

Wednesday 23 April 2025

Sir Jon Cunliffe
The Independent Water Commission
Defra Ground Floor
Seacole Building
2 Marsham Street
London
SW1P 4DF

Submitted via email to: cfe.water@defra.gov.uk

Dear Sir Jon,

Independent Water Commission - Call for Evidence

The Chartered Institute of Internal Auditors (Chartered IIA) welcomes the opportunity to respond to this important consultation. We urge the Independent Water Commission to recommend, as part of its final report, proportionate and practical ways of setting a clear expectation that all regulated water companies should establish and maintain an independent internal audit function. This would help strengthen corporate governance across the sector and bring water companies in England and Wales into closer alignment with publicly owned water companies in Scotland and Northern Ireland, ensuring a consistent and joined-up regulatory approach across the UK, as well as other regulated industries, such as financial services. Currently, Ofwat lacks regulatory requirements or guidance on the importance of internal audit within water companies' governance structures, which are crucial for identifying, managing, and mitigating major risks.

Water companies are responsible for running and maintaining critical national infrastructure, including the provision of clean and safe drinking water, a service that is vital to public health, environmental stewardship and the functioning of modern society. Given the significant operational and financial pressures facing the sector, and the current spotlight it is under, it is more important than ever that companies have robust internal control, risk management and assurance arrangements in place, underpinned by the presence of strong and effective internal audit functions. This is vital to help protect customers, the environment and long-term resilience.

There are several ways this could be achieved. For example, Ofwat could update its board leadership, transparency and governance principles; enhance the reporting requirements for risk and compliance statements to include expectations around internal audit assurance; encourage companies to review the adequacy of their internal audit arrangements regularly, as seen in the Charity Commission's CC8 guidance on internal controls for charities¹, or even develop something similar to the Financial Conduct Authority's Internal Controls Handbook², or develop something like Ofgem's Financial Responsibility Principle³ that incorporates clear regulatory guidance regarding internal audit.

We also recommend that where internal audit functions are already in place, they must be appropriately positioned, resourced and empowered to deliver high-quality, independent assurance on water companies' business-critical risks. Internal audit is most effective when it operates with a clear and formally defined mandate, reporting functionally to the chair of the audit committee and administratively to the CEO, in line with the Chartered IIA's Internal Audit Code of

¹ Charity Commission for England and Wales - Internal financial controls for charities (CC8)

² FCA Handbook, SYSC 14.1 Application

³ Ofgem, Financial Responsibility Principle

Practice⁴. It should have unrestricted access to all people, data and parts of the organisation, and be supported by the necessary skills, experience and budget to carry out its work effectively. Based on discussions with our members, we recognise that the four large water companies we spoke to maintain internal audit functions. The examples shared and provided in our response illustrate how internal audit can be used to contribute to board oversight, governance, and independent assurance in the water sector.

However, our wider research indicates internal audit arrangements across the sector are not consistently applied. We believe this is a timely opportunity to strengthen the role of internal audit across the sector and set clear expectations. Internal audit provides boards with independent and objective assurance on whether key risks are being effectively managed and whether governance, compliance and delivery frameworks are operating as intended. This assurance spans critical areas such as financial resilience, infrastructure delivery, environmental compliance, cyber security and supply chain risk.

Our research on the internal audit capabilities of water companies, carried out in 2024 and reported by the Financial Times, found that at the time, three regulated water-only companies in England did not have internal audit functions. Two of these were on Ofwat's financial resilience watchlist, as set out in its Monitoring Financial Resilience Report 2023–24. While we are not suggesting that the absence of internal audit was the direct cause of their financial challenges, we believe it highlights a gap in regulatory expectations around internal assurance that merits further attention. This is especially important at a time when public trust in the water industry is under intense scrutiny and robust governance and oversight are more critical than ever.

