

Annual report 2006-07

Ofwat – Protecting consumers, promoting value and safeguarding the future



Annual report 2006-07

For the period 1 April 2006 to 31 March 2007

Presented to Parliament in pursuance of Section 192B of the Water Industry Act 1991
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Annual report 2006-07

To

Rt Hon David Miliband MP
Secretary of State for Environment, Food and Rural Affairs

and

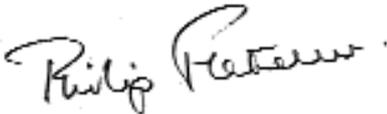
Rt Hon Rhodri Morgan AM
First Minister

We enclose the report of the Water Services Regulation Authority (Ofwat) for the year ending 31 March 2007 as required by Section 192B of the Water Industry Act 1991.

This has been a year in which the industry has been in the spotlight for a number of issues, mainly arising from the drought in the south-east of England.

It has also been a year spent planning for the future and setting out how we, and the industry, need to respond to long-term challenges such as climate change. Central to this we announced that when we next review price limits in 2009 for the five-year period 2010-15, we will do so within a longer-term context. Our aim is to protect consumers, promote value and safeguard the future.

Our change in structure on 1 April 2006, moving to a Board structure with a new Chief Executive, has also allowed us to develop our strategy and approach. Our new structure will bring fresh thinking to the way we regulate the industry.



Philip Fletcher
Chairman, Ofwat
June 2007



Regina Finn
Chief Executive, Ofwat
June 2007

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Chairman's foreword

In protecting consumers Ofwat has faced some testing challenges in its first year since restructuring as the Water Services Regulation Authority. We have responded vigorously under the direction of our new nine-member Board, with six non-executive and three executive members. I am grateful to Lord Whitty for the contribution he made before resigning to take up his appointment to the Board of the Environment Agency. I welcome the appointment as Chief Executive from October 2006 of Regina Finn.

The widespread drought following two very dry winters required hosepipe and sprinkler bans in south-east England. Most companies sought to give a clear lead to their consumers in saving water, but Thames Water, by its failure in successive previous years to control leakage from its own pipes effectively, exacerbated consumer concerns. We believe the imposition of a legally binding agreement which requires the company's owners to spend £150 million by 2010 on further mains replacement is a proportionate remedy.

Security of supply in the face of climate change remains a major challenge for the future. Ofwat is working closely with other stakeholders through the Water Saving Group to respond, including developing measures to improve water efficiency.

Ofwat has acted to strengthen the integrity of water company processes. Investigations continue into aspects of consumer service for three of the largest companies – Thames, Severn Trent and Southern Water. We will use our new power to fine those companies for such failures, subject to completion of the investigations, and to fine United Utilities for failure to trade at arm's length from its associate companies.

We will continue to protect consumers from assuming risks which properly belong with investors arising from financial restructuring

of companies. But we will maintain a consistent approach which enables investors to evaluate regulatory risk and minimises the cost to consumers of financing continuing large investment programmes.

We are determined to pursue our duty to protect the interests of consumers wherever appropriate by promoting effective competition. Our review suggests that we need to promote a vigorous drive for competition to enable consumers to switch supplier and to seek changes in the legislative framework.

Our duty to contribute to the achievement of sustainable development encourages us to promote value and safeguard the future. We will set price limits at the 2009 review within this long-term context.



Philip Fletcher

Chief Executive's report

This is my first annual report as Ofwat's Chief Executive. Our aim as the economic regulator of the water and sewerage industry in England and Wales is to protect consumers, promote value and safeguard the future. We have therefore structured this annual report to demonstrate what we have done during 2006-07 to further these core values.

The main focus of the report, and most of the activities we have undertaken, is on protecting consumers. However, because we are protecting the consumers of the future as well as the present, safeguarding that future underpins much of this work. Also, we protect consumers by promoting value for money for the environment and for the bill payer. While we are accountable to Parliament and to the National Assembly for Wales, it is water and sewerage consumers in England and Wales to whom we are ultimately answerable.

Since the industry was privatised Ofwat's regulatory regime has ensured that significant benefits have been delivered. Customers' bills today would have been around £90 higher without our intervention. I want to build upon that success, focusing not only on what we do, but also on how we can make sure that our effort is focused on those areas that present the greatest opportunities for delivering value for consumers.

One such area is how we monitor companies' activities in light of the investigations relating to regulatory data that we have carried out over the past year into a number of companies. We will take the lessons from those investigations and build a monitoring and enforcement regime that will deliver best value.

Another key area we have been looking at with a fresh perspective is competition. This includes not only how certain aspects are working, such as inset appointments, but also how competition within the industry is operating as a whole – from legislation to

implementation. We plan to consult stakeholders more widely during the coming year about how effective competition can best be fostered to deliver benefits to consumers.

We have also been considering how we, and the industry, should plan for long-term issues such as climate change. In November we published our paper, 'A sustainable water industry – To PR09 and beyond', in which we set out how we will address the challenges in both the short and long term. Crucially, although we are still more than two years away from setting price limits in 2009, we have already started to focus the industry on that longer term by asking each company to develop a 25-year strategic direction statement within the context of which we will examine their five-year business plans.

Finally, I would like to take the opportunity to thank all Ofwat staff for their hard work and the welcome they have given me since I arrived. I look forward to continuing to draw on their knowledge and expertise but also their willingness to work with me to bring fresh thinking to how we regulate. Together we can build on Ofwat's professional approach and ensure that all consumers continue to receive high quality, sustainable water and sewerage services now and in the future.



Regina Finn



Ofwat’s Board and senior management team

We held ten Board meetings and two special Board meetings during 2006-07. The two special meetings covered the Competition Appeal Tribunal’s judgements on Shotton Paper Mill (Albion Water vs Water Services Regulation Authority) and the Competition Commission’s inquiry into the merger of Mid Kent Water and South East Water. Minutes of these meetings are published on our website along with our rules of procedure.

Lord Whitty resigned as non-executive director on 31 July 2006 due to other commitments. Regina Finn took up her position as Chief Executive on 9 October 2006. Two new non-executive directors, Mike Brooker and Gill Owen, were appointed on 1 February 2007.

The current members of the Board and senior management team are as follows.

