9 February 2026

Executive summary

Defra has confirmed in the Water White Paper that it will require and support the new regulator to adopt a supervisory approach. In this note, we focus on the specific implications of this for future economic regulation and regulatory enforcement in the sector.

Given the government's reform objectives, the design of the new regulatory approach must be proportionate, reduce regulatory risk, create appropriate incentives for performance and delivery in the interests of customers, and improve significantly the attractiveness of the sector to investors.

Balancing supervision, incentives and enforcement

Economic regulation fundamentally seeks to align company incentives with the delivery of the public interest. Regulators, however, face a problem of information asymmetry, since the regulated company will know more about its business than the regulator does. There are numerous ways in which regulators can seek to overcome this information asymmetry and to align company incentives with public policy objectives. This includes designing 'ex ante' rules and incentives, applying supervisory oversight, and the threat of 'ex post' enforcement.

There has been a tendency since the Independent Water Commission's (IWC's) report last summer to treat a supervisory approach and an incentive-based approach as distinct regulatory philosophies. In reality, supervision and incentive-based regulation can (and should) be complementary. In designing the future regulatory system, consideration should be given to how these various regulatory tools—e.g. supervision, regulatory incentives and enforcement—can work together as part of a coherent regulatory framework.

Shifting to a more supervisory model has the potential to address some of the main criticisms of Ofwat's current regulatory approach, in particular by better accounting for regional and company-specific differences, while allowing for pragmatism over the use of benchmarking and yardstick competition in decision-making. It could reduce the overreliance on strengthening regulatory incentives to drive behaviours, allowing for an overall reduction in risk exposure while ensuring that companies are still held accountable for performance and delivery.[1] These are core outcomes to attracting investment.[2]

As ever with regulatory design, the devil will be in the detail. The White Paper is currently light on the detail of how supervision will work, the areas in which it will complement or replace existing regulation, and who the supervisors will be.[3] However, the expectation of supervisors appears to be broad.

The remit of supervision should be thought through carefully to keep it focused. The remit, powers and extent of supervisory discretion must be captured in legislation. Experience from other sectors suggests it is difficult to remove elements from supervision systems—rather, additional elements tend to be added over time. Preventing scope creep and aligning with the government's goal of regulatory cost minimisation will be essential.

Supervision and price reviews

A key area for further exploration is the intended role of supervisors within the price review, and how this will interact with existing regulatory tools and methods, such as comparative benchmarking and performance incentives. The White Paper indicates that company-specific supervisory teams would have some responsibility over funding decisions, but the exact nature of this role is yet to be determined. This

[1] The need for a rebalancing of risk is discussed further in Oxera and Anglian Water (2026), 'Attracting Investment: How regulatory reform can promote investability', 30 January.
[2] Moreover, more flexible and proactive regulation could help to avoid the imposition of strict, 'one-size-fits-all' rules on areas such as financial resilience, which can be negatively perceived by investors.
[3] For discussion of what might be captured in the government's forthcoming transition plan, see Oxera and Anglian Water (2026), 'An effective transition: How to phase in the new arrangements', February.

is a central regulatory design question that must be addressed with speed, but also with careful thought.[4]

There are wide ranging options with varying levels of supervisory input to price reviews and we present five such options in this paper. The greater the role of supervisors in assessing efficient costs and performance, the greater the ability to reflect company-specific circumstances. However, increased supervisory judgement in price reviews could also lead to less-predictable regulatory decision-making across companies, which could undermine investor confidence and affect the sector's cost of capital. Investors have decades of experience with incentive-based regulation as applied to price-controlled utilities, but supervisory regulation remains untested in this context. Thought will therefore need to be given as to how to promote predictable decision-making within the supervisory framework.[5]

Supervision and enforcement

As well as facilitating a rebalancing of regulatory risk and incentives, the move to a more supervisory approach to regulation is also an opportunity to reset the enforcement philosophy within the sector. Punitive, deterrence-based enforcement has not secured compliance and has added to financial pressures within the system.[6] It has contributed to a downward spiral in company resilience which has affected the attractiveness of the sector to outside capital, and therefore compromised the ability for companies to address performance and delivery.

Learning from best practice in other regulated sectors, such as aviation safety, future enforcement should look to promote learning from mistakes and encourage company boards to focus on effectively managing operational and environmental risk (rather than focusing on the risk of regulatory enforcement). Strong sanctions should still be part of the enforcement toolbox, but a distinction should be made between: (i) non-compliance caused by bad intentions or gross negligence; and

[4] Illustrative examples could be used to understand the scope of supervisory input and the scope of benchmarking. For example, the respective roles of supervision and benchmarking in the assessment of regional service level expenditure requirements for leakage or region-specific asset health considerations.
[5] As well as how this fits into the 5/10/25 year planning horizons discussed in the White Paper.
[6] Particularly given the 'double jeopardy' risk that has been identified by the White Paper, with enforcement actions taken by Ofwat and the Environment Agency stacking on top of price control incentive mechanisms.