This contrasts with the approach taken in other parts of the UK, including Scotland and Northern Ireland. Scottish Water is required to comply with the Scottish Public Finance Manual and Governance Directions, which mandate appropriate internal audit arrangements. Northern Ireland Water, as a government-owned company, maintains an internal audit function in line with the governance expectations set out in Managing Public Money Northern Ireland. These precedents suggest that internal audit requirements in the water sector are both feasible and aligned with good governance practice and could offer a useful model for England and Wales.

Our response draws on direct engagement with internal audit leaders from across the water sector, including a virtual roundtable discussion, as well as one-to-one interviews and our own research. Based on these insights, we believe that clearer regulatory guidance on the necessity of internal audits could better equip companies to manage risk, deliver for customers and the environment, and ensure a cohesive and consistent regulatory approach across the UK. We welcome the opportunity to contribute to this consultation and would be happy to discuss any of the views expressed in more detail.

We are happy for our response to be published.



Gavin Hayes
Head of Policy and Public Affairs

⁴ Chartered IIA's Internal Audit Code of Practice, 2024

Chartered Institute of Internal Auditors Response to the Call for Evidence: Independent Water Commission

Section 2 – Questions on Chapter 2 – Overarching Framework for the Management of Water

Q19. Do you believe changes are needed to improve how we monitor and report on the health of the water environment? If so, what changes do you believe could lead to improvements?

Tick other

If you selected other, please specify below

The Chartered IIA believes improvements are needed to strengthen the reliability and transparency of monitoring and reporting on the health of the water environment. Internal Audit, when positioned and resourced effectively, can provide independent, risk-based oversight that supports the integrity of the wider systems, controls and governance underpinning environmental data and compliance reporting. In a sector where self-reporting plays a role in environmental compliance, internal audit can provide independent assurance that effective systems, processes, controls and oversight are in place.

We acknowledge that internal audit is present in the water sector as this is the case in the four large water companies we spoke to. Our recent roundtable discussion with senior internal audit executives from these companies provided multiple examples of internal audit's work regarding the health of the water environment. One senior internal audit described their work regarding pollution reporting ***"We agreed on a very detailed scope of work with the head of wastewater and the chief exec. We progressed with a very deep dive audit. So, it wasn't scratching the surface. We got right under the skin of pollution reporting (process)."*** They added: ***"(the findings) were very well received by senior management. The chief exec and the audit committee"***.

We recommend that regulators and policymakers consider how internal audit could be better integrated into the environmental monitoring framework through clearer regulations and guidance. Strengthening independent internal assurance over environmental data is vital to restoring public trust, supporting enforcement, and ensuring our water environment is properly protected.

Q21: What changes, if any, should be made to how the government provides strategic direction for the water industry?

Tick - Changes are needed

If you selected that changes are needed, please describe what changes you feel are needed and why

We believe that the government's Strategic Policy Statement (SPS) for Ofwat should be strengthened to provide clear expectations around governance, independent internal assurance and company-level accountability. While the current SPS rightly prioritises environmental outcomes, resilience and long-term value for money, it offers little direction on the internal audit and assurance arrangements that water companies should have to deliver these priorities effectively.

A key gap is the absence of any reference to internal audit. Internal audit is a cornerstone of good governance, providing boards with independent and objective assurance on the effectiveness of internal controls, risk management and compliance. This can include assurance over areas directly relevant to the SPS, such as environmental obligations, asset health, financial resilience, and the delivery of long-term plans.

Our research carried out in January 2024 found that, at the time, three regulated water-only companies in England did not maintain internal audit functions. Two of these companies are currently listed on Ofwat's financial resilience watchlist, as set out in its Monitoring Financial Resilience Report 2023–24⁵. By no means are we suggesting that the absence of internal audit functions was the direct cause of these companies' financial difficulties. However, we believe it is in the public interest to highlight the important role that internal audit plays in helping organisations manage risks and safeguard their financial and operational resilience.

