter in using the supplies we have, develop new ways of capturing, storing and sharing water, and reduce the amount of water we waste. We also need to take action where too much water is being abstracted from catchments and damaging water ecosystems, and reform our approach to abstraction to reduce the risk that these problems become worse in the future.

3.17 The Government expects Ofwat to shape its regulatory framework to support these policy objectives, using its regulatory tools to encourage water companies to consider all options for meeting their supply and demand balance sustainably, including development of new sources and storage, interconnectivity across company boundaries, opportunities for trading water, or other cross boundary solutions.

3.18 The drought that we faced during 2012 had significant impacts on some businesses and households. If it had continued, the economic and social impacts would have been considerably greater. The Government expects Ofwat to work with Government, the

Environment Agency and water companies to learn the lessons of the drought, including considering the standards of service water companies might provide for the future.

Smarter in using the supplies we have

3.19 Ofwat has a statutory duty to further water conservation and take the desirability of conserving water into account in the exercise of its functions. Government expects Ofwat to have particular regard to these duties when agreeing outcomes for demand management. The Water White Paper set out the Government's clear expectation that all appropriate demand management measures should be thoroughly explored and tested in water company plans. Ofwat should encourage companies to demonstrate how they will reduce water use per person, and recognise in its decisions the need for companies to take a long term approach to delivering changes in customer attitudes and behaviour on water conservation. There is a specific expectation that activity to drive reduction in water use will be more significant in areas designated as water stressed or where demand is above the national average.

3.20 The Water Resources Planning Guideline sets out the approach required to demonstrate that companies have fully considered demand side options in their plans. As a Statutory Consultee to this process, Ofwat has undertaken to satisfy itself that water company water resources management plans have fully and consistently explored all the available demand management options. The Government expects Ofwat to incentivise action to reduce demand for water, recognising that companies are required to demonstrate that projected reductions in demand are insufficient or measures are unjustified in terms of cost in order to justify development of sustainable new supply side measures. In assessing the costs and benefits of options, the focus should be on best overall value in terms of long-term resilience rather than a 'least cost' approach for the short-term.

3.21 Tackling leakage remains a priority for Government, as it is for water company customers. Lowering leakage not only reduces pressure on available water resources; it also has a symbolic importance that makes it critical to efforts to persuade consumers to make sustained changes in the way they use and value water. The Government expects Ofwat to incentivise a new and sustained approach to reducing leakage by water companies that continues to represent good value for customers; the framework should also encourage a flexible response to reflect changing pressures on water resources.

3.22 In considering their approach to regulating leakage, Ofwat should take full account of the short and longer term benefits and balance these against the impact on customer bills. The reputational impacts of customer views on leakage, and the possible effect these can have on customer behaviours and attitudes to demand management should be fully reflected in the decisions it takes and exercise of its functions.

3.23 To increase the resilience of our water resources, greater connectivity between different parts of the water network is an area of particular priority. The Environment Agency's analysis of future water availability demonstrates the importance of increasing

interconnection, whilst Ofwat has estimated that the country-wide savings from improved interconnection could be as high as £960 million. We are therefore looking to Ofwat to actively support the drive for greater connectivity, network optimisation, interconnection and bulk water trading through its use of incentives and support tools for water companies.

Tackling unsustainable abstraction

3.24 The Water White Paper set out our commitment to tackling the long-standing legacy of unsustainable abstraction in parallel to developing and implementing a reformed abstraction regime. At the moment the damage over-abstraction causes to the environment is not fully reflected in the price we pay for our water. Nor is it properly reflected in the options appraisal carried out by water companies when they consider how best to balance supply and demand.

3.25 The Government expects Ofwat's regulatory framework to enable action by companies to tackle unsustainable abstraction. Government wishes to achieve an outcome where companies plan in an integrated way to deliver a sustainable supply demand balance, enabling water companies to surrender abstraction licences causing damage to ecosystems where it is cost beneficial to do so.

Priority VII: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review the impact of their regulatory approach on the sustainable management of water companies' water resources and approach to managing their supply demand balance, including in times of drought.

Ofwat will report regularly to the Secretary of State with an assessment of the impact of their regulatory framework on sustainable management of water resources by water companies.

Engaging customers in reducing the amount of water we waste

3.26 The Water White Paper set out the Government's clear expectation that water companies should plan on the basis of a downward trajectory in demand for water over time. Where companies are in a designated water stressed area, or where they have demand that is above the national average, they are expected to produce a water resources management plan that will deliver overall demand reductions in the first five years.

