



**BRIEFING PAPER**

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# Economic regulation of the water industry in England and Wales

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1. Water sector overview
2. Price Review
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## Summary

The water industry in England and Wales was privatised in 1989. Most water and sewerage companies are regional monopolies, with dedicated pipe networks and water supplies in each company area. This means that household customers cannot choose or switch their supplier and competition is limited. Consequently, there is a need for economic regulation of the industry to ensure that the industry delivers value for consumers and the environment.

[Ofwat](#) (the Water Services Regulation Authority) is the economic regulator for the water industry in England and Wales. The Department for Environment, Food and Rural Affairs (Defra) and the Welsh Government set the policy and legislative framework in England and Wales, respectively.

### Average water bills

Average water bills have risen since privatisation (after inflation) and have remained relatively stable since 2010. In 2020-21 bills are expected to drop below £400 for the first time in 15 years. [Water bills vary between different companies](#) because the costs of delivering infrastructure and services are different in different regions. Rising bills since privatisation have come alongside investment by water companies, improvements to services and drinking water quality.

### Price Review

The prices that water companies charge customers in bills is controlled by Ofwat through a 5-yearly process called the [price review](#). During the price review Ofwat sets wholesale price limits for each water company alongside performance targets, such as for leakage reduction, reducing pollution incidents and lowering personal water consumption. When setting company prices, Ofwat must balance the interests of the customer for lower prices with the need to make sure the water company can finance its operations and meet environmental responsibilities.

### Price Review 2019 (PR19)

The last price review occurred in 2019 ([PR19](#)) and set prices from 1 April 2020–31 March 2025. Ofwat stated that overall, PR19 would result in a [12%, or about £50, fall in customer water bills](#) (before inflation) and £51 billion investment by industry over the 5-year period. Ofwat states that the price review set “stretching but achievable” performance commitments on environmental improvement, for example, reducing leakage by 16% by 2025. PR19 has been described by Ofwat, the water industry and press as the “toughest yet” on the sector. Some companies are concerned that Ofwat focused too much on short term bill reductions at the expense of long-term investment in infrastructure. Four companies have asked Ofwat to [refer their determinations](#) to the Competition and Markets Authority for review. The Consumer Council for Water welcomed the price review as a good outcome for consumers.

### Water company performance

Water company performance has come under [increasing public scrutiny](#) in the last few years from across the political spectrum. The [profits and financial management](#) of some companies alongside some high-profile service failures have raised criticisms that the sector is not delivering value for money for consumers.

Ofwat made [some changes in PR19](#) in response to some of the concerns about the regulatory framework. These included reducing the allowed cost of capital, adding

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mechanisms for sharing benefits with customers from certain financial structures, setting expectations for maximum dividend payments and introducing financial reporting expectations. The water industry stated it [fully supported](#) Ofwat's changes.

# 1. Water sector overview

## 1.1 Privatisation of the water industry

The water industry in England and Wales was privatised in 1989.<sup>1</sup> Most water and sewerage companies are regional monopolies, with dedicated pipe networks and water supplies in each water company area. This means that household customers cannot choose or switch their supplier and competition is limited. Consequently, there is a need for regulation of the industry to ensure that customers get value for money. Business customers in England can switch their water provider following the introduction a competitive retail market in 2017. For further information, see the Library briefing paper, [Water: non-household retail competition](#) (CBP 8925).

There are 11 companies that supply water and sewerage services to [large regional areas in England and Wales](#) (see Box 1 on companies operating in Wales).<sup>2</sup> There are also some water-only and sewerage-only companies as well as companies serving smaller local areas. In total, there are 17 regulated companies. Some customers receive water and sewerage services from different companies.<sup>3</sup> This paper will refer to “water companies” to include both water and sewerage companies.

Water and sewerage supply and policy is devolved. This paper will cover England and Wales only. In Scotland and Northern Ireland, public drinking water and sewerage services are provided by publicly owned companies. There is therefore no equivalent economic regulation system.

The Department for Environment, Food and Rural Affairs (Defra) is the lead government department for the water industry in England and sets the policy and legislative framework. The Welsh Government sets the overall water and sewerage policy framework in Wales. The Senedd Cymru/Welsh Parliament Research Service briefing: [The Water Industry in Wales](#) (September 2018) provides more information about Welsh Government policy and priorities for water.

### Box 1: Water companies in Wales

There are two main companies serving customers wholly or mainly in Wales:

- [Welsh Water \(Dŵr Cymru\)](#) is a water and sewerage company covering most of Wales and some adjacent parts of England. Welsh Water has been owned by Glas Cymru since 2001. Glas Cymru is a single purpose not-for-profit company limited by guarantee – a unique company structure in the water sector. It has no shareholders and financial surpluses are re-invested in the company. Welsh Water’s assets are financed through capital markets without Government support.<sup>4</sup>
- [Hafren Dyfrdwy](#) (owned by Severn Trent) is a water and sewerage company serving customers in north east Wales. It brings together Welsh customers previously served by Severn Trent Water and Dee Valley Water, after Severn Trent Plc bought Dee Valley Water in 2017.<sup>5</sup>

<sup>1</sup> Ofwat, [Water sector overview](#) [accessed 27 December 2019]

<sup>2</sup> Ofwat, [Your water company: contact details](#) [accessed 29 May 2020].

<sup>3</sup> Discover Water, [Who’s who in the water sector](#) [accessed 2 June 2020]

<sup>4</sup> Dŵr Cymru Welsh Water, [Company Information: Glas Cymru](#) [accessed 2 June 2020]

<sup>5</sup> For more information, see the Welsh Parliament Research Service briefing: [The Water Industry in Wales](#) (September 2018)

## 1.2 Regulation of the water industry: an overview

All water companies hold an appointment as a water undertaker (or sewerage undertaker as relevant), which is subject to conditions with which the companies must comply. This is also referred to as a licence. Copies of each undertaker's licence are available on the Water Services Regulation Authority's (Ofwat's) [webpage on licences](#). Ofwat, the economic regulator for England and Wales, is responsible for enforcing the licence conditions.

The water industry is highly regulated. In addition to their licence conditions, water companies must comply with a range of water quality, environmental and economic legislation. There are three main regulatory bodies that enforce compliance by companies:

- [Ofwat](#) sets limits on the prices that water companies can charge customers, which are reviewed every 5-years (see Section 2 on the price review process). Ofwat incentivises companies to operate efficiently and with financial and operational resilience.
- the [Drinking Water Inspectorate](#) (DWI) is the drinking water quality regulator for England and Wales. The DWI provides independent reassurance that drinking water supplies in England and Wales are safe and that drinking water quality meets the strict standards set out in legislation.<sup>6</sup>
- the [Environment Agency](#) (England) and [Natural Resources Wales](#) (Wales) are the environmental regulators. They oversee water company compliance with environmental legislation and monitor water company environmental performance. This includes regulating sewerage discharges, (non-drinking) water quality, and the use of water resources (abstraction).