In addition, publicly owned water providers in other parts of the UK already operate with clear requirements from their devolved Governments to establish and maintain internal audit functions as standard practice in line with the rest of the public sector. Scottish Water, as a public body, is required under the Scottish Public Finance Manual⁶ to maintain an independent internal audit department and comply with the Scottish Water Governance Directions⁷. Northern Ireland Water maintains an internal audit function per the expectations set out in Managing Public Money Northern Ireland⁸, and this is formalised through its Internal Audit Charter⁹. These arrangements provide useful models and demonstrate that high standards of internal assurance are both feasible and appropriate within the UK water sector.

We suggest that future versions of the SPS set a clearer expectation for water companies to have effective internal assurance arrangements in place to support long-term outcomes. In particular, the SPS could recognise the value of internal audit in providing boards with independent assurance over governance, risk and control. The four large water companies we spoke to have established internal audit functions which they described as playing a role in supporting governance and board oversight. However, internal audit arrangements remain inconsistent across the sector, and clearer expectations would help ensure that all companies, regardless of size, are held to the same standards.

Encouraging companies to establish and maintain an internal audit function that reports to the audit committee would help promote a consistent regulatory approach across the UK and strengthen board-level oversight. This could be signalled through the SPS and included in Ofwat's existing guidance, such as the Board Leadership, Transparency and Governance principles or expectations for risk and compliance statements.

Section 3: Questions on Chapter 3 – The Regulators

Q24: How would you rate the performance of the water regulatory framework?

Tick - Performing poorly

Q26: What changes, if any, do you consider are needed to the framework of water regulators to improve the regulation of the water industry? Please consider both potential benefits and costs of any proposed changes.

Please answer and explain below, providing supporting examples or evidence, where possible - max 500 words.

The Chartered IIA supports the Independent Commission's focus on strengthening regulatory oversight and improving outcomes for customers, the environment and public confidence in the sector. We believe the regulatory framework could be strengthened by setting a clearer expectation, through guidance or regulation, that all water companies should have an independent internal audit function as an integral part of their governance structure.

⁵ Ofwat, Monitoring Financial Resilience Report 2023–24

⁶ Scottish Public Finance Manual 2025

⁷ Scottish Water Governance Directions 2023

⁸ Managing Public Money Northern Ireland

⁹ NI Water, Internal Audit Charter

Internal audit provides high-quality independent, objective, risk-based assurance on the adequacy and effectiveness of internal controls, governance and risk management. In the context of the water sector, this assurance extends to a wide range of issues, including service delivery, environmental compliance, financial resilience and performance reporting. This could help the board and senior management of water companies to protect the assets, reputation and sustainability of the organisation. It can also support efforts to improve the performance of water companies by identifying inefficiencies and imbalances in risk control. As one water company senior internal auditor put it at our virtual roundtable discussion: ***“Where we see inefficiencies, we call that out”.***

The absence of any requirements or guidance on the need to have internal audit contrasts with regulatory expectations in other sectors. For example, financial services regulators (the FCA¹⁰ and PRA¹¹) require that where appropriate and proportionate in view of the nature, scale and complexity of its business, regulated entities establish and maintain an independent internal audit function. In our view, a similar requirement should apply to the water sector to help ensure a consistent standard of governance and assurance and to set clearer regulatory expectations regarding internal audit.

During our roundtable with senior internal audit executives from four of the largest water companies, participants highlighted how internal audit functions are adapting to increasing demands in the sector. One senior internal auditor observed: ***“All the conversation is about beefing up and actually putting more internal audit in. It's not about downsizing. It's about making sure that we've got appropriate skills and more people to deliver the new programs.”*** This underlines that in some parts of the sector, there is recognition of the growing importance of internal audit in managing increasing regulatory, financial and environmental demands. However, in the absence of a clear sector-wide regulatory expectation, the practice remains inconsistent across the sector, particularly amongst smaller water companies, and there is a potential risk that companies may choose to scale back or remove these functions altogether, particularly following changes in ownership, strategy or mounting financial pressures.