Board members

Philip Fletcher, CBE, Chairman



Philip was previously Director General of Water Services from 1 August 2000. Prior to that, he had a variety of roles at the Department of the Environment and was the Receiver for the Metropolitan Police District.

Michael Brooker, Non-executive Director



Mike is a scientist who retired in 2005 as Chief Executive of Dŵr Cymru. He is also a non-executive member of the Water Industry Commission for Scotland.

Regina Finn, Chief Executive



Previously, Regina established a new regulatory authority for telecommunications, post and electricity in Guernsey as well as developing the telecommunications regulatory framework with the Irish Office of

the Director of Telecommunications Regulation. She was heavily involved in developing an all-island energy market in Ireland.

Peter Bucks, Non-executive Director



Peter has been Senior Financial Adviser at Ofgem since 1997. He was previously Corporate Finance Adviser at Ofwat. He is also a non-executive director at the Office of Rail Regulation.

Peter spent thirty years in investment banking in London and New York.

Penny Boys, CB, Non-executive Director



Penny was Executive Director in the Office of Fair Trading and Secretary (Chief Executive) at the Competition Commission, Head of Personnel at the DTI, and the first Deputy Director General at the Office of Electricity Regulation.

She is also an Independent Member of the Horserace Betting Levy Board.

Jane May, Non-executive Director



Jane was previously at Freemans, becoming Customer Relations Director in 1992, before joining Thames Water in 1994 until 2000. Jane is also a non-executive at the Office of Rail Regulation, the Public

Guardianship Office and SITA Trust.

Gillian Owen, Non-executive Director



Gillian is an independent consultant, a Senior Research Fellow at the Warwick Business School and Policy and Regulation Adviser to the Renewable Energy and Energy Efficiency Partnership (REEEP). She was previously a

member of the Competition Commission, a non-executive director at Ofgem and a member of the Bedfordshire Police Authority.

**Dr Melinda Acutt,
Director of Network Regulation**



Melinda joined Ofwat in January 2006 and is responsible for scientific matters, capital investment, serviceability, capital maintenance, comparative efficiency, leakage, quality framework and reporters. Before

that she was in the regulation team at Yorkshire Water and was an academic economist, publishing widely on environmental and regulatory economics.

**Keith Mason, Director of Regulatory
Finance and Competition**



Keith is Director of Regulatory Finance and Competition. He has responsibility for mergers, corporate finance, financial modelling and ring fencing, as well as development of competition policy. He has been with Ofwat for

more than ten years and has experienced three price reviews. He is a Chartered Accountant and was previously at KPMG.

Senior management team

Huw Brooker, Director of Legal Services



Huw joined Ofwat in November 1999, as the Deputy Legal Adviser. He is a solicitor and became Head of Legal Services in April 2003. He is responsible for all aspects of legal advice to Ofwat. Huw previously worked in

private practice, specialising in competition law.

**Andrew Dunn,
Director of Consumer Protection**



Andrew joined Ofwat in February 2007 and is responsible for consumer policy, including customer service and social issues, customer research, tariffs, disputes and complaints. Andrew is a civil engineer and was

employed as an independent consultant immediately before joining Ofwat. He worked for Yorkshire Water between 1975 and 2005 on operational and customer service management.

Roger Dunshea, Director of Operations



Roger joined Ofwat in December 1997 as Director of Operations. He is responsible for finance, facilities, human resources, information systems and business planning. Roger previously worked within the NHS. He was

an executive director of the North Wales Health Authority before joining Ofwat.

Fiona Pethick, Head of Corporate Affairs



Fiona joined Ofwat in October 1989 and is managing the 2009 price review in addition to her responsibilities for stakeholder involvement, media, parliamentary and public relations and support to the Ofwat Board.

During the 1980s she was a statistician in the Department of Employment.



Chapter 1 – Protecting consumers

We are the economic regulator of the water and sewerage industry in England and Wales. Consumers expect to receive high quality, sustainable water and sewerage services at a fair price and most companies are delivering this. We work with the companies to make sure they make further improvements for their consumers. However, in a few cases this year we have had to use our enforcement powers where companies have not met their obligations.

Monitoring and enforcement

For the majority of water and sewerage consumers there is no choice of supplier. Consumers therefore rely on us to regulate in a way that means that these essentially monopoly suppliers provide them with a good quality service at a reasonable price. We monitor a wide range of the companies' activities, including their service performance, investment programmes, and ability to meet consumers' demand for water. We regularly publish league tables that compare each company's performance. This information puts pressure on companies to make improvements and deliver for their consumers.

However, in a few cases companies have not met their obligations and we have taken appropriate action to ensure that companies address any problems. Where needed we have a number of powers, which we can use to protect consumers' interests.

We make wide use of comparisons, naming and shaming failing companies and challenging companies to improve. When problems are more serious we make use of our specific powers to enforce statutory standards and licence requirements. For example, we can issue an enforcement order if we consider that a company is failing or is likely to fail to meet its obligations. Since April 2005 we have also had powers to fine companies.

The Water Industry Act 1991 sets out the steps we must take before we can issue a fine. Our 'Statement of policy' explains how we will apply our fining powers. Within this statutory and policy framework, we will pursue the approach we consider will best protect

consumers' interests. This may include obtaining a legally binding undertaking from a company that it will address the problem to a deadline, or in some cases using restorative justice where the company agrees to take additional action at its own expense to remedy the identified problem.

This year, we have taken enforcement action in response to failures in some companies' performance.

Failure to meet leakage targets

Each company has a leakage target, set by reference to its economic level of leakage. This is the optimum level of leakage that balances the cost of repair against the cost of the water lost. Last year, Thames, United Utilities and Severn Trent failed to achieve their three-year rolling average leakage targets. We took regulatory action against all three companies.

For Thames, which failed to meet its annual leakage target for the third time, we accepted a legally binding undertaking that essentially committed the company to:

- undertake an additional 368 kilometres of mains renewal in London at a cost of some £150 million, to be met entirely by the company's shareholders;
- complete the current phase of its Victorian mains renewal programme 12 months early;
- reduce leakage by an extra five million litres a day by 2009-10;
- achieve security of supply by 2009-10; and

- submit to us a fully updated water resource plan.

This approach met the Macrory principles of restorative justice. Professor Macrory's report set out the six principles that regulators should use when applying their enforcement powers to the companies they regulate.