3.27 Metering can provide a direct incentive to reduce water usage, which can help to reduce a household's bills and control prices for all customers by reducing the need for investment in new water supply infrastructure. Meters can also help identify leakage in customers' and water companies' pipes. The Water White Paper set out the Government's policy on metering, which recognises that water companies are best placed to find the appropriate local solution in discussion with their customers. Ofwat is expected to regulate in support of that approach, working with water companies to ensure that water companies implementing metering schemes maximise benefits and manage any adverse impacts on

vulnerable customers. This could be by working in partnership with trusted third parties, such as environmental groups and advice agencies like Citizens Advice to explain the benefits of metering to customers and help them reduce their water use.

4. A customer focused water sector

A fair deal for customers

4.1 Ofwat's core role is in regulating the prices that water companies can charge their customers. In the 22 years since the water industry was privatised the stable regulatory regime has enabled investment of over £108 billion to ensure high quality drinking water and achieve a dramatic improvement in the health of many of our rivers. Alongside that, Ofwat's work to drive efficiencies has ensured that customer bills are around £120 a year lower than they would otherwise have been, with the average water and sewerage bill currently just over £1 per day.

4.2 The Water White Paper recognised that the level of investment required in the coming decades will continue to be significant. Customers will have to meet the cost of financing new infrastructure and improvements to services, so it is essential that Ofwat regulate to drive efficiencies and support and incentivise water companies to adopt approaches such as water trading and demand management which can reduce the need for new investment. The regulatory system must incentivise companies to select cost effective options and only invest in the measures that are needed to deliver the secure and sustainable supplies that customers want.

4.3 Ensuring that all customers get a fair deal is at the heart of the Government's policy priorities. The Government is acutely aware of the range of pressures on household budgets and the need to keep costs down for businesses. In delivering against their statutory duties of consumer protection, financeability; and sustainable development Ofwat must manage carefully the challenging tradeoffs between ensuring a fair deal on customer bills by continuing to drive efficiency in the sector, whilst also ensuring companies can raise the revenue they need to fund management of their assets, investment in resilience and improvements in services.

Providing extra support for vulnerable customers and those that struggle to pay

4.4 On the whole, water and sewerage bills represent good value and are relatively low-cost compared to other utilities. However, some households struggle to pay their water bill, either because they are on a low income or because they live in an area where bills are higher than average. The Water White Paper set out a dual approach to tackling affordability pressures. To reduce the affordability problems households are currently facing, water companies are now able to create social tariffs to reduce the bills of those

who would otherwise struggle to pay their charges. Looking to the longer term, we are introducing a package of reforms to limit the future impact on customers' bills by increasing competition to drive efficiency and innovation.

4.5 Protecting and supporting vulnerable groups remains a key government priority. Alongside its general duty to protect the interests of all consumers, Ofwat has particular responsibilities towards certain groups in society; the disabled or chronically sick, pensioners, individuals with low incomes, those in rural areas.

4.6 The Company Social Tariff Guidance published in June 2012 to companies and Ofwat sets the framework within which a company can bring forward a social tariff if it chooses to do so. Where an undertaker brings forward a social tariff that complies with the Company Social Tariff Guidance there is a clear presumption in favour of approval by Ofwat. Ofwat should have particular regard to ensuring that there are no barriers in place for companies wishing to bring forward a social tariff.

Priority VIII: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review whether companies are taking sufficient action to have a measurable positive impact on the needs of those customers that may struggle to afford their charges.

Ofwat will report on this matter annually to the Secretary of State.

Customers: Increasing Choice, Improving Service

4.7 A central priority for Government is to influence the development of the water industry so that companies become more sharply focused on the needs of their customers and improve the levels of service they offer. We expect Ofwat to incentivise high standards of customer service in the water sector.

Household customers

4.8 We look to Ofwat to incentivise companies to improve their understanding of their customers in order to increase the quality and responsiveness of their customer service. In particular, improved customer data will help companies tackle bad debt and target new support at households struggling to pay their bills. It can also be used to influence more water efficient behaviours by offering practical advice and help to enable customers to reduce their water consumption, achieving benefits for both customers and the environment.

4.9 In pursuing their duty to protect consumers Ofwat should remain mindful of the potential benefits of innovation as well as the risks; ensuring that water companies have the freedom to explore novel approaches, such as more innovative tariffs that can tackle affordability problems and encourage efficient water use, and take proportionate risks without being unduly penalised for failure.

4.10 The level of bad debt in the water industry is approximately three times higher than that of the energy sector, despite water and sewerage bills being around a third of the cost of average energy bills. The costs of unpaid bills are passed on to paying customers and can currently add as much as £15.00 per year to household water bills. The Government expects Ofwat to keep the impact of bad debt on the bills of paying customers under close scrutiny. Ofwat should consider carefully the penalties and incentives they put in place to drive best practice in preventing and managing debt and how these relate to penalties and incentives on customer service more generally.