To encourage greater consistency, regulators could consider integrating clear expectations for internal audit into existing guidance, such as Ofwat's board leadership principles or making it part of any risk and compliance statements. Another option would be to ask water companies to periodically assess the adequacy of their internal assurance arrangements as per the Charity Commission's CC8 Guidance on Internal Controls for Charities¹².

In Scotland, Scottish Water, a public entity, is mandated by the Scottish Government's Scottish Public Finance Manual¹³ to maintain an independent internal audit department and comply with the Scottish Water Governance Directions 2023¹⁴. Similarly, Northern Ireland Water, as a government-owned company, maintains an internal audit function in line with the governance expectations set out in Managing Public Money Northern Ireland¹⁵ and formalised through its Internal Audit Charter¹⁶. These precedents underline the value of internal audit functions in the governance of essential public services and provide a model that could be adapted for water companies in England and Wales. It also highlights another inconsistency in the governance and regulatory system of the water sector across the UK.

Greater consistency could be achieved through proportionate changes to regulatory guidance that help to establish clearer expectations regarding the need for internal audit in water companies. This would enhance and support strong corporate governance and independent assurance across the entire sector. Not all assurance provides the same level of insight or is delivered to the same level of quality. Internal audit offers an objective, independent perspective that

¹⁰ FCA Handbook, SYSC 6.2 Internal audit

¹¹ PRA SS21/15 – Internal Governance

¹² Charity Commission for England and Wales - Internal financial controls for charities (CC8)

¹³ Scottish Public Finance Manual 2025

¹⁴ Scottish Water Governance Directions 2023

¹⁵ Managing Public Money Northern Ireland

¹⁶ NI Water, Internal Audit Charter

complements other assurance activities and supports better risk governance and oversight. We would welcome the opportunity to support regulators and the Commission in exploring how this could be taken forward.

Section 4: Questions on Chapter 4 – Economic Regulation

Q30. What, if any, changes could be made to the Price Review process to better enable the water industry to deliver positive outcomes?

Please answer and explain below, providing supporting examples or evidence, where possible

We believe the Price Review process could be strengthened by explicitly recognising the role of internal audit in supporting delivery, assurance and continuous improvement across the Price Review cycle. This could contribute to improving regulatory confidence, help to increase the robustness of business plans and enhance long-term outcomes for customers and the environment.

The Price Review is Ofwat's primary mechanism for setting performance expectations and driving accountability across the sector. It now includes tools such as Outcome Delivery Incentives (ODIs) and Price Control Deliverables (PCDs) to link funding more directly to performance. However, in our view, the assurance framework that underpins these mechanisms would benefit from further development, particularly around internal assurance and explicitly recommending that water companies leverage their internal audit functions where appropriate.

In our PR24 consultation response, we recommended that Condition B (relating to PCDs) in each company's licence include a requirement for the board audit committee to establish and maintain an independent internal audit function. Internal audit can provide ongoing, risk-based assurance that controls and processes for delivering PCDs are in place and working effectively. This would help to reduce delivery risk, provide greater transparency and allow for earlier identification of emerging issues.

Currently, assurance requirements around enhancement schemes and PR commitments are primarily externally focused. While independent third-party reviews are important, they are often limited in scope. Internal audit functions, when appropriately positioned with a reporting line to the board audit committee, are uniquely placed to offer ongoing, independent assurance on whether risks are being managed and commitments are being met.

Internal audit, in tandem with third-party assurance providers, can also be leveraged to provide independent assurance of the quality and reliability of performance data and reporting, which are fundamental to the credibility of the Price Review. One Chief Audit Executive from the water sector told us:

"We tend to focus more on the governance and processes around the Price Review. The third-party providers typically handle the reporting side, making sure the numbers are flowing through. But it's a mixture. We'll do walkthroughs and sample testing of the data tables and processes followed, while others might do the detailed number work."

