Response to Skylight report - "How should Ofwat's approach to price control regulation focus on the long term?" – by Salmon & Trout Conservation

The report recently produced by Skylight Consulting Limited, paid for by Anglian Water, suggests that reform of economic regulation of the water industry is required to provide "as much freedom as possible to develop plans, which meet the long-term interests of their customers and the environment".

S&TC takes a different view of what is required.

The statutory and regulatory system that has been in place since 1991 does not need reform. It is the approach of OFWAT, in terms of the policies it has applied under that system, and the demands of consecutive Secretaries of State for the Environment and their guidance to OFWAT, that has been and remains at fault.

The system would work if the Secretary of State and OFWAT made it clear that what was and is required from the water companies is the simple act of meeting their legal duties (particularly under section 94 of the 1991 Act).

It is the collective failure of Secretaries of State and OFWAT over many years to **provide for** and **require** investment from the water companies that has led to the current state of underinvestment in sewerage infrastructure in England.

Last year, S&TC submitted a formal complaint to the Office for Environmental Protection along these lines.

It is therefore true, as the Executive Summary of the Skylight report states, that "at least part of the reason for [the failure to invest for the long term] resides in the approach Ofwat takes to price control regulation", but that is not the same as saying that the statutory and regulatory system is at fault.

The fault lies in how that system has been applied.

At paragraph 4 of the Executive Summary, the Skylight report argues that "a failure to …reform the regulatory system accordingly would potentially undermine the long-term focus required".

Quite the opposite is true.

S&TC takes the firm view that reform would just be a distraction from the abject failures of water companies to meet their duties, particularly those under section 94.

Of course, it is entirely understandable why the companies might want such a distraction, but that is what it would be. Recognition of the failure to invest does not require reform of the statutory and regulatory framework.

Nor is it true, as the Report suggests, that the perceived emphasis on short-term investment necessarily compromises long-term investment. In any business, which is properly planned, and managed, short-term investment is part of a long-term investment strategy. At paragraph 8 of the Executive Summary, it is not true that regulation needs necessarily to "continue disproportionately to reward short-term goals to the detriment of future generations".

The Report suggests there is a strong degree of alignment across stakeholders on the need to focus on the long term (paragraph 2.1). While the long-term is very important, given the parlous state of sewerage infrastructure in England and the appalling sewage pollution of rivers and bathing waters caused by that infrastructure, short-term, or perhaps, more accurately, **immediate corrective investment** is urgently required. We need action now not in the long-run. To paraphrase Keynes, in the long-run, all our rivers will be dead.

At paragraph 2.4 reference is made to Water Resources Management Plans (introduced via the Water Act 2003) and Drainage and Wastewater Management Plans to be introduced via the Environment Act 2021. Of course, the reality is that any water company charged with statutory duties under the Water Industry Act 1991 would be negligent in the extreme, were it not to plan for water resources and wastewater management, whether or not the law requires the production of documents.

Indeed, perhaps one of the few things in the Skylight report with which S&TC agrees wholeheartedly is the reference in paragraph 2.5 to regulation "placing requirements on companies to produce documentation rather than achieve outcomes". That is a fault not only of water companies, but also of numerous regulators, the Environment Agency being the worst culprit. The archive shelves of Environment Agency offices are heavy and creaking with plans and strategies past, that were never implemented and never achieved any real outcomes. And the Agency is still writing more.

It is also wrong to suggest that the urgency society now feels that the water companies should address both **immediate corrective** and **long-term** investment (paragraph 2.6), is a result of increased environmental expectations. There is ample historic evidence of the damage being caused by sewerage infrastructure inadequacies to rivers and bathing waters and that has been the case for many years.

Recent heightened public concern, largely off the back of Philip Dunne MP's Private Members' Bill, and the sewage-related clauses in the Environment Act 2021 that resulted, does not mean that this is a new issue. It is entirely wrong to suggest somehow that water companies have not known about the dissatisfaction in the public concerned with the treatment of sewage.

