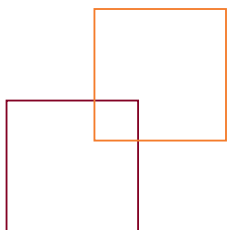


Review of Ofwat and consumer representation in the water sector



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Foreword

Dear Secretary of State and Welsh Minister,

In September 2010 you asked me to lead a review of Ofwat, the economic regulator for the water sector in England and Wales, and of the arrangements for consumer representation in the sector. The Terms of Reference for the review asked us to assess whether the existing arrangements are fit for purpose in the light of the future challenges the sector faces and to recommend changes where appropriate.

Ofwat has contributed to significant achievements in the water sector since it was established in 1989. In that period the industry has invested some £90 billion and has achieved substantial improvements in water and environmental quality. The stability and predictability of the regulatory regime have facilitated the financing of this investment while Ofwat's efforts to improve efficiency in the sector have significantly reduced the impact on consumers through higher charges.

No-one we spoke to recommended radical change to the sector's regulatory arrangements. However, the sector faces substantial future challenges. Ofwat needs to make some important changes to the way it works to allow the companies it regulates to address these challenges as best they can. In particular, Ofwat must work more closely with other stakeholders and should take a series of steps to allow the companies to be more proactive in their approach. To play its part, Government must be clear on its policy objectives for the sector. Continuing effective consumer representation will also be essential.

Although the scope of the review was restricted to Ofwat and consumer representation the regulatory arrangements in the sector are complex and it is clear to me that implementation of our recommendations will require effective engagement between Ofwat and a range of other stakeholders, including Government, the other regulators, consumer representatives and the companies themselves. Our recommendations are primarily directed towards Ofwat but all parties need to work together to ensure a successful outcome.

I am encouraged by the willingness shown by a wide range of stakeholders to participate in the review and I would like to thank them all for providing us with their views and helping us to develop our thinking. I would like to extend particular thanks to Ofwat, the Consumer Council for Water and the regulated companies for their extensive help in providing briefing and responding to our questions. Thanks are also due to the wide range of officials in Defra and the Welsh Government who helped us in our work.

Finally, I would like to thank the review team in Defra, Tony Ripley, Anita Payne and Adam Stevens, for all their support and hard work over the past year.

David Gray

Executive Summary

The review was established to assess whether the existing arrangements for economic regulation and consumer representation in the water sector are fit for purpose in the light of the future challenges it faces, and to recommend changes where appropriate. The review team's main conclusions are that regulation in the water sector has worked well since privatisation and that major changes to the statutory and institutional framework are not required.

However, we identified a need for clarity in the UK and Welsh Governments' objectives for the sector and some key areas in which improvements could be made to the way in which the regulatory regime operates. In particular, Ofwat should work more constructively with the other regulators in the sector and needs to reduce substantially the burden that regulation places on the water companies. We also concluded that the current functions of the Consumer Council for Water should be retained in any reorganisation of consumer representation and we express a preference for continuation of the status quo.

Background to the review

The review was commissioned by the Secretary of State for Environment, Food and Rural Affairs and Welsh Ministers in August 2010. Our purpose was to consider whether any changes were needed to enable Ofwat to continue to operate a robust, predictable, independent and cost-effective regulatory regime and for the UK and Welsh Governments to achieve their desired policy outcomes. We were also asked to consider how effectively the views of water consumers influence the way the sector is managed and regulated. The review will feed in to the development of the Water White Paper to be published later this year and will inform the Welsh Government's future policies on water.

The review is one of a series of projects considering the approach to regulation in the water sector and elsewhere. Anna Walker's review of charging for household water and sewerage

services looked at the fairness and effectiveness of the current methods of charging. Martin Cave conducted a review of competition and innovation in water markets. More recently the Department for Business, Innovation and Skills has published documents setting out the principles for economic regulation and considering consumer representation in the regulated sectors.

Ofwat itself has launched a wide-ranging reassessment of how it regulates the sector, looking at the scope for increasing the role of competition and markets, developing better ways of regulating the core monopoly businesses and moving towards a risk-based approach to compliance. These projects are ambitious in scope and could lead to significant changes in the way that Ofwat fulfils its role.

Against this background we were asked to consider the overall framework for regulation of the water sector, Ofwat's relations with other stakeholders, its governance and the value for money it provides, its contribution to sustainable development and to minimising the burdens from its regulatory activity, and the scope for learning from good practice by other economic regulators. We were also asked to consider the current arrangements for consumer representation in the sector. The full Terms of Reference are set out in Annex A.

Recommendations for Government

Clarity on policy and roles

We found a widespread desire among stakeholders for greater clarity on the Government's objectives for the sector and on the respective roles of Government, Ofwat and the other regulators. This was most evident in relation to the potential extension of the role of competition and markets and the introduction of social tariffs.

We recommend that the UK Government should take the opportunity of the forthcoming White

Paper to set out clearly its future policies for the sector and the role of the various regulators in implementing policy. The Welsh Government should also clarify any changes to its policy position following the Welsh Assembly election. These policy statements should be combined with clearer guidance to Ofwat as to how it should seek to balance its various duties in arriving at regulatory decisions. We would also see value in more specific memoranda of understanding between Ofwat and the UK and Welsh Governments setting out clearly their respective roles.

Ofwat's statutory duties

We do not recommend changes to the wording or status of Ofwat's statutory duties. Its primary duties are to protect the interests of consumers, to ensure that the companies it regulates can finance their functions and to ensure that these functions are properly carried out. The only area in which we heard any significant call for change was in relation to the status of its secondary duty to contribute to the achievement of sustainable development. We acknowledge the concern of some stakeholders that Ofwat does not do enough to fulfil this duty, but we are not persuaded that elevating its status in the hierarchy of duties would have the effect that these stakeholders seek. To the extent that a change of approach is required we consider it is more likely to be encouraged by more explicit guidance from Government and by some of the changes we recommend in the way that Ofwat approaches its role.

Recommendations for Ofwat

There are two main areas in which we would like to see changes in the way that Ofwat behaves. First, Ofwat needs to engage more constructively and effectively with the full range of stakeholders in the sector and be more transparent in its decision making. Secondly, it needs to reduce the burden of regulation on the companies to encourage them to be more flexible and innovative in their approach.