This division of roles highlights the complementary nature of internal and external third-party assurance, each bringing a different lens, but both contributing to greater transparency and confidence. Where internal audit is involved in reviewing how performance data is collected, validated and governed, it can significantly strengthen the robustness of company submissions. This, in turn, enables more effective regulatory decision-making and reduces the need for retrospective challenge or intervention.

While some companies do maintain internal audit capabilities that support assurance over performance commitments and investment delivery, this is not consistent across the sector. Our engagement with four of the largest water companies suggests internal audit can play a role in this space. However, not all water companies currently operate an

internal audit function. To ensure a consistent standard of assurance across the sector, we recommend that Ofwat consider making the use of internal audit a formal requirement as part of the Price Review framework. This could be achieved through guidance or an update to company monitoring frameworks. Recognising the role of internal audit in this way would strengthen the delivery of PCDs, support the effectiveness of ODIs, and improve outcomes for customers, the environment and the wider public.

Q41. To what extent is change required to the economic regulatory framework to support water companies' financial resilience?

To some extent

Q42: Which of the following changes to the economic regulatory framework, if any, would improve outcomes for the water industry?

The Chartered IIA believes the economic regulatory framework could be improved by introducing clearer expectations around corporate governance, assurance and financial resilience. In particular, we see value in the framework encouraging all water companies to establish and maintain an independent internal audit function, applied in a way that is proportionate and appropriate to the size, complexity and risk profile of the organisation. One way to strengthen the framework could be to set clear expectations regarding internal audit. For example, the regulator could encourage companies to regularly review whether they have appropriate internal audit arrangements in place. This might be achieved through updates to Ofwat's existing Board Leadership, Transparency, and Governance principles, or enhanced guidance relating to annual reporting, such as risk and compliance statements.

At present, the regulatory framework does not provide specific expectations or clear guidance in this area. Research that we conducted in January 2024 identified three water companies operating without any internal audit function. In our view, the absence of internal audit represents a significant weakness in the governance and assurance arrangements of those companies. Boards may be operating without the high-quality, independent, objective insight and assurance needed to assess how risks are managed, how investments are delivered, and whether internal controls are working effectively.

Internal audit plays a vital role in regulated sectors by supporting board oversight and providing independent and objective assurance over financial and operational risks. It is particularly valuable in the water sector given the long-term nature of investment programmes, the complexity of capital delivery, and the increasing financial pressures many companies face. Internal audit functions, when appropriately positioned and resourced, can provide regular independent and objective assurance to the board audit committee, covering areas such as cost escalation, contractor performance, financial planning, and regulatory reporting. They can also help identify operational inefficiencies or duplicative processes that may hinder delivery. As one senior Internal auditor put it: ***"Because we have sort of the helicopter view of what's going on, we can share best practices we're seeing in one area with another... that could increase efficiency, savings, productivity."*** This ability to spot systemic issues, share learning across departments and help to improve delivery frameworks further highlights the value of internal audit in supporting cost-effective, accountable governance.

We also believe the framework should go further in strengthening financial resilience requirements. Recent developments have shown that financial fragility within some companies can have wider implications for customers, investors and the overall stability of the sector. Internal audit can support this agenda by reviewing the robustness of financial resilience plans, testing controls over debt management and cash flow forecasting, and ensuring that risks to financial sustainability are escalated appropriately. It can also evaluate the effectiveness of financial stress testing and economic scenario planning, both of which are vital risk mitigation tools. By validating assumptions, assessing risk

impacts, and reviewing mitigation strategies, internal audit helps ensure these processes are meaningful and reliable, providing boards with greater confidence when navigating economic and financial uncertainty.