It is a matter of fact (paragraph 2.8) that there are indeed industry-wide rates of asset replacement that are unsustainably low, but that has been the case for many years and it is not true, (paragraph 2.9), that the scale and nature of that challenge had not percolated through to those with the power to do something meaningful about it, namely former Secretaries of State for the Environment and Directors-General of OFWAT. Where are you all now, so you can see the mess you've left behind?

For political reasons, past Governments were more preoccupied with keeping water bills low and allowing water companies to pay excessive dividends to shareholders, rather than requiring investment for the future. That is why we are currently in the mess that we find ourselves in. Over the last 30 years, since privatisation, those in power, and the water companies themselves, have turned deaf ears to the ticking timebomb of failing and insufficient sewerage assets. The rivers have suffered as a result and will do for years to come.

It is true, (paragraph 2.10), that criticism is not confined to the water companies involved, but also to the regulatory authorities and to the Government, but it is the water companies who have failed to comply with their duties under the Water

Industry Act 1991 and who have presided over the lack of investment. Regulatory failure is no defence for water companies' failure to comply with the law.

Do not forget the speech of Michael Gove delivered in March 2018[1] to Water UK's City Conference.

"Far too often, there is evidence that water companies - your water companies - have not been acting sufficiently in the public interest.

Some companies have been playing the system for the benefit of wealthy managers and owners, at the expense of consumers and the environment.

Particularly in the last decade, some companies have not been as transparent as they should have been.

They have shielded themselves from scrutiny, hidden behind complex financial structures, avoided paying taxes, have rewarded the already well-off, kept charges higher than they needed to be and allowed leaks, pollution and other failures to persist for far too long.

And when there has been acknowledgement that change is required – following public pressure or actions by regulators – far too often there has been prevarication and procrastination, ducking and diving and dragging of feet.

Change having been promised in many cases, hasn't happened, or hasn't happened quickly enough".

Remember that speech was delivered by Michael Gove, not Jeremy Corbyn.

If water companies, over the numerous periodic reviews, had not felt that they were being permitted to make sufficient investment to protect the environment for future generations then, under the systems in place under the Water Industry Act 1991, they should have argued for better determinations by OFWAT, and, in extremis, they should have used all the avenues available to them to appeal.

Reference is made (at 6.3 in the Summary of Recommendations) to projects being rejected that might "on the balance of probability still be in the long-term interests of customers and the environment for them to proceed", but if that were ever the case then the water companies should have used the appeal mechanisms within the 1991 Act to ensure that funding was provided for those projects.

Perhaps one reason the water companies did not squeal louder at the time, is that it would have risked exposing the payments of generous dividends to shareholders to public scrutiny, and might have required that money to be directed to investing for the long term instead of the convenient result of providing shareholders with overly generous returns.

As Mr Gove also said in 2018:

"In cash terms, over £18.1billion was paid out to shareholders of the nine large English regional water and sewerage companies between 2007 and 2016.

[1] https://www.gov.uk/government/speeches/a-water-industry-that-works-for-everyone

Of course, generous dividends can be justified if they've been generated by the lean and efficient running of an operation – and have been paid out after appropriate capital investment.

But the £18.1 billion paid out in dividends was actually almost all of the profit made by water companies after tax – the total profit was £18.8billion over the same period.

95% of the profit went in dividends to shareholders".

It is certainly not true that the need to invest for the long term is some new revelation.

A simple examination of Strategic Policy Statements from earlier years demonstrates that the Secretary of State for the Environment understood that to be necessary. Perhaps the fault was that the Government of the day appeared to want to have it both ways – always seeking to avoid, as far as possible, rising water bills, as well as seeking investment.

Unfortunately for the water companies' shareholders, the immediate corrective investment we now need may come with reduced dividend payments - a recognition that dividend payments in the past have been too generous.

There is one point where the Skylight report leaves the real world completely.