Our action against Thames directly tackles leakage and delivers benefits to consumers in a way that a fine could not. We are monitoring Thames' performance closely, including receiving updates every three months on progress in addition to its June return, which all companies submit each year.

We required United Utilities and Severn Trent to put in place action plans to restore leakage to target levels for 2006-07. United Utilities has made progress in line with its action plan. Severn Trent is on notice that we will consider using our formal enforcement powers in the event of any further failure. We are monitoring both companies' performance closely.

A fourth company, Southern, failed its 2005-06 target by a small margin but remains within the three-year rolling average target. We are satisfied with the company's explanation for the failure and we are not taking formal action at this stage.

Special investigations

During 2006-07 we launched investigations into irregularities in customer service data at two companies (Severn Trent and Thames) and continued our investigation into irregularities at a third (Southern).

Our investigations of all three companies continue, but we have given notice of our proposal to impose financial penalties for each company's failure to meet the performance standards set by the Water Supply and Sewerage Services (Customer Services Standards) Regulations 1989 (as amended) – the GSS Regulations. We are also separately considering whether all three companies may have contravened conditions of their licences by providing us with false information in relation to their customer service performance.

The issues raised by the investigations are complex and take time to investigate thoroughly and obtain all the evidence necessary to take further action. Our work has been carried out by a dedicated team at Ofwat supported by independent accountants.

In July 2006 the Serious Fraud Office (SFO) concluded that the matters at Southern were sufficiently serious to warrant a separate investigation, but it decided in April 2007 not to take its investigation further. We will publish the findings and conclusions on our investigation into Thames, Severn Trent and Southern later this year.

In 2004 we began an investigation following allegations made by a Severn Trent employee, which centred on the handling of the company's accounting and regulatory returns to us. We referred this to the SFO and once it has completed its investigation into the company's leakage data we will present our own findings.

Arm's length trading

Each company is required to trade at arm's length from its associates. United Utilities has failed to do this for a number of years, but has repeatedly assured us that it would put matters right. We adjusted price limits in 1999 and 2004 to protect customers from potential overcharging. We identified in the company's 2006 June return that it was still not complying with its licence. In December 2006, we secured a legally enforceable undertaking from United Utilities that it would change its trading arrangements with associates by 30 April 2007 in order to comply with its licence.

We announced in April 2007 a proposal to impose an £8.5 million fine on United Utilities for contravening its licence condition for the period October 2005 to March 2007. This action reflects the seriousness with which we view this contravention and the need to deter future non-compliance so that consumers' interests are protected and companies adhere to their licence conditions.

Reporting irregularities

As part of our annual monitoring of regulatory information we identified an error in Tendring Hundred's income data. The error related to the company's estimates of its income from metered customers since 2002-03. Tendring Hundred gave us an informal undertaking to ensure that it does not benefit from the error and has put in place adequate systems of control. To correct for the error, the company did not take up its full allowance under price limits in 2007-08. This means that its average customer bill decreased by about 3% instead of increasing by almost 5%.

Jointly with Tendring Hundred we appointed independent auditors to verify the size of the error, how it happened and to recommend improvements to mitigate the risk of similar errors. We are currently considering the auditor's report and the next steps we need to take.

Information to support regulation

We rely on information the companies provide to us to carry out our work. We expect this information to be reliable, accurate and complete. We also expect high standards of corporate governance, including rigorous systems of internal control, to operate throughout each company.

In December 2006, in light of the reporting problems evident at some companies, we required each company and its auditor to review its systems, procedures and controls for compliance with the Guaranteed Standards Scheme (GSS) Regulations and customer service reporting. We asked the companies to report to us and we are currently analysing these reports.

We also reviewed the use of reporters and auditors and our internal processes in reviewing the June returns that the companies submit. As a result, we have taken five actions to ensure the quality of the information each company provides.

- We have clarified our guidance on the information companies are required to submit.
- We have carried out work so that we can be confident that each company has an appropriate corporate governance system in place.
- We are strengthening independent expert challenge by reporters and auditors.
- We take a consistent and proportionate approach across Ofwat to our review and challenge of regulatory information.
- We provide feedback to companies, reporters and auditors following each June return.

Levels of service to consumers

We monitor the services each company provides and include our findings in our annual 'Levels of service for the water industry in England and Wales' report. Research suggests that consumers were generally satisfied with the levels of service and value for money delivered during 2005-06. Since then, companies in the south-east of England have experienced drought. Consumers of seven companies experienced restrictions on water use such as hosepipe bans or sprinkler bans.

During the year we:

- improved the way that security of supply is reflected in the overall performance assessment (OPA). The OPA measures levels of service delivered across a broad range of areas. An adequate supply of water is important to consumers and this change to the OPA reinforces the incentives on water companies to deliver adequate security of supply.
- commissioned with the Consumer Council for Water (CCWater) deliberative research into consumer views on fair charging. This explored consumers' perceptions about all aspects of paying for water and sewerage services, including value for money, fairness and the principles of charging. We will consider consumers' views as we develop our charging policy for the future.

- published information on levels of household revenue outstanding, the recovery costs associated with this and details of the volume of debt recovery actions that the industry had taken. Following a review with stakeholders, we published our conclusions and revised debt guidelines in March 2007. We provide guidelines to set out how companies' debt policies and procedures might best take account of customers' needs. One of our conclusions was that companies that choose to sell debt to third parties should take care to select reputable agents and should only do so after all other debt recovery methods have been attempted.

Disputes and complaints

CCWater represents consumers in the water industry. Since its establishment in October 2005, CCWater deals with the majority of complaints from consumers about the service provided by their water or sewerage company, which the company itself cannot resolve. We continue to support CCWater's complaint-handling role by providing advice on individual cases and by contributing to workshops.

We are responsible for:

- complaints about regulatory policy;
- allegations of breach of duty by a company;
- water supply and sewer connection charges;
- requisitioning of water mains, sewers and lateral drains;
- adoption and financial arrangements in respect of self-laid mains;
- sewer appeals;
- refusals by companies to install an optional meter;
- GSS payments;
- trade effluent appeals; and
- pipe laying in streets and in private land.

We dealt with almost 2,000 disputes and complaints across Ofwat in 2006-07, obtaining

compensation and rebates for customers of more than £2.5 million.

We have reviewed our complaint recording, working practices and standards of service to make sure that our complaint handling process is clear to consumers and meets their expectations, and taken forward our findings.

