



Department
for Environment
Food & Rural Affairs



By email only

25th November 2020

Dear All,

Green economic recovery: Regulatory assessment process

In July, the Government, the Environment Agency, the Drinking Water Inspectorate, Ofwat and the Consumer Council for Water (CCW) wrote to you to set out how water companies can help to meet the economic and social challenges England faces as we seek to build back greener from the Covid-19 pandemic, while delivering real and lasting improvements to the environment for current and future generations.¹

Recognising the essential role the water industry plays in a successful society, economy and a thriving natural environment we invited you to play your part in the country's green economic recovery. We would like to thank companies that have since stepped forward with proposals to support these ambitions and who have engaged with us productively through meetings and by participating in the roundtable on 4th November. Your feedback is vital to enable us to make progress.

We are looking forward to continuing discussions about individual proposals with you. This letter outlines how proposals will be assessed by each of the regulators and what each regulator would like to see from companies, building on the helpful comments made at the roundtable discussion on 4th November.

In line with that discussion, we understand that not all companies will be in a position to participate in this process. Companies should only put forward proposals if they consider that they can robustly deliver more, over and above the significant commitments already included in their price control settlement.

We envisage a **two-stage process**, that will help companies to accelerate their current programmes, while also encouraging the submission of detailed and well-evidenced proposals for customer funding which will attract greater scrutiny

1. **As soon as possible:** acceleration of existing AMP7 plans, including WINEP measures.

¹ Defra, Ofwat, Drinking Water Inspectorate, Environment Agency, CCW, '[Green economic recovery – the water industry's role in building a resilient future](#)', July 2020.

2. **No later than 31 January:** formal submission of fully developed proposals for additional funding, from companies that are on track for delivery of existing commitments.

We welcome the submission of fully-developed proposals before the formal January deadline and encourage companies to engage with the relevant regulators about their proposals before that date. The process we have developed provides clarity around the criteria we set out in our letter in July. We consider our approach is consistent with the principles set out in our previous joint letters and our respective statutory roles. We are happy to work with companies to help them understand our expectations and the type of evidence we require, and we are looking forward to continuing discussions about how companies can best play their part in the green economic recovery.

Yours sincerely,



Sally Randall

Director of Floods and Water
Defra



Rachel Fletcher

Chief Executive
Ofwat



Marcus Rink

Chief Inspector of Drinking Water
Drinking Water Inspectorate



Harvey Bradshaw

Executive Director of Environment and Business
Environment Agency

A handwritten signature in black ink, appearing to read 'E Clancy', with a long horizontal flourish extending to the right.

Emma Clancy

Chief Executive
CCW

Regulatory assessment process for Green economic recovery proposals

Steps to approval (for proposals requiring customer funding)

- Initial details of proposals submitted by water companies at least one week before any meeting;
- Meeting held between Defra, regulators and individual company for the company to set out how schemes support the Green economic recovery (including, for example details of job creation / retention, environmental impact, and local investment) and how the company plans to meet the criteria we have set out;
- Company to provide evidence that it meets our core principles including the requirement for on-track delivery in order to proceed;
- Proposals to be formally submitted by the water company for assessment by 31 January. The lead regulator will bring other regulators into the decision-making process as appropriate;
- A lead regulator will be assigned;
- Proposals will be considered depending on the regulatory requirements for the type of proposal;
- Agreement to proceed, or proposal refused;
- Proposals incorporated into existing permitting and management processes, and/or decision letter sent to company.

Types of proposal

The Government and regulators have committed to take an approach that best ensures proposals deliver maximum benefits to customers, the environment and society.

Where proposals will not affect customer bills, we will take a less prescriptive approach, as set out in the July letter. Therefore, how we assess what companies put forward will depend on the nature of the proposal:

- **Acceleration of existing AMP7 plans:** We invite companies to accelerate existing plans and environmental priorities within the agreed 2020-25 plans, considering the enhanced use of nature-based solutions to deliver them. These proposals may well not need further regulatory consideration, but we would expect companies to provide assurance that bringing such schemes forward will have no adverse impact on the delivery of existing regulatory obligations;
- **Bringing forward AMP8 enhancement proposals from 2025 and beyond;**

- Implementing **specific new innovative ideas**: These could include water resources, flood mitigation, net zero or water quality improvements, which would benefit future generations or current customers.

