

Living in Hackney Scrutiny Commission

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Paper by Ofwat

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We welcome the opportunity to appear before the scrutiny commission to discuss our role regulating Thames Water. In this paper we provide a brief overview of Ofwat's role and functions and a short summary of recent enforcement action against Thames Water and our final determinations for the company in our 2019 price review.

1. Ofwat's role and regulatory functions

The Water Services Regulation Authority (Ofwat) is the body responsible for economic regulation of public supply water and sewerage companies in England and Wales. Ofwat's statutory duties include protecting the interests of consumers, securing the long-term resilience of water supply and wastewater systems, and ensuring that regulated companies carry out their functions and are able to finance them.

One of the main ways we regulate is through the five yearly price review process. This includes controlling the revenue that companies can collect from their customers, and setting the minimum performance commitments which companies make to their customers and the costs of operations and investment which customers should fund. The outcome of the most recent price review – PR19 – was published on 16 December 2019.

As part of the price review, we must balance consumers' interests with the need to ensure the companies we regulate are also able to finance the delivery of water and sewerage services. We also need to ensure sure they are able to meet their other legal obligations, including their environmental and public health duties. In doing so we work closely with the Environment Agency, responsible for environmental regulation, and the Drinking Water Inspectorate, responsible for regulating drinking water quality.

The other key way we regulate is through the obligations imposed on each company to secure the proper carrying out of their functions, which are set out both in legislation and in the licences under which the companies are allowed to operate. These duties include, but are not limited to, requirements to maintain effective and economical system water supply and to have in place management controls required to achieve this. Ofwat may take enforcement action against the companies it regulates where these companies either fail to comply with their statutory duties and licence obligations, or are likely to do so. Enforcement action can include making an enforcement order to secure compliance, and where appropriate a financial penalty.

In general, we take a stepped approach: we will usually pursue informal regulatory action with companies first where that is the most appropriate means of making sure that they meet their obligations. If this does not achieve the desired result, we may take formal regulatory action, including enforcement action. Our monitoring and assurance framework provides a way of enabling us to decide when we may need to step in to

protect customers, and where applicable, where we may need to take enforcement action.

2. Ofwat enforcement action in relation to Thames Water

Ofwat has publicly and repeatedly challenged Thames Water to improve its performance for customers. In 2017, Ofwat's Chair wrote publicly challenging the company to deliver significant improvements in its communication with customers, transparency on the company's performance against its aspirations, and measures to ensure that Thames Water's Board is able to effectively hold the company's management to account for its delivery for customers.¹ We continue to discuss with the company its plans to improve operational performance and the effectiveness of its communications with customers and other stakeholders. In 2018, an Ofwat investigation found that Thames Water breached two of its legal obligations through poor leakage management.² It concluded that Thames Water's Board and management did not pay enough attention to reducing leakage and that the company underestimated the significance of its underperformance on leakage when assuring Ofwat that it was meeting its statutory obligations, one of which is to deliver an efficient and economic service.

Following this investigation, in addition to a financial and non-financial package worth £120 million to customers, we accepted formal undertakings from the company committing it to a number of actions to address concerns we had identified. Thames Water is required to provide compliance reports to Ofwat every six months providing updates on its progress and compliance with these undertakings. The undertakings were wide-ranging but included requirements to:

- reduce its leakage to 606 megalitres per day (ML/d) or better by 31 March 2020 across the company's area of operation, i.e. in London and the Thames Valley;
- prepare its PR19 business plan on the basis of a commitment to reduce leakage by a further 15% in 2020-25 period and by 50% over the longer term; and
- implement a series of steps to improve transparency and engagement on its public reporting of its leakage performance against its leakage recovery plan for customers and stakeholders to access.

Thames Water now publishes a monthly leakage report on its website³ providing details of its latest performance against leakage, including any risks to its recovery plan. The page also has details of how customers and stakeholders can engage with and provide feedback to Thames Water on leakage. We consider continuing scrutiny of the company's performance on this key performance issue by a range of local and national stakeholders, including by London borough elected members, to be an important part of securing improved confidence in the ability of Thames Water to meet the performance commitments it has made to its customers.

As can be seen from the monthly reporting, Thames Water's leakage levels have remained higher than it forecasted in its recovery plan when we accepted the undertakings. In part this is due to the challenges of the '*Beast of the East*' followed by a very dry summer, both of which resulted in increased leakage. It is however also due to

¹ <https://www.ofwat.gov.uk/publication/holding-thames-water-account-utility-week-column-jonson-cox-chair-ofwat/>

² <https://www.ofwat.gov.uk/investigation-thames-waters-failure-meet-leakage-performance-commitments/>

³ <https://www.thameswater.co.uk/help-and-advice/leaks/our-leakage-performance>

a range of other factors as detailed in Thames Water's reports. Ofwat is monitoring this closely and receiving regular updates from Thames Water on its progress. It will become clear in Q4 2019-20 whether or not it will reach the commitment in its undertakings to reduce leakage to 606 ML/d by the end of March 2020, and therefore whether it has complied with or breached the undertakings accepted by us. If the latter Ofwat will consider whether further enforcement action is likely to be the best way of protecting customers.

3. Thames water and the PR19 Final Determinations

Ofwat has continued to challenge the Thames Water throughout the PR19 process to ensure its plans for future performance deliver improvements for customers. Following our initial assessment of company business plans for the forthcoming five year period, Thames Water was one of only four of the seventeen largest water companies to be assessed as requiring "significant scrutiny" during the remainder of the process, and we intervened in a wide range of areas to require the company to improve its plans and provide for more efficient delivery and greater ambition in its plans for improved service for customers.

Thames Water is an outlier of poor water network performance in the period 2014-19. This has had material consequences for customers in London in particular. In light of this, we are intervening in PR19 to put in place a gated funding process to ensure a systematic review of resilience and options for addressing risks to resilience⁴. We will conditionally allow up to £300 million of customer funding for investment in 2020-25 to improve the performance of the London water network and £180 million to investigate risks to the resilience and the mitigation of risk to water supplies in North East London.

Thames Water will face greater scrutiny on this allowance than would normally be the case. We will return the allowance to customers unless Thames Water demonstrates that it understands the challenges facing its network, produces a well thought-through plan in a defined time frame with clear and measurable deliverables, and commits to new performance standards that capture likely benefits to performance from any planned work. Thames Water's shareholders must also make a substantial contribution to the cost of the improvement works, as part of any plan.

Alongside this, and reflecting the need to improve performance in London and to provide additional assurance and transparency for stakeholders in the capital, Thames Water will develop specific reporting on 'Performance for London' alongside reporting on the performance commitments set out in our final determinations for PR19.

Ofwat remains concerned by Thames Water's performance in London, and will continue to press the company to improve both its underlying asset performance and its ability to respond effectively where operational disruptions occur, including through improved communications with customers and with borough and city governments.

Ofwat

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⁴ see: <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Thames-Water-Cost-efficiency-additional-information-appendix.pdf>