This paper will focus on economic regulation of the water industry by Ofwat.

In addition, the [Consumer Council for Water](#) (CCWater) is the independent representative of household and business customers in England and Wales. CCWater promotes consumer interests to governments, regulators and industry, conducts consumer research and provides a [free advice](#) and [complaint handling](#) service for customers.

## 1.3 Role of Ofwat

Ofwat is a non-ministerial Government department directly accountable to Parliament.

The [Water Industry Act 1991](#) (as amended) sets Ofwat's statutory duties, powers and the regulatory framework for the industry.

Ofwat's primary [statutory duties](#) are:<sup>7</sup>

- to ensure that water and sewerage companies properly carry out their functions and are able to finance them;

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<sup>6</sup> Drinking Water Inspectorate, [About Us](#) [accessed 2 June 2020].

<sup>7</sup> Section 2, *Water Industry Act 1991* (as amended).

- to further the consumer objective: this is about protecting the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services. Section 2 of the *Water Industry Act 1991* identifies particular types of customer that Ofwat is legally required to have regard to the interests of. These include individuals who are disabled or chronically sick; individuals of pensionable age; individuals with low incomes; and individuals residing in rural areas. For more information, see the Library briefing paper, [Water bills: affordability and support for household customers](#) (9 August 2016).
- to further the [resilience objective](#):<sup>8</sup> this is about ensuring the long-term supply of water and sewerage systems in light of external pressures such as environmental pressures, population growth and changes in consumer behaviour.

The UK and Welsh Governments provide policy direction to Ofwat through statutory strategic statements.<sup>9</sup> Ofwat must act in accordance with the statements when carrying out its functions and is required to report on the steps they have taken in response.

The most recent strategic policy statements are:

- UK Government, [Strategic policy statement to Ofwat](#), September 2017
- Welsh Government, [Strategic Priorities and Objectives Statement to Ofwat](#), 2017

## 1.4 Why is regulation needed?

Because household customers cannot choose or switch their supplier, there is a need for economic regulation to ensure that consumers get value for money. This means ensuring that prices are fair for the services and investment that water companies deliver. An effective regulatory system must strike a balance between keeping bills low for consumers, while ensuring that water companies have enough income to finance an efficient and high-quality service that delivers for customers and the environment.

The economic regulatory system is also used as a policy tool to ensure that water companies deliver on societal and Government expectations. For example, with pressures of population growth, climate change and water scarcity, ensuring long-term sustainable water supplies is an important priority for companies, customers and the Government. Water companies have a role to play in managing sustainable water supplies through reducing leakage (Box 2) and through encouraging customers to use less water. Currently, the price review process is the main regulatory tool used to incentivise companies to take action in these areas (see Section 2 below).

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<sup>8</sup> For further information, see Ofwat's pages on [resilience](#).

<sup>9</sup> Section 2A and 2B, *Water Industry Act 1991* (as amended)

**Box 2: Leakage**

Water is piped under high pressure from treatment plants to customer homes. Leakage refers to water being lost from pipes before it reaches a customer. The less water that is lost from leakage, the less water that needs to be taken from the environment.

From April 2018 to March 2019, on average, 3.17 billion litres of water were lost by leakage each day.<sup>10</sup> This is equivalent to 53 litres per person per day and around 21% of the water taken from the environment each day by water companies.<sup>11</sup>

Leakage and burst pipes can happen for a variety of reasons and it varies between different areas. For example, old pipes are more likely to leak, extreme weather conditions can cause pipes to expand or contract which can cause damage. Some soil conditions can cause some types of pipe materials to degrade more quickly, and compressed soil in built up areas can damage pipes. Reducing leakage requires significant investment by companies, both through repairing and identifying leaks, particularly when pipes are in built up areas and are not readily accessible.

Leakage rates have reduced by 30% in the decade post-privatisation.<sup>12</sup> However, the National Audit Office (NAO), the National Infrastructure Commission (NIC) and the House of Commons Environment Food and Rural Affairs (EFRA) Committee have raised concerns that progress on reducing leakage has slowed in recent years while concerns about water scarcity, particularly in the South East, are growing.<sup>13</sup>

As part of the price review (see Section 2 below), Ofwat sets each company a target for reducing leakage that reflects the specific circumstances of that company area, such as the cost of reducing leakage and ease and cost of taking water from other sources. If companies do not meet their targets, Ofwat can take action, such as impose a fine.<sup>14</sup> For more information and company comparisons, see the Discover Water pages on [leakage](#).

## 1.5 Average water bills

The chart below shows trends in the real level of average water and sewerage bills since the late 1990s.<sup>15</sup> The period following privatisation in 1990 saw the steepest rise in prices, up by 50% in real terms in the ten years to 1999-00. Prices fell in 2000 at the start of a new price control period and remained at a similar level for the rest of this period (to 2005). They increased over the following five-year control period to reach more than £400 in 2010 (2019–20 prices). Real prices remained at around this level until 2020–21 when levels are expected to drop below £400 for the first time in 15 years. The water industry argues that the increase in bills since privatisation has been accompanied by investment in infrastructure by companies and improvements in service quality (see Section 1.6 below).

<sup>10</sup> [Discover water, leaking pipes](#) (source: Source: Water UK; England and Wales, Apr 2018 - Mar 2019)

<sup>11</sup> [Discover water, where water comes from](#) (source: Environment Agency and Natural Resources Wales; England and Wales, Jan 2015 - Dec 2015) stated 15,315 million litres of water is taken from the environment each day by water companies. Ofwat, [Final determinations: policy summary](#), page 11 (leakage, distribution input and population served data from company annual performance reports 2018-19).