(ii) non-compliance from normal human error, systemic challenges, or factors outside of company control.

Change in industry culture to support supervision

The skills, capabilities and culture within the supervisory teams will be critical, particularly if these teams have power and responsibility in shaping regulatory allowances and targets. This should be given considerable thought in the development of the supervisory regime. Culture and mindset towards industry will also be critical in building a dialogue and trust between regulator and regulated.

Companies should be motivated to make this work by the benefits supervision can bring in terms of company-level understanding, but they will have to change their own behaviours (and organisational structures) to be transparent and earn the trust of supervisors.

Transitioning to supervision

It takes considerable time to set up supervisory systems fully. It is currently not clear who will be responsible for taking forward critical regulatory design questions but a clean break from the past is needed. Assigning full responsibility for regulatory design to Ofwat is unlikely to provide stakeholders with confidence that reform will lead to meaningful change. An implementation group with cross-industry representation could help to unpick key regulatory design questions.[7]

Supervision may play a more narrow role in PR29, focused on the priority areas where supervisory insight can inform better decision making, and evolve incrementally in future price reviews building on the lessons learned from early stages of implementation.

1 Introduction

The economic regulation of the England and Wales water sector has, for several decades, relied heavily on comparative benchmarking to determine cost allowances and set performance targets and incentives. Companies have been benchmarked against each other, and regulatory

[7] See Oxera and Anglian Water (2026), 'An effective transition: how to phase in the new arrangements', February.

allowances and targets set at the level of a hypothetically efficient company (often based on 'upper quartile' performance).[8] Companies have been given strong financial incentives to meet or surpass these targets.

This approach seeks to overcome the information asymmetry between the regulator and regulated company through the use of comparative data and incentive mechanisms that should, in theory, reveal information about efficient costs and service levels over time.[9] A top-down, comparative, incentive-based approach of this kind can help to avoid micromanagement by the regulator—incentives are put in place but it is left to the company to decide the best way of achieving the regulatory targets.

This approach contributed to better outcomes for consumers following privatisation (at least in the early years).[10] However, over time, its limitations have become apparent.

1 **The *top-down* approach has insufficiently accounted for regional and company-specific factors**. A robust framework of economic regulation requires an objective, comparative framework for what costs should be for an 'efficient' company. However, the top-down, comparative approach by design does not provide the economic regulator with a complete understanding of each company's asset base or operations. Companies are treated as fundamentally the same, rather than reflecting their different regional challenges and characteristics. As the IWC has recognised: 'there are fundamental limits to how precise and accurate a benchmarking framework and econometric tools can be', and the extent to which they can, in isolation, be relied upon for setting prices.[11]

[8] This has led to the question of whether it is feasible for any given company to achieve upper quartile performance across both cost and service metrics, or whether this approach has resulted in an unachievable hypothetical 'frontier' which companies have been expected to meet.
[9] Shleifer, A. (1985), 'A Theory of Yardstick Competition', *The RAND Journal of Economics*, **16**:3, pp. 319–27.
[10] National Audit Office (2015), 'The economic regulation of the water sector', 14 October. 'Today's report also finds that, since privatisation in 1989, most measures of service quality have improved markedly, including the quality of the UK's drinking and bathing water. [...] Increases in bills have been moderated by Ofwat's challenges on efficiency gains, and by the sharing of those gains with customers. Ofwat's approach has encouraged greater company efficiency, resulting in lower customer bills, but the rate of saving is now smaller than in earlier years.'
[11] Independent Water Commission (2025), 'Final Report', 21 July, p. 183, para. 388.

2 **The setting of targets based on *comparative* benchmarks has driven a wedge between top and bottom performers**.[12] Stakeholders have pointed to a self-perpetuating cycle in which 'good' performers have been rewarded and have been able to reinvest in further performance improvements, while companies struggling in performance terms are benchmarked against higher performing companies, resulting in a downward spiral of lower funding, weakened financial resilience and reduced ability to improve.[13]

3 **Companies have responded to the *incentives* but sometimes with perverse consequences due to regulatory miscalibration**.[14]

The IWC recommended that a more supervisory approach to regulation be adopted in the water sector, thereby invoking a potentially fundamental change in how economic regulation is undertaken in future.[15] The Water White Paper confirms that Defra 'will require and support the new regulator to adopt a supervisory approach'.[16]

This has the potential to address some of the limitations identified above, taking better account of regional and company-specific differences, and inhibiting aggressive financial approaches, while avoiding overreliance on econometric benchmarking models. Closer, more frequent engagement between regulator and regulated could allow for earlier identification of issues and more proactive intervention, in turn delivering a more trusting and constructive environment between the two parties.