Relationships with other stakeholders

The regulatory landscape in the water sector is complex. Ofwat regulates a large number of companies, ranging from large incumbent water and sewerage companies to small new entrants. There are two other regulators, the Drinking Water Inspectorate and the Environment Agency, which have the ability to impose obligations on the companies. In developing their business plans the companies are subject to a number of planning processes and other inputs which may be consulted upon separately and have varying degrees of statutory force. Consumers, who have a strong interest in ensuring that the required quality standards and other objectives are delivered at an acceptable cost, are represented by the Consumer Council for Water.

With so many interested parties it is essential that Ofwat engages effectively with other stakeholders and that its role is clearly understood and accepted by all concerned. In practice, stakeholders gave us the impression of a rather remote organisation that tends to impose its own views on the companies, often without adequate explanation, through the price control process. It is clearly correct for Ofwat to be independent and to make decisions in the context of its statutory duties, but independence of decision making does not require Ofwat to act in isolation.

We did not find evidence that Ofwat's approach has significantly undermined the work of the other regulators or the achievement of the Government's objectives for the sector, but it does appear to have had some unhelpful effects such as introducing an unnecessary degree of friction into the price control process and involving the companies and others in wasted or duplicated effort. A better approach would involve more "joined up" efforts between the various regulators and the Consumer Council for Water to achieve clarity of approach and minimise the disruptive effects of the regulatory process on the companies. We therefore make a series of recommendations about how Ofwat

should engage with other stakeholders and explain its decisions. We do not accept that such engagement would compromise Ofwat's independence. Ultimately, Ofwat must make its own decisions in the context of its statutory duties and powers, as must the other regulators in the sector, but there is scope for Ofwat, and the other regulators, to adapt their processes and ways of working to allow more efficient and effective regulation of the sector in the round.

Consultation and engagement

We heard widespread concern about Ofwat's approach to consultation and engagement, suggesting that Ofwat does not take the views of others properly into account and that the reasons for its decisions are often not clear. We also saw evidence of a lack of trust between Ofwat and the companies it regulates. This seems to be partly related to historical issues over data falsification but it also reflects the point about transparency of decision making. The relationship between a regulator and the companies it regulates will never be free from friction, but the companies should feel they are able to predict Ofwat's decisions with a reasonable degree of confidence so that they can react to changed circumstances without the need for direct regulatory approval of their actions. The presence of other regulators in the sector and the large number of interested parties means that it is particularly important that Ofwat engages effectively with all relevant organisations. Greater transparency and clarity of decision making should help in this respect.

The burden of regulation

We found a clear consensus that the burden imposed on the companies by the regulatory regime is excessive and needs to be reduced. This is important in its own right but the problem goes further than just the scale and cost of the regime. We saw considerable evidence to suggest that Ofwat goes too far into the detail of company business plans and that, as a result, the companies are very Ofwat-focussed and very cautious and

conservative in their approach. Rectifying this will require a substantial change of approach by both Ofwat and the companies it regulates.

There is also some evidence that the system of incentives applied by Ofwat may be too focussed on penalties and compliance as opposed to positive incentives for desired changes of behaviour. We recommend that Ofwat, in conjunction with the companies, should set clear targets for a substantial reduction in the burden of regulation and suggest that progress towards these targets should be monitored by the National Audit Office. We also recommend that Ofwat, in its current review of its use of incentives, should seek to ensure that the future framework of incentives sets the right balance between rewards for success and penalties for failure.

Changing company behaviour

The changes we recommend in these areas are important because everyone we spoke to acknowledged that the water sector faces substantial future challenges. There was some disagreement about whether these challenges were new and exactly how they should be addressed but no-one suggested they did not exist. Government and the regulators must set the policy objectives and required outcomes but it is the companies that will have to take the necessary action and it would be much better for them to take the lead and to have the freedom and flexibility to devise innovative solutions that are in the best interests of consumers. This will require a substantial change of approach and culture both in Ofwat and in the companies themselves.

Better co-ordination of input from the quality regulators and consumer representatives to Ofwat's price review should reduce the risk of them passing confusing or conflicting messages to the companies and allow the development of better business plans with clearer objectives. A reduction of the burden of regulation should free up management time for other purposes; more importantly, it should return ownership of

the business plans to the companies and provide more flexibility in their implementation. Finally, an appropriate use of positive incentives should encourage the companies to be more proactive and innovative in their approach. Each of these issues is important in itself but in combination they could provide a powerful stimulus towards an improved system of regulation and facilitate the achievement of Government's objectives for the sector.

Licence modernisation

We support Ofwat's project to modernise, simplify and standardise the companies' Instruments of Appointment ("licences"). Modernisation and simplification of the licences is a desirable objective in itself. Greater standardisation would enhance Ofwat's ability to pursue improvements in company performance through the introduction and enforcement of licence conditions: for instance, it would facilitate our recommendation that Ofwat should take steps to improve the companies' standard of service to third parties such as housing developers.

Accountability

Many stakeholders told us that Ofwat was not sufficiently accountable either to Parliament or to stakeholders in general. To improve the position we recommend that Ofwat should develop a series of outcome-based objectives and performance measures which would allow its effectiveness and the value for money it provides, to be assessed more readily. The National Audit Office should be involved in agreeing these objectives and, from time to time, in monitoring Ofwat's progress towards them, as part of its assessment of the value for money Ofwat provides.

Ofwat's independence

None of our recommendations are intended to reduce or restrict Ofwat's independence. The importance of independence has been recognised in the UK Government's '*Principles for Economic Regulation*'. However, this independence needs

to be exercised, as far as possible, in the context of transparent decision making and constructive relationships with other stakeholders; otherwise the legitimacy of Ofwat's decision making may be undermined.

Consumer representation

The Consumer Council for Water (CCWater) currently provides advice to water company customers, handles their complaints, and represents their views to Government, Ofwat and the other regulators. We found a high degree of support for these functions and approval of CCWater's role in providing them.

After the review began, the Secretary of State for Business, Innovation and Skills announced his intention to make changes to the institutional landscape for consumer and competition policy. Subject to the agreement of sponsoring Departments, this would involve transferring the consumer-related research and advocacy functions in the regulated sectors into Citizens Advice.