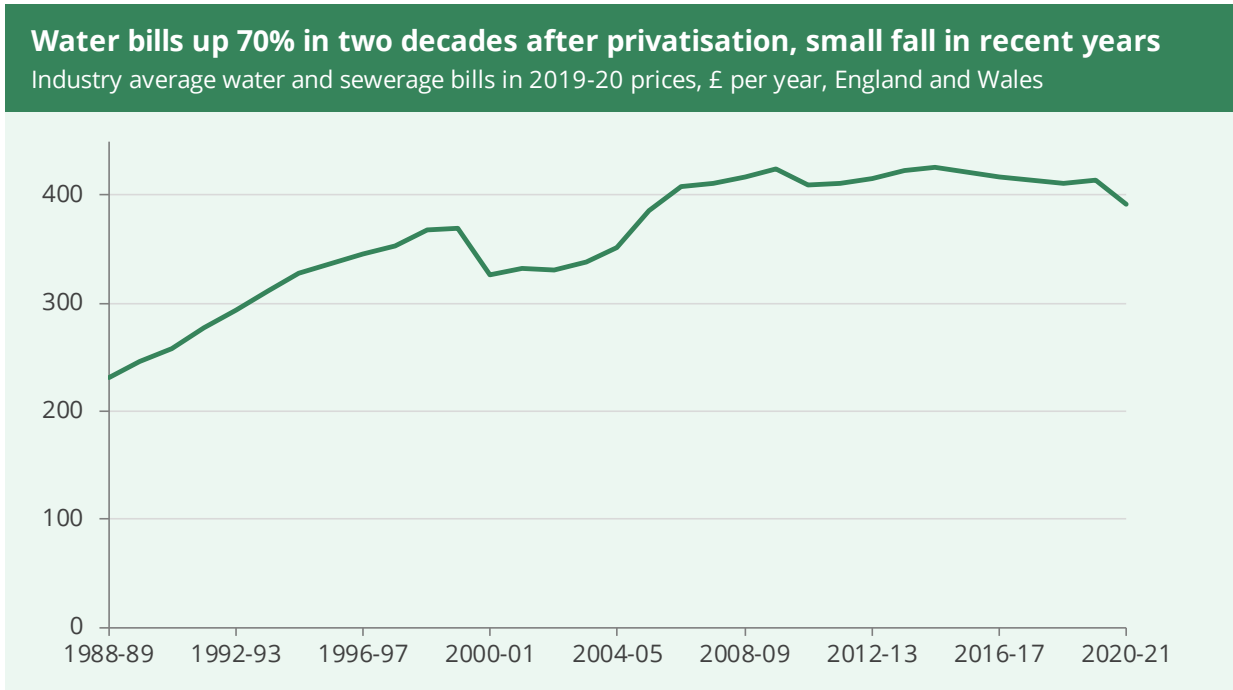
<sup>12</sup> Ofwat PR19 final determinations [policy summary](#), 16 December 2019, page 10–11.

<sup>13</sup> NAO, [The economic regulation of the water sector](#), 14 October 2015; NAO, [Water supply and demand management](#), 25 March 2020; EFRA Committee, [Regulation of the Water Industry](#), 8<sup>th</sup> Report of Session 2017–2019, HC 1041, 9 October 2018, para 24; NIC, [Preparing for a drier future: England's water infrastructure needs](#), 25 April 2018.

<sup>14</sup> Ofwat, [Leakage](#) [accessed 3 June 2020].

<sup>15</sup> Data is for water and sewerage companies only up to 2008/09 and all companies thereafter. Bills are annual forecasts of average bills made at the start of each year from 2009/10 onwards.





Sources: Ofwat Parliamentary Relations Office; *Average household bills factsheet* (various years), Ofwat; *Household water and sewerage bills for 2016-17*, Water UK ; <https://discoverwater.co.uk/annual-bill>

These figures represent average customer bills across England and Wales. Water bills vary between different water company areas because the cost of providing services varies significantly between areas. For example, factors such as regional geography, different population densities, the availability of water, the degree of treatment needed and the level maintenance or new infrastructure required are all factors that affect the cost of providing services.

Water bills vary between different water company areas because the cost of providing services varies significantly between areas

Comparisons of average water and sewerage bills between different company areas can be found on the [Discover Water webpages](#). Customers can check which water and/or sewerage company supplies their area by using the Water UK [online postcode checker](#).

### What is included in a water bill?

The [Discover Water dashboard](#) provides an illustration of how money collected from customers is spent by companies. The largest components go towards staff costs (41%), followed by the costs of private investment to improve services (such as interest payments on debt, 21%).

For every £1.09 (the average household cost per day):

- 45p: people and material [41%]
- 15p: maintaining our equipment [14%]
- 12p: Building new assets [11%]
- 6p: Energy [5%]
- 9p: Paying taxes, rates and licences [8%]

23p: Paying for investment to improve service [21%].<sup>16</sup>

Discover Water is a dashboard collating information and data on the water industry in England and Wales, provided by the Ofwat, CCWater, environmental regulators and Water UK (the water industry trade body).

### 1.6 Water company investment

Water companies are very capital-intensive as they need to fund considerable investment into infrastructure such as maintenance of pipes, pumping stations and treatment plants. As shown above, the staff and investment costs needed to fund these activities are the biggest components of company expenditure. Water UK state that water companies own and maintain 345,034 km of mains pipes, 566,884 km sewerage pipes, 1,081 water treatment works and 6,341 sewage treatment works.<sup>17</sup> Maintenance of pipes is required to reduce leakage (Box 2), reduce [sewer flooding](#)<sup>18</sup> and improve water quality. Treatment plants ensure that drinking water is high-quality and safe and that sewage can be processed and discharged to the environment safely.<sup>19</sup>

The services provided by water companies are almost entirely funded by their customers and financed through private investment.<sup>20</sup> Since privatisation, water companies have invested nearly £160 billion to maintain and improve infrastructure and services.<sup>21</sup> Water UK highlight that customers are now much [less likely to face service interruptions](#), sewer flooding or low water pressure as a result of the industry's investment.<sup>22</sup> The National Audit Office in its 2015 report on [economic regulation of the water industry](#) found that service quality have improved "markedly" on most measures since privatisation, including the quality of the UK's drinking and bathing water.<sup>23</sup>

### 1.7 Challenges for the water sector

Pressures from climate change and population growth are continuing to put pressure on water companies to invest to ensure the long-term sustainability of water supplies. For example, see Box 2 on leakage above. The National Infrastructure Commission in its [October 2019 report on strategic investment and public confidence](#) noted that in this context it is important for public trust in regulated industries to be high as, ultimately, this investment will be largely drawn from customer bills.<sup>24</sup>

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<sup>16</sup> Discover Water, [Breakdown of bill](#) (percentages calculated by HoC library).

<sup>17</sup> Discover Water, [Leaking pipes](#). (Source: Water UK, Apr 2018 - Mar 2019). For more information about the process of getting water to customer homes, see the Discover Water pages on [treatment and supply](#).

<sup>18</sup> House of Commons Library Briefing Paper, [Sewer Flooding](#), 19 December 2016.

<sup>19</sup> Discover Water, [Environmental performance](#) [accessed 3 June 2020]

<sup>20</sup> NAO, [The economic regulation of the water sector](#), 8 October 2015, para 1.