Of course, supervision is not a regulatory panacea. There are risks, as well as potential benefits. The risk of supervisory capture—in which supervisors become too closely aligned with, and ultimately too lenient

[12] As covered in our paper on 'Attracting Investment', miscalibrated incentives have created downside risk for the sector as a whole, with only 4 of 16 companies earning their base equity returns in AMP7. The variance in performance between companies is substantial. Oxera and Anglian Water (2026), 'Attracting investment: How regulatory reform can promote investability', 30 January, Figure 2.3.
[13] There is evidence to suggest that some companies have persistently performed below average, and that differences between top-performing and poor-performing companies have increased over time. Independent Water Commission (2025), 'Final Report', 21 July, p. 187, para. 400.
[14] For example, it has been argued that Ofwat's approach to setting the allowed rate of return with a notional gearing assumption (that was initially higher than actual gearing following privatization) in early price reviews explicitly encouraged companies to increase leverage in the 1990s and 2000s. Miscalibrated performance incentives also risk diverting expenditure towards performance areas with the highest incentive rates and encouraging companies to spend on shorter term solutions rather than longer term resilient ones.
[15] Independent Water Commission (2025), 'Final Report', 21 July, p. 449, recommendation 18.
[16] Defra (2026), 'A new vision for water', January, p. 19.

towards, the firms they oversee—is well documented.[17] At the other end of the spectrum is the risk of micromanagement, where supervisors become too involved in the day-to-day running of the business.[18] A third is that supervision becomes much more expensive than other forms of regulation, with large teams of supervisors for every company, adding to the overall cost of regulation and putting further upward pressure on customer bills.

As ever with regulatory design, the devil will be in the detail. The White Paper is currently light on the detail of how supervision will work, the areas in which it will complement or replace existing regulation, and who the supervisors will be. However, the expectation of supervisors appears to be broad.

In this note, we consider how the remit and architecture of supervision could be designed to maximise the benefits and minimise the costs of a more supervisory approach in the specific context of water regulation and the industry's future investment needs. We provide a number of observations on how supervision and the more 'traditional' methods of economic regulation (e.g. comparative benchmarking and incentive mechanisms) could work together.

1 There are important differences in context between supervision in financial services and water

The recommendation for a more supervisory approach to water regulation draws on Sir Jon Cunliffe's extensive experience in banking supervision. At a functional level, banking supervision involves understanding business models, market dynamics and the people who matter within regulated firms; monitoring compliance with rules; identifying material risks to regulatory objectives; and persuading firms to do the right thing when action is deemed appropriate (through a combination of sticks and incentives).

Much of this is transferable to the water sector. However, there are important differences in terms of the market failures that are being addressed (i.e. preventing the abuse of natural monopoly power in water; preventing systemic resilience issues in banking). Supervision has been applied in banking because poorly managed problems in the

[17] Basel Committee on Banking Supervision (2025), 'Lessons on supervisory effectiveness—a literature review', Working Paper 45, July, section 5.3, pp. 38–39.
[18] This can lead to a blurring of accountability and a loss of company ownership over critical business decisions.

sector can cause large-scale damage to the wider financial system, public finances, and the economy as a whole, as has been repeatedly demonstrated. Given the scale of potential harms, the high costs of the supervisory model have been judged acceptable in banking.[19]

Moreover, the combination of supervision and economic regulation brings unique challenges. Most notably, water companies operate within the confines of regulator-imposed price controls, which constrain their commercial flexibility. As a result, financial performance is a function of (i) company performance *and* (ii) regulatory allowances—meaning the regulator is itself a key driver of financial risk and returns. Furthermore, in water the services being provided are relatively straightforward, mostly physical and all on-shore—in contrast to banking.

The combination of supervision and economic regulation is largely untested, although there are case studies that may be of relevance (including the recent transition to a more supervisory approach in the Dutch energy sector, as well as the adoption of ethical business regulation and practice in the Scottish water sector).[20] The design of supervision will need to start from an understanding of the specific market failures and asymmetries of information that arise in the England and Wales water sector, and how these can best be addressed.

2 Supervision, incentive-based regulation and enforcement can be complementary

Since the recommendation by the IWC, there has been a tendency to think of a supervisory approach and incentive-based approaches as distinct regulatory philosophies. In reality, supervision and incentive-based regulation can (and should) be complementary. In designing the future regulatory system, consideration will need be given to how various regulatory tools—e.g. supervision, regulatory incentives and enforcement—can work together as part of a coherent regulatory framework.[21]

[19] Bank of England PRA (2023), 'The Prudential Regulation Authority's approach to banking supervision', July.
[20] For discussion of the Scottish water experience, see Appendix A2.2 of Oxera (2025), 'A new approach to performance and supervision in the England and Wales water sector', prepared for Water UK, 23 April, pp. 93-98.
[21] Ofwat's regulatory framework already incorporates elements of supervision—such as performance meetings, Ofwat's monitoring financial resilience reports and ongoing reporting on the delivery of price control deliverables. However, there has been less evidence on how insight gleaned from these activities has influenced subsequent price reviews.