At paragraph 3.10, it is suggested that improvements can be made to the price control process, which could help to ensure the process delivers on the long-term objective and that "Ofwat should create the conditions – **perhaps including an explicit amnesty from enforcement action** – that facilitate the exposure of the true underlying state of industry assets".

This is an astonishing suggestion given the duties of the water companies to provide information to OFWAT under the 1991 Act and under their licences. If it is the case that water companies have not been giving a true picture of the infrastructure to OFWAT and to the Secretary of State, then they should be held accountable and that includes by way of criminal sanctions. There can be no amnesty for duties that have been in place on the water companies since the 1991 Act. Water companies cannot pretend that the current state of infrastructure is nothing to do with them and if they are in any way hiding the extent of the problem, then they are culpable in the extreme and OFWAT must act.

The general suggestion of the report is that the water companies should be given (per paragraph 3.10) "as much freedom as possible to develop plans, which meet the long-term interests of their customers and the environment". The truth of the matter is that the water companies have not complied with the basic duties placed on them as undertakers under the 1991 Act. If the water companies had been more determined in their protection of their asset base and of the environment over previous periodic reviews, then they would have met those long-term interests and we would not be in the position we are in now.

The water companies do not need greater freedom.

In fact, quite the opposite.

The approach of the regulators has been insufficiently rigorous and too 'soft touch'. Even Mr Gove recognised that "the reality is that privatised natural monopolies bring

with them specific challenges and temptations that must be addressed by a strong and energetic regulator".

At paragraph 4.12 it is at least acknowledged that "reforms carry some risk that companies might simply choose to channel additional funding to shareholders as opposed to deploying it to the long-term advantage of their customers and the environment". That is indeed a significant risk and past performance suggests that that risk is very real.

We do not support any loosening of the ties of regulation - because they are evidently slack already - but the regulators and Government do need to be focused on the interests of the environment and customers, as opposed to water companies and dividend payments.

At paragraph 5.4, the report does suggest that "the threat of enforcement action, where companies are found to have breached the fundamental statutory obligations under section 37 and 94 of the Water Industry Act 1991 arguably creates a powerful deterrent to the management and/or shareholders contemplating skimping on expenditure in the short term".

Quite so.

But that is of course only true if the regulator enforces those duties using its section 18 powers under the Water Industry Act 1991. Ofwat's failure to enforce the specific duty to effectually deal with sewage per section 94(1)(b) of the 1991 Act is the basis of S&TC's complaint to the Office for Environment Protection.

Finally, there is reference in the report, for example paragraph 5.11, to the issue of trust – "If companies could demonstrate that they were more worthy of trust, e.g. perhaps based on their track record or with reference to statements and associated actions demonstrating a strong commitment to a public purpose then the regulator might be more sympathetic to applications for enhancement expenditure".

The issue of trust is of course a major problem for the water companies given the recent behaviour of Southern Water and most recently in evidence given to the Environmental Audit Committee by the Chief Executive of Severn Trent Water, which was described by that Committee as "disingenuous", which is as close as most polite Parliamentary Committees allow themselves to get to jumping up and shouting "Liar! Liar!" at its guests.

At paragraph 6.6, the report notes that "the more confident the regulator can be that a company is genuinely committed to serving the long-term needs of its customers and the environment, the more supportive should be the regulatory approach applied to that company".

Clearly, we are a long way off that position of trust. Given the investigation triggered by the brilliant work of Professor Peter Hammond, now being conducted by OFWAT and the Environment Agency into over 2,000 sewage treatment works for failure to meet permit conditions, trust is likely to be in short supply. Let's not forget that these works were under the operational control of the water companies, and no-one else, and were monitored by the companies themselves under the Agency's ill-conceived Operator Self-Monitoring.

And, of course, future trust has to be earned, does it not?

At paragraph 5.11, the report notes that, in the 30 years since privatisation, “ethics have arguably played little part in proceedings”.

If, as the Skylight report suggests, adopting ethical regulation “might unlock a surprising amount of energy, goodwill and efficiency within companies strengthening trust and confidence in the sector”, the water companies know where to start.

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