<sup>21</sup> Water UK, [Thirty years on, what has water privatisation achieved?](#) Michael Roberts, 5 July 2019.

<sup>22</sup> Water UK, [Thirty years on, what has water privatisation achieved?](#) Michael Roberts, 5 July 2019.

<sup>23</sup> NAO, [The economic regulation of the water sector](#), 8 October 2015, para 7.

<sup>24</sup> NIC, [Strategic Investment and Public Confidence](#), 11 October 2019.

Research by CCWater on [customer satisfaction with water companies](#) (July 2019) found that 90% of customers in England and Wales were satisfied with their water services, a significant increase since 2011.<sup>25</sup> However, CCWater raised concerns that this figure had fallen in recent years and that on some specific measures satisfaction remained unchanged. CCWater reported that 63% of customers thought their bills were fair. Customers in Wales were generally more positive about their water companies than customers in England.<sup>26</sup>

There has been intense public and political scrutiny of water company performance and financial management in the last few years as well as of the ability of the regulatory system to respond – some of these concerns are discussed in more detail in Section 4 of this paper below. The Labour Party campaigned in both the 2017 and 2019 General Elections to re-nationalise the industry.<sup>27</sup> Others have argued for alternative models of ownership, for example the not-for-profit model employed by Welsh Water (see Box 1 above) or for wider changes to the regulatory system such as competitive tendering of company licences.<sup>28</sup> For further discussion of these topics, see the Library briefing paper on [public ownership of industries and services](#) (May 2018), Library debate pack on the [Future of the water industry in England and Wales](#) (January 2019) and Library Insight [Regulating utilities: What will change in 2020?](#) (18 December 2019).

In a speech in May 2019, the chief executive of the Environment Agency (Sir James Bevan) described this scrutiny as a “political challenge” facing the sector, alongside describing the successes of the industry and areas for improvement (such as on environmental performance):

So let’s be clear: the water industry is under a level of scrutiny it has not experienced before, much of that scrutiny is hostile, and it’s coming from a wide range of sources.

In many ways this is deeply unfair. The story of water in this country over the last several decades is not one of failure. On the contrary, it is mostly a story of stunning success.

[...]

So let’s be clear: there are many things about our present water industry that we should be proud of. But if the industry wants to meet the political challenge I have outlined, or indeed survive in its present form, then it needs to up its game.<sup>29</sup>

In April 2019 the water industry in England pledged a [Public Interest Commitment](#) (PIC) on tackling wider social and environmental challenges. The industry agreed to:

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<sup>25</sup> CCWater, [Water Matters – Household customers’ views of their water and sewerage services 2018; Water companies failing to address households’ concerns over fair bills](#), 11 July 2019 [accessed 3 June 2020]

<sup>26</sup> CCWater, [Customer satisfaction remains high for water companies in Wales](#), 11 July 2019 [accessed 3 June 2020].

<sup>27</sup> [Labour Party Manifesto 2017](#) and [Labour Party Manifesto 2019](#).

<sup>28</sup> [HC Deb 22 January 2019](#) [Water Industry]; [The UK water regime calls out for change](#), *Financial Times*, 21 September 2017.

<sup>29</sup> Speech by Sir James Bevan, Chief Executive of the Environment Agency, [What future for water? Three challenges for the industry](#), 14 May 2019 [accessed 3 June 2020].

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champion measures through which water companies can enshrine what it means to operate in the public interest within their business purpose, in line with best practice among leading socially-responsible businesses.<sup>30</sup>

The sector set the following five key social and environmental goals for the following 10-year period:

- Triple the rate of sector-wide leakage reduction by 2030
- Make bills affordable as a minimum for all households with water and sewerage bills more than 5% of their disposable income by 2030 and develop a strategy to end water poverty.
- Achieve net zero carbon emissions for the sector by 2030.
- Prevent the equivalent of 4 billion plastic bottles ending up as waste by 2030.
- Be the first sector to achieve 100% commitment to the Social Mobility Pledge.<sup>31</sup>

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<sup>30</sup> Water UK, [Public Interest Commitment \(PDF\)](#), 25 April 2019 [accessed 3 June 2020].

<sup>31</sup> Water UK, [Water industry reaffirms pledge to work in the public interest](#), 25 April 201 [accessed 3 June 2020]

## 2. Price Review

### 2.1 What are price reviews?

The [price review](#) is the process by which Ofwat sets price controls on what each water company may charge its customers in return for the services and investment the company provides. During the price review, Ofwat must balance the interests of the customer for lower prices with the need to make sure the water company can finance its delivery of infrastructure and services to customers as well as meet their other legal obligations including environmental responsibilities.

When setting prices, Ofwat must consider the funding companies need to deliver services and finance investment. As part of this, Ofwat sets targets for water company performance, including targets for affordability and vulnerable customer support, reducing leakage, pollution incidents and supply interruptions. There are financial incentives built-in for companies that deliver above and beyond their performance targets; in this way the price review is a policy tool for addressing customer and Government priorities in these areas (see Section 1.4 and Box 2 above for an example on leakage). The price limits set a cost challenge for companies to deliver on performance targets efficiently.

The price review process occurs in five-year cycles; this means that wholesale prices are fixed for a five-year period. The five-year price review cycles are referred to as Asset Management Planning Periods or AMPs. For commentary on the 5-year cycle, see Section 4 below.

Ofwat finalised its decisions for the 2019 Price Review (PR19) in December 2019. This set price limits for water companies from April 2020–March 2025 (AMP7); more information about PR19 is provided in section 2.3 below. The previous price review was carried out in 2014 and set price limits from April 2015 to March 2020 (AMP 6).

### 2.2 What does a price review involve?

During the price review process companies are required to submit business plans to Ofwat in line with Ofwat's Methodology (published ahead of each price review). Companies consult on their business plans with their customers before submitting them to Ofwat.<sup>32</sup>

Ofwat then scrutinises water company business plans and assesses whether they meet the expectations set out by Ofwat for water company performance in the five-year period. Ofwat's Methodology and assessment of company plans must reflect Ofwat's statutory duties and the Strategic Statements provided by Defra and the Welsh Government (see Section 1.3). The price review process overall takes several years, encompassing lengthy and complex documentation.

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<sup>32</sup> For more information on how customers are involved, see Discover Water: [Price Review](#).

Companies are incentivised to submit plans that meet Ofwat's expectations. Plans that Ofwat deems acceptable are "fast tracked", giving the company (and its investors and customers) certainty about the process along with financial and reputational benefits. Alternatively, Ofwat can require companies to make changes to their plans if they do not meet expectations.