Table 1 Performance standards

Performance standards	Achievement 2006-07
80% of non-investigated cases within 10 working days	81.5%
65% of investigated cases resolved within 3 months (65 working days)	72%
80% of investigated complaints resolved within 6 months (130 working days)	88%

This year we started asking consumers about how we handled their complaints about their water or sewerage company. During the period October 2006 to 31 March 2007 we received the following responses.

Table 2 Consumers' views

Consumers' views	%
Satisfied or very satisfied with outcome of complaint	52%
Considered that we had dealt with complaint as quickly or quicker than expected	82%
Considered our correspondence clear or clear and easy to understand	92%
Satisfied or very satisfied with way we handled their complaint	53%

We will review our handling of complaints and performance standards again in light of this feedback from consumers.

Consumer representation

During 2006-07 we undertook joint research with CCWater into consumers' views on fair charging, using water wisely and competition. We jointly established systems to deal effectively with consumers' complaints and to provide a one-stop shop when consumers contact either organisation.

Approving charges schemes

Every year, each company sets its charges, within its overall price limit, and publishes these in a charges scheme. We check and approve the schemes before they are published. We make sure that each company's charges:

- comply with its price limit;
- reflect relevant costs; and
- are consistent with guidance from the Secretary of State.

The CCWater regional committees provide advice to us during this process.

We approved each company's 2007-08 charges scheme in February 2007. This year we approved a new tariff for Wessex Water for customers in financial difficulty who are unable to pay their bills in full. We made sure that the tariff does not have a material impact on other customers' bills. We welcome this initiative and would expect any similar initiatives from other companies also to meet this requirement.

Finance and structure

As part of our ongoing monitoring work we examine the companies' financial performance. Where companies seek to restructure we have a role to ensure that efficient companies can continue to finance their functions and that customers are not exposed to undue risk.

Financial restructuring

During the year three companies restructured their water and sewerage businesses. A summary is set out in appendix 1.

It is for each company's management to choose its capital structure. At the 2004 price review we set price limits that assumed a common level of gearing. Companies can choose to adopt a gearing level above this level. However, in such cases the associated risks should be borne by investors, not consumers. Such structures may potentially offer benefits to consumers, if they lead to lower tax charges and a sustainable lower cost of financing. But they remain untested over the medium to long term and in a less benign economic environment.

Protections in each company's licence provide us with reassurance that each company can retain access to the capital markets in the short to medium term. For example, each company must provide an annual certificate of financial adequacy and is required to maintain investment grade credit quality.

In September 2006 we signalled our view that there is merit in water companies adopting cash lock-up provisions similar to those already applied to energy companies. This followed consideration of responses to our discussion paper on financing networks.

The cash lock-up provision sets out the steps we can require the regulated business to take in order to preserve the financial viability of the regulated company. The cash lock-up provision would prohibit, subject to certain limited exceptions, and without our prior consent, the transfer of cash or other assets to an associated company in certain circumstances where the company's investment grade credit rating is threatened.

We will seek to introduce cash lock-up provisions into licences as and when suitable circumstances arise, including financial restructuring.

So far, we have signalled that we propose to introduce this licence condition into the licences of Thames, Severn Trent and Anglian. We are also discussing with Yorkshire a number of changes to its licence, including the cash lock-up provision. This follows the proposed financial restructuring announced by its parent company, Kelda Group plc, in November 2006.

Changes of ownership

A number of water companies were acquired by companies or consortia of investors who, prior to that acquisition, had no material investment in the regulated water companies in England and Wales.

We cannot block acquisitions or mergers of water companies. But to protect the interests of consumers we look to make sure that any owner of a water company is 'fit and proper' to provide such an essential public service. We regulate through the provisions of each company's licence and can impose amendments if necessary. These are subject to appeal by the company to the Competition Commission in the event of disagreement.

Following each acquisition we publish a consultation paper that describes the acquisition and sets out the regulatory issues and our initial assessment of them.

We invite views on the capacity of the acquiring entity and its investors to be the owners of a regulated water business. We also discuss the need for modifications to the water company's licence to ensure it has sufficient financial resources and is appropriately ring fenced.

Once we have considered responses to our consultation, we publish a position note. In cases where we require modifications to a company's licence we publish a notice providing 28 days for respondents to comment on the intended licence amendments. Subject to responses to this notice, we subsequently modify the company's licence.

We dealt with a number of changes in ownership during the year. These are summarised in appendix 1.

South East Water Limited and Mid Kent Water Limited

In October 2006 Utilities Trust of Australia (UTA) and Hastings Diversified Utilities Fund (HDUF) acquired South East Water Limited. UTA and HDUF already own Mid Kent Water Limited and in November 2006 the OFT referred the acquisition to the Competition Commission (CC).

In these cases the CC decides whether a merger has taken place and whether it may be expected to prejudice our ability to make comparisons between water companies.

The CC published its provisional findings in March 2007. It found this merger would prejudice our ability to make comparisons and that this prejudice should be remedied. We sought remedies that:

- benefit the entire customer base;
- are guaranteed;
- provided customers of the merged company with tangible benefits; and
- customers should face no additional costs or drop in service as a result of the merger.

In May the CC published its final report setting out the remedies to offset the prejudice it found to our ability to make comparisons. These included a one-off payment to customers and a reduction to the base operating costs of the merged company at the next price review.

Review of regulatory accounting guidelines

Companies are required to prepare and publish annual regulatory accounts.

Following consultation we introduced additional reporting requirements, and a requirement to include information on the links between directors' pay and standards of performance, a requirement introduced by the Water Act 2003. Other changes to the regulatory accounting guidelines include amendments to:

- reflect changes to statutory reporting requirements;
- align the regulatory accounting tables with the inputs to Aquarius 3, our financial model; and
- clarify our guidance on the infrastructure renewals charge.

We published our summary of the companies' financial results for 2005-06 in our 'Financial performance and expenditure of the water companies in England and Wales' report in September 2006 and placed more detailed information on our website.

Ofwat – Protecting consumers, promoting value and safeguarding the future



Chapter 2 – Promoting value

We undertake a number of activities that promote value. Central to these is the price review that will take place in 2009. At present, we are at an early stage in preparing for the review. In the long term, competition will also promote value for customers by driving companies to be more efficient and provide a better service than their competitors.

