HOW COULD A SUPERVISORY APPROACH IN WATER WORK IN PRACTICE?

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Background and objective

In addition to the creation of a new super regulator, the most fundamental shift in the approach to regulating the water sector articulated by the Cunliffe review is the introduction of a supervisory approach. Recommendation 18 states that the regulator should adopt a more 'supervisory approach' to regulating individual companies. This applies to England and Wales. The report further identifies that the supervisory approach should be "forward-looking, judgement-based and proportionate, based on company circumstances and risks. For example, if the company is heading in a direction which would bring risk of public harm, supervisors would engage and challenge the company to take pre-emptive remedial action".

While the supervisory approach presents an exciting opportunity to improve regulation of the sector to the benefit of all stakeholders, there is a risk in adopting an approach that was designed for financial regulation without adapting it appropriately to the water sector. The supervisory approach in financial services is implemented across three regulators and applies to tens of thousands of firms. A risk-based approach to deal with a long tail of small financial services firms will not work for a small number of water and wastewater companies.

There are a series of questions that need to be considered in detail to design a supervisory approach for the water sector:

- What are the benefits that the supervisory approach needs to deliver to be successful? What are the key risks?
- How can the approach work in practice?
- What are the design choices?
- What is different in water compared to financial services?
- How can it best interact with other regulatory approaches such as benchmarking of comparative information? This is addressed in a separate paper.

This paper aims to provide initial thoughts and ideas to start the process of designing a supervisory approach for water. It is not intended to be complete or provide conclusions but highlights the need for substantial further work to develop the approach.

What are the benefits that the supervisory approach needs to deliver to be successful? What are the key risks?

On a practical level, the supervisory approach is a remedy that can address a number of issues in the sector: increase trust between regulators and companies, increase delivery of infrastructure by providing appropriate flexibility and avoid companies getting caught in a "doom spiral".

However, to design a successful supervisory approach, we need to ask ourselves how the supervisory approach will add value – particularly as the Cunliffe review is also clear that it needs to be combined with the current comparative benchmarking approach with broadly equal weight. There are two ways of looking at the rationale for adding a supervisory approach as a regulatory tool:

- Existing benchmarking may not take sufficient account of company specific circumstances.
- The current philosophy of regulation – that efficiency should be based on a notional company, and customers should not pay for companies to correct past inefficiencies – is wrong. In other words, efficiency targets should be achievable for the actual company.

The first one is an empirical matter and while Ofwat has tried to reflect company-specific adjustments to the benchmarking it is not clear how effective they are. Accepting that Ofwat's approach was not perfect leads to a clear role for a supervisory approach that can better reflect company-specific circumstances.

The second one is a more profound change of approach. While the supervisory approach is not the only way to move away from the notional company approach (e.g. glidepaths to efficiency targets or pure incentive regulation as per Bearley and Littlechild could achieve this), it would represent a clear shift in how companies are assessed. If the rationale for supervision is to move away from regulating the notional company, this raises clear risks in terms of consistency of implementation. In the context of water companies (as opposed to financial regulation), this requires a wide mix of engineering, asset management, operational and financial skills to ensure the supervisory approach has a full "whole of company" view.

A third way of looking at the supervisory approach is to view it as an alternative way to address information asymmetry that arises in monopoly markets between the regulator and the regulated companies. Companies hold more information about their true costs and performance capabilities than regulators and the traditional way of overcoming information asymmetry is via benchmarking and by providing incentives to reveal information. Both of these methods have limitations:

- Benchmarking may not be able to correctly distinguish between inefficiency and company-specific factors and incentives intended to reveal information can also lead to gaming.

- Benchmarking can also not distinguish between efficiency and risk. The simplest example is a company that costs schemes with a low contingency and therefore takes a higher risk of cost overruns. But this extends to how companies manage asset maintenance and operations. While there could be benefits for companies to have different risk appetites, high-risk low-cost approaches are not necessarily efficient. This may not appear so in a benchmarking exercise that does not consider risk.

- Benchmarking based on historical relationships also may not provide a good basis for assessing costs in the future, particularly in a world of accelerating climate change.