We consider it essential that the functions currently undertaken by CCWater should be preserved in any new institutional arrangements and, while we accept that there are alternative models for achieving this, we see real value in retaining CCWater in its current role. We also see a degree of risk in making substantial changes to the approach to consumer representation in the water sector at a time when significant changes to the regulatory arrangements are under consideration. Our recommendation is that the current arrangements involving CCWater should be retained.

Introduction

Ofwat and the water sector

The water industry in England and Wales was fully privatised in 1989. Ten water and sewerage companies were created from the publicly owned Regional Water Authorities. These were sold by way of a major stock market flotation, joining the twenty nine generally much smaller private water supply companies already in existence. To ensure that these companies delivered a public service at good value Ofwat was established as their independent economic regulator.

Today, after some consolidation among the smaller companies, Ofwat regulates ten water and sewerage companies (WaSCs) and twelve water only companies (WoCs)¹. Through the 'New Appointments' (or 'inset') regime there are also now five New Appointees and following the introduction of measures to permit competition in the Water Act 2003 Ofwat also regulates seven water supply licence (WSL) holders. There are therefore twelve 'new entrants' but six of these are subsidiaries of the twenty two incumbent water companies.

The Water Act 2003 also replaced the Director General for Water Services with the Water Services Regulation Authority (WSRA) as the responsible body for economic regulation of the water sector. This created a board structure based on the corporate sector model, led by a non-executive Chairman².

The Welsh Government is responsible for water policy in Wales and water companies wholly or mainly in Wales. The Secretary of State is responsible for water policy in England and water companies wholly or mainly in England. Ofwat and the Consumer Council for Water (CCWater)

are both co-sponsored by the Department for Environment, Food and Rural Affairs (Defra) and the Welsh Government. The Secretary of State appoints the Chair and board of the WSRA in consultation with the Welsh Ministers. In CCWater's case the Secretary of State appoints the Chair in consultation with the Welsh Ministers and appoints the English Regional Chairs and independent members to the board. The Welsh Ministers appoint the Chair of the Welsh Committee to the CCWater board.

Both Ofwat and CCWater recruit their respective Chief Executives in consultation with the Secretary of State. In Ofwat's case, the Secretary of State consults the Welsh Ministers when appointing the Chief Executive and other non-executives to the WSRA. HM Treasury appoints Ofwat's Accounting Officer and sets Ofwat's annual budget. Defra and the Welsh Government appoint CCWater's Accounting Officer and set CCWater's budget.

Background to the regulatory framework

Regulatory framework

The water and sewerage sector is characterised by a system of tripartite regulation, with Ofwat responsible for economic regulation, and the Drinking Water Inspectorate (DWI) and the Environment Agency (EA) responsible for drinking water and environmental quality respectively.

The EA and the DWI were also established at the time of privatisation (the EA under the guise of the National Rivers Authority)³. They have their own separate statutory duties and responsibilities, which include the regulation of drinking water quality and the environmental requirements to be met by water companies.

1 Through the remainder of this report we generally refer to "water companies" or "the companies". Both these terms should be taken to mean both water and sewerage companies and water only companies.

2 The Office for Water Services was the name of the non-ministerial Government department that served the Director General and Customer Service Committees, but it was not a legal body in its own right. Collectively the WSRA and the department is known as "Ofwat". For simplicity, and to reflect the way that Ofwat and the WSRA specifically were referred to throughout the responses to the call for evidence, the review normally refers to Ofwat and its "Board".

3 The DWI and the EA are commonly referred to as the "quality regulators" in the water sector and are referred to occasionally as such in this report.

As the water sector is largely controlled by strong monopoly businesses, consumer representation is particularly important. Consumers are represented by the Consumer Council for Water, which was established in 2005, under the Water Act 2003. Previously part of Ofwat, known as Water Voice, CCWater is an independent organisation which handles complaints, gives advice to consumers and provides advocacy and input into the price review process (see below).

Ofwat, as the independent economic regulator, is also responsible for protecting the interests of consumers while ensuring that water companies carry out and are able to finance their functions, which include the meeting of environmental and drinking water requirements.

In addition, water companies are either subject to, or responsible for, several different statutory planning processes, each with its own methods of development, scrutiny (including public consultation) and approval.

These many planning processes, along with the tripartite system of regulation, mean that some functions and actions of the water companies are specified by organisations other than Ofwat. However, decisions regarding the funding of these functions and actions are Ofwat's responsibility solely.

The majority of the drinking water and environmental standards the companies have to meet derive from European Union (EU) legislation with which the UK Government is required to comply. The UK and Welsh Governments also set wider social and environmental policies which apply to the water sector.

The quality regulators have their own enforcement powers to require water companies to take action in areas covered by their statutory responsibilities, and there are separate appeal processes relating to these powers.

Price review process

Ofwat has sole responsibility for setting price limits as a condition of water companies' appointments. Ofwat has undertaken four price reviews (PRs), each of which has set price limits for each company for five years. These reviews are commonly referred to as PR94, PR99, PR04 and PR09⁴, reflecting the year in which the review was completed. PR09 set price limits for 2010-15.

In general, a price review involves Ofwat assessing and challenging each company's business plan to determine how much revenue will be required to allow the company to meet its obligations and earn a reasonable return on its capital. In order to develop business plans, the companies require information about how Government policies may affect their obligations over the price control period. The UK Government therefore informs the companies and Ofwat of the full range of relevant policies and legal requirements that will apply in the review period; most recently by way of a Statement of Obligations⁵.

While the main steps in a price review are standard, each price review has been different, with new mechanisms and processes identified to address the particular circumstances of the review.

Other planning processes

River Basin Management Plans are required by the Water Framework Directive. They are prepared by the Environment Agency and signed off by the Secretary of State. The current plans cover the six year period 2010-2015 and set out how EU Member States expect to achieve the objective of the Directive in relation to reaching 'good ecological status'. The plans look across all sectors including the water industry which may affect the achievement of the WFD's objectives.

4 Or Asset Management Period (AMP) 1-4.

5 Statement of Obligations, Information for Water and Sewerage Undertakers and Regulators on Statutory Environmental and Drinking Water Provisions Applicable to the Water Sector in England, Defra (December 2007).