It will be important that the revised regulatory framework does not throw out all the existing tools in favour of supervisory judgement. For example, use of relative benchmarking to set cost allowances and performance targets can be a powerful tool for economic regulators when used appropriately. If the limitations of these models are well understood and the findings are interpreted carefully, they can provide useful insight into questions of efficiency and value for money. Likewise, financial incentives have helped to drive performance improvements over time.

Supervision has the potential to provide new sources of information and intelligence that can be used alongside these traditional methods to enhance regulatory decision making and improve regulatory calibration. Indeed, supervision could inform incentive design, while providing ongoing assurance that incentives are not leading to perverse behaviours within the water companies. At the same time, supervision could allow for a streamlining of regulatory incentive mechanisms, with less reliance on continuously ratcheting incentives to drive behaviours. This could allow for an overall reduction in risk exposure while ensuring that companies are still held accountable for performance and delivery.

Importantly, the approach taken across supervision, incentive-based regulation and enforcement will need to be aligned. Supervisory and policy teams will need to work together, and consider the full range of regulatory tools that are available.

3 The remit of supervision must be thought through carefully to keep it focused and proportionate

The remit, powers and extent of supervisory discretion will (at least to some degree) need to be captured in legislation. Supervisory teams must operate with a clear remit and clarity on what is expected of them and the boundaries of their roles.[22] They will need sufficient power and discretion to gather intelligence on each company and intervene proactively where they identify risks to the public interest. This will need to be underpinned by robust, objective and transparent frameworks for supervision to promote predictability and objectivity, which are critical to investor confidence.

[22] Specifically, the IWC referred to the concept of 'constrained discretion'—where the constraints on discretion need to be established to prevent the exercise of excessive supervisory judgement.

At the same time, Defra has emphasised the need for proportionality and the government's goal of reducing the cost of regulation. Supervision can be burdensome, and the broad expectations of supervision set out in the White Paper could lead to a significantly more expensive regulatory system than the status quo. Experience from other sectors indicates that it is harder to remove things from supervisory systems than it is to add in new things. The initial remit will therefore need to be considered carefully and discipline will be needed to prevent scope creep over time.

There will need to be appropriate checks and balances on supervisors to protect against micromanagement or other supervisory failings, with the White Paper rightly recognising the need for such guardrails.[23]

4 A key area for further exploration is the role of supervisors within the price review

In considering the potential remit of supervision within an economic regulation context, it is worth starting from an understanding of the various roles that Ofwat currently plays. (We note that supervision could also inform environmental and drinking water quality regulation, but our focus in this paper is on economic regulation.) Broadly, Ofwat plays three main roles:

1. It conducts **price reviews** to determine (on a forward-looking basis) the allowed revenues that companies can earn over five-year control periods. The general building blocks of price reviews include:

    - assessing efficient expenditure, which can approximately be split between: (i) day-to-day operating spend; (ii) asset maintenance and replacement (iii) network enhancements;
    - setting performance expectations;
    - setting the allowed rate of return that companies will earn if they deliver the performance targets for the amount of expenditure that has been allowed;
    - shaping the cost recovery profile (through depreciation);[24]
    - calibrating the risk/incentive package, including any sharing of cost savings between company and customers, and

[23] Defra (2026), 'A new vision for water', January, pp. 19-20.
[24] In the water sector, this is referred to as 'RCV run-off'—i.e. the rate at which the regulatory capital value (RCV) is depreciated and recovered through bills.

rewards/penalties based on outturn performance relative to expectations.

2 Ongoing **monitoring of performance and investment delivery**, as well as compliance with general licence conditions.
3 Oversight of companies' **financial resilience** and compliance with the regulatory ring-fencing licence conditions.

In each of these areas, a more supervisory approach to regulation could lead to a materially different regulatory model than the status quo. For example:

- in terms of the price review, supervision could allow for a better balance of comparative benchmarking and company-specific insight;
- in terms of ongoing performance monitoring, supervision could allow for a continuous, forward-looking assessment of the most critical risks and issues for each water company;
- in terms of financial resilience, supervision could allow for better understanding of individual business models and financial risk, with earlier and more targeted intervention to the specific issues.

Figure 1.1 below highlights some of these potential differences.

Figure 1.1 How a more supervisory approach could compare to the status quo

	Status quo	Supervisory approach
Conducting price reviews	Incentive-based, comparative competition	Firm-level; lower-powered incentives
	Reliance on econometric benchmarking	Equal weight to insights from supervision and econometric evidence
	Treat companies as fundamentally the same	Treat each company as individual
Ongoing performance monitoring	Backwards-looking	Forwards-looking
	'Set-piece' events	Ongoing dialogue
	Data tables	Focus on key emerging risks and issues
Financial supervision	Notional financeability assessment	Individual company financial resilience (business models and financial risk)
	Reliance on credit ratings agencies	Supervisory risk assessments (incl. stress testing)
	Financial decisions left to companies	Minimum capital requirements

Source: Oxera.