Based on the plans and any interventions required by Ofwat, each company is issued with a "determination"; this is the price, service and incentive package that Ofwat requires the company to follow for the 5-year period. Each company receives a separate determination that reflects the particular circumstances of that company.

If a company does not want to accept the final determination issued by Ofwat, they may ask Ofwat to refer the determination to the Competition and Markets Authority (CMA) for review. The CMA would review the decision in its entirety over a 6-month process. It is relatively rare for companies to ask for determinations to be referred to the CMA. However, four companies have done this following PR19 (see more below).

More information on the price review process is set out on [Ofwat's webpages](#).

### 2.3 Price Review 2019 (PR19)

Price Review 2019 (PR19) set water company prices and investment for the five-year period April 2020–31 March 2025. Ofwat published water companies' [final determinations for PR19](#) on 16 December 2019.<sup>33</sup> Ofwat's approach to PR19 has been described by Ofwat, the water industry and the press as the "toughest yet" on water companies.<sup>34</sup>

Ofwat stated that overall, the PR19 determinations would result in a 12%, or about £50, fall in customer water bills (before inflation) and £51 billion investment by industry over the 5-year period. Ofwat stated that the determinations set "stretching but achievable" performance commitments on environmental improvement with £4.8 billion investment by the sector to support them. Ofwat says these commitments and investment should overall lead to:<sup>35</sup>

- Reduction in leakage by 16% by 2025
- Reducing pollution incidents by 30% by 2025.
- Reducing customer water use by up to 13% per person by 2025 (down to an average 131 litres per person per day).

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<sup>33</sup> Ofwat, [PR19: Final Determinations](#), 16 December 2019.

<sup>34</sup> [Water firms hit by toughest profit crackdown in 30 years](#), *BBC News*, 16 December 2019; [UK water companies ordered to cut bills by £50 by 2025](#), Julia Kollwe and Jillian Ambrose, *The Guardian*, 16 December 2019; [Water rates set to fall after regulatory shake-up](#), Gill Plimmer, *Financial Times* [subs only], 16 December 2019; Water UK, [Response to Ofwat's Final Determinations announcement](#), 16 December 2019.

<sup>35</sup> Ofwat, [Overview of companies' final determinations \(PDF\)](#), 16 December 2019.

Some notable changes to Ofwat's approach in PR19 compared to previous price review approaches included:

- Including vulnerable customers as a specific part of the price review for the first time, requiring companies to devise and deliver plans to identify and help customers in vulnerable circumstances.<sup>36</sup> Ofwat states that by 2025, 2 million more customers will be registered for priority support services from companies, along with other support schemes such as payment matching and payment holidays offered by some companies.
- Including a new method for measuring customers' experience and satisfaction with water companies. The measure will be used to compare the service standards of water companies to other areas of the economy, rather than just comparing water companies amongst themselves (as in previous price reviews).
- Lowering the allowed cost of capital to the lowest level ever set, 2.96% (see Box 4).<sup>37</sup> This is a key factor towards reducing customer bills.

### Box 3: Cost of Capital

The cost of capital is the amount that Ofwat estimates that water companies will need to raise to compensate lenders and investors for providing finance to the business (for example, interest payments on debt). It in turn affects the amount companies can collect from customers through bills – the main source of company income. The cost of finance is a significant proportion of water company costs (see section 1.5).

In the Price Review, Ofwat must set the cost of capital at a rate that ensures water companies remain attractive for private investment while also being fair for customers. Setting the rate too low may result in water companies struggling to attract finance. Overestimating on the other hand, leads to water companies making financial gains from consumers. Ofwat states that its aim is to “allow for a return on capital that is no more than necessary for an efficiently run company to get the funding they need from capital markets.”<sup>38</sup>

The National Audit Office, CCWater and Citizens' Advice, had raised concerns that Ofwat's approach to calculating the cost of capital in previous price reviews had allowed companies to receive financial gains that were not fairly shared with customers.<sup>39</sup>

The Consumer Council for Water (CCWater) [welcomed Ofwat's final determinations](#), in particular the low cost of capital, stating that the determinations provided a good deal for most consumers.<sup>40</sup> However, CCWater cautioned against communicating that bills would fall, because in real terms (after taking into account inflation) that may not

<sup>36</sup> For background information, see the House of Commons Library briefing paper, [Water bills: affordability and support for household customers](#), 9 August 2016.

<sup>37</sup> The allowed return on capital in the final determination is 2.96% for the whole business, and 2.92% for wholesale controls (without retail). Ofwat, [Overview of companies' final determinations \(PDF\)](#), 16 December 2019.

<sup>38</sup> Ofwat, [Profits and dividends](#) [accessed 3 June 2020]

<sup>39</sup> Citizens' Advice, [Monopoly Money: How consumers overpaid by billions](#), 30 May 2019; NAO, [The economic regulation of the water sector](#), 8 October 2015; CCWater, [Water companies' financial performance report 2018-19](#), 5 March 2020. For further discussion, see the House of Commons Library briefing paper, [Water bills: affordability and support for household customers](#), 9 August 2016. The National Infrastructure Commission's report: [Strategic Investment and Public Confidence](#), 11 October 2019 also discussed calculating the cost of capital for regulated utilities in general.

<sup>40</sup> CCWater, [2019 Price Review: Good deal in the pipeline for most water customers](#), 16 December 2019.

be the case for some companies.<sup>41</sup> CCWater also called for water companies to go further in supporting vulnerable consumers, to ensure that everyone can afford to pay their bill.<sup>42</sup>

The water industry has been challenged by Ofwat's approach to PR19,<sup>43</sup> with only three companies reaching "fast track" status after submitting their first draft plans (Severn Trent, South West Water and United Utilities). Ofwat required all other companies to further re-work their plans before the final determinations, in some cases "substantially".<sup>44</sup>

Some water companies thought the plans ultimately imposed by Ofwat under the final determinations are too stretching and create a risk that the performance targets will be unachievable in practice given the financing allowed.<sup>45</sup> Some companies argue that Ofwat placed too much emphasis on cutting customer bills in the short term, rather than prioritising long-term investment in infrastructure upgrades.<sup>46</sup>

The challenge of achieving a balance between investment and affordable bills was raised by the National Audit Office in its March 2020 report on [Water supply and demand management](#). The NAO found that water companies find it difficult to know what level of investment the Government will consider appropriate, particularly if the trade-off is higher customer bills:

Neither Defra nor Ofwat has an explicit policy to reduce prices, and water companies told us that the government had not provided a sufficient steer on how to balance the need for investment with maintaining affordable bills, particularly where they have evidence that their customers are prepared to pay more to finance infrastructure investment.<sup>47</sup>

### CMA referrals

Ultimately, four companies asked Ofwat to refer their determinations to the CMA for reconsideration (Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water).<sup>48</sup> This was described by *The Times* as the "largest revolt in the 30-year history of the privatised industry".<sup>49</sup> The companies raised concerns about the financeability of the plans given the allowed returns and stretching performance

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<sup>41</sup> [Don't mislead customers about lower bills, warns CCWater](#), Ruth Williams, *Utility Week* [subs only], 17 December 2019.