Adding a supervisory approach to the mix has the potential to address information asymmetry in a different way. This is particularly relevant to identifying whether differences between companies are driven by (different types of) inefficiency or exogenous factors that cannot be captured by the model (e.g. different operating environment).

The picture below illustrates that to date, regulators have set a high hurdle for accepting company-specific factors as drivers of differences and it is likely that this has resulted in over-estimating the size of the gap that can be attributed to inefficiency. This leads to unachievable targets for costs and performance. The supervisory approach enables regulators and companies to engage more constructively on differences in costs and performance and identify where there is room for catch up efficiency and where there isn't. A successful supervisory approach could therefore lead to regulatory decisions that are closer to the "true split" (that is unobservable). This would benefit all stakeholders as targets are truly stretching but achievable for all companies. However, there are two key risks:

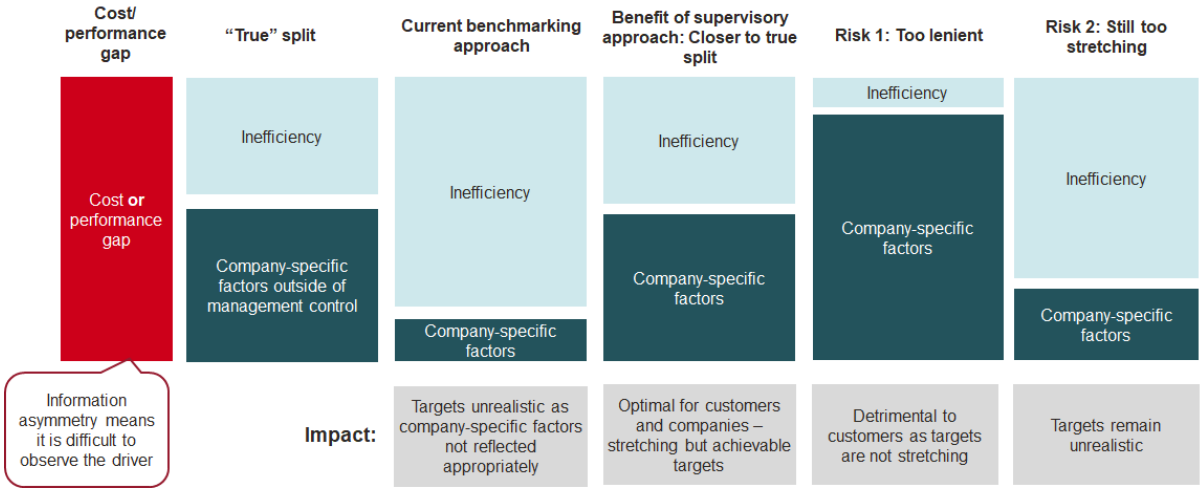
- The supervisory approach could lead to overestimating the role of company-specific factors – this would mean that targets are too lenient to the detriment of customers. This could be a result of regulatory capture.

- The supervisory approach may not shift the dial – this could happen for various reasons, for example the supervisory team may find the benchmarking evidence more compelling than engagement with companies.

A third risk arises if there are material inconsistencies between companies. This could mean that for company A the gap is largely (and wrongly) attributed to inefficiency and for company B the gap is largely (and wrongly) attributed to company-specific factors. While the benchmarking approach is not necessarily fairer (e.g. company A's cost drivers may be captured better by the model than company B), it may be more difficult to attribute differences in the regulators' views to inconsistencies in the supervisory approach.

Overall, we conclude that a successful supervisory approach needs to be designed so it delivers consistent outcomes that are closer to the true split than relying on benchmarking alone. This applies both at the time of setting allowances as well as during the delivery phase of a price control.

Figure 1 Benefit of supervisory approach



Source: Frontier

How can the approach work in practice?

