Date: Wednesday 7 September 2022

OFWAT
PR24@OFWAT.GOV.UK

Dear Ofwat,

This is the response of British Water to Creating tomorrow, together - Consulting on our methodology for PR24. We do not require anything in the response to be treated as confidential.

British Water represents the interests of UK water and wastewater supply chain companies together with wider stakeholders across the sector, through our UK, Technical and International forums, connecting them to contacts to raise their profile, grow their business and promote best practice. Our Water Industry Forum provides challenge-led, independent thought leadership, to tackle the challenges facing the sector

Our purpose is to therefore provide leadership, support and best practice and address the challenges faced by the UK water sector through the UK, Technical and International forums, and neutral Water Industry Forum.

The structure of our response to the consultation is as follows.

- Overview
- Supply chain perspective on PR24
- Areas with potential for improvement
- Initiating joint working

Overview

The context for PR24 is shifting around us with the worsening affordability crisis on the one hand and pressures to address carbon, environment, and performance issues on the other. The aims set out in the methodology will remain relevant and all are welcomed by the supply community.

Focus on long-term, adaptive planning	This should help deal with the long-standing issue of unnecessary cost to customers of the water sector's unusually cyclical investment profile.
Delivering greater environmental and societal value	Regulating for whole system outcomes will encourage consideration of whole system benefits and costs and lead to improved allocative efficiency.
Reflecting a clear understanding of customers and communities	This will encourage the water companies to address some of the historically monopolistic and internalising tendencies. The supply chain is a community in its own right and can bring important markets to water if enabled.
Driving improvements through	This is an area where the supply chain has a big part to

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efficiency and innovation	play in boosting the growth in productivity that has been flat in recent years.

Supply chain perspective on PR24

British Water believes that the supply chain plays an important role on the performance and outcomes of the businesses that Ofwat regulates. This is true across the range of performance measures and outcomes referred to in the consultation document.

The supply community is a network or system that includes the customers, the company, and the supply chain. The significance of the supply chain in the water industry reflects the fact that importantly, the consultation focuses on outcomes and the incentives in the water companies. The supply chain plays a crucial role in the delivery of the outcomes. External expenditure on goods and services amounts to some 55% of water company revenues[1]. The water industry is the most capital intensive of all major sectors and its supply chain is complex, and will become increasingly so as the industry shifts focus away from asset intensive processes to services (such as nature based solutions) and demand management.

The relationship between the regulatory regime and inputs from the supply chain is indirect and works via the water companies' planning and procurement of the inputs they need to deliver services to customers and the environment and the management of the companies' relationships with the supply community. British Water believes that this indirect linkage can be improved with substantial benefits for customers, the environment, the companies, and their shareholders.

This response sets out areas where we believe this potential exists. Drawing conclusions about how the potential can be converted and the implications for the regulatory regime should be the subject of joint working between suppliers and the water companies and the response sets out how this can be initiated. Because of the indirect nature of the relationship, the supply chain does not feature in the draft methodology or in the consultation questions it contains.

Areas with potential for improvement

We identify three areas under this heading

- Acknowledge suppliers (the supply chain) as an important community
- Cyclical and unstable nature of expenditure programmes
- Pace of innovation

Acknowledge suppliers (the supply chain) as an important community

Given the importance of the supply chain to the functioning of the water sector and its potential as a vehicle for introducing more extensive competition[2] and innovation into the vertically integrated monopolies, it would be beneficial for the supply chain to be acknowledged as an important community in PR24.

[1] https://www.icevirtuallibrary.com/doi/full/10.1680/mpal.11.00022

[2] This would be the equivalent of expending the DPC approach to smaller programmes and activities.

Ofwat's duties to protect customers arises from the absence of effective competition markets. While Ofwat talk about the need for markets, they are largely silent about the needs of other actors in those markets to ensure there is healthy capacity, capability, and liquidity to meet the substantial challenges of future adaptation and in particular the need for extensive innovation in all parts of the water system.

We hope that the high quality and ambitious business plans that Ofwat intends to encourage will include steps to convert the potential we believe exists. This would be facilitated if Ofwat were to include in its assessment of the business for the BPI consideration of the companies' organisational resilience, of which the value of their procurement and supplier relationships would be an important element. We think this should take into account the role water companies have as dominant "buyers" in markets and the steps they are taking for the long term health and capability of markets and suppliers to deliver for the future.

We believe that success in this will involve a greater degree of openness among the water companies to the solutions that suppliers can offer including the opportunities that Ofwat's concept of open data should create. For this to be credible, the supply chain will need to adduce arguments and soundly based evidence to show how it would work.

We believe an extension of the concept of direct procurement might help in this matter. Water Companies tend to seek services to integrate into their monopoly rather than convene services on behalf of the system. The challenge of data collection from meters is a good example of where companies focus on revenue collection is limiting the opportunities of other providers to demand side services and incentives.

We would also recommend a measure of supply chain satisfaction with water companies and water company satisfaction with their supply chains, building on the work of British Water's annual Water Company Performance Survey. S-Mex would help build an understanding of resilience in the sector at a time when supply chain connectivity is of paramount importance.