4.11 Debt problems can often be linked to customers' ability to pay. Support for struggling households and affordability measures should help reduce levels of bad debt. Many water companies already use credit referencing and contact with customers to assess customers' ability to pay. They can then actively pursue those they believe are choosing not to pay and offer support and advice to those struggling to do so. The Government also expects Ofwat, within the scope of their duties, to encourage water companies to know their customers and to offer appropriately targeted tariffs and payment plans designed to minimise the numbers falling into debt and to maximise the numbers addressing their debts.

4.12 The Water White Paper puts customers at the heart of decision-making in the water sector. In 2011 *Ofwat published Involving customers in decisions about water and sewerage services*⁹ which set out the key principle that, where a company can demonstrate effective customer engagement and widespread support for a well evidenced business plan that delivers value to customers, Ofwat will subject that plan to a lower degree of scrutiny. The Government supports this approach and expects Ofwat to incentivise companies to listen to their customers and deliver affordable and innovative services that reflect their changing expectations. In considering information about customer willingness to pay Ofwat will need to balance their responsibilities to both current and future customers.

Non household customers

4.13 The Water White Paper identified the features of the industry where the Government considers change is needed. In particular, it set out the gains that we wish to see from an evolutionary approach to increasing levels of competition both in the retail market and upstream. This package of reforms is designed to drive innovation in the sector; stimulating water companies to find cost-effective solutions and minimise costs to customers. In addition, it aims to make the market more attractive to new entrants by removing unnecessary regulatory barriers and burdens.

4.14 Government is therefore committed to reforming the market for business customers by removing barriers to competition. Unlike other utilities, most water customers are supplied by their local monopoly company. However, many businesses wish to negotiate higher standards of performance, better services and lower costs from water suppliers.

⁹ http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf1104fpl_customer.pdf

The Government has set out a package of reforms to allow all non-household customers to switch their suppliers. We will create a joint market with Scotland, where business customers already have a choice of suppliers.

4.15 Competition is not an end in itself, these reforms are designed to drive new ways of working and reduce risk-averse behaviour in the sector. Ofwat's objectives in promoting competition should be to increase customer choice and stimulate water companies to find more cost-effective solutions, thereby minimising costs to both household and non-household customers. Reform must be delivered in a way that protects customers and ensures the sector can continue to attract competitively priced investment.

4.16 In setting out its approach to these reforms the Government has established explicit boundaries regarding the nature, extent and pace of the changes we wish to see. The Water White Paper strongly emphasised the need for changes to be evolutionary in nature and balanced carefully against the priorities of maintaining a regulatory environment which is attractive to investors. Ofwat's changes to its regulatory regime are expected to support this package. In line with the *Principles for Economic Regulation*, the regulatory approach should reflect the boundaries set by Government and not prejudge decisions about the future direction of policy.

Priority IX: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review its approach to promoting the progress of competition in the water sector to ensure this continues to reflect the aims set out in the Water White Paper and the clear boundaries set by Government. In particular, Ofwat must ensure that changes to the regulatory framework are consistent with Government policy and do not anticipate or pre-empt decisions regarding future reform of the sector.

Ofwat will report annually to the Secretary of State on the alignment of its approach to competition with wider Government policy for the water sector.

The Price Review: delivering value for all customers

4.17 Regulating the prices that water companies can charge their customers is Ofwat's central area of responsibility. In preparation for the Price Review in 2014, Ofwat has undertaken substantial work to ensure that their regulatory approach will enable water companies to plan for the long term; to innovate; and to come up with new ways of meeting their customers' needs. In order to deliver these outcomes Ofwat plans to make a number of changes to their Price Review Methodology and approach. Effective evaluation of the impacts of these changes will be critical.

Priority X: [In line with the powers set out in section 27(3) of the Water Industry Act]

Ofwat shall, as a matter of priority, keep under review the effectiveness of the 2014 price determination; assessing its impact against priority outcomes for customers and other stakeholders.

Ofwat will report to the Secretary of State on its evaluation of the impact of the 2014 price determination towards the end of the price review period, making particular reference to the outcomes delivered for customers and other key stakeholders.

Social and Environmental Guidance

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Social and Environmental Guidance