Water Resource Management Plans are prepared by water companies and cover a 25-year time horizon. They set out how companies intend to secure a long-term sustainable balance of supply and demand for water in their regions. The plans are reviewed annually, and new plans are consulted on every five years.

Local flood strategies produced under the Flood and Water Management Act 2010 will set out an expected contribution from sewerage undertakers to avoid surface water flooding. Certain water company functions regarding the management of surface water in sewers are classified as relating to flood risk and have to be carried out in a manner consistent with the national flood strategy and with regard to local flood strategies.

Water companies are required to comply with the Security and Emergency Measures Direction 1998. This requires undertakers to have plans in place to provide essential water supplies and sewerage services in the event of a civil emergency,

i.e. natural disaster or other emergency, such as flooding, or an event affecting national security. Similar requirements are imposed on licensed water suppliers in subsequent Directions.

Strategic Direction Statements were initiated by Ofwat in the run up to PR09, to encourage water companies to think about their business planning in a longer-term context, typically a period of 25 years. Ofwat asked the companies to prepare these long-term plans in consultation with customers, CCWater and the quality regulators in time to inform draft business plans.

The Quadripartite Groups and Wales PR09 Forum were formed at the suggestion of CCWater in the lead up to PR09. The groups included the companies, CCWater, Environment Agency, Drinking Water Inspectorate, and in some cases Natural England or the Countryside Council for Wales. The groups met throughout the price review process, and in many cases have continued to do so after the final determination.

A summary of Ofwat's statutory duties

Primary duties:

- Further the interests of consumers, wherever appropriate by promoting effective competition (the Consumer Duty).
- Secure that undertakers (i.e. water companies) are able to finance their functions, in particular by securing reasonable returns on their capital (the Financing Duty).
- Secure that the functions of each water company are properly carried out and that companies with water supply licences (i.e. those selling water to large business customers, known as licensees) properly carry out their functions (together the Functions Duties).

Secondary duties:

- Promote economy and efficiency by companies in their work.
- Secure that no undue preference or discrimination is shown by companies in fixing charges.
- Secure that consumers' interests are protected where companies sell land.
- Ensure that consumers' interests are protected in relation to any unregulated activities of companies.
- Contribute to the achievement of sustainable development.
- Have regard to the principles of best regulatory practice.

A summary of the Consumer Council for Water's statutory duties

- Represent the interests of water and sewerage customers and, in doing so, to have regard to the interests of: individuals who are disabled or chronically sick; individuals of pensionable age; individuals with low income; individuals residing in rural areas; and consumers who are ineligible to change their water supplier.
- Deal with complaints about the service provided by a licensed water supplier or water company.
- Publish advice or information about consumer matters or consumers' views where it would promote the interests of consumers.

Policy context

Part of the purpose of this review is to ensure that Ofwat is fit to regulate in light of the key challenges the water industry faces. These include:

- **Climate change** – Climate predictions suggest that the UK's weather will be more volatile in the future. There is a significant risk of increasingly variable and reduced water availability as a result. This could increase water scarcity and lead to drier summers, and produce more devastating floods such as those seen in 2007 and 2009.
- The water and sewerage sectors are currently responsible for about 1.1 per cent of UK greenhouse gas emissions, but this rises to 6 per cent if emissions related to water heating are included. This must be addressed and new technologies, processes and approaches are needed to help the transition to a low carbon economy.
- **Population growth** – By 2050 pressure on water resources will increase however effectively demand is managed, due to the impacts of climate change and meeting the needs of a growing population. Population growth and other demographic changes mean that demand for water is likely to increase. This could be by 5 per cent by 2020 and as much as 35 per cent by 2050.

- **Customer experience** – Some customers are not happy with the range or quality of services they receive and a growing number have difficulty paying their bills. The sector will have to adapt to do more to help vulnerable customers and make an impact on the costs associated with bad debt⁶.

Ofwat has to operate within a changing policy context, whether this stems from the European Union, the UK Government or the Welsh Government. This has been particularly true in recent years when a number of relevant pieces of work have been published.

The UK and Welsh Governments commissioned a '*Review of Competition and Innovation in Water Markets*'⁷ conducted independently by Martin Cave. Cave concluded that the gradual introduction of further competition and innovation to the water sector would deliver considerable environmental and service improvements. His recommendations looked at reforming competition regimes, including allowing all non-household customers to be able to choose their water supplier. It also looked at giving the Environment Agency greater powers to facilitate the trading of abstraction licences, and allowing more mergers between water companies.

⁶ Ofwat estimates that the costs associated with bad debt add around £14 to each bill.

⁷ Independent Review of Competition and Innovation in Water Markets: Final Report, Professor Martin Cave (April 2009). <http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/index.htm>

The UK and Welsh Governments also commissioned Anna Walker to carry out, again independently, a *'Review on Charging for Household Water and Sewerage Services'*⁸. Walker was asked to look at the fairness and effectiveness of the current methods of charging. The report covered a number of areas, including incentives for efficient water use, affordability, and metering.

In April, Defra published *'Affordable water: a consultation on the Government's proposals following the Walker Review of Charging'*⁹. This stated that *"the Government believes that it is essential to have a robust framework in place to protect households from unaffordable bills before taking decisions around metering policy"* and that a fuller response to the Walker and Cave Reviews as well as this review would be set out in the Water White Paper later this year.

Prior to the recent Welsh election, the Welsh Government published an updated Strategic Policy Position Statement on Water¹⁰ which set out the Welsh Government's position on key water issues including those covered by the Cave and Walker Reviews. The Welsh Government also published subsequently a consultation on the recommendations contained in the Walker Review¹¹. It is anticipated that the new Welsh Government will confirm its intentions in relation to developing Welsh policy on these matters.

Aside from the work of the UK and Welsh Governments in the water sector, developments in economic regulation, consumer representation and infrastructure policy are relevant to this review.

*'Principles for Economic Regulation'*¹² sets out the UK Government's views on how Government should work with economic regulators. The principles recognise the continued need for independent economic regulation in monopoly sectors where investment is often capital intensive, long-term and with significant sunk costs. The principles are broken down into six key areas: accountability, focus, predictability, coherence, adaptability, and efficiency (see box below).