Competition

We believe that consumers' interests will be best protected if we promote effective competition in the water industry.

The framework for competition is set out in the Water Industry Act 1991 and by subsequent legislation the Competition and Service (Utilities) Act 1992, the Competition Act 1998 (CA98) and the Water Act 2003 (WA03).

The WA03 introduced a duty on us to protect the interests of consumers, wherever appropriate by promoting effective competition. It also set the framework for the new water supply licensing (WSL) regime.

The Competition Appeal Tribunal's judgements on Shotton Paper Mill (Albion Water vs Water Services Regulation Authority) took up a considerable amount of time and resources in 2006-07, and acted as a spur to our review of competition.

Water supply licensing

The WSL regime was introduced in December 2005. It is only open to consumers who are likely to buy at least 50 million litres of water a year (approximately 2,200 businesses).

Under the WSL regime, appointed water companies have a duty to provide access to their supply systems on reasonable terms. Following consultation in July 2006, we took action to streamline the process. We amended condition R to give appointed water companies an extra month to publish their access codes.

In September 2006 we published version 3 of our access code guidance, which sets out the standard provisions that we expect an

appointed water company to include in its access code or any access agreements. This incorporated changes to the application process, and included a significant reduction in application fees that licensees pay to appointed water companies. High application fees could be a barrier to new entrants entering the market, which is why we introduced a temporary maximum fee payable by licensees.

Review of market competition

We are very concerned with the lack of progress on WSL competition as no customer has yet changed its supplier.

Following an internal review of market competition, including WSL, inset appointments and self-lay, we published our findings and the next steps in April 2007. The review found that:

- retail competition is unlikely to flourish under the current regime;
- the Costs Principle, which governs how access prices are calculated, is an obstacle to competition;
- stakeholders consider that the legal framework for inset appointments should remain unchanged but that the application process could be quicker; and
- the self-lay market generally appears to be operating effectively.

We will consult, later in 2007, on wider aspects of market competition, including WSL issues such as the 50 million litre threshold and access pricing rules, designed to open up the market.

With CCWater we conducted research into business customers' views on competition in the water industry. The results have informed our respective policy positions on competition.

Inset appointments

There is currently a lot of interest in inset appointments for new developments. We continue to work with potential appointees on a variety of inset proposals. In August 2006 we issued RD12/06, 'Updating the inset appointment guidance', asking for stakeholders' views.

We plan to consult on the role of inset appointments later in the summer as part of our wider review of competition. We will update the current inset guidance later in the year, taking account of stakeholders' responses to RD12/06.

Seeking best value for consumers and the environment

We need to protect consumers from the costs of companies delivering services or standards inefficiently or unnecessarily. In this role we challenge the scope of schemes that the companies put forward. We recognise that there is a balance to be struck between improving the environment and what customers are asked to pay for.

For example, at the 2004 price review Thames proposed building a desalination plant at Beckton in London to resolve security of supply issues in east London. Following the refusal of planning permission, Thames appealed to the Secretary of State. We submitted a statement to the inquiry. We recognise that the water that will be produced is relatively expensive and there may be significant environmental implications. However, given the relatively high cost of alternatives, we consider that a desalination plant offers the best value for consumers and the environment in this instance.

In the case of the Thames Tideway, after years of investigation into the options, the Government has decided that a 30 kilometre tunnel should be built to intercept storm sewage alongside the River Thames and to transport the wastewater for treatment in east London. We welcome the clarity brought by the Government's decision but remain concerned about the value for money for water customers of this scheme. We estimate that the cost of more than £2 billion could add an extra £37 by 2017-18 to the average annual bill for Thames' customers. But we consider there is every possibility that when the proposals and options for delivery have been fully evaluated the consequences for customers' bills could be significantly different and potentially higher. We will continue to examine how we can bring competitive pressures to bear on the costs of delivering the project.

Preparing for the 2009 price review

We will next set price limits in November 2009 for the period 2010-15. This year we began our preparations by:

- taking the decision to set price limits for a five-year period and setting this in a longer-term context;
- setting out the timetable for the review, following consultation;
- setting out our expectations for the strategic direction statements we are asking each company to submit later in the year;
- setting up a Chief Executives' group, which will enable information and views to be exchanged between key parties during the review; and
- publishing with Ofgem, in February 2006, a discussion paper, 'Financing networks', which considered ideas for regulating the efficient financing of utility companies' capital investment programmes.

International benchmarking

We continue our work to learn from water and sewerage enterprises and regulators around the world. The information we obtain allows us to put the service to consumers and bills for England and Wales in a wider context. This year we continued to work with the major Scandinavian companies. We also started working with our Portuguese counterpart, the Instituto Regulador de Águas e Resíduos (IRAR), and look forward to publishing robust comparisons from its evolving regulatory regime. We are also developing contacts with a group of Canadian benchmarking partners. In each case, we make valuable comparisons on service, price, efficiency and environmental impact. We also work with regulators in Scotland and Northern Ireland.



Chapter 3 – Safeguarding the future

As well as regulating on behalf of current consumers, we regulate in a way that allows the companies to meet their long-term outputs and continue to provide a high quality service for future generations.

A sustainable water industry

Following consultation we brought together a number of cross-cutting themes, particularly the need to further develop long-term planning in a number of areas, in our document, 'A sustainable water industry – To PR09 and beyond'. We concluded that we:

- would work in accordance with the Government's five principles of sustainable development;
- should set price limits for 2010-15 within a long-term context; and
- would take an integrated, long-term approach to each company's capital maintenance and asset management proposals.

In April 2007 we published our sustainable development action plan in our forward programme for 2007-08 to 2009-10. This sets out how our work fits with the five principles of sustainable development. A key contribution to sustainable development will be the delivery of a successful price review.

Water resources

Our role is to protect consumers and to make sure that the needs of consumers are balanced with those of the environment. A guaranteed safe supply is a priority for consumers.

As part of their long-term water resource planning we expect companies to demonstrate that they have assessed the willingness of their customers to pay higher bills to avoid restrictions and balance this against the cost of reducing restrictions.

During the extended dry period, which started in the winter of 2004-05, we worked with water

companies, the Environment Agency and CCWater to protect consumers.

Water companies successfully minimised the risk of serious supply problems in the south-east during the summer of 2006 by using restrictions, undertaking additional leakage control and through their water efficiency programmes.