1. Introduction

- 1.1 This is the second edition of Defra's Social and Environmental Guidance to Ofwat. Its purpose is to provide Ofwat with a steer on the key environmental and social policies to which the Government expects it to contribute in carrying out its role as the independent economic regulator of the water industry. It should be read in conjunction with the Strategic Policy Statement above.
- 1.2 This Guidance is issued by the Secretary of State to Ofwat under powers contained in the Water Industry Act 1991. Ofwat is required to have regard to this Guidance when discharging its statutory functions. This Guidance covers Ofwat's work in relation to water and sewerage undertakers and licensed water suppliers who operate wholly or mainly in England.
- 1.3 Ofwat has a statutory duty to contribute to the achievement of sustainable development. This Guidance provides a formal steer on how this duty can be met. Further detail is set out in *Mainstreaming Sustainable Development – the Government's vision and what this means in practice*. This established the Government's refreshed vision and commitments for sustainable development; building on the principles that underpinned the UK's 2005 SD strategy.
- 1.4 Sustainable development means making the necessary decisions now to realise our vision of stimulating economic growth and tackling the deficit, maximising wellbeing and protecting our environment, without negatively impacting on the ability of future generations to do the same. It means looking beyond the short term and taking decisions in the long-term interests of our economy, our society and the environment. All regulatory practice and decisions must have regard to the Government's policy on Sustainable Development.
- 1.5 The Government set out its vision for the water sector in the Water White Paper: *Water for Life*, published in December 2011. This set out the challenge of increased water scarcity due to climate change and demographic trends and highlighted an increased emphasis on resilience, long term planning and customer focus. It further developed the messages set out in the Natural Environment White Paper: *The Natural Choice* published in June 2011. This established the Government's commitment to taking an 'ecosystems approach' to environmental management and highlighted the economic and social benefits that can result from managing environmental activities at a larger scale, an approach with particular relevance to management of the water environment across a whole catchment. Together, *Water for Life* and *The Natural Choice* provide the strategic direction that informs this Social and Environmental Guidance.

2. A Customer focused Water Industry

2.1 General Approach

2.1.1 The Water White Paper set out the Government's vision for an increasingly customer-focused water industry. The Government expects Ofwat to work closely with the Consumer Council for Water (CCWater) to ensure that appropriate customer protection measures are in place and to ensure that water companies engage with and consult their customers.

2.2 Innovation, Competition and Market Reform

2.2.1 The Water White Paper set out the Government's plans to increase contestability in water and sewerage markets. We are introducing deregulatory legislative changes to make existing competition regimes work more effectively for the benefit of customers. Ofwat must have regard to all guidance issued by the Secretary of State on water charges.

2.2.2 As the SPS makes clear, competition is not an end in itself but a means for improving outcomes for customers. Like all aspects of Ofwat's work it should be considered squarely in the context of sustainable development; taking full account of the need to protect customers and achieve positive environmental outcomes.

2.2.3 As the economic regulator for the water sector Ofwat has a key role in the implementation of these reforms. However, both Government and Ofwat recognise that the process for implementing these reforms must be an inclusive one, designed to draw on the considerable experience and expertise of those market participants who will ultimately be responsible for its success.

2.2.4 Small and medium enterprises (SMEs) will, in particular, need protecting as the non-household market is introduced. The Government expects Ofwat to develop a regulatory regime which ensures that appropriate protections are in place for SMEs and that they have access to sufficient information in order to make informed choices about their retail supplier of water and sewerage services.

2.3 A Fair Deal for Customers

2.3.1 The Government expects that Ofwat will take account of the views of Customer Challenge Groups in relation to price determinations whilst balancing these views with the ongoing need to protect both current and future water customers.

2.3.2 Ofwat should ensure that there are effective procedures in place to enable them to handle all customer disputes for which they are responsible in an efficient, timely manner.

- 2.3.3 The Ofwat and Cave reviews looked at the issues faced by housing and other developers in dealing with water and sewerage infrastructure and found areas in need of improvement. The reviews identified problems with the level of service that water and sewerage companies provide to developers, the transparency of charges for connecting to water and sewerage infrastructure and the way Ofwat has handled disputed cases and complaints. The Government expects Ofwat to use its regulatory tools to drive improved standards of service for developers. Defra will issue charges guidance and Ofwat will issue charging rules to increase the transparency of the infrastructure and requisition charges paid by developers.
- 2.3.4 The Government expects Ofwat to regularly review its use of Guaranteed Service Standards and to incentivise companies to strive for better levels of service. In doing this, Ofwat should consider customer views.

2.4 Keeping bills affordable

- 2.4.1 For many household customers, the most critical issue is the affordability of their bills. Although water and sewerage services remain relatively cheap, some households struggle to afford their charges. Water companies are now able to create social tariffs to reduce the bills of those customers who would otherwise struggle to pay their charges. Section 44 of the Flood and Water Management Act 2010 enables water companies to use cross-subsidies between customers to fund social tariffs.
- 2.4.2 Ofwat must have regard to the Company Social Tariff Guidance published by Defra. This sets the framework within which a company can bring forward a social tariff if it chooses to do so. Ofwat is expected to work constructively with water companies that seek advice on the development of a social tariff, with a view to ensuring compliance with the guidance. Where an undertaker brings forward a social tariff that complies with the guidance, there is a clear presumption in favour of approval by Ofwat.
- 2.4.3 The Government wants to see adequate safeguards in place to protect the customers of resellers of water. To this end, Ofwat should continue to keep the resale order under review and take particular account of the support needs of resale customers.
- 2.4.4 The Government expects Ofwat to work with companies to drive debt management and recovery practice that reflects best practice in comparable sectors. Action to recover debt must be fair, reasonable and well aligned with mechanisms to support customers at risk of affordability problems.