<sup>42</sup> CCWater, [2019 Price Review: Good deal in the pipeline for most water customers](#), 16 December 2019.

<sup>43</sup> NAO, [Water supply and demand management](#), 25 March 2020, para 1.19-1.2,

<sup>44</sup> Four companies were assessed as requiring "significant scrutiny", which means that Ofwat required substantial reworking of the plans (Affinity Water, Hafren Dyfrdwy, Southern and Thames Water).

<sup>45</sup> [Water companies gear up for battle with Ofwat](#), Gil Plimmer, *Financial Times*, 15 December 2019; [Ofwat hits back over price cut challenges](#), Robert Lea, *The Times*, 15 February 2020.

<sup>46</sup> [Ofwat faces biggest battle with water companies since privatisation](#), Gill Plimmer, *Financial Times*, 14 February 2020; [Water industry says watchdog ignored need for long-term investment](#), Gill Plimmer, *Financial Times*, 10 February 2020.

<sup>47</sup> NAO, [Water supply and demand management](#), 25 March 2020, para 11.

<sup>48</sup> CMA, [Ofwat Price Determinations](#) [accessed 3 June 2020]

<sup>49</sup> [Ofwat hits back over price cut challenges](#), Robert Lea, *The Times*, 15 February 2020.



commitments.<sup>50</sup> Anglian and Northumbrian water argue that their customer research showed a preference for greater long-term investment to tackle drought resilience challenges but that Ofwat's determination does not allow them to address that priority.<sup>51</sup>

Ofwat argues that their determinations provide sufficient room to finance investment if services are delivered with greater efficiency, arguing "customers shouldn't pay for inefficiency or to top-up funds to cover companies' previous shortcomings and help them catch up with others".<sup>52</sup>

The normal 6-month timeframe for review of the determinations has been extended by 6 months due to the coronavirus crisis. The CMA's [timeline for the review process](#) published on 19 March 2020 sets the "end of November/start of December 2020" as the target for its determination(s) to be sent to Ofwat.<sup>53</sup> The final determinations set by Ofwat in December 2019 apply from 1 April 2020 unless the CMA makes a different determination following the review process.<sup>54</sup>

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<sup>50</sup> Bristol Water, [Business plan update](#), 13 February 2020; Yorkshire Water, [Yorkshire Water asks Ofwat to refer its final determination to the Competition and Markets Authority](#), 10 February 2020.

<sup>51</sup> Anglian Water, [Decision by Board to request Ofwat to refer its PR19 Final Determination to the Competition and Markets Authority \(CMA\)](#), 14 February 2020; Northumbrian Water, [Northumbrian Water Limited asks Ofwat to refer its PR19 Final Determination to the Competition and Markets Authority](#), 14 February 2020. For full text of submissions, see: CMA, [Ofwat Price Determinations](#) [accessed 3 June 2020].

<sup>52</sup> Ofwat, [PN 04/20: Ofwat makes submission to CMA following company appeals](#). Full text of Ofwat's submissions can be found on the Ofwat webpage: [Competition and Markets Authority referrals](#).

<sup>53</sup> CMA, [Ofwat Price Determinations](#) [accessed 3 June 2020]

<sup>54</sup> HoC Library correspondence with Ofwat.

## 3. Water company financial management

### 3.1 Concerns about company financial practices and performance

As private companies, water companies are responsible for their financial structure and choices such as dividends and executive pay (within the broader regulatory framework and in line with company law). However, Ofwat oversees the financial resilience of companies during price reviews and may step in and raise concerns or challenge a company to demonstrate how their financial practices allow them to maintain long-term financial viability.

There has been increasing public scrutiny of water company performance and financial management in the last few years.<sup>55</sup> The National Infrastructure Commission, National Audit Office, CCWater and Citizens' Advice have all raised concerns about the fairness and value for money provided by the sector and the regulatory system for consumers.<sup>56</sup> This has followed reports of high profits and dividends by some companies alongside some high-profile service failure and environmental incidents that have placed water company performance into the spotlight.<sup>57</sup> For example, the freeze-thaw event following the "Beast from the East" in March 2018 caused supply interruptions to thousands of customers.<sup>58</sup> In its review following the event, Ofwat stated that some companies were poorly prepared for such an event and caused "real hardship as a result".<sup>59</sup> In its July 2019 Environmental Assessment Report, the Environment Agency stated the environmental performance of most water companies in 2018, such as the degree of pollution incidents from untreated sewage, had deteriorated, reversing the "trend of gradual improvement in the sector" since 2011.<sup>60</sup> Environment Agency Chair Emma Howard Boyd reflected in the report's foreword that companies should be "reflecting on their environmental performance" and "asking themselves whether dividends are justifiable".<sup>61</sup>

<sup>55</sup> Speech by Sir James Bevan, Chief Executive of the Environment Agency, [What future for water? Three challenges for the industry](#), 14 May 2019 [accessed 3 June 2020].

<sup>56</sup> NIC, [Strategic Investment and Public Confidence](#), 11 October 2019; Citizens' Advice, [Monopoly Money: How consumers overpaid by billions](#), 30 May 2019; NAO, [The economic regulation of the water sector](#), 8 October 2015; CCWater, [Water companies' financial performance report 2018-19](#), 5 March 2020.

<sup>57</sup> EFRA Committee, [Regulation of the Water Industry](#), 8<sup>th</sup> Report of Session 2017–2019, HC 1041, 9 October 2018, para 51-62.

<sup>58</sup> Ofwat, [PN 26/18: Hard lessons for water sector following "Beast from the East" review](#), 19 June 2018.

<sup>59</sup> Ofwat, [PN 26/18: Hard lessons for water sector following "Beast from the East" review](#), 19 June 2018.

<sup>60</sup> Environment Agency, [Summary: environmental performance of the water and sewerage companies in 2018](#), 10 July 2019.

<sup>61</sup> Environment Agency, [Environment Agency tells water companies to clean up their act and protect the environment from pollution](#), 19 July 2019.