The area in which there is currently the least clarity on the role of supervisors relates to their involvement in the setting of price reviews. The White Paper indicates that company-specific supervisory teams would have some responsibility over funding decisions, but the exact nature of this role remains to be determined.[25]

There are wide ranging options with varying levels of supervisory input to price reviews. This could include the following (from 'lighter-touch' to 'more involved').

- Option 1: supervisors play an independent reporter-type role, providing internal advice within the regulator on technical issues and undertaking 'deep dives' in certain areas.
- Option 2: the company-specific supervisory team acts as an expert technical panel that reviews the company's business plan, provides expert challenge and (potentially) formal advice

[25] 'Supervision will operate through teams with company-specific expertise, who are responsible for oversight and funding decisions relating to each water company.' See Defra (2026), 'A new vision for water', January, p. 19.

on the robustness of the plan. This could be a technical expert equivalent of the customer challenge groups that were mandated for previous price reviews (PR14 and PR19).

- Option 3: supervisors provide a cross-check of top-down benchmarking to identify whether and where there is justification for company-specific divergence, and use this to provide recommendations on company-specific adjustments.
- Option 4: supervisors undertake detailed assessments of companies' decision-making processes, resources and capabilities, and use this to come to a view on efficient cost and performance. This would be given equal weight alongside econometric evidence.
- Option 5: full supervisory control over funding allocations and targets. Econometric evidence is provided as an input to the supervision teams, but the supervisors hold final responsibility for their company's price settlement.

We note that these options are not mutually exclusive, and are intended only to highlight some of the potential high-level options around allocation of roles.

Figure 1.2 Options for supervisory input in to price reviews

Source: Oxera.

There are clearly trade-offs to be considered when designing the future supervisory regime. The greater the role of supervisors, the greater the ability to reflect company-specific circumstances. Conversely, it would be costly for supervisors to develop a complete understanding of the companies they oversee.[26] Increased supervisory judgement in price

[26] The new regulator would also have to develop appropriate governance to reflect the relative weight attached to supervisory decisions—the more material these decisions, the more the Board would likely want to have oversight, and the opportunity to amend, approve or reject.

reviews could also lead to less-consistent and less-predictable regulatory decision making across companies and over time.[27]

The role played by supervisors could evolve over time. Given the time pressures in establishing supervision ahead of PR29, and the well-known tendency in regulation for addition to be easier than subtraction, it would be prudent for the initial role to be narrower in focus, with the option to expand in light of experience for subsequent price reviews.

Equally, the role of supervisory evidence could be different for different elements of the price review. For example, supervisors could play different roles in the assessment of base OPEX, capital maintenance and enhancement expenditure, as shown in Table 1.1 below.

Table 1.1 Examples of how supervisory evidence and econometric evidence could be balanced within price reviews

	Potential supervisory evidence	Potential benchmarking evidence
Base OPEX	• Identifying potential company-specific circumstances (e.g. regional wages). • Targeted assessment of company capabilities and resources. • Greater use of cross-utility process benchmarking.	• Maintaining econometric benchmarking with a refined set of cost drivers directly related to OPEX. • Better considering the current efficiency/starting point of each company to set more achievable targets for 'laggards'.
Base CAPEX (capital maintenance)	• Assessment of asset management capabilities. • Engineering expertise and understanding of firm-level forward-looking capital maintenance activity requirements. • Greater scope for companies to highlight emerging, company-specific risks. • Risk assessments (status quo vs £m spend and km activity intervention).	• Taking capital maintenance activity (e.g. km) requirements as inputs from the supervisor. • Less reliance on econometric assessment, but cost benchmarking could still play an important role. • Aiming to determine industry unit cost benchmarks (e.g. £ per km of mains replaced), while allowing for company-specific adjustments.

[27] This could, in turn, affect investor confidence and lead to a higher cost of capital

	Potential supervisory evidence	Potential benchmarking evidence
Enhancement	• Supervisors could provide engineering expertise and better understanding of firm-level activity requirements. • Targeted reviews of programme, project and cost management. • Deep-dive assessments of scheme need, optioneering, cost, wider value.	• Activity requirements could be taken as inputs from supervisors. • Econometric models could still be used in areas where enhancement activities are comparable. • Potential to increase the use of company-level cost benchmarking for a better recognition of company-specific circumstances.
Performance commitments	• Supervisory deep dives into areas of perceived poor performance • Assessment of regional and company-specific factors that influence service and environmental performance • Assessment of regional priorities in relation to performance • Joint assessment of cost and performance	• Benchmarking of performance across companies to understand where there is variance (which can be explored by supervisors)

Source: Oxera.