Acceleration of existing plans

In the first instance, we encourage companies to consider where they can bring forward elements of their AMP7 programme, including WINEP measures. These proposals would require minimal regulatory oversight and represent great opportunities to maximise the benefits of the PR19 settlement and promote the green recovery. Where companies propose to use additional customer funding to bring forward enhancement spending or to implement new ideas, but do not plan to accelerate existing expenditure as a priority, we will expect companies to provide evidence as to why this is appropriate and why existing investment commitments cannot be accelerated.

Bringing forward enhancement proposals from 2025 or beyond or implementing specific new innovative ideas

Where proposals would result in customer bill increases, they will be assessed appropriately (depending on the novelty and complexity) and proportionately (depending on value) as set out under 'Ofwat assessment criteria' below.

Where companies submit proposals to accelerate AMP8 schemes, they should be linked to specific statutory drivers and include comprehensive supporting evidence. For example, if customer research has previously been carried out on these schemes, companies should consider whether that evidence remains relevant or requires revision. Where appropriate, the Environment Agency expects companies to demonstrate that proposals meet existing regulatory expectations as set out in the PR19 WISER and EPR guidance.² For drinking water quality, proposals should be in line with the industry long-term planning guidance around resilience, climate change adaptation, and regulatory standards. As part of the assessment process, we will assign a lead regulator to each proposal according to the nature of the scheme and whether it would impact on customer bills. Each regulator will also seek views where appropriate from the other regulators and from government.

Given the focus on economic recovery, we are interested in company proposals that increase expenditure when the economy needs it most: that is, over 2021-22 and 2022-23. Companies should set out how their proposals will help economic recovery

² Environment Agency, Natural England, '[Water industry strategic environmental requirements \(WISER\)](#)', 2017; Defra, '[Environmental permitting: Core guidance](#)', March 2020.

over this period in particular, over and above their existing expenditure commitments.

Submitting green recovery proposals

Companies should submit initial details of their green recovery proposals to Defra in the first instance. Defra will then arrange a meeting for each company to set out to government and regulators how their proposals support the green economic recovery, for example, by creating or retaining jobs, improving the environment and providing local investment.

Companies should also set out:

- when their proposed schemes will be delivered;
- how any proposals for additional customer funding fit with the acceleration and delivery of existing PR19 commitments; and
- how their proposals meet the principles we set out in our July letter.

Investment and performance commitments on track

As set out in July, existing investments and performance commitments must be on track for **any** green recovery proposals to be approved. It would be contrary to the aims of the green recovery and customer interests if companies were distracted from delivering their PR19 commitments because of these additional schemes.

Accordingly, we will require companies to provide assurance that existing investments and performance commitments are on track, including:

- at least six months' performance data to demonstrate that their **investment programmes** are on track. If a company is not in a position to provide this evidence, we expect it to be back on track shortly. The company will need to set out Board assurance on when its programme will be back on track, including the steps it will take to get back on track;
- at least six months' performance data showing that their key **performance commitments** are on course to be achieved and Board assurance of on-track delivery of performance commitments for the remainder of the financial year, taking into account:
 1. outturn performance for the 2015-20 period;
 2. outturn performance for the current year; and
 3. predicted performance over the remainder of the current year, based on current and historical performance and performance in the first and second halves of previous years.

Ofwat will take an in-the-round approach to assessing this evidence and, while key performance commitments should be met in the round (in particular, any related to accelerated proposals), companies are not expected to be on track with every performance commitment. When undertaking this assessment, Ofwat will take into account the impact of Covid-19, in particular on levels of per capita consumption.

Ofwat assessment criteria (for proposals requiring customer funding only)

Companies will recognise the importance of carefully considering the impact on customers during the 2020-25 period. The affordability of customer bills is likely to be a significant issue as incomes are hit by the effects of the pandemic. Further, some customers are already likely to experience in-period bill rises as household demand increases due to lockdown restrictions and if social tariff schemes are extended to more customers. All proposals should have regard to their associated affordability impacts, both in their design and scale, as well as the timing of cost recovery from customers.

Ofwat considers there is a high bar to proposals which seek to increase customer bills beyond the level allowed for in PR19 and expects companies to explore all alternative options before any proposal to do so. Where companies are proposing any bill increases before 2025, the onus is on companies to demonstrate that any such increase is affordable and fair and recognises the impact of Covid-19 on customer circumstances. Consistent with regulatory predictability and certainty and avoiding a reopening of price controls, Ofwat expects that any proposed changes will be proportionate and modest.

However, Ofwat acknowledges that deferring the recovery of all costs until PR24 might unduly limit investment proposals and adversely impact notional company financeability. Therefore, in the interests of facilitating a strong green recovery, we are open to companies proposing the recovery of some costs in the 2020-25 period, where there is compelling evidence. Clearly, increasing customer bills in the short term can also reduce the effectiveness of an economic stimulus, Ofwat will work with companies to get the right balance to best support the green recovery.