Cyclical and unstable nature of expenditure programmes

There has been a long running debate about the unnecessary cost to customers of the water sector's unusually cyclical investment profile – the cyclicality problem. Our members observe that expenditure cyclicality is more acute in water than in other regulated and unregulated sectors. They adduce the periodic nature of price controls, a short-term focus of the regime, and the unmitigated monopoly status of the water companies as contributing to this.

Less attention has been paid to a related issue, sometimes referred to as the tumble dryer effect – a continual re-evaluation, reiteration, and rescoping of plans, which imposes additional unnecessary risks to the suppliers and costs to customers.

Our members have observed that Covid and other sources of disruption and uncertainty, including policy and regulator responses to the CSO controversy, have exacerbated these problems.

We hope that the first of Ofwat's stated ambitions for PR24 - focusing on the long term with stronger adaptive planning – will allow and encourage water companies to manage their delivery plans in a longer term and more stable way.

This is not to understate the reality and significance of, for example, the CSO issue but rather to hope that better horizon scanning, evidence about the value of solutions and outcomes, and adaptive behaviour will lead to a smoother outcome in PR24 and beyond. We believe the run up to PR24 will provide opportunities to revisit these problems and use the tools for the longer-term tool kit to good effect.

We believe this will result in procurement processes that entail less unnecessary risk in the supply community, are better suited to the particular purposes of the water companies and are the subject of more sector-wide standardisation – all contributors to better value. British Water is neutral towards the procurement models used by the water companies. We believe the problem is not the models but their ineffective and unstable deployment.

We will play our part in seeking to produce evidence of the issues, align with the objectives of Ofwat and the companies and reflect potentially radical changes in the sector, including digitalisation, non-network solutions and new business models. Undoubtedly, in current circumstances delivering a massive CSO programme will be problematic for individual companies and even more so the sector as a whole, and is symptomatic of the boom and bust approach. Capacity in the supply chain will be sorely tested to expand programmes so dramatically, while information of what is required is scarce.

A rapid escalation of expenditure is not in the best interests of outcomes or customers; what is required is a planned transition to ramp up investment, allowing companies and the supply chain the necessary space to consider the data and identify efficient responses to the challenge and to build a sustainable market to support it.

Pace of innovation

The sector has been good at incremental innovation with steady progress since it was privatised. The low-risk environment is less positive to forms of radical innovation and there is evidence that the pace of improvement, never rapid, has slowed in recent years, even though the apparent scope for innovation has increased.

Monopoly company cultures can be problematic and it seems that the incentives in the regime, have not stimulated the water companies to push for radical innovation and may have stifled initiatives because of an absence of necessity. Ofwat's proposal on strong incentives may change this position. Even so, British Water believes that the supply chain can contribute much more. it may be less risky for the regulated businesses to turn to their suppliers to play a more significant role in innovation and the open data initiative should be instrumental in this area. One benefit of a greater role for suppliers would be the more rapid dissemination of successful innovations across the sector. It would also reduce the tendency of the water companies to engage in an excess of tests and pilots, whereas the value of innovation is only realised when it is exploited at scale.

British Water is keen to work with the companies to see how the tools Ofwat has proposed can be deployed to focus on more rapid and significant innovation. For this to be effective the suppliers would need to gain access to information and evidence about the concerns and preferences of customers and stakeholders.

The long term nature of planning will be helpful to developing capacity and capability in the supply chain provided innovation is not constantly deferred; for innovation to be an option to be deployed at scale when it is needed requires a long term commitment to the market to develop and learn, including from failures which are an essential part of innovation.

How value is assessed is an important driver to company behaviour. We note cost assessment is acknowledged as an important tool in considering the quality and evidence of company plans. The result of this, in the absence of any real innovation driving efficiency, is to lead companies to squeeze the supply chain to accept more risk and less cost.

We welcome Ofwat's commitment to seeing greater value delivered, but for this to work it needs to consider how value and risk is measured (including wider value created through multiple benefits), incentivised and shared appropriately with all the actors in the system, not just two communities, investors and customers.

Initiating joint working

In each of the areas we have discussed Ofwat's draft methodology includes provisions that can stimulate improvements and that can provide opportunities for the supply chain to participate and to up its contribution.

We will need to work with the companies on the detail of how to align our work with their objectives and the incentives in the regime. This will make the sector better able to tackle its joint problems. This will be with individual companies and also with sector organisations including Water UK, UKWIR, WRC, SPRING and CIWEM, all of which have specific contributions to make. British Water will be able to involve its UK, Technical and International Forums as well as its independent Water Industry Forum[3] in this.

It will be important to provide information to all the regulators on the nature of the joint working and invite their participation so we can avoid falling at regulatory hurdles. We would intend to make sure that the regulators acknowledge the issue to be addressed, are briefed on the discovery approach we are taking as well as the intended outcomes and risks, and can provide input. In addition, British Water will be able to develop arguments and evidence to support the changes.

In this inclusive approach, we hope to be able to align with and make the best out of the methodology that Ofwat ultimately adopts.

Yours sincerely,

Rachel Lewis

Rachel Lewis,
Chair of British Water's UK Forum

[3] https://www.britishwater.co.uk/page/Services