A consultation on *'Empowering and protecting consumers'*¹³ by the Department for Business, Innovation and Skills (BIS) is seeking views on transferring the functions of various consumer representatives into the Citizens Advice service. The consultation proposes that there should be a single unit that should take over responsibility for:

- all Consumer Focus functions in relation to gas, electricity and (except Northern Ireland) postal services;
- key, non-sector specific advocacy functions of Consumer Focus; and
- sectoral consumer bodies for water (in England and Wales), transport, communications and legal services, if the relevant Departments and Devolved Administration responsible for those bodies so decide.

In March, BIS also launched a consultation on *'A competition regime for growth'*¹⁴. This is considering reforms to the existing competition regime to maximise the ability of the competition authorities to secure vibrant, competitive markets,

8 The Independent Review of Charging for Household Water and Sewerage Services: Final Report, Anna Walker CB (December 2009). <http://archive.defra.gov.uk/environment/quality/water/industry/walkerreview/index.htm>

9 Consultation: Water affordability in response to the Walker Review of charging for water and sewerage services, Defra (June 2011). <http://www.defra.gov.uk/consult/2011/04/05/water-affordability-1104/>

10 Strategic Policy Position Statement on Water 2011, Welsh Government. <http://wales.gov.uk/topics/environmentcountryside/epq/waterflooding/publications/statement2011/?lang=en>

11 Consultation on the Walker Review of charging for household water and sewerage services, Welsh Government (July 2011). <http://wales.gov.uk/consultations/environmentandcountryside/walkerreview/?lang=en>

12 Principles for Economic Regulation, BIS (2011). <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/p11-795-principles-for-economic-regulation.pdf>

13 Empowering and Protecting Consumers: Consultation on institutional changes for provision of consumer information, advice, education, advocacy and enforcement, BIS (June 2011). <http://www.bis.gov.uk/Consultations/empowering-and-protecting-consumers>

14 A Competition Regime for Growth: A Consultation on Options for Reform, BIS (June 2011). <http://www.bis.gov.uk/Consultations/competition-regime-for-growth>

in the interests of consumers and to promote productivity, innovation and economic growth.

'*The National Infrastructure Plan*'¹⁵ committed the UK Government to develop a more resilient model of strong and sustainable growth. The plan is the UK Government's response to the estimated £200 billion of investment in UK infrastructure over the next five years, and sets out how Government will help ensure and encourage that investment from the private sector.

The Department of Energy and Climate Change (DECC) '*Ofgem Review*'¹⁶ has run concurrently with the Ofwat Review. Defra and DECC worked closely to establish common practices and principles. Chapter 5 discusses the two reviews' differing conclusions.

Ofwat's Future Regulation programme

In light of the future challenges facing the sector, Ofwat has started a wide-ranging review of its approach to economic regulation. There are four key projects within the programme:

- **Future Price Limits** is considering what a new framework for regulating the sector and setting prices in the future would look like. Ofwat aims to implement the first steps of any new model in time for PR14.

- **Market reform** emerged following the publication of the Cave review and is considering the recommended changes to the water supply licensing framework to allow new companies to enter the market, and exploring the opportunities for water trading and retail competition.
- **Future water charging** was established following the publication of the Walker review and is reviewing Ofwat's charging approach to enable the companies to set tariffs that are fair, affordable and promote environmental and economic sustainability.
- **Regulatory compliance** was set up following PR09 and aims to simplify compliance monitoring and reduce the regulatory burden, focusing regulation and enforcement on the biggest areas of risk to customers and the environment.

15 National Infrastructure Plan, HM Treasury (October 2010). http://www.hm-treasury.gov.uk/ppp_national_infrastructure_plan.htm

16 Ofgem Review, DECC (2010). http://www.decc.gov.uk/en/content/cms/meeting_energy/markets/regulation/regulation.aspx

Summary of *'Principles for Economic Regulation'*

Accountability

- Independent regulation needs to take place within a framework of duties and policies set by a democratically accountable Parliament and Government.
- Roles and responsibilities between Government and economic regulators should be allocated in such a way as to ensure that regulatory decisions are taken by the body that has the legitimacy, expertise and capability to arbitrate between the required trade-offs.
- Decision making powers of regulators should be, within the constraints imposed by the need to preserve commercial confidentiality, exercised transparently and subject to appropriate scrutiny and challenge.

Focus

- The role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services by ensuring the operation of well-functioning and contestable markets where appropriate or by constraining the exercise of market power of dominant companies.
- Economic regulators should have clearly defined, articulated and prioritised statutory responsibilities focussed on outcomes rather than specified inputs or tools.
- Economic regulators should have adequate discretion to choose the tools that best achieve these outcomes.

Predictability

- The framework of economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long-term investment decisions with confidence.
- The framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets.

Coherence

- Regulatory frameworks should form a logical part of the Government's broader policy context, consistent with established priorities.
- Regulatory frameworks should enable cross-sector delivery of policy goals where appropriate.

Adaptability

- The framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time.

Efficiency

- Policy interventions must be proportionate and cost-effective while decision making should be timely, and robust.

General themes in responses to the call for evidence

The review team issued a call for evidence which received 59 responses, including evidence from water companies, Ofwat and CCWater. Full details of the call for evidence can be found in Annex B. The review team also gathered evidence through interviews with respondents and other key stakeholders.

Both the responses and the subsequent interviews covered a wide range of topics. Some consistent themes emerged which cut across the main issues the review team identified and these themes should be noted as providing some of the context to the discussion of specific issues rather than as issues in themselves.

We have referred to the responses to the call for evidence in some detail throughout the review to set the scene for our discussion of the issues. But we should make clear that the inclusion of the views expressed to us does not necessarily mean that we agree with those views or have made recommendations in response to every issue raised.

Pace and scale of change

The vast majority of stakeholders recognised how much the current regulatory regime has delivered for the water sector in the last twenty years. Respondents consistently pointed out that the existing framework had enabled high levels of investment and delivered many improvements for customers and the environment. Whilst stakeholders were clear that this did not rule out the need for significant improvements to some aspects of the system, most argued that such changes should be evolutionary not revolutionary. They did not advocate significant structural change to Ofwat.