2.5 Vulnerable Groups

- 2.5.1 Protecting and supporting vulnerable groups is a government priority. Alongside its general duty to protect the interests of all consumers, Ofwat has particular responsibilities towards certain groups in society; the disabled or chronically sick,

pensioners, and individuals with low incomes. Ofwat also has particular responsibilities for customers living in rural areas.

2.5.2 Ofwat is expected to regularly review how it fulfils these duties, taking into account:

- information contained in the Vulnerable Groups Regulations,
- the Government's wider policy approaches to meeting the needs of vulnerable groups,
- relevant policies on income related benefits.

2.6 Metering

2.6.1 The Government expects Ofwat to ensure that companies charge customers in a way which is fair and transparent. Metering can be a component of this and can help reduce household bills by providing a direct incentive to reduce water use.

2.6.2 Evidence has indicated that groups such as single adults and pensioners are likely to benefit from opting for a meter and the Government expects Ofwat to regulate in a way which encourages water companies to raise awareness of the benefits of metering amongst these groups. Whilst many customers would benefit from switching to a metered charge, some customers may see their bills increase. In areas of serious water stress, where water companies are able to bring forward universal metering programmes, the Government expects Ofwat to ensure that the transition to metering programmes is handled sensitively; ensuring that customers are treated fairly and that vulnerable groups are assisted.

2.6.3 Metering also allows companies to understand patterns of water use amongst their customers and to offer more innovative tariffs. These can increase customer choice, help tackle affordability and encourage efficient water use. Ofwat should ensure companies are able to consider the provision of more innovative tariffs, in consultation with their customers.

3. Resilience and Environmental Protection

3.1 General Approach

3.1.1 The Natural Environment White Paper focused on the benefits of taking an 'ecosystems approach' to integrate environmental management on both land and water. The Government developed this approach in relation to the water environment through the Water White Paper, which set out the challenge of protecting the environment, water quality and the resilience of the water sector in the context of climate change, more extreme weather patterns and population changes.

- 3.1.2 The Water Framework Directive (WFD) establishes a strategic approach to managing the water environment. This includes a common approach to setting environmental objectives for groundwater, dependent wetlands and surface water bodies across Europe. The WFD establishes standards and objectives for protected areas, and requires the implementation of programmes of measures to meet those objectives. The Government has adopted an integrated approach to meeting the requirements of the Water Framework Directive and achieving the strategic objectives set out in Water and Natural Environment White Papers. This focuses on joined-up action to deliver both environmental and drinking water quality goals.
- 3.1.3 The Environment Agency is the lead regulator responsible for overseeing delivery of the requirements of the Water Framework Directive. Ofwat should ensure that, its regulatory actions do not present a barrier to the effective delivery of Water Resource Management Plans, River Basin Management Programmes and other programmes implemented to support meeting the requirements of the Water Framework Directive. In doing so, Ofwat is expected to co-operate effectively with the environmental and quality regulators, water companies and other interested parties.

3.2 Supply and Demand Balance

- 3.2.1 Ofwat has a statutory duty under the Water Act 2003 to encourage water conservation and the Government expects Ofwat to have regard to this duty when making regulatory decisions.
- 3.2.2 It is essential that the water resources planning process and price review process are aligned to ensure water companies deliver the best outcomes for customers and the environment. Government welcomes the joint undertakings from Ofwat and the Environment Agency to work in partnership on the water resources management planning process, providing clear signals to the companies on the outcomes they are expected to deliver. The Government expects Ofwat to use its role as a statutory consultee on water resources plans to identify at an early stage any proposals within a WRMP that would be inconsistent with its approach to the price determination process.
- 3.2.3 As stated in the Water White Paper, Government expects to see all demand management measures thoroughly explored and tested in water company plans. Water companies are expected to show how they will reduce water use per person, with this reduction more significant in areas designated as water stressed or where demand is above the national average. The water resources planning guideline sets out the approach to planning that we expect companies to follow and the evidence we shall expect to see in order to demonstrate that companies have fully considered demand side options in their plans
- 3.2.4 Ofwat will need to satisfy itself that water company water resources management plans have fully and consistently explored options to manage demand. The

companies should consider the full range of options for reducing demand for water, demonstrating with appropriate analysis where necessary that projected reductions in demand are insufficient or measures are unjustified in terms of cost in order to justify development of sustainable new supply side measures.

- 3.2.5 The Government expects Ofwat to work with Government, the Environment Agency and water companies to learn the lessons of the drought and to apply these in the exercise of its duties.