The water sector can also look to other regulators for good practice in this area. In 2023, we worked with Ofgem to strengthen its Financial Responsibility Principle (FRP)¹⁷ following widespread supplier failures in the energy sector. Of the thirty energy suppliers that collapsed, including Bulb, which was the seventh-largest energy supplier in the UK, none had any form of internal audit capability. In response, the FRP now requires suppliers to report annually on their internal audit arrangements. Where no internal audit function exists, companies must explain its absence, how independent internal assurance is achieved, and whether internal audit is needed. Broadly speaking, this aligns with the clear expectations set out in the Financial Reporting Council's UK Corporate Governance Code regarding internal audit. The updated FRP also sets expectations around how internal audit contributes to judgments on capital and liquidity planning, risk management and governance. We believe a similar approach would help the water sector raise its governance and assurance standards and support long-term financial resilience.

Section 5: Questions on Chapter 5 – Water Industry Public Policy Objectives

Q52. Do you believe that legal and/or regulatory requirements would benefit from review or consolidation?

If so, please explain your answer and provide evidence and examples, where possible

Yes, we believe the legal and regulatory requirements governing the water sector would benefit from targeted review and consolidation. One key gap is the absence of clear expectations or guidance regarding the need for internal audit. We recommend that regulators consider introducing guidance or regulatory expectations for water companies to establish and maintain an independent internal audit function, where appropriate and proportionate to the nature, scale and complexity of the organisation.

Internal audit is an integral part of effective corporate governance. It enables boards to independently assess how well internal controls are working, whether risks are being managed appropriately, and whether the business is meeting its legal, financial and operational obligations. These functions also provide ongoing assurance over areas such as performance reporting, capital investment, and environmental compliance.

Based on our engagement with four large water companies, we understand that they each maintain internal audit functions. However, our research carried out in January 2024 identified three water suppliers that, at the time, had no internal audit capabilities in place. One of these companies has since introduced group-level arrangements following an acquisition, though it remains on Ofwat's financial resilience watchlist, as set out in its Monitoring Financial Resilience Report 2023–24¹⁸. Of the two companies that continue to operate without internal audit, one is currently categorised by Ofwat as "Action Required", and the other is listed under the "Elevated Concern" category.

We are not suggesting that the absence of internal audit is the direct cause of these financial resilience concerns. However, we do see this as an indication of inconsistency in governance and assurance arrangements across the sector. Clarifying and consolidating expectations around internal assurance could help ensure greater consistency and support improved board oversight across all regulated water companies.

¹⁷ Ofgem, Financial Responsibility Principle

¹⁸ Ofwat, Monitoring Financial Resilience Report 2023–24

Furthermore, to improve the quality and consistency of governance across the sector, regulatory expectations should address not only whether internal audit is present, but also whether it is positioned, empowered and resourced to provide boards with meaningful, independent assurance.

We recommend that regulators review the relevant legal and regulatory instruments to ensure they set out clear, proportionate expectations for internal audit. For example, regulators might encourage water companies to regularly assess whether they have appropriate internal audit arrangements in place. This could be achieved through updates to existing Ofwat guidance, board leadership principles, or annual reporting frameworks such as risk and compliance statements. Setting clear expectations in this way would support greater consistency in governance practices, help to strengthen internal controls and risk management, and enhance independent assurance across the industry.

Other regulated sectors already reflect this approach. In financial services, both the PRA¹⁹ and FCA²⁰ require firms to establish and maintain an internal audit function as part of their governance frameworks. Whereas Ofgem's updated Financial Responsibility Principle (FRP)²¹ requires licensed energy suppliers to report annually on their internal audit arrangements. Where no internal audit function exists, suppliers must explain its absence, how independent internal assurance is achieved, and whether internal audit is needed. These examples demonstrate that it is feasible to set clearer regulatory requirements for internal audit that are proportionate and help to elevate assurance standards.

Water providers elsewhere in the UK are also required to maintain internal audit functions. In Scotland, Scottish Water is required to have Internal audit in line with the Scottish Government's Scottish Public Finance Manual²² and the Scottish Water Governance Directions 2023²³. Similarly, Northern Ireland Water, as a government-owned company, must have Internal audit as per the expectations set out in Managing Public Money Northern Ireland²⁴ and formalised through its Internal Audit Charter²⁵.