In a [speech in March 2018](#) Michael Gove (then Secretary of State for Defra) praised the investment provided by the industry since privatisation but stated that the system is “not working as well as it should”.<sup>62</sup> He stated that financial behaviours by some companies, such as opaque and complex financial structures, offshore entities, large profits and high executive pay, were eroding trust in the sector. The House of Commons EFRA Committee made similar comments in its October 2018 report, [Regulation of the Water Industry](#):

55. The financing arrangements of some water companies fall below the standards that we expect from providers of an essential public service. High levels of executive pay, shareholder dividends and debt ratios risk reducing public trust in the water industry. We welcome the Secretary of State’s focus on this issue and consider that water companies should instead invest more in their businesses. Ofwat should have firmly tackled the imbalances in the financial models of some water companies much earlier, and we were not satisfied with its explanations as to why it had not done so.<sup>63</sup>

In a [series of letters](#) to Ofwat in early 2018, the then Secretary of State asked Ofwat to investigate what further measures could be taken to tackle financial behaviours that are not in the public interest.<sup>64</sup> Noting that Ofwat had already been challenging companies in recent years, the Government indicated it was willing to consider changes to the regulatory framework if Ofwat’s current powers were insufficient to address change.<sup>65</sup>

Water UK accepted that “legitimate concerns” had been raised by the then Secretary of State which, “while not equally applicable to all companies, were affecting the reputation of the sector as a whole”. It highlighted that actions were already underway to address some issues of concern (such as closing offshore entities) and that all water companies were “firmly committed to working at pace” with Ofwat to finalise proposals for reform.<sup>66</sup> Water UK highlighted the industry’s public service commitments (see Section 1.7 above) and customer polling research that found high levels of overall trust in the industry:

Water companies take their responsibility to work in the public interest very seriously. Research shows that there are high overall levels of trust in the industry, but there is more to do on financial issues and the environment where about three out of four people trust us to get things right. Companies fully support the need to resolve concerns about financing and governance arrangements in the sector, and are already taking swift action.<sup>67</sup>

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<sup>62</sup> Defra, Speech by the Rt Hon Michael Gove MP, [A water industry that works for everyone](#), 1 March 2018.

<sup>63</sup> EFRA Committee, [Regulation of the Water Industry](#), 8<sup>th</sup> Report of Session 2017–2019, HC 1041, 9 October 2018, para 55.

<sup>64</sup> Defra, [Water industry: corporate behaviour of water companies](#), Letters, 5 February – 18 April 2018.

<sup>65</sup> Defra, Ofwat, [Water industry: corporate behaviour of water companies](#), Letters, 5 February – 18 April 2018.

<sup>66</sup> Water UK, [Improving the environment, increasing trust](#), 18 April 2019 [accessed 3 June 2020].

<sup>67</sup> Water UK, [Improving the environment, increasing trust](#), 18 April 2019 [accessed 3 June 2020].

## Ofwat's response: bringing the sector back into balance

In July 2018 Ofwat outlined changes it would make to its regulatory framework to "[bring the sector back into balance](#)" and address the concerns regarding the financial management of water companies raised by the then Secretary of State and others.<sup>68</sup> Ofwat's plans were open to consultation with the industry in April–May 2018. Water industry body Water UK stated that all water companies were "fully on board" with Ofwat's proposals for reform.<sup>69</sup>

Ofwat's response included targeted changes to the PR19 methodology, including:

- Requiring water companies to clearly set out their dividend policy in their business plans and explain how they take account of commitments to customers and other stakeholders. Ofwat did not place a cap on dividends but set a base dividend rate of 5%. If companies wish to pay dividends higher than that they would be expected to justify why it reflects customer interests.
- Requiring companies to set out performance-related pay policies in their business plans and provide evidence of how those policies demonstrate a substantial link to stretching performance delivery for customers.
- Requiring companies with levels of financial gearing above 70% to have some mechanism in place to share financial gains from this financial structure with customers.<sup>70</sup> High levels of gearing means that a company has a high level of debt finance (borrowing) relative to equity finance (shareholder interests). This is often a higher-risk financial structure which can lead to high financial returns for shareholders. Water UK argued in 2014 that tax benefits from high gearing resulted in lowering bills for consumers and higher rates of private investment.<sup>71</sup> The Consumer Council for Water welcomed the introduction of a mechanism to share financial gains from high levels of gearing but said that this would not sufficiently address the gains made by some water companies in the past.<sup>72</sup>
- Changing the main measure of inflation used to adjust prices during the price review period. It will now use the Consumer Prices Index (which includes owner-occupiers' housing costs) (CPIH) rather than the Retail Prices Index (RPI) (which it been previously used). The CPIH is a less volatile and more accurate measure of inflation than RPI and is generally lower. The NAO

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<sup>68</sup> Ofwat, [Putting the sector in balance: position statement on PR19 business plans](#), July 2018.

<sup>69</sup> Water UK, [Improving the environment, increasing trust](#), 18 April 2019 [accessed 3 June 2020].

<sup>70</sup> Ofwat, [Putting the sector in balance: position statement on PR19 business plans](#), July 2018, page 42 footnote 10.

<sup>71</sup> Water UK, [Investment, profits and tax](#), 14 November 2014. For discussion, see the House of Commons Library briefing paper, [Water bills: affordability and support for household customers](#), 9 August 2016

<sup>72</sup> CCWater, [Water companies' financial performance 2017-18](#), 22 May 2019, page 8. For further discussion on gearing, see the National Infrastructure Commission report: [Strategic Investment and Public Confidence](#), 11 October 2019.

called for a change to the CPIH measure in their 2015 report on economic regulation of the water sector.<sup>73</sup>

In its December 2019 PR19 Final Determinations, Ofwat said that all companies had taken steps to meet expectations on the above changes.<sup>74</sup> For more information, please see Ofwat's [summary of the final determinations](#).

## Company licences: board leadership, transparency and governance

Separately to the PR19 changes, in July 2018 Ofwat held a [consultation on revising board leadership, transparency and governance principles](#). This included proposals to change water company licences to include a condition requiring companies to meet the new principles.<sup>75</sup> Water company licences were modified accordingly on 22 July 2019 following agreement by the water companies.<sup>76</sup>

The Government has welcomed actions by Ofwat to “bring the sector back in balance” but identified shortfalls in the powers that Ofwat currently has to modify company licences.<sup>77</sup> Currently, in practice, Ofwat only modifies licence conditions with the consent of water companies. Both the EFRA Committee in October 2018 and the National Infrastructure Commission in October 2019 made recommendations that the Government take steps to give Ofwat greater powers over modifying licence conditions.<sup>78</sup>

The [Environment Bill 2019-20](#) includes provisions that would give Ofwat more flexible powers to modify water company licence conditions. This would allow Ofwat to modify licences by notification to water companies with the option for companies to appeal. Defra consulted on proposals for these changes in January 2019.<sup>79</sup>

The *Environment Bill* passed its second reading in the House of Commons without division on 26 February 2020. Committee stage started on 10 March 2020 but was adjourned on 19 March due to the impact of coronavirus. Further information can be found in the [Commons Library Analysis of the Environment Bill 2019–2020](#) (6 March 2020).