Since supervision provides an alternative means of overcoming information asymmetries and aligning company incentives with public objectives, it could allow for a reduced reliance on regulatory incentives within the price control framework. Supervision, rather than incentives, could be used to reveal information on efficient levels of cost and performance, and ensure companies are held to account for delivery. This could allow for a streamlined set of incentives, with a rebalancing of overall risk exposure.[28]

There is a related question of the role of supervisors once the price control is in flight. Ofwat's current regulatory framework includes a set of reconciliation mechanisms that can lead to revenue adjustments (either within the period or at the start of the next period). These are applied automatically and mechanistically according to a rulebook developed alongside the price-review process. Outside of these mechanistic adjustments, reopeners are limited to pre-agreed factors (notified items) or significant adverse events (interim determinations).

[28] This is happening to some degree in other sectors, where significantly larger investment programmes are being delivered than in the past—e.g. Ofgem (the GB energy regulator) has adopted a more cost-plus approach with lower-powered incentives and greater use of uncertainty mechanisms.

Under a supervisory model, in which the supervisory teams are in continuous dialogue with the company during the price control, there is the option that supervisors could have some flexibility to provide additional allowances or re-calibrate the price settlement on an ongoing basis to reflect what supervisors are seeing 'on the ground'. This would be a significant change from the status quo, and would need to be carefully thought through to avoid: (i) undermining incentives; (ii) layering on additional uncertainty for investors.

There are therefore critically important regulatory design questions that need to be answered around both the role of supervisors in price reviews and the ability of supervisors to make interventions once the price control starts.

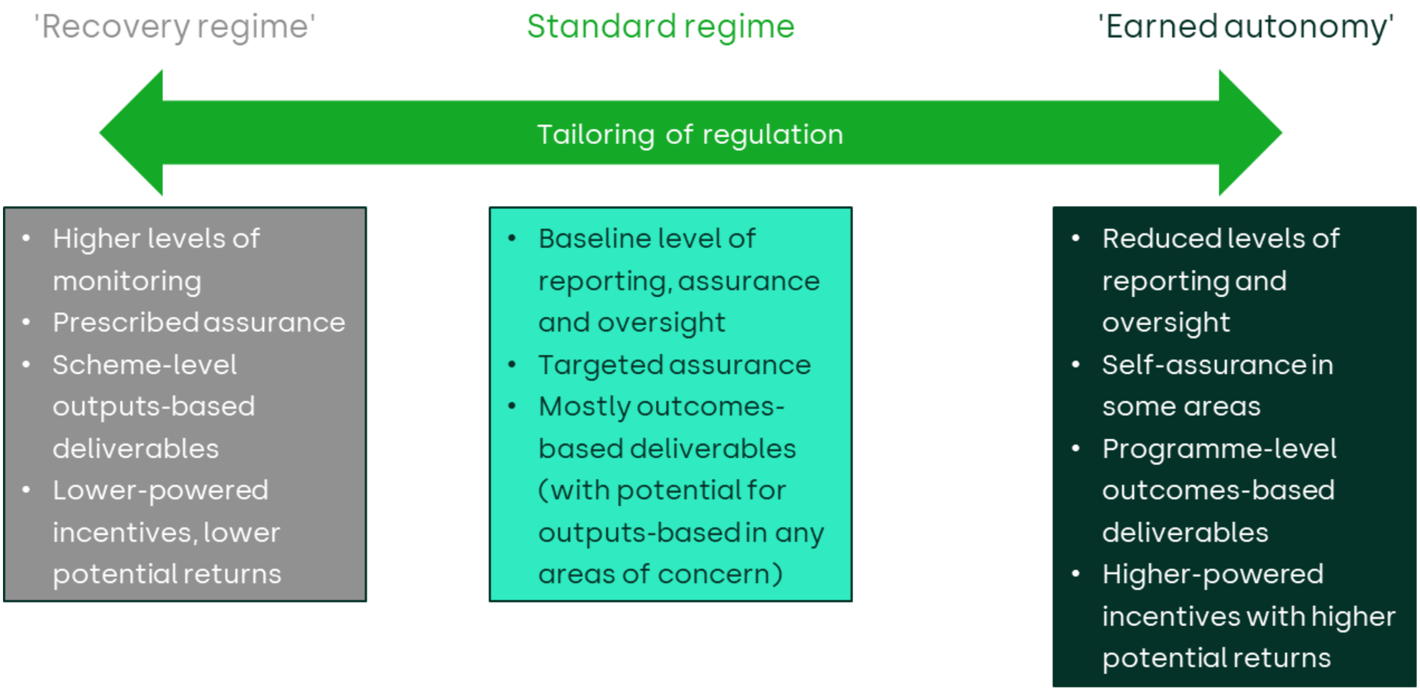
5 The concept of a risk ladder could be used to tailor regulation in a targeted and proportionate way

The White Paper states that 'supervision will operate on a "risk ladder", backed by a clear framework, where regulatory scrutiny is proportionate to risk level, avoiding disproportionate regulatory burdens'.[29] While Defra does not expand on how such a risk ladder might work, we envisaged a similar approach (in an earlier report for Water UK) under which the regulator would be able to scale oversight up or down according to the circumstances supervisors observe and the levels of trust and confidence that stakeholders have in the company's ability to deliver its plans.[30]

A key principle of this approach would be that good performers are rewarded with 'earned autonomy' (and potentially opportunities to earn higher returns), while poor performers are subject to relatively higher levels of scrutiny. Both the degree of supervisory activity and the package of regulatory incentives could be tailored to supervisory assessments of company-specific performance and risk.