Drawing on these existing frameworks in the UK, the Commission could consider whether Ofwat's regulatory framework should promote clear and consistent expectations for internal audit across all water companies in the UK. This could help strengthen governance, enhance board-level oversight, and support better outcomes for customers, the environment and wider stakeholders.

Q54. Which of the following changes to water industry environmental regulatory requirements, if any, would improve outcomes from the sector?

Other (please specify)

If you selected other, please specify

We recommend the regulatory framework include rules or guidance setting clear expectations for water companies to establish and maintain an independent internal audit function. Internal audit provides independent and objective assurance over environmental compliance and internal controls, enabling earlier identification of weaknesses and supporting timely action. As one senior internal auditor at our virtual roundtable discussion noted: ***"We're covering every department and every function, to some extent every year, and where there is a heightened risk, pollution, reporting,***

¹⁹ PRA SS21/15 – Internal Governance

²⁰ FCA Handbook, SYSC 6.2 Internal audit

²¹ Ofgem, Financial Responsibility Principle

²² Scottish Public Finance Manual 2025

²³ Scottish Water Governance Directions 2023

²⁴ Managing Public Money Northern Ireland

²⁵ NI Water, Internal Audit Charter

doing the right thing by the environment.” Clarifying expectations would strengthen accountability and help support more preventative management of environmental obligations across the sector.

Q55. Which of the following changes to the water industry environmental regulation, monitoring and enforcement framework, if any, would improve outcomes for the sector? (Please select all that apply)

Tick expanded use of inspections and audits

Tick Other (please specify)

If you selected other, please specify below

We support the expanded use of inspections and audits and recommend that this be complemented by stronger internal assurance within companies. Independent internal audit functions can provide independent and objective assurance over how environmental obligations are managed, how data is validated, and whether internal controls are operating effectively. Internal audit also plays a preventative role, helping to identify issues early and recommend timely corrective action. Introducing clearer expectations around internal audit within the regulatory framework could help raise assurance standards and support more consistent and effective environmental outcomes across the sector.

Q58: What changes, if any, could be made to the overall water regulatory framework to ensure it can secure a resilient long-term supply of water? (Please select all that apply)

Tick other (please specify)

If you selected other, or want to provide additional views, please specify below

We believe the regulatory framework should more clearly define the role of internal assurance in supporting the long-term resilience of water supply. Providing regulatory guidance or rules encouraging water companies to regularly review whether they have adequate internal audit arrangements in place, or whether such arrangements need to be established, would help ensure water resource management plans (WRMPs) are robustly governed, effectively monitored, and aligned with identified risks.

Internal audit can provide independent oversight of key planning and delivery processes. It can assess the integrity of data used for WRMPs, test whether risk management frameworks are robust, and evaluate whether governance arrangements are in place to track progress and adjust where needed. In a sector facing mounting pressures from climate change, demand growth and drought, this kind of independent scrutiny is increasingly important.

Internal audit is not currently explicitly referenced in any Ofwat regulatory guidance relating to resilience or long-term supply. This creates inconsistency across the sector and limits the ability of boards and regulators to obtain ongoing, independent assurance over resilience planning and execution.

Introducing an expectation for internal audit would improve the accuracy and reliability of WRMPs, while also strengthening the assurance framework for delivery. It would enable earlier identification of delivery challenges, cost risks, or governance weaknesses, helping to safeguard long-term customer and environmental outcomes.

We encourage the Commission to consider how internal audit could be included in future regulatory guidance, rules or licence conditions to support long-term water supply resilience in a proportionate and practical way.

Q62. What changes, if any, could be made to the overall water regulatory framework to better support infrastructure resilience? (Please select all that apply)

Other (please specify)

If you selected other, please specify below

To strengthen infrastructure resilience, the regulatory framework could set out rules or guidance encouraging water companies to regularly review their internal audit arrangements and, where none exist, consider establishing independent internal audit functions that reports into the board audit committee.