3.3 Sustainable Abstraction

- 3.3.1 Tackling over-abstraction was a key commitment of the Water White Paper and will play a key role in protecting rivers and their ecosystems and building resilience in the water sector to meet the challenges of climate change and evolving demographic trends. The Government expects Ofwat to support abstraction reform through its regulatory functions.

- 3.3.2 The Government expects Ofwat to work closely with the Environment Agency, and to use their regulatory tools and mechanisms to ensure that, water companies identify sustainable sources of water, do not cause avoidable environmental damage and are able to finance plans for alternative ways of meeting their supply demand balance.

3.4 Catchment Management, Water Quality and Water Ecosystems

- 3.4.1 The Natural Environment White Paper established the Government's framework for an ecosystems approach, which involves integrating management of land and water and basing management decisions on a thorough assessment of the costs, benefits and socio-economic impacts of the various options.

- 3.4.2 The Government is committed to protecting water ecosystems to achieve 'good ecological status' through a river basin planning approach under the Water Framework Directive. It recognises the need to increase the rate of progress towards good status by working at a catchment and sub catchment level to involve interested parties and address the pollution sources that are causing water bodies to fail. Ofwat is expected to ensure that its regulatory approach provides an enabling framework in which water companies can make an appropriate contribution to these goals.

- 3.4.3 Evidence shows that catchment management (joint planning, collaboration and management between all water abstractors, suppliers, users and land managers at a catchment level) is an effective way of managing water resources fairly and of predicting, limiting and remediating environmental damage. This approach is a key component of meeting the requirements of the Drinking Water Directive for

identifying the most efficient and effective way of solving problems with drinking water quality. The Government expects Ofwat to ensure that the regulatory framework presents no barriers to water companies making an appropriate contribution to catchment management.

- 3.4.4 Ofwat should actively encourage water companies to consider catchment schemes to address pollution as an alternative to end of pipe solutions wherever this is the most economically viable approach.
- 3.4.5 Payments for Ecosystem Services (PES) schemes can be a highly cost effective way of achieving benefits for the water environment and the Government supports further engagement by water companies with such schemes. Ofwat are expected to ensure that there are no regulatory barriers to appropriate use of PES schemes where these are based on robust economic and scientific evidence of cost effectiveness. A common methodological approach to valuing ecosystems services can be helpful in establishing PES schemes. The Government would encourage all parties involved in such schemes to have reference to the Treasury's *Green Book supplementary guidance on accounting for environmental impacts in policy appraisal*.
- 3.4.6 Many water companies are already actively involved in schemes such as Local Nature Partnerships and Nature Improvement Areas. Where there are diffuse pollution problems, companies may also wish to engage in related schemes such as the Catchment Sensitive Farming initiative and Entry Level options under the Environmental Stewardship scheme. The Government expects Ofwat to ensure that there are no regulatory barriers in place to water companies engaging in integrated partnership working across catchments and landscapes.

3.5 Habitats and Biodiversity

- 3.5.1 As a public body, Ofwat has a statutory duty to have regard to the purpose of conserving biodiversity when undertaking its functions. Water companies, as statutory undertakers, also have to comply with this duty.
- 3.5.2 Many important sites and habitats are on water company land which offers scope for innovative management approaches with multiple benefits for biodiversity and water quality and availability. Ofwat and water companies must comply with laws in respect of protected sites. In complying with their biodiversity duty, Ofwat should have regard to the Biodiversity Strategy 2020 in taking regulatory decisions. Water company activities must not undermine the objectives of the strategy or result in a breach of the Habitats Directive.
- 3.5.3 Ofwat are expected to carry out their duties under section 40 of the Natural Environment and Rural Communities Act 2006, section 28G of the Wildlife and Countryside Act 1981 (as amended), and regulation 9(3) of the Conservation of habitats and Species Regulations 2012 (as amended). Ofwat is legally required to

have regard to the purposes of National Parks (and the Suffolk and Norfolk Broads) and Areas of Outstanding Natural Beauty when coming to decisions or carrying out their activities relating to or affecting land within these areas.

3.6 Climate Change Adaptation

3.6.1 The Climate Change Act 2008 made the UK the first country in the world to have a legally binding long-term framework to cut carbon emissions. It also created a framework for building the UK's ability to adapt to climate change, including:

- a UK wide climate change risk assessment that must take place every five years;
- a national adaptation programme which must be put in place and reviewed every five years to address the most pressing climate change risks to England;
- a mandate giving the government the power to require 'bodies with functions of a public nature' and 'statutory undertakers' (including water companies) to report on what they are doing to address the risks posed by climate change to their work.

3.6.2 The Government published the first UK Climate Change Risk Assessment (CCRA) on 25 January 2012 that will be updated in 5 year cycles. This work will allow a better understanding of what climate change means for the UK, and to inform the development of a programme of adaptation policies to address those risks.