[29] Defra (2026), 'A new vision for water', January, p. 19.
[30] Oxera (2025), 'A new approach to performance and supervision in the England and Wales water sector', prepared for Water UK, 23 April.

Figure 1.3 Tailoring under a supervision-based framework



Source: Oxera (2025), 'A new approach to performance and supervision in the England and Wales water sector', prepared for Water UK, 23 April, Figure 6.1, p. 70.

Such an approach would require clear and objective criteria to provide consistency (of process) across companies and to promote predictable decision-making, which is critical from an investor perspective. Such a segmentation has been used before in the water sector—for example, Ofwat's company monitoring framework set three categories of assurance based on a categorisation of companies according to the quality and reliability of their information reporting.

6 Performance improvement regime

In our April 2025 submission to the IWC, we noted that an effective regulatory framework should enable companies that are not performing well to turn around their performance.[31] Without this, the customers of underperforming companies could be faced with levels of service that are perpetually below expectations, and these companies could become less attractive for investment. We noted that the existing performance regime had not supported underperforming companies in addressing performance issues and that there was some evidence of a

[31] Oxera (2025), 'A new approach to performance and supervision in the England and Wales water sector', prepared for Water UK, 23 April, pp. 49-53.

'doom loop'. Consequently, we recommended that a new recovery regime should be introduced, to help companies that are failing to meet customer expectations and have weak financial resilience to turn around their performance.

The WWP confirms that a Performance Improvement Regime will be introduced for poorly performing companies. It envisages that this would draw on supervisory insight, and would incorporate a mix of supportive and punitive measures to tackle performance issues.

We believe that such a recovery regime is needed. As noted in our previous report, however, this would need to operate within a clear framework.

- First, there needs to be clarity regarding the circumstances under which the regime would be triggered, including trigger thresholds.
- Second, the recovery regime should be intended to be transitory. Companies should not consistently fall under the regime and there should be a clear plan for how to get companies back out again. Indeed, we recommended that the first step of the recovery regime should be the development of a turnaround plan identifying the root causes of the performance and financial issues and the company's plans to address these issues.
- Finally, there should be some 'pain' for companies that fall within the regime to reduce moral hazard and aid public legitimacy.

7 Supervision could unlock a change in enforcement philosophy

The existing regulators (the Drinking Water Inspectorate, Environment Agency and Ofwat) hold powers of enforcement, which create additional risk of sanctions on top of price control incentives. There has been considerable discussion of the weaknesses of these frameworks, including the risk of double jeopardy, the overall size of potential sanctions, and the negative skew that has been observed over multiple AMPs.

The enforcement philosophy has largely been deterrence-based and punitive in nature. Breaches have led to large financial sanctions,[32] but

[32] In the past, penalties imposed by Ofwat (mainly around misreporting) were typically between 0.3% and 3.5% of relevant company turnover. These have increased over time, and have expanded

there is evidence that this has not been successful in achieving compliance.

- First, by placing emphasis on punishment and deterrence, the enforcement regime has not promoted a learning-based performance culture. Research has shown that deterrence-based enforcement policies have limited effect on behaviour. The response to non-compliance is to blame, rather than to analyse and learn. This ultimately inhibits progress and leads to mistakes being covered up.
- Second, it places extra weight on those setting the penalties at the expense of those with better information acting within the companies, risking misallocation of company resources to manage regulatory enforcement risk rather than underlying operational/environmental risk.
- Third, financial penalties have placed additional financial pressure company and reduced the attractiveness of the sector to outside capital.

The move to a more supervisory approach to regulation is an opportunity to reset the enforcement philosophy within the sector, with enhanced company-specific oversight and engagement allowing the new regulator to better understand the causes of non-compliance and tailor its interventions accordingly.

The concepts of ethical business practice and regulation, developed by Professor Chris Hodges and Ruth Steinholtz, are of relevance here.[33] The authors point to the example of the aviation safety, where enforcement is based on differentiating between harms caused by bad intentions or gross negligence (which are deserving of sanctions) and harms arising from ordinary human or system error (which require support and learning). Under such an approach, the strongest sanctions (e.g. financial penalties) remain part of the enforcement toolkit, but are used sparingly. The focus is instead on learning from mistakes and sharing these lessons. Research shows there have been material improvements in aviation safety over the time that the sector has moved towards a full reporting and learning philosophy.[34]

into new areas. For example, Thames Water was recently fined £104.5m for its management of wastewater treatment works and networks (and the impact on storm overflows)—corresponding to 9% of turnover for its wastewater business. Ofwat (2025), 'Enforcement case in Thames Water's management of its sewage treatment works and sewerage networks', May.