Ofwat invites companies to consider how to maximise scope for green recovery investment and limit impacts on customer bills before 2025. For example, by minimising the recovery of costs before 2025 and considering how they can share the burden of additional costs with customers by making an appropriate financial contribution towards their green recovery schemes. To be clear, this contribution is not a requirement, and we also invite proposals that do not include such a contribution.

This could be done through accepting a reduced return on additional investments before 2025, and/or from a reduced recovery of PAYG totex and RCV run-off over the period. Companies should also consider how any outperformance on PR19 cost allowances and incentives could be used to contribute to any additional costs of green recovery proposals. It is for companies to put forward the proposals they consider are in the best interests of customers and that best meet the objectives of the green recovery.

In the absence of exceptional evidence, we do not consider that it is appropriate for companies to propose schemes that failed to be accepted in the PR19 process. In the event that companies propose schemes that were not taken forward at PR19, it will be important to set out convincing evidence that there is a material change in circumstances, including, where appropriate, refreshed evidence of customer support and efficiency in optioneering and delivery.

The green recovery provides an opportunity to develop new and innovative ways of working and collaborating. In this vein, some companies have already explored opportunities to use third-party funding or government schemes. As set out in the July letter, all companies should do so and provide evidence of doing so, before seeking additional customer funding for any proposal.

The normal price control process for 2020-25 involves the development and assessment of investment proposals over a two to three year period and has only recently been completed. The green recovery process is, by design, an accelerated process outside the normal price control process. To protect customers, we are therefore proposing to accept only the very best proposals for additional customer funding. This will mean that some companies might not see any proposals accepted and other companies will not see all of the proposals that they put forward accepted. However, all companies have the chance to accelerate current commitments to maximise the value of the price control.

It is also important to note that water customers can only be expected to fund schemes that are consistent with the proper carrying out of the functions of a water undertaker or, where relevant, a sewerage undertaker.

Appendix I sets out further detail around the additional criteria Ofwat would expect proposals to meet in order to secure customer funding, as previously specified in the July letter and at the roundtable in November. Appendix II sets out CCW's customer engagement principles and expectations for companies.

Appendix I: Ofwat assessment criteria

Delivery of schemes

Companies should provide assurance around the successful delivery of schemes. Companies will firstly need to demonstrate their ability to finance the proposed schemes while maintaining an appropriate level of financial resilience. Secondly, companies will need to show that their proposed investments are deliverable alongside their current commitments. To demonstrate this, we would expect companies to consider the overall volume of expenditure and amount of activity planned for each year of the remainder of AMP7 compared to the level of efficient expenditure they have achieved in previous periods. If a scheme gets cancelled, delayed or reduced in scope, any PR24 reconciliation will be adjusted to reflect this.

Value for money for customers

To ensure that proposals deliver value for money, Ofwat expects to take a similar approach to its deep dive assessments of enhancement proposals at PR19.³

This includes expecting companies to provide clear, high-quality evidence of need, and the incremental improvement to be delivered. Some of these schemes may arise from a statutory driver, in which case it may be necessary for the Environment Agency or DWI to undertake an assessment of need.

In selecting a preferred scheme to meet the need, companies must provide evidence that an appropriate range of options were considered and were subject to a robust cost–benefit analysis, including consideration of wider environmental, societal and economic impacts. We also expect evidence that the proposed investments are not for activities included in our base cost allowances.

Ofwat expects companies to provide persuasive evidence that cost estimates are robust and efficient, including evidence of outturn costs of similar or comparable projects (in particular for the acceleration of activities already in progress) and activity cost benchmarking. The cost estimates and the efficiency of the specific proposals are expected to have been through a third party assurance process. Where companies are bringing forward investments from AMP8, there should be no

³ Ofwat set out the types of evidence it expected companies to submit in support of their enhancement proposals in Ofwat, '[Delivering Water 2020: Our final methodology for the 2019 price review, Appendix 11: Securing cost efficiency](#)', December 2017, pp. 14-15, Box 2. The process at PR19 did not require that every claim needed all the evidence listed in Box 2. Different types of proposals may require different evidence to support them. It will be for companies to provide the appropriate evidence to support their proposals.

loss of efficiency or benefits from bringing forward the investment. Where appropriate, schemes should reflect efficient cost estimates made at PR19.