3.6.3 In its Climate Change Adaptation Report, Ofwat states that its role is to provide the right regulatory incentives to enable the companies to adapt to climate change, and take action if they fail to meet their obligations. The most important risks relate to:

- water supply and demand;
- asset resilience;
- discharge of wastewater to the environment; and
- the coping capacity of sewer systems.

3.6.4 The Government expects Ofwat to work towards the targets of its Adaptation Report and to ensure that its regulatory approach explicitly supports companies in adapting to climate change.

3.7 Climate Change Mitigation

3.7.1 The Government expects companies to fully meet any compliance obligations under the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) and that no barriers will be put in place to achieving the scheme's objectives and requirements.

3.7.2 The Government expects Ofwat to incentivise companies to improve their energy efficiency and to drive down their energy consumption. Further policy levers to reduce emissions are the renewable financial incentives which are designed to

increase the uptake of renewable energy. These include support for renewable electricity through the Renewables Obligation and the Feed In Tariff, and heat through the Renewable heat Incentive. Ofwat should ensure that there are no regulatory barriers to companies to working with OFGEM on achieving these targets.

3.8 Planning for Growth

3.8.1 The National Planning Policy Framework is a key part of the Government's reforms to make the planning system less complex and more accessible, to protect the environment and to promote sustainable development.¹⁰

3.8.2 Water and Sewage Companies should continue to actively plan for new development and increasing demand on both water and sewerage networks, and to engage with planners, consumers, developers and others to ensure that the system is resilient and capable of supporting sustainable growth. The Water Resources Management Planning Guideline, produced jointly by Environment Agency, Ofwat, Defra and the Welsh Government, sets out the approach to forecasting planning for future population growth in order to ensure that the network is capable of supporting projected growth.

3.9 Managing Flood Risk

3.9.1 Climate change and new housing development are likely to place greater pressure on drainage networks, increasing the risk of surface water and sewer flooding. Water companies are required to act in a manner which is consistent with the National Flood and Coastal Erosion Risk Management (FCERM) Strategy and guidance when exercising their flood risk management functions under S94 Water Industry Act 1991. The Water White Paper set out the Government requirement for water companies to take a more strategic approach to drainage planning. Water companies are statutory consultees on local strategies and are required to have regard to them in the exercise of their effectual drainage duties.

3.9.2 In this context, Ofwat should ensure that there are no regulatory barriers to companies working with risk management authorities, partners, landowners and developers to plan and deliver long-term solutions. These need to be sustainable, cost beneficial, adaptable to climate change and more resilient to extreme weather. The regulatory framework should be sufficiently flexible to enable a broad range of measures including catchment solutions and investment in third party assets to meet their obligations.

¹⁰ *National Planning Policy Framework*, CLG, March 2012

- 3.9.3 Water companies have a duty to cooperate with other risk management authorities. Water companies are expected to maintain good quality information about their drainage networks so that they can co-operate effectively with requests from the Environment Agency and Lead Local Flood Authorities. Ofwat should ensure that there are no regulatory barriers in place to proactive engagement by companies in the development of local strategies.
- 3.8.4 Ofwat should encourage water companies to incentivise the use of Sustainable Drainage Systems wherever possible and to raise awareness amongst their customers of the potential benefits of fitting Sustainable Drainage Systems in existing properties. Ofwat should consider how they can use their role as a Statutory Consultee and during any pre-application discussions further to the implementation of Schedule 3 the Flood and Water Management Act.

3.10 Sewer Capacity

- 3.10.1 Water and Sewage Companies should continue to actively plan for new development and increasing demands on the sewer system, and to ensure that the system is resilient and capable of supporting sustainable growth.
- 3.10.2 The Government expects Ofwat to take a lead in ensuring that companies have the flexibility in their business approaches to cope with changes implemented under reforms to the planning for private sewer regimes. For example, understanding better where assets are, and also understanding the issues relating to building over of their assets by consumers (for example, during the construction of extensions, etc) and developing proportionate and consumer-focused responses to requests for partnership working in these circumstances.

Annex A: Defra's Policy Priorities for Ofwat

There are ten priorities highlighted within the body of this guidance. These are general directions to Ofwat, issued in accordance with sections 27(3) and 192(B) of the Water Industry Act. They are not presented in any particular order, each is equally important. In their role as independent economic regulator, Ofwat is expected to manage any tensions of tradeoffs between the priorities and to report on these as part of the periodic reporting process.