Companies made use of drought orders and permits, and introduced restrictions on non-essential use such as hosepipe and sprinkler bans. Only Sutton & East Surrey needed to implement a non-essential use drought order, enabling it to restrict the use of water for non-essential purposes such as filling privately owned swimming pools or operating ornamental fountains.

Although the winter of 2006-07 was much wetter than average and the immediate concerns have receded, we need to learn from the experience. We welcome proposals from the Department for Environment, Food and Rural Affairs (Defra) and Welsh Assembly Government to clarify the rules on future hosepipe bans. We also welcome the proposals in recent consultations launched by the Environment Agency and Defra to identify and encourage compulsory metering in areas of serious water stress. Increased metering, where it is economic, will enable more innovative tariffs to be implemented that will allow consumers to make more informed choices about their consumption of water and sewerage services.

Companies have a duty to promote the efficient use of water by consumers. We continue to monitor their work in this area and report on it annually in our 'Security of supply, leakage and water efficiency' report. We expect companies to work on improving water efficiency and to increase their activity during

increased value of the water saved. This year we wrote to Sutton & East Surrey and Dee Valley about their 2005-06 performance and asked them to increase their efforts on water efficiency.

We continued to play an active part in the work of the government-led Water Saving Group. The group is made up of representatives from Defra, the Department for Communities and Local Government (DCLG), the Environment Agency, CCWater, Waterwise, Water UK, and us. The group was established in 2005 to monitor and review projects in relation to efficient water use. We are leading a sub-group on developing best practice in water efficiency and incentives for companies to promote water efficiency.

In November 2006 we published a register of good practice by companies in water efficiency activity. The register, which will be updated each year, provides an evidence base for particular types of water efficiency activity and a checklist for companies undertaking activities in this area.

We were also involved in research commissioned by CCWater into:

- consumer awareness, attitudes and behaviour towards valuing water;
- their attitudes and inclination towards efficient water usage; and
- which methods will encourage consumers to use water more wisely in the future.

We continue to develop our approach to leakage regulation and improve the advice we give to companies on managing leakage. After consulting key stakeholders, we commissioned, with the Environment Agency, three projects to improve decision making and understanding of our approach to setting economic levels of leakage targets. These cover:

- variations in per capita consumption;
- alternative approaches to leakage target setting; and

- improvements to how companies incorporate environmental and social costs into leakage planning.

We will use the outcomes of these projects to develop the current approaches to leakage and leakage target setting. As set out in chapter 1, we took action where companies were not meeting their leakage targets.

Parliament and the public held our work under close scrutiny as the drought continued through 2006. We have contributed to investigations by the House of Lords Science and Technology Committee and by the National Audit Office (NAO).

In its report, 'Ofwat – Meeting the demand for water' (January 2007), the NAO made a number of recommendations about our approach to water efficiency, leakage, incentives and enforcement. We accepted the NAO's recommendations and have already initiated a number of pieces of work to address them. For example, we are clarifying our guidance for including water efficiency projects in water resource and business plans.

We attended a Public Accounts Committee (PAC) hearing in January 2007 to answer questions about the NAO's findings. The PAC published its recommendations in May.

Improving drinking water quality and the environment

The price limits we set for 2005-10 assume a work programme that will deliver and consolidate improvements to drinking water quality and lessen the impact of the sewerage service on the environment.

We receive annual reports from the Drinking Water Inspectorate (DWI) and the Environment Agency, as well as each company's June returns. We have used this information to assess the companies' progress at the end of the first year of the substantial investment programme. Where necessary, we adjusted the schedules on our website to reflect changes to the agreed programme of

work between the company and the Environment Agency for the sewerage service. Where the changes are non-trivial we will make appropriate adjustments to the regulatory capital value of the companies affected at the next price review.

We held joint environmental performance meetings with the Environment Agency and the ten water and sewerage companies to discuss their performance over the past year. This included an update of progress in delivering the enhancement programme. Although this was only the first year of a five-year programme, relatively few schemes were completed. We paid particular attention to significant changes to the improvement programme, such as those affecting intermittent discharges for United Utilities and the Thames Tideway.

We also held a number of joint meetings with companies and the DWI where we had concerns relating to progress on drinking water quality enhancement projects.

Water Framework Directive

We continued to work with other government departments to support implementation of the Water Framework Directive (WFD). We want to secure an outcome that is fair, proportionate and in the interests of consumers. We aim to provide well-balanced, sound information relating to the water industry, on which decisions on appropriate measures required under the WFD can be taken. This should ensure that water company customers pay a fair share, but no more, of the costs of implementing the WFD over the three river basin planning cycles to 2027.

This year we have:

- participated in the Defra-chaired stakeholder and implementation meetings;
- responded to the consultation paper on the river basin planning process; and

- contributed to the Defra-led collaborative research programme to develop the economic analysis necessary to inform the river basin planning process.

We are also chairing and co-ordinating the contribution of the water companies to the Defra-led preliminary cost-effective analysis, which is investigating the potential costs and mechanisms to deliver the environmental objectives of the WFD across all sectors.

Impact assessments

We have reviewed the impact assessment process that we use to challenge our policy decisions and have developed an improved impact assessment tool. We have recognised we need to build impact assessments into all our decision making to a greater extent than we have in the past. The new assessment tool will help us to examine our decisions against our consumer and sustainable development objectives, as well as considering the costs and benefits.



Chapter 4 – How we do our job

Accountability

We are accountable to Parliament and the National Assembly for Wales.

In 2006-07 we gave evidence to the PAC on managing demand and the House of Lords Select Committee on Regulators. In addition, we responded to the House of Lords Science and Technology Committee's report on water management. We attended and presented at meetings of the All Party Parliamentary Water Group (APPWG), working with the group's secretariat to keep Members of Parliament (MPs) informed of water industry issues.

During the year we corresponded with more than 80 MPs, Assembly Members and other elected representatives, and helped provide answers to many written parliamentary questions.

Our library and information services team has most contact with the public and handles the majority of enquiries. In 2006-07 we dealt with nearly 4,000 telephone enquiries and replied to more than 2,000 written enquiries. The number of written enquiries rose by 17% compared with the previous year. Some of this increase related to drought issues and the higher profile of the industry generally.