Views on competition and markets

The merits of competition and innovation in the water sector were assessed in detail by Martin Cave in his review published in 2009 and are outside the scope of this review. However, it is clear that many of the views expressed by respondents on Ofwat and the regulatory system were to some extent conditioned by their views on the proposed introduction of further competition and their perception of Ofwat's role in this. At its simplest, those who were opposed to the introduction of competition and markets were more likely to favour constraints on Ofwat's powers and independence. Others recognised in principle the arguments for competition, but wanted Ofwat to demonstrate a more evidence-based approach to its decision making in this area. Most respondents felt a need for further clarity as to the respective roles of Ofwat and Government in this area.

Financing of investment

Stakeholders generally accepted that the ability of water companies to maintain access to large scale, low cost funding has been critical to achieving the improvements to date at an acceptable price and will continue to be so. Respondents recognised that this ability was founded on the confidence of the financial markets in the stability and predictability of the regulatory regime and mentioned this as being one of Ofwat's key successes, delivering significant benefits to customers in the process. Many respondents stressed the importance of avoiding a loss of confidence through prolonged uncertainty or unnecessary change to the regulatory regime.

Chapter 1:

How Ofwat works with others

Summary

The review team was asked to consider the effectiveness of Ofwat's relations with other water regulators and water companies. We received a substantial amount of feedback on this issue and on Ofwat's relations with stakeholders more generally.

The regulatory landscape for the water and sewerage sectors is highly complex due to the existence of multiple regulators, each with different statutory roles and responsibilities, and multiple planning processes each with different degrees of formal effect or influence¹⁷. Despite this complexity, we received a clear message that the system works and is not fundamentally flawed. We do not therefore recommend substantial changes to the overall structure and framework of regulation in the sector. However, we identified a number of areas of concern which, in essence, relate to the ways in which Ofwat, the other regulators, the Consumer Council for Water (CCWater), the companies and other parties work together.

Our main recommendation is that Ofwat and the other regulators should seek to work in a more "joined up" fashion. While Ofwat must ultimately make its own decisions in the context of its own statutory duties and powers it needs to engage more effectively with the other regulators and the wider range of stakeholders. We have not tried to go into the detail of what this should mean in practice as it is important that working arrangements are developed co-operatively between the bodies concerned but it is important that progress is made. We believe that the changes we have suggested can be achieved without prejudicing Ofwat's independence or risking a perception of regulatory capture.

Ofwat should also be more transparent in its decision making and provide clear explanations of its decisions in instances when these are inconsistent with the outcomes of other planning or consultation processes.

Evidence

We received responses to the call for evidence from a wide variety of organisations including water companies, the quality regulators, organisations such as Natural England and non-governmental organisations (NGOs).

Generally these expressed support for the approach of separate regulators each addressing different aspects of the industry. Most respondents argued that if one body were to be made responsible for economic regulation, drinking water quality and environmental regulation, there would be less transparency over trade-offs between these objectives.

"It is important that there are separate regulatory entities with clear lines of responsibility and public accountability for water quality, the environment, consumer representation and protection and economic regulation. Consolidation of these regulators would be undesirable as it would create a significant risk of a single regulator managing between conflicting objectives through value judgements and internal tradeoffs." **Southern Water**

There was wide-ranging support for the introduction of the Quadripartite Groups (and the Wales PR09 Forum¹⁸) and the Strategic Direction Statements (SDSs) at the 2009 price review (PR09). Companies in particular were often highly supportive of the value-added by the quadripartite process in terms of helping them prepare their business plans.

¹⁷ See "Other Planning Processes" p.9.

¹⁸ When referring to the quadripartite process in the review, this includes the Wales PR09 Forum.

"As part of the recent PR09 process, CCWater set up 'Quadripartite Groups' in each region which included CCWater, companies, the Environment Agency, Drinking Water Inspectorate and, in our region, Natural England. These meetings aimed to provide a forum for discussing companies' business plans, how they had researched customers' willingness to pay and, in particular, what trade-offs might be necessary between investment and affordability. We believe the forums were useful, and the constructive challenge provided helped us deliver a better business plan." **Severn Trent Water**

However, the responses also highlighted problems, particularly the lack of an agreed outcome from the different regulatory and planning processes. Funding decisions were taken by Ofwat alone and did not necessarily reflect conclusions reached through other planning processes. In particular, companies argued that Ofwat did not take proper account of the SDS or the outcome of the quadripartite process in making its funding decisions, or explain the rationale for those decisions.

"It was not always clear...in reaching its determinations, what status Ofwat gave to the views of the group collectively, and stakeholders in their individual representations. Ofwat needs to either participate in the process or be committed to the outcomes which the process produces." **Severn Trent Water**

Apart from the general issues mentioned above, the companies raised a number of specific points about the processes involved at PR09. Some felt that the disjoint between the different regulatory processes could leave them in a position in which they were subject to obligations that could be enforced by the quality regulators, but for which funding was not subsequently allowed by Ofwat. The impact of this could include additional costs

being incurred to try to resolve the conflict, undermining the achievement of the objectives of other planning processes and, ultimately, obligations not being funded.

"It is not acceptable for companies to be placed in the position where one regulator can enforce delivery of an output but another regulator will not allow the company to recover the cost of so-doing. Most issues are managed with goodwill but greater clarity on the respective roles of the various regulators would be helpful. For instance, is the DWI the final arbiter of drinking water quality requirements or is it legitimate for Ofwat to constrain requirements to meet affordability objectives?" **Northumbrian Water**

Similar issues were identified in relation to other planning processes where companies had agreed to take a particular course of action only to find it was not then funded by Ofwat; in particular the Water Resource Management Plans (WRMPs), where companies felt that Ofwat should be required to fund outcomes agreed through consultation and signed off by the Secretary of State for Environment, Food and Rural Affairs.

"Ofwat's stance was to separate itself from this process and to decide independently the best solution for delivering the necessary water resource solutions. This has left a number of companies in the somewhat perplexing situation of having a WRMP signed off and agreed by the Secretary of State but unfunded in its price determination. It is unclear whether this is an issue of process or one of conflicting duties in terms of setting policy but nevertheless it is one that should not be repeated in future price setting reviews." **South East Water**

We heard similar concerns about other aspects of the wider planning framework such as land use planning, resilience planning and local flood risk planning. Water companies also highlighted problems with the timing of UK Climate Projection

data in their recent Climate Change Adaptation Reports¹⁹.