Priority I:

Ofwat shall, as a matter of priority, keep under review the impacts of any changes to the regulatory framework on investment prospects for the water industry; seeking to avoid regulatory uncertainty wherever possible; taking appropriate account of investor views on the impact of the existing regulatory framework and any proposals for reform. Where proposed changes are sufficiently substantive, Ofwat will be expected to provide a thorough assessment of the impact of their proposals on both consumers and investors, including evidence of the costs and benefits. Ofwat will report regularly to the Secretary of State on investment prospects for the water sector in the context of Ofwat's primary duties to ensure that efficient companies can finance their functions and protect consumers.

Priority II:

Ofwat shall, as a matter of priority, keep under review the proportionality of its regulatory framework and the actions they have taken to minimise burdens and reduce costs for business. Ofwat will report regularly to the Secretary of State on this matter taking account of the relevant recommendations of the Ofwat Review and their response to this.

Priority III:

Ofwat shall, as a matter of priority, keep under review whether its regulatory framework has an impact on the profile of investment in the water and sewerage sector. Ofwat will report regularly to the Secretary of State on the issue of cyclical investment in the water sector, building on its previous work in partnership with Infrastructure UK.

Priority IV:

Ofwat shall, as a matter of priority, keep under review their contribution to the achievement of the Government's sustainable development objectives. Ofwat will report annually to the Secretary of State on the outcomes achieved, using the Government's Sustainable Development Indicators as a guide and publish this alongside their Annual Report.

Priority V:

Ofwat shall, as a matter of priority, keep under review the impact of their assessment methodologies, penalties and incentives on activity by water and sewerage sector to prepare for longer-term challenges. Ofwat will report regularly to the Secretary of State on this matter. This should consider the profile of investment in the full range of measures

required to ensure the future sustainability of the sector over the long-term, taking account of evidence of future pressures such as the Climate Change Risk Assessment and the Environment Agency's Case for Change work.

Priority VI:

Ofwat shall, as a matter of priority, keep under review the impact of their regulatory approach on the widespread implementation of innovative approaches, such as catchment management schemes, that offer both good value for customers and the potential to deliver multiple benefits. They should also consider whether the regulatory framework presents any barriers to innovation in this area. Ofwat will report periodically to the Secretary of State, having reviewed the impact of their regulatory framework on implementation of innovative approaches, such as catchment management.

Priority VII:

Ofwat shall, as a matter of priority, keep under review the impact of their regulatory approach on the sustainable management of water companies' water resources and approach to managing their supply demand balance, including in times of drought. Ofwat will report regularly to the Secretary of State with an assessment of the impact of their regulatory framework on sustainable management of water resources by water companies.

Priority VIII:

Ofwat shall, as a matter of priority, keep under review whether companies are taking sufficient action to have a measurable positive impact on the needs of those customers that may struggle to afford their charges. Ofwat will report on this matter annually to the Secretary of State.

Priority IX:

Ofwat shall, as a matter of priority, keep under review its approach to promoting the progress of competition in the water sector to ensure this continues to reflect the aims set out in the Water White Paper and the clear boundaries set by Government. In particular, Ofwat must ensure that changes to the regulatory framework are consistent with Government policy and do not anticipate or pre-empt decisions regarding future reform of the sector. Ofwat will report annually to the Secretary of State on the alignment of its approach to competition with wider Government policy for the water sector.

Priority X:

Ofwat shall, as a matter of priority, keep under review the effectiveness of the 2014 price determination; assessing its impact against priority outcomes for customers and other stakeholders. Ofwat will report to the Secretary of State on its evaluation of the impact of the 2014 price determination towards the end of the price review period; making particular reference to the outcomes delivered for customers and other key stakeholders.

Annex B: The Statutory Basis for this Guidance

This Strategic Policy Statement and the Social and Environmental Guidance is issued by the Secretary of State for Environment Food and Rural Affairs under the following sections of the WIA:

- section 2A – the Secretary of State and the Welsh Ministers may issue guidance about Ofwat’s contribution to the attainment of social or environmental policies. This guidance (which is enclosed at pages 27 - 36 of this statement) must be consulted on with Ofwat, CCW, and water and sewerage companies. The final guidance will be laid before parliament in accordance with the requirements of the WIA.
- section 27(3) – Under section 27 of the WIA, Ofwat has a duty to keep the water and sewerage sectors under review and to collect information with respect to the carrying on of licenses activities. Under subsection 27(3), the Secretary of State may give general directions indicating what matters Ofwat should have particular regard to in prioritising these things and also in determining whether and how to exercise its powers under particular parts of the WIA¹¹. Pages 7 - 25 of this statement contain these general directions. Ofwat is under a duty to comply with these directions.
- section 192B(2)(e) the Secretary of State may require reports on matters in addition to Ofwat’s other reporting requirements from time to time. The general directions contained within this statement include some such additional reporting requirements.

¹¹ These are Part II – Regulation of Undertakers (and Licensees), Part III – Water Supply, Part IV – Sewerage Services, Part V – Financial Provisions and Part VII – Information Provisions