Companies must explicitly quantify the customer and environmental benefits arising from the scheme and any potential impacts on agreed PR19 outcomes. Where the benefits of the investment has a direct impact on specific PR19 outcome delivery incentives (ODIs) including performance commitment levels, this should be quantified as part of the proposal. Companies should set out how existing performance commitments should be adjusted to take account of the benefits of the additional investment, together with any new performance commitments to allow the monitoring of the delivery of scheme outcomes. In line with the goals of the green recovery, we would also expect to see companies demonstrate the environmental, social and any other public value benefits of the scheme.

As part of the assessment process, Ofwat will also seek views where appropriate from the other regulators and from government.

Customer support

Companies should demonstrate their proposals align with customer priorities and preferences by presenting robust customer evidence. Where companies are undertaking customer research, they should engage with CCW and Ofwat in advance of any research. Ofwat will take account of CCW's view on the quality of customer engagement and participation and CCW will be happy to work with companies to set out expectations of what good evidence would look like.

In general, the level of customer engagement should be proportionate to the level of investment proposed. If companies plan to bring forward AMP8 enhancement proposals where customer research has previously been carried out, they should consider whether that evidence remains relevant or requires revision.

CCW's guidance to companies around its expectations for the green recovery initiative and the customer evidence that companies should provide can be found in Appendix II. As Ofwat has not set expectations for customer engagement at PR24 and the role of CCGs, there are no expectations surrounding the role of CCGs on customer engagement for the green recovery.

Managing affordability pressures

The Covid-19 pandemic significantly impacts on many customers, with reduced incomes and high levels of uncertainty about the future of jobs and businesses. Companies should consider the potential bill impacts of increases in social tariff provision resulting from the impact of Covid-19.

For large schemes in particular, companies will need to demonstrate that the investment would not adversely impact on affordability, or otherwise how they will manage any resulting affordability pressures for customers in the short and long term. This includes considering any impacts of schemes on the availability of social tariffs.

Affordability for customers can be protected in the short term by recovering the value of schemes at PR24, as this will avoid increasing customers' bills in the current 2020-25 price control period. Companies should also consider how to mitigate the cost impact of new or brought forward schemes on customers' bills in the future by enhancing the assistance provided to financially vulnerable customers. This could include, for example, increasing the company-funded contribution to social tariffs.

Companies' engagement with customers to explore their support for any new or brought forward schemes should also show customers' views of how acceptable and affordable the proposals are in terms of the potential bill impact.

Ofwat will work with CCW to obtain assurance on affordability impacts and determine what action we would expect to see from companies where impacts would be material.

Exploring alternative funding

Some companies have already explored opportunities to use third-party funding or government schemes. As set out in the July letter, we expect all companies to do so and to provide evidence of doing so, before seeking additional customer funding for any proposal.

Appendix II: CCW principles and expectations

- Companies should show how they will prioritise and accelerate delivery of existing 2020-25 commitments before any post 2025 investment is brought forward or new initiatives are considered.
- Companies should demonstrate how the outcomes they are seeking to achieve would benefit current and future customers. The outcomes should reflect evidence of customers' priorities. The package of proposed improvements to deliver these outcomes should also have customer support.
- Evidence of customer support should be included as criteria in the decision making process to approve new or brought forward initiatives.
- Customer support can be evidenced from a variety of sources (such as existing PR19 research, other parties' research, or engagement of other types). Companies may need to undertake new customer engagement to gather customers' views on any new proposals.
- Companies should consider how evidence of customer support should be proportionate to the size of the proposed investment. The evidence should also reflect meaningful engagement with customers.
- CCW would expect companies to engage with customers on:
 - **Outcomes:** Do outcomes companies are aiming for reflect customer priorities?
 - **What the investment will deliver:** What will current and future customers see or experience from this investment?
- New initiatives to address environmental issues such as river water quality may provide an opportunity for companies to work with local communities in identifying and gaining support for an appropriate solution.
- Companies should show that they have looked at how their proposals affect the affordability of customers' bills, taking into account the pressures on customers due to economic uncertainties caused by the Covid pandemic. Companies should demonstrate how they have considered and mitigated any potential affordability impact.

- If a package of new or brought forward investment may lead to an increase in customers' bills in the future, companies should provide evidence to show if this is acceptable and affordable for customers.
- Companies should avoid seeking to reopen the PR19 settlement and avoid increasing customers' bills by considering alternative funding options and reinvesting outperformance to fund new initiatives. This may offset some of the costs customers may be asked to pay at PR24.
- If companies fail to deliver their commitments, the cost customers may have paid for this should be returned.
- Companies and regulators should be transparent with stakeholders through the process to allow sufficient time for scrutiny and challenge.