Companies also saw problems arising from overlap or duplication of activities undertaken by the regulators.

"We do not understand why OFWAT has a water quality team when that function is already in the very capable hands of the Drinking Water Inspectorate. It is even more confusing when the OFWAT team and the DWI appear to be at odds when it comes to dealing with technical issues. In such circumstances it is the consumers who OFWAT claim to protect that are at risk of being disadvantaged." **Cholderton and District Water**

Some responses questioned the role of cost-benefit analysis (CBA) in relation to schemes driven by statutory requirements, when they felt that the key principle should be to ensure that statutory obligations were met by way of the least cost approach. Ofwat told us that it used CBA to identify for further scrutiny the schemes which appeared to offer the least value to customers. However, others argued that the appropriate methodology to apply was cost-effectiveness analysis – unless there was flexibility in the statutory obligation which meant information regarding a comparison on costs and benefits could be taken into account (as is the case under the Water Framework Directive (WFD)).

Several companies highlighted the impact that lack of clarity about the status of WRMPs and the quadripartite process could have on the operation of the Capital Incentive Scheme (CIS) introduced at PR09. A key element of the CIS is the determination by Ofwat of the capital expenditure 'baseline'. Companies argued that investment plans which had been required by the quality regulators or agreed in the quadripartite process were then not included in the baseline leading

them to incur potentially substantial financial penalties under the operation of the CIS.

Many of the issues raised by the companies were highlighted in other responses, including those from environmental NGOs, consumer groups and various industry experts. The NGOs highlighted, in particular, the problems associated with the interaction of the WRMP and price review processes. They also highlighted the need to ensure that a consistent approach was taken across the regulators to issues such as water efficiency and demand management. Consumer groups including CCWater and Consumer Focus highlighted the need for a strong customer voice in discussions between regulators.

There were several calls to clarify the roles and responsibilities of the regulators and many responses said there was a need for clarity over who should be the final arbiter in conflicts between regulators. Opinions on this varied significantly. Some thought Ofwat's role in making the final decisions in relation to funding allowed it too much scope to undermine the requirements of the quality regulators. Others emphasised Ofwat's important role in challenging the proposals of the quality regulators to ensure that costs to customers did not rise unnecessarily.

The responses of the quality regulators to the call for evidence repeated the positive feedback regarding the quadripartite groups in PR09 and added to it regarding the national processes that Ofwat chaired for PR09 (i.e. the PR09 Senior Coordinators Group and the Chief Executives Group). The responses also identified similar problems to those pointed to by the companies. The Environment Agency (EA) was clearly concerned that Ofwat's funding decisions affect its areas of responsibility.

In particular, the EA felt that the duplication between the WRMPs and the supply/demand

¹⁹ Adaption Reporting Power reports, Defra (2011).
<http://www.defra.gov.uk/environment/climate/sectors/reporting-authorities/reporting-authorities-reports/>

balance planning in companies' business plans was problematic.

The Drinking Water Inspectorate (DWI) gave views in particular on how the PR09 process worked. It supported the quadripartite process as it felt the process put the onus on companies to balance competing demands and provided a forum for CCWater to ensure customer priorities were reflected.

The DWI emphasised the different statutory roles of the various regulators and highlighted that the statutory drinking water quality programme included in business plans at a price review is directly linked to enforcement action to deal with breaches of standards or instances where there is evidence of likely failure. It felt that Ofwat's categorisation of this activity as an 'enhancement' in relation to the capital programme, suggesting that it was discretionary in nature, was therefore misleading.

The DWI had concerns about the use of serviceability as a tool for performance assessment and resource allocation for drinking water supply services. It was concerned that when companies were already in breach of drinking water standards then they could potentially subsequently show an improvement in serviceability while still breaching the drinking water standards and it was better to focus companies on meeting their legal obligations rather than on meeting specific indicators of limited value. The DWI also pointed to examples where Ofwat has cut across the remits of other regulators, particularly in the area of enforcement where there had been several examples of both regulators taking enforcement action to deal with the same issue. This had caused confusion in the companies and with company reporters²⁰.

In its response Ofwat acknowledged the presence of the other regulators in the water and sewerage sectors. It argued that it was for Government to decide where the boundary of responsibility lay

between the various regulators. Ofwat's view was that given the conflicting areas of responsibility, it was appropriate for the relationships between the regulators to be characterised by "*some healthy tension and challenge*".

Ofwat noted that it considered it an essential part of its own role, once the outcomes of the quadripartite process had been agreed, to apply its own independent challenge to ensure that those outcomes were delivered at the best value to customers.

In relation to enforcement action, Ofwat did not accept that there were cases when it, the DWI and/or the EA had taken enforcement action to deal with the same issue as it enforced against failing trends in serviceability rather than specific single failures as the other regulators do. It also wanted to prevent the companies benefiting financially in cases where the breach of standards resulted from a decision not to incur expenditure.

Regarding the funding of outcomes specified by the other regulators, Ofwat emphasised that the current process delivered effective outcomes, with the PR09 price limits including more than 99 per cent of the quality schemes in the Environment Agency's National Environment Programme.

Discussion

The regulatory landscape in the water sector is complex. There are a number of regulators, each with its own specific role and duties, and there are a number of planning processes which influence and shape the companies' business plans. These include the WRMPs, SDSs (discussed in Chapter 3), River Basin Management Plans (RBMPs) and a range of other processes such as local development plans and flood risk strategies.

When we presented our informal interim findings in January, our starting point on this issue was that we saw real value in an approach involving

²⁰ The Reporters and reporting teams act as professional commentators and certifiers on the regulated activities of individual water companies. http://www.ofwat.gov.uk/regulating/prs_web_audreporters

separate regulators with clearly defined roles. We have not changed this view. Almost all of the evidence received by the review suggests that the separate regulators approach is sensible and should not be changed. Institutional change, such as combining the regulators into one organisation, would reduce the transparency of the trade-offs that are required between measures to improve environmental and drinking water quality and the impact these would have on customers' bills. It would also threaten the independence of the role of economic regulation which is critical to the perception of the stability of the regime among investors and lenders to the sector.