Drawing on supervisory approaches in financial services,[1] we have developed a high-level approach in Figure 2. In phase 1, the benchmarking team in the regulator undertakes a consistent quantitative assessment that provides a comprehensive view of the company's current and forward-looking performance across all relevant areas. At a minimum, this would include performance around costs, delivery, outcomes and finance:

- For costs, delivery and outcomes, the analysis should compare the company against its own historical performance, against other companies and against the price control allowances to provide a full picture.
- Delivery needs to include progress to deliver enhancement and maintenance schemes.
- On outcomes, there is an opportunity to include a mix of input, output and outcome-based metrics. For example, key metrics on asset maintenance can be included as well as standardised customer-facing metrics such as supply interruptions or internal sewer flooding.
- On the financial side, this phase should include a detailed set of financial metrics including information on profitability, dividends, cost structure, credit ratings, cashflows, leverage and debt profile. This would be part of implementing a financial supervisory function.

The forward-looking analysis also needs to include a risk assessment. This would test how the metrics could change under a set of standardised events.

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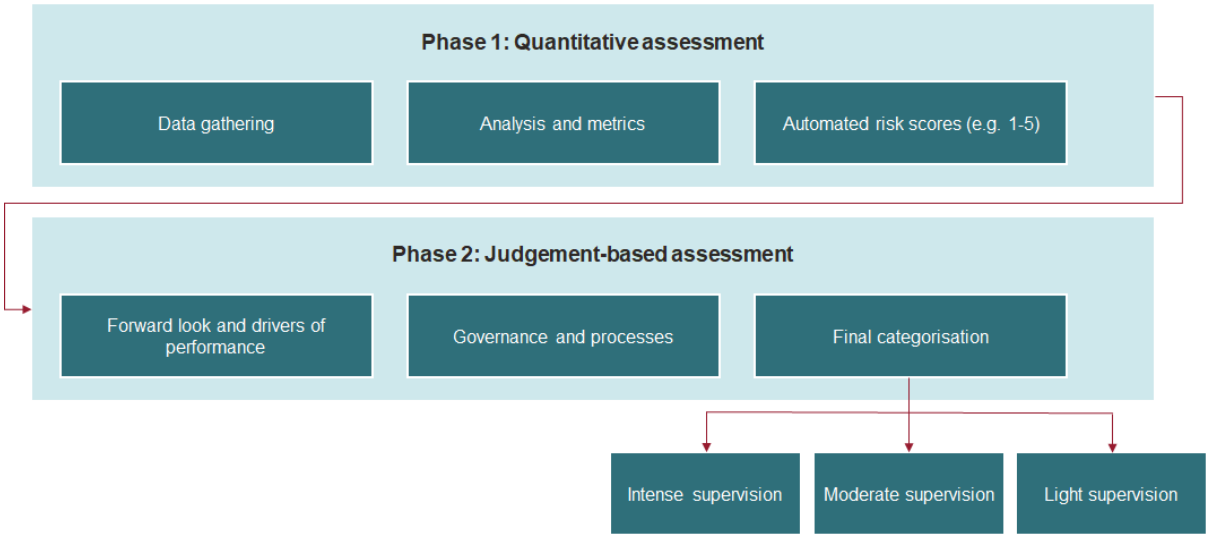
1 For example, the European Central Bank discusses the supervisory methodology here.

In addition to the core metrics and to develop a "whole of company" view as identified in the Cunliffe review, this analysis could go further and include:

- Legal and compliance risk – enforcement action, class action, disputes, investigations, etc;
- Skills and capabilities – key supply chain metrics, number of vacancies, attrition, etc;
- Information from the company risk register and financial viability statements.

All of the information and data in Phase 1 would then be aggregated into automated risk scores that could be categorised from 1 to 5 – where 1 is a high performer and 5 represents serious concerns.

Figure 2 How could a supervisory approach work in practice?



Source: Frontier

In Phase 2, the supervisory teams would then receive the quantitative analysis and engage with the company on:

- **A forward look and drivers of performance** – What are the key factors driving performance across all areas? How does the company expect the key metrics to evolve over time? Are there any factors that are missing from the analysis? What is the context the supervisory team needs to be aware of?