We aim to answer 95% of written enquiries within ten working days but the increase in enquiries this year has meant that we only achieved a response rate of 90%. This is the first time we have ever missed this target. We expect to return to our usual level of performance.

Stakeholder engagement

We seek to communicate effectively and operate transparently. We regularly meet with key stakeholders, including the companies, Defra, Welsh Assembly Government, the Environment Agency, the DWI, CCWater, Natural England, the Countryside Council for Wales and Water UK.

This year we again placed all of our publications on our website, including details of all our main proposed policy changes, responses to our consultations and explanations of our decisions.

Events and workshops

During 2006-07 we held a number of events and workshops, including:

- a forward programme workshop to discuss our draft forward work programme for 2007-08 until 2009-10 (we consulted on this between December 2006 and February 2007); and
- a briefing to the City on our views on financial and regulatory issues such as the cost of capital, relative levels of gearing, profits and changes in ownership.

www.ofwat.gov.uk

Our website is our prime communication tool and we aim to keep it up to date and accurate. We recently initiated a website redesign project, Project Connect. We are consulting with users to see what improvements they would like to the site's content, structure and functionality. We aim to launch a new, improved website in 2008.

Resource management

Recruitment and diversity

We value the diversity of our staff and recruit staff on merit through fair and open competition. Recruitment activities are subject to external audit by the Civil Service Commissioners to check that we comply with the guidance set out in their recruitment code.

During the year we undertook 31 separate recruitments, which in some cases sought more than one member of staff. The results are summarised in table 3.

**Table 3 Staff recruitment during 2006-07
(by gender and ethnic group)**

Level	Number appointed	Proportion of women (%)	Proportion from ethnic minorities (%)
Head of team/function	3	67	33
Middle management	18	56	11
Clerical and secretarial	16	75	44
Total	37	65	27

Everyone was recruited through open competition, with the exception of two staff on casual appointments.

Ofwat has a total staff of 190 (full-time equivalent, as at 31 March 2007) of whom:

- 58% are women;
- 22% are from ethnic minority groups;
- 7 are members of the Senior Civil Service (4 men and 3 women);
- 12 are employed on fixed-term and casual contracts;
- 14% work part-time; and
- 1% are disabled.

Staff turnover is currently running at 12%.

Learning and development

This year we were re-accredited with the Investor in People standard, demonstrating our commitment to develop our staff so they can make the most of their potential.

Senior staff changes and remuneration

Under the Water Act 2003, our new Board replaced the Director General on 1 April 2006. The Board is made up of:

- a part-time Chairman – Philip Fletcher (10 to 12 days a month);
- five other non-executive directors (two days a month) – Penny Boys, Michael Brooker, Peter Bucks, Jane May and Gill Owen;
- a Chief Executive – Regina Finn; and
- two executive directors – Melinda Acutt and Keith Mason.

In February Andrew Dunn joined us as Director of Consumer Protection Division.

The Chairman’s salary is £100,000.

Salaries for members of the Senior Civil Service (as at 31 March 2007):

Chief Executive 60,000 – 65,000 (full year equivalent £130,000)	1
100,000 – 105,000	1
95,000 – 100,000	1
85,000 – 90,000	1
80,000 – 85,000	2
5,000 – 10,000 (full year equivalent £75,000 – £80,000)	1

Diversity

We check that staff do not receive less favourable treatment because of their race or background. None of our ethnic staff were involved in disciplinary procedures during the year, nor were there any grievance cases due to race or ethnic background. The table below sets out staff training attendance by ethnic group.

Table 4 Staff training attendance 2006-07 (by ethnic group)

Ethnic group	Number of days training*	%**
White	365	85
Other ethnic groups	62	15
Total number of days	427	100

* Number of days have been rounded up.

** Percentage has been rounded to the nearest whole number.

Workplace management

During the year we started a programme of work to upgrade our office accommodation. This will conclude in 2007-08 with a reduction in our overall space requirement and accommodation costs.

We continue to put in place environmentally friendly practices and in the past year promoted public transport for journeys to and from work. This led to an increased uptake among Ofwat staff of the Travelwise discount scheme. In 2006-07, 40% of Ofwat staff took part in the scheme.

Information management and technology

In summer 2005 we launched Project Reservoir, a long-term project to restructure the office-wide software suite that we rely on to collect, process and store regulatory information. We are developing, in-house, an innovative approach, using web browser technology to deliver systems that will be flexible, open and powerful. Project Reservoir uses open source software, which will make our systems transparent and freely available to our stakeholders. We have shared our progress with the water industry to prepare the companies for the new system – particularly the June return 2007 information capture system – which they will begin to use during 2007.

We have also initiated a review of our information technology hardware provision and the potential to increase the amount of remote working. This review combines value for money and sustainability, and should improve the performance of our systems.

Finance

The financial information provided is the latest available forecast and is subject to external audit by the NAO. Accounts are prepared in accordance with HM Treasury's resource accounting requirements.

There was an estimated 7% underspend of £888,000. This arose from a reclassification of some revenue to capital projects, contingency not required and in year savings on pay and non-pay. We will use £600,000 of this underspend to offset against licence fees in 2007-08. The remainder will be carried forward. The tables opposite provide a breakdown of our estimated income and expenditure, administration costs and resource allocation for 2006-07.

Table 5 Estimated income and expenditure 2006-07

	£000s	£000s
Income		
Licence fees recovered	11,804	
Other income	456	
Licence fees unused to carry forward	(744)	
Total income		11,512
Expenditure		
Permanent staff	7,196	
Personal overheads	555	
Consultancy projects	1,086	
Accommodation	1,136	
Accommodation upgrade	192	
Non-cash items, eg depreciation	322	
Other	1,025	
Total expenditure		11,512

Table 6 Administration costs – by activity group

	2006-07 estimated outturn (£000s)
Regulatory monitoring and action	5,071
Corporate affairs and legal services	2,324
Finance, human resources, facilities management, information management and technology	2,223
Accommodation	1,894
Total expenditure	11,512