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<sup>73</sup> NAO, [The economic regulation of the water sector](#), 8 October 2015

<sup>74</sup> Ofwat, [Overview of companies' final determinations \(PDF\)](#), 16 December 2019.

<sup>75</sup> Ofwat, [Consultation on revised Board Leadership, Transparency and Governance principles](#), 11 July 2018.

<sup>76</sup> Ofwat, [Ofwat modifies licences of the 17 water companies to include the objectives of the Board leadership, transparency and governance principles](#), 22, July 2019.

<sup>77</sup> Defra, [Improving our management of water in the environment](#): consultation document, 15 January 2019, page 35

<sup>78</sup> EFRA Committee, [Regulation of the Water Industry](#), 8<sup>th</sup> Report of Session 2017–2019, HC 1041, 9 October 2018, para 57; NIC, [Strategic Investment and Public Confidence](#), 11 October 2019, page 49.

<sup>79</sup> Defra, [Consultation: Improving our management of water in the environment](#), 23 July 2019.

## 4. Is regulation fit for purpose?

Alongside the specific concerns above regarding water company financial management, there has also been a broader focus recently on whether the economic regulatory system is fit for purpose to meet future needs. The sections above have touched on this already, regarding the challenge of balancing increasing investment to address climate change challenges while maintaining affordable customer bills (see Section 2.3 above). Concerns have also been raised about the length and complexity of the price review process overall, and the suitability of the 5-year planning cycles.<sup>80</sup>

The EFRA Committee in its 2018 report on [Regulation of the water industry](#) noted a range of different stakeholder views regarding the price review and recommended that the Government commission an independent review on whether the water industry and regulatory system are fit to meet future needs:

82. While Ofwat has increasingly tried to take a less prescriptive approach and focus more on outcomes, the price review methodology has become more lengthy and detailed. It is unclear whether economic regulation has overall become more or less burdensome for water companies and what the impact is.

83. *We recommend that the Government commissions an independent review of whether the water industry and regulation are fit to meet future needs such as drought resilience, as well as delivering value for money for customers. Consideration should also be given to whether the price review cycle is too short to allow long-term planning in the industry. Our recommended review should begin immediately so that it can influence the 2024 price review. A strong, independent regulator will be needed in England and Wales in the future, under all circumstances.*

In October 2018, the Government asked the National Infrastructure Commission (NIC) to conduct a study into [regulation across the UK's utilities](#) (energy, telecoms and water industries) to consider how future frameworks can deliver investment and innovation while ensuring affordability. The NIC's final report – [Strategic investment and public confidence](#) (October 2019) provides a discussion of common challenges across regulated utilities in general and made a number of recommendations to Government and regulators, some of which are referred to elsewhere in this paper. Overall, the Commission concluded that the regulatory systems did not need a complete overhaul but suggested several “major shifts in perspective” were necessary to cope with future demands such as climate change (reaching net-zero emissions), changing weather patterns, and increasing digitisation.<sup>81</sup> The Government has not made a formal response to the report.

For example, one recommendation made by the Commission, that has also been raised by Citizens' Advice and the National Audit Office with

<sup>80</sup> EFRA Committee, [Regulation of the Water Industry \(PDF\)](#), 8<sup>th</sup> Report of Session 2017–2019, HC 1041, 9 October 2018.

<sup>81</sup> NIC, [Strategic Investment and Public Confidence](#), 11 October 2019, page 9.

respect to the water industry,<sup>82</sup> is that large strategic investments, such as building new reservoirs, should be removed from the price review process and opened to wider competitive tender. The Commission argued that the 5-year process does not work well for large long-term investments and that wider procurement could bring more innovation and competitive pricing.<sup>83</sup>

Additionally, the National Audit Office in its March 2020 report on [Water supply and demand management](#) raised questions about how well the economic regulatory system can adapt to changing Government priorities within a 5-year regulation cycle.<sup>84</sup> The NAO provided the example of leakage, noting that despite Defra bringing in new ambitions to minimise leakage in 2016, there were only limited incentives for companies to improve performance in the interim period before more ambitious targets came into force in 2020 (through PR19). The NAO highlighted that Defra's call for evidence on [reducing personal water consumption](#) launched in July 2019 is expected to report on key Government priorities for personal water efficiency in 2020,<sup>85</sup> i.e. after water company targets for reducing personal consumption have been set for AMP7:

Defra will need to ensure there is sufficient flexibility within the planning cycle to accommodate any resulting changes to the government's priorities or to what is required from water companies during the five-year period, for example more stretching performance commitments on personal consumption.<sup>86</sup>

## Looking ahead to PR24

The next price review will occur in 2024 (PR24) to set prices for 2025–2030. As part of PR19 Ofwat has already set how it will consider performance outcomes in the 2020–2025 period during the PR24 process.<sup>87</sup>

[Ofwat's Strategy](#) (October 2019) explains that the core elements of the existing price review framework will remain going forward but identifies some areas to consider for improvements for the next price review.<sup>88</sup> These include:

- considering whether there are areas of company activity that should be considered outside the price review process, such as large infrastructure projects (see above).
- considering how to assess company performance on a more regular basis during each price control period with the aim of reducing the intervention required during the price control

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<sup>82</sup> NAO, [Water supply and demand management](#), 25 March 2020, para 14; Citizens' Advice, [Monopoly Money: How consumers overpaid by billions](#), 30 May 2019 page 17 and 39.

<sup>83</sup> NIC, [Strategic Investment and Public Confidence](#), 11 October 2019, pages 9, 40–42.

<sup>84</sup> NAO, [Water supply and demand management](#), 25 March 2020, para 10, 1.21 and 1.24.

<sup>85</sup> Defra, [Water conservation: measures to reduce personal water use](#), 19 July 2019 [accessed 3 June 2020].

<sup>86</sup> NAO, [Water supply and demand management](#), 25 March 2020, para 1.23.

<sup>87</sup> Ofwat, [2024 price review](#), [accessed 3 June 2020].

<sup>88</sup> Ofwat, [Time to act, together: Ofwat's strategy \(PDF\)](#), October 2019, page 34.

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process or potentially streamlining the process for companies with a strong track record

- considering how to improve customer engagement in shaping company business plans and improve approaches to customer research
- consider how the price review aligns with companies delivering on agreed long or medium-term targets that extend beyond the 5-year period.



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