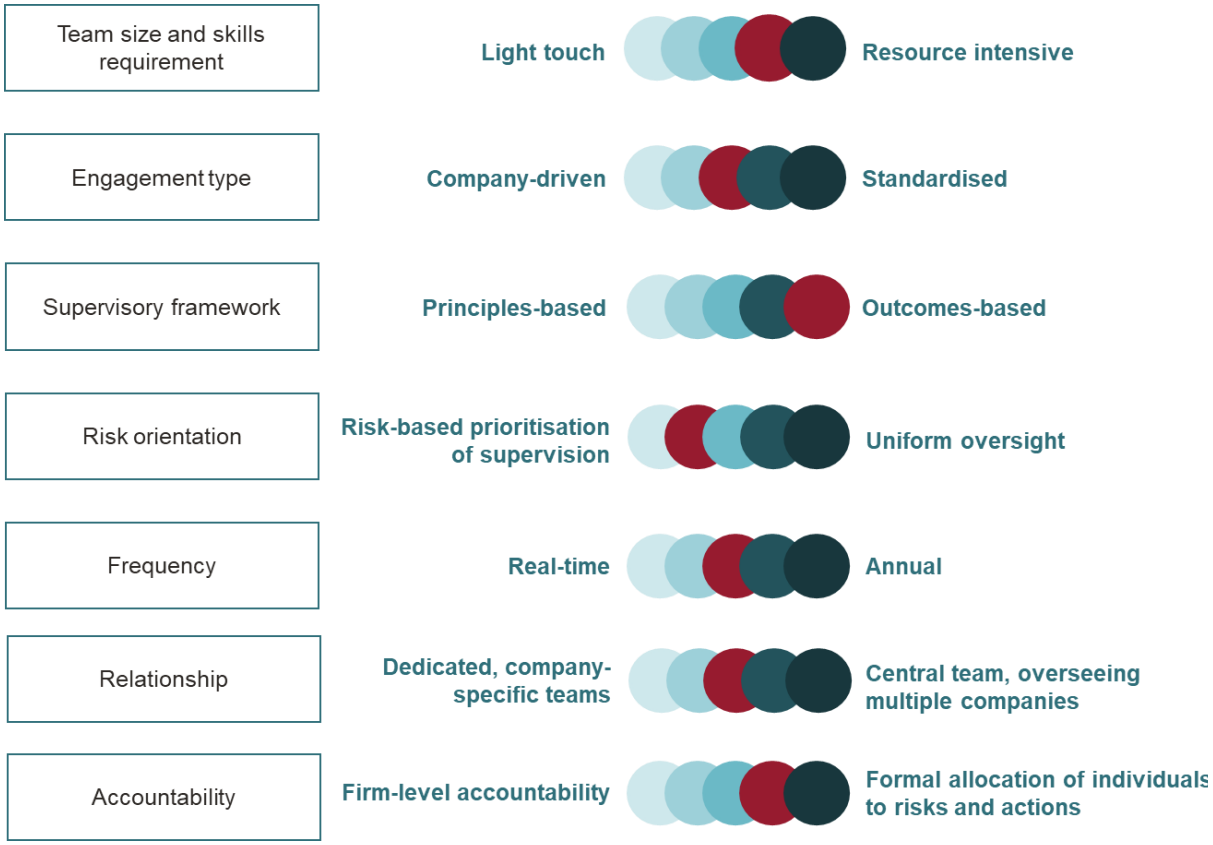
- **Governance and processes** – what is the company doing to improve performance? What are the governance arrangements and management processes that the company can rely on to take appropriate action? What are the factors outside of companies' control that need to be discussed?

The supervisory teams would effectively conduct qualitative benchmarking of the company. At the end of this phase, the supervisory team would then combine the automated risk scores from Phase 1 with its own judgement of the company's ability to manage the risk to derive the final categorisation. This could lead to three buckets: Intense supervision where risk is high and management control low, moderate supervision (for either moderate risk and management control or combinations of high risk and high control) and light supervision (for low risk and high control). The supervisory manual would then prescribe the engagement between the supervisory team and the company for each category. For example, under intense supervision we would expect frequent engagement and deep dives into specific issues. In contrast, light engagement would be less frequent and not require the same depth of engagement. The same framework could also be used to set more specific requirements.

What are the key high level design choices?