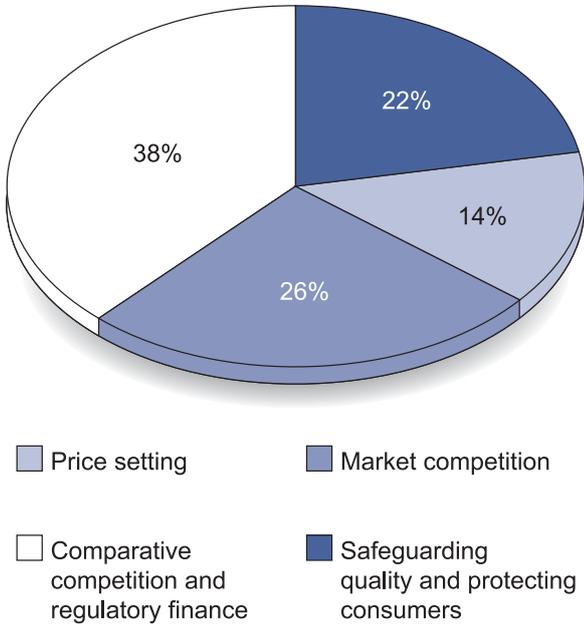
Table 7 Our administration costs

	2005-06 outturn (£000s)	2006-07 estimated	2007-08 plans (£000s)
Gross administration costs:			
Staff	6,896	7,196	8,342
Other	3,675	4,316	4,658
Total gross administration costs	10,571	11,512	13,000
Related administrative receipts from licence fees and other minor receipts	(10,571)	(11,512)	(13,000)
Total net administration costs	–	–	–

- Notes:**
1. This table is included as a requirement stipulated by HM Treasury. Outturn figures are taken from our published resource accounts. We operate on the basis that licence fees recovered from the industry should cover our costs.
 2. 2006-07 gross administration costs are based on estimated outturn and are subject to review by audit.
 3. Other administration costs for 2006-07 include the accommodation upgrade and Competition Appeal Tribunal costs.

The chart below provides an estimate of how our resources were allocated to the main areas of work.

Figure 1 Resource allocation (%)



Audit

The financial and risk management systems and reports are scrutinised by the Audit Committee. Members of the committee are Peter Bucks (Chairman) and Penny Boys, both non-executive directors. Audit Committee is attended by NAO, Internal Audit (KPMG), Regina Finn, Roger Dunshea and senior finance staff. The Audit Committee met three times during the year and looked at a number of issues, including internal audit reports, internal accounts, financial and procurement systems and monitoring staff sickness.

Risk management

We have revised and updated our risk management procedures. The Board and Audit Committee receive regular reports on the operational and business risks that we face as an organisation and how these are being managed.

Table 8 Consultancy and professional services expenditure summary 2006-07 (company contracts costing more than £50,000 excluding VAT)

Project	Supplier
Recruitment of Chief Executive	Odgers
Accommodation upgrade	EC Harris

Resource accounts

The resource accounts for 2005-06 were published in July 2006 (HC1484). The accounts received an unqualified audit certificate from the Comptroller and Auditor General. The resource accounts are prepared in accordance with the Government Resources and Accounts Act 2000 and directions issued by HM Treasury.

Appendix 1 – Financial restructuring and changes in ownership from outside the industry

Table 9 Summary of financial restructuring

Company	Date	Description	Licence modifications sought
Thames Water Utilities Limited	September 2006	Increase over time in the level of debt finance as a percentage of the regulatory capital value to the low 60s, preceding sale of the appointee	Cash lock-up provision
Severn Trent Water Limited	October 2006	Increase in the level of debt finance to around 60% of the regulatory capital value	Conditions F and P to be modified to current standard, including cash lock-up provision and conditions relating to adequate systems of planning and internal control
Yorkshire Water Services Limited	November 2006 (announced)	Increase in the level of debt finance to around 60% of regulatory capital value	We are discussing with Yorkshire Water a number of modifications to its licence

Table 10 Summary of changes in ownership from outside the industry

Company	Date	Acquisition vehicle	Licence modifications sought
Sutton & East Surrey Water	January 2006	Aqueduct Capital (UK) Ltd	No further changes but modifications originally sought as a result of Kellen Acquisitions Limited purchase of Sutton & East Surrey (April 2005) carried forward such that conditions F and P modified to current standard
Bristol Water	May 2006	Sociedad General de Aguas de Barcelona, S.A.	Condition P modified to current standard
Anglian Water	October 2006	Osprey Acquisitions Ltd	Conditions F and P modified to current standard, including cash lock-up provision
Thames Water	December 2006	Kemble Water Ltd	Conditions F and P modified to current standard, including cash lock-up provision and conditions relating to adequate systems of planning and internal control
Sutton & East Surrey Water	January 2007	Syndication of Deutsche Bank AG's stake in Aqueduct Capital (UK) Ltd	Licence modified to include cash lock-up provision

In November 2006 the OFT referred the merger of South East and Mid Kent to the Competition Commission. The CC published its report on 1 May 2007.

Appendix 2 – Competition law cases

We have concurrent powers with the Office of Fair Trading (and certain other sectoral regulators) to enforce the Competition Act 1998 (CA98) and European competition law in the water and sewerage industry in England and Wales. This allows us to investigate allegations of anti-competitive behaviour and take appropriate enforcement action to protect consumers.

This year we responded to a Department of Trade and Industry and HM Treasury review of the regulators' use of their concurrent powers in December 2006.

Appeals

If a complainant is not happy with a decision we make under the Competition Act 1998 they can appeal to the Competition Appeal Tribunal (CAT).

During 2006-07 we addressed a number of appeals to the CAT against our decisions or actions. These are summarised below.

Table 11 Summary of Competition Act appeal cases

Case	CAT decision	Update
Albion Water Limited v Water Services Regulation Authority (formerly the Director General of Water Services) – Dŵr Cymru/Shotton Paper	The CAT found that Dŵr Cymru held a dominant position in the market and found the company guilty of margin squeeze (third judgement, December 2006)	We are currently doing some work on reasonably attributable costs of the transportation and partial treatment of water, which the CAT referred back to us
Albion Water Limited v Water Services Regulation Authority (formerly the Director General of Water Services) – Thames Water/Bath House	The CAT set aside only one part of our decision. The CAT did not remit the matter back to us because it considered the WSL regime addressed the problem going forward	n/a
Independent Water Company (IWC) Limited v Water Services Regulation Authority (formerly the Director General of Water Services)	The CAT handed down its judgement on 26 January 2007 and found in our favour, ruling IWC's appeal to be inadmissible	n/a



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