[33] Hodges, C. and Steinholtz, R. (2017), *Ethical Business Practice and Regulation: A Behavioural and Values-Based Approach to Compliance and Enforcement*.

[34] Ibid.

8 The success of supervisory regulation will depend on getting the right skills, capabilities and culture

Given the weight that is placed on supervisory judgement, effective supervision is directly dependent on the capabilities of the supervisors and their ability to reach informed judgements. The skills, capabilities and culture within the supervisory teams will be critical, particularly if these teams have power and responsibility in shaping regulatory allowances and targets. The supervisory teams will need to possess the skillsets to be able to understand a range of complex issues including financial, engineering and operational expertise.

The obvious question is who will these people be, and how will their skillsets differ from existing staff within the Environment Agency and Ofwat? This should be given considerable thought in the development of the supervisory regime. A clean break from the past is needed, as well as new insight and perspectives—therefore, the supervisors should not simply be the same people who have worked for the regulators to date. Moreover, the process for designing supervisory regulation should include individuals that possess these skills, since they will have the best understanding of what would be required to make supervision successful.

The regulator will need to be able to access the right calibre of people to be able to take a 'whole company' perspective and consider complex strategic and operational issues. The higher the expectations on supervisors, the more skilled they will need to be. The ability to offer competitive compensation packages will be crucial to accessing these skills (as recognised by the IWC).[35]

Culture and mindset towards industry will also be critical in building a dialogue and trust between regulator and regulated firms. Supervisors typically spend considerable time in developing and refining target operating models, with much thought given to how to optimise supervisory relationships and engagement with industry. The relationships will need to move away from the parent/child mentality that has pervaded economic regulation.

The expectations on companies should also change. High quality regulatory decision making is reliant on good quality data and

[35] Independent Water Commission (2025), 'Final Report', 21 July, p. 197.

information from the regulated companies, and transparency about where there are issues that need to be addressed. This does not change under a more supervisory approach and, if anything, it will increase in importance. Companies should be expected to build trust through candid assessment of their performance and risks, but also to be able to verify through data, evidence and analysis. They should be able to show that they have adopted a set of behaviours centred around doing the right thing and that their decisions have been made on the basis of what is in the public interest. This will require reform on the company-side as well as from the regulators.[36]

9 Effective and objective supervision requires new data-led insight and analysis

Supervisors will need insight on company performance that goes beyond high-level KPIs. This could come from a wide range of data about the company that may be quite granular in particular areas of interest. For example, concerns around asset health might warrant an understanding not just of asset condition reports, replacement rates and maintenance expenditure, but might also include process testing and bottom-up analysis of maintenance and operational interventions being undertaken to verify that the company was making appropriate trade-offs to address the issue within existing constraints.

There does not need to be a one-size-fits-all approach to the level and granularity of information the supervisor requires. To do so would either unnecessarily over-burden both supervisor and companies in areas of little concern, or result in a lowest common denominator that excludes valuable insight on matters of concern that could otherwise be used for specific companies.

This sharing of data will need to go beyond annual reporting of lagging output measures, to be closer to real-time leading indicators on which the supervisor can form their own independent view on whether the company is appropriately identifying and addressing risks.

The supervisor will therefore need to be able to have the skills and systems to receive and analyse a wide range of information flows from companies, with dedicated data expertise to generate the insight on which judgements can be made. Companies will also need to

[36] Regulatory strategies based on seeking to ‘game’ the new arrangements, or mislead supervisors, could be particularly damaging for trust and confidence.

proactively invest to make available the information that is required, or that they feel is particularly relevant for a supervisor to assess their performance and risks.

The data that underpins the relationship will likely evolve over time, as understanding by the supervisor matures and risks emerge or recede.

10 Transitioning to supervision

The move to a more supervisory approach to regulation in the water sector is a change from prior approaches. It can take considerable time to set up supervisory systems fully,[37] and there are fundamental questions of regulatory and supervisory design that must be worked through. The architecture of supervision, and its interaction with existing regulatory tools and methods, will need careful thought.

It is currently not clear who will be responsible for taking these forward. As discussed in other papers, a clean break from the past is needed and assigning responsibility for regulatory design to Ofwat is unlikely to provide stakeholders with confidence that reform will lead to meaningful change.

As part of an effective transition programme, an implementation group with cross-industry representation could help to unpick key regulatory design questions. In the meantime, supervisory teams could be set up across the EA and Ofwat to trial new approaches. Supervision could then be implemented incrementally over time (i.e. over multiple price reviews), learning from what works and what is less successful in the early stages of implementation.

[37] For example, the current approach to banking supervision has been refined over many decades. The Office of the Comptroller of the Currency (OCC) was set up to supervise US banks in 1863 and much of modern banking supervision can be traced back to the establishment of the Basel Committee on Banking Supervision in 1974.