Putting the framework discussed above into practice still requires a number of high-level design choices summarised in Figure 3. All of these will have implications for both the regulatory burden and effectiveness of the supervisory approach (and for the resources required to implement the approach). In the figure, we have identified the design choices, and the red circles provide our early view of the optimal system based on our expert judgement and the Cunliffe review – this is intended to be a starter for discussion and not a final view.

Figure 3 Key high-level design choices



Source: Frontier

The key choices are:

- **Team size and skills requirement**. A light touch approach could put more emphasis on Phase 1 discussed above whereas a resource-intensive approach could add more value to the judgement-based Phase 2. The Cunliffe review is quite clear that teams will require a diverse skillset, including engineers, environmental experts, financial experts, and regulation economists so the optimal approach is likely to be more towards the resource intensive side.

- **Engagement type**. This could be bespoke to companies or be standardised across the board. The high-level approach described above would strike a balance in the middle with standardised data analysis and bespoke engagement on the basis of the data. This is aligned with the Cunliffe review references to a risk categorisation system similar to that employed in the financial sector,[2] such that the nature of the engagement will depend on the risk level assigned to each company.

[2] Independent Water Commission (2025), Final Report, para 424

- **Supervisory framework**. The Cunliffe review clearly specifies an outcome focused[3] approach aligned with the approach described above. This contrasts with an approach where supervisory teams check if companies adhere to the right principles.

- **Risk orientation**. A fully uniform approach would not be appropriate to identify and address emerging risks and circumstances. The categorisation system described above would allow for the prioritisation of larger risks, while ensuring that the resources are being deployed in the most sensible manner – the Cunliffe review supports this approach.

- **Frequency of data collection and Phase 1 and 2 analysis**: This could range from real-time data on one extreme to annual data on the other (which is the current frequency of data collection through Annual Performance Reports). While an annual process may be sensible for the final categorisation, a more frequent re-assessment of the quantitative risks is required if the supervisory approach should deliver pre-emptive action. We therefore think a balance is required so that judgements can be made based on recent data with as minimal a lag as possible, while minimising the regulatory burden that would be implied by very frequent data provision requirements. A quarterly data collection process should be able to indicate trends and any changes that would require addressing promptly.

- **Relationship**. In order to understand the specific circumstances, the companies are operating in, it is important that there will be specific teams assigned to regions, or companies. However, the review recommends dedicated measures to avoid regulatory capture, including periodic circulation of staff between teams and controls and restrictions in place for senior staff. An additional measure could be the oversight from a central team on top of the dedicated supervisory teams to ensure that the supervisory approach lends itself to decisions that are made at arm's length.

- **Accountability**. The Cunliffe review recommends changes to governance including a new regime for senior accountability. The Senior Managers & Certification Regime (SM&CR) is quoted, along with engagements with Ofgem which has indicated that it is considering a senior managers regime. Considering this, we think there will be links between the new senior accountability regime and the supervisory approach, with senior managers being assigned specific business areas or risks and actions for which they will be responsible.

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3 Ibid.

What is different in water?

Any approach to supervisory regulation in water needs to be mindful of the following key differences to financial services:

- **In the water sector, the regulator sets the cost allowances, performance targets and returns –** this means that underperformance can be driven by regulatory targets. The supervisory team may therefore interpret any underperformance against the targets that it set itself as a clear management competency issue rather than external circumstances. While this is helpful to avoid regulatory capture, it increases the risk that the supervisory approach only adds value at the point of setting the price control but not throughout the period. We discuss the role of the supervisory team in determining cost allowances and outcomes here.

- **The mix of skills required is wide –** as discussed above, a wide range of engineering, asset management, operational and financial skills is needed to successfully implement a supervisory approach.

- **The number of companies is small –** this could increase the risk of regulatory capture as water is a "small world" with a limited pool of individuals.

Next steps

This paper has provided an early view of what makes the supervisory approach a success, how it could be implemented in practice and the key design choices. It is clear that substantial further work is needed to develop the approach in detail. This includes being clear about what a success looks like, how to design an approach that works both at and during the price control and balances regulatory intervention with letting companies get on with delivery.

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