Infrastructure resilience depends on companies' ability to identify and manage operational risks, monitor asset health, and govern investment plans effectively. Internal audit can independently assess whether these processes are working as intended. It provides assurance on risk identification, control design, investment delivery, and the quality of governance overseeing maintenance and resilience programmes.

When we carried out research in January 2024, we found that three water companies operate without an internal audit function, despite the growing complexity of resilience challenges and the critical nature of water infrastructure. This absence weakens internal governance and limits boards' ability to monitor emerging risks and ensure compliance with resilience obligations.

By recommending the need for internal audit within future regulatory guidance, rules, or licence conditions, the Commission could support improved consistency of internal assurance across the sector. This would not only improve company-level governance but also enhance regulators' confidence in firms' ability to cope with disruption and deliver long-term resilience outcomes.

Q63. What changes, if any, could be made to the overall water regulatory framework to better support infrastructure security? (Please select all that apply)

Tick other

If you selected other, please specify

We recommend strengthening the regulatory framework by introducing guidance or rules encouraging all water companies to regularly review their internal audit arrangements or consider establishing independent internal audit functions, to improve assurance over cyber security and digital infrastructure. Infrastructure security increasingly depends on resilience against cyber threats. Internal audit, when appropriately positioned and resourced, plays a vital role in providing independent assurance over cyber security controls, incident response capability, and risk governance.

As highlighted in a case study in our Mind the Gap report, Northern Ireland Water's internal audit team provided significant value in this area. By commissioning cyber maturity reviews and working alongside co-sourced specialists, the function helped build the case for investment in operating technology (OT) cyber security, advised on resilience programmes, and reviewed key cyber risks across the organisation and supply chain. This included providing assurance over firewall integrity, vulnerability management, disaster recovery planning, and cyber awareness training. Internal audit also contributed to enhancing cyber security culture by advising on policy development, assessing staff training effectiveness, and ensuring audit rights over key third parties.

These activities demonstrate how internal audit can complement second-line functions and support infrastructure security on an ongoing basis. However, not all water companies maintain internal audit functions, creating inconsistency in oversight.

Clear and explicit regulatory guidance around internal audit would help ensure more consistent and robust assurance over infrastructure security and cyber resilience. This will help boards and regulators be better informed about the evolving risk landscape and better positioned to respond.

Q64. What changes, if any, could be made to the overall water regulatory framework to better manage risks from supply chains? (Please select all that apply)

Tick other

If you selected other, please specify

We recommend the regulatory framework include rules or guidance encouraging all water companies to review their internal audit arrangements regularly, or where none exist, consider establishing independent internal audit functions. Water companies rely on complex supply chains to deliver capital programmes, maintain operations and meet service obligations. Disruption or failure in these supply chains can have far-reaching consequences, from delays in infrastructure delivery to regulatory non-compliance.

Internal audit has a clear role to play in assessing how well these risks are identified and managed. It can provide boards with independent and objective assurance over the design and effectiveness of procurement processes, third-party oversight, contingency planning and ESG due diligence. This is especially important given the increasing reliance on outsourced delivery models and the growing expectation that suppliers meet high environmental and social standards.

Recent supply chain pressures, including inflation, labour constraints and cyber threats, have exposed vulnerabilities across critical industries, including water. In this context, internal audit can serve as an additional layer of defence, helping to ensure that supplier risks are being proactively mitigated and that business continuity arrangements are in place.

Our recent reports on supply chain resilience²⁶ and ESG risks²⁷ highlight the value internal audit can bring in raising red flags early and providing assurance to boards and audit committees on critical supplier and third-party risks.

By recommending the need for internal audit in regulatory guidance or rules, the Commission could encourage more consistent assurance across the sector, helping to improve resilience and support better outcomes for customers and the environment.

²⁶ Supply Chain Resilience and Security: Harnessing the Potential of Internal Audit, Chartered IIA

²⁷ Supply Chain ESG Risks: Harnessing the Potential of Internal Audit, Chartered IIA