We have not identified any major deficiencies in the roles and responsibilities of the regulators as set out by Government; nor were any such deficiencies identified in responses. In practice, the main issues raised by respondents revolve around a desire for clarity on where the primacy of decision making lies. In other words, in cases of dispute, which regulator's decision should prevail? In the current arrangements there is no clear answer. Where there are statutory requirements for quality standards these must clearly be met although there is scope for differing interpretation of how this should be done. In cases where there is no statutory driver the eventual decision must come through the interaction of the quality regulators, CCWater and Ofwat.

In January, we characterised the key issue here as the concern that Ofwat was not interacting well with the other bodies and processes that fed into the price review and was simply imposing its own views on value for money on these inputs, thereby potentially:

- undermining outcomes previously agreed between other parties;
- creating uncertainty about the capital programme; and
- diverting effort away from identifying the most cost-effective option.

We recognised that the companies could be placed in a difficult position if caught between conflicting views of the various regulators and agreed that similar considerations applied in the case of non-statutory requirements arising from WRMPs, the quadripartite process or other planning processes.

In response to these issues we proposed that the scope of the quality programme should be established and agreed, with Ofwat involvement, earlier in the price review process. Our intention was to ensure that the companies would have a clear understanding of what was required of them before submitting their business plans. As well as avoiding unnecessary work this would also clarify the working of the CIS and reduce the risk of companies being penalised for including schemes they felt had been agreed in the course of other planning or consultation processes. It would still be possible for Ofwat to challenge whether the specific proposal delivered the desired outcome efficiently. We acknowledged that this would nonetheless impair Ofwat's ability to make its final determinations in the light of a full understanding of all aspects of the companies' business plans and the potential impact on charges. As a counterbalance we suggested that Ofwat might prepare a report for ministers after each price review process commenting on the value for money, from the standpoint of water customers, of the eventually agreed quality and environmental programme.

We have had further discussions with the EA, DWI and Ofwat on the idea of agreeing the scope of the quality programme at an earlier stage. We have concluded that the practical issues involved, which would include the outcomes of the various planning processes such as the WRMPs and RBMPs also being available at a much earlier stage, would be too difficult to overcome. This is particularly true for PR14 in the light of the large amount of work that is under way in relation to the implementation of the Water Framework Directive which has its own statutory timetable.

We also concluded that our proposal to move forward the specification and agreement of the quality programme would require Ofwat's detailed involvement in the consideration of individual investment schemes in a way that would be inconsistent with our, and Ofwat's, stated aim to reduce the regulatory burden imposed by the price review process.

After presenting our interim findings, we asked the companies to provide evidence of cases in which statutory requirements had not been funded. We also discussed the issue further with the quality regulators. In practice the companies could provide very little evidence of such requirements literally not being funded in Ofwat's final determinations. They did give examples of cases when such schemes were excluded from Ofwat's draft determinations but reinstated later, after further representations to Ofwat supported by the quality regulators. They also provided evidence of cases in which Ofwat had argued that the output required by the quality regulator could be achieved in a more cost-effective fashion. More generally, they cited a number of instances when proposals that had been supported in the quadripartite process had been rejected by Ofwat.

In light of the evidence presented to us, we do not believe that Ofwat's decisions in PR09 substantially undermined the achievement of Government's objectives as expressed through the EA's and DWI's requirements. The evidence shows that in many cases the process is not working as well or as smoothly as it could be, but it does not suggest that significant changes are required to the roles of the regulators, nor that the companies need a specific right of appeal on work to meet statutory obligations as we suggested in the interim findings.

We are not persuaded that the sector needs a final decision making body to impose a view in cases where the regulators disagree. In the end the final decision on funding business plans must lie with Ofwat acting in the interests of consumers

but, given the complexity of the manner in which water companies' obligations and undertakings are determined, it is simply not feasible or realistic for Ofwat to make these decisions in isolation.

The evidence that the current system does not work smoothly should not be dismissed. The process needs to be judged on how effectively outcomes are achieved and there is clear evidence that there are problems in this respect. The companies, the quality regulators, and CCWater felt that in the later stages of PR09 they had to expend considerable time and effort in arguing for the reinstatement of schemes that had been supported in the quadripartite process, or were required by the quality regulators, but were excluded by Ofwat at its draft determination stage. This does not appear to be an efficient process. The review team recognises that in some cases schemes were rejected by Ofwat because the proposal in question had been inadequately presented and justified by the company in its business plan. Challenging such poorly presented proposals is obviously necessary but this step should be integrated more closely into a process of interaction with the quadripartite process or in the scrutiny processes built into the separate planning processes.

The desired outcome must be for each of the regulators to take proper account of the others' remits, the statutory requirements they are trying to fulfil, and the planning and decision making processes they use, in a way that is consistent with their own statutory duties and does not jeopardise independence. We must maximise the benefits of having several distinct regulators while minimising the costs of this approach to companies and their customers. It is in the interests of all concerned for them to take account of each other's decision making timetables and to ensure that their various processes fit together as smoothly and effectively as possible.

Since we presented our interim findings Ofwat has published, *'Involving customers in decisions about water and sewerage services'*²¹ setting out

21 Involving customers in decisions about water and sewerage services, Ofwat (2011). http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf1104fpl_customer.pdf

a number of options for customer engagement in the price review process. A key aspect of the proposed approach is the principle that, where a company can demonstrate effective customer engagement and widespread support for its business plan, Ofwat will subject its plan to a substantially lower degree of scrutiny. In principle, for companies qualifying for the light scrutiny or “fast track” approach this should address many of the issues discussed above.

Where the required degree of support cannot be demonstrated Ofwat will scrutinise the individual components of the plan in detail and, when it does not feel that proposed investments have been justified, these will be referred back to the companies for reconsideration through the quadripartite process or by the quality regulators. The provision of a “feedback loop” and an opportunity for reconsideration of the justification of investment schemes should to a significant extent avoid the need for the last minute representations seen in previous price review processes. If the problem is inadequate justification of proposals by the company, the feedback loop should identify this. Where there is underlying disagreement over the requirement for a project, there will need to be further discussion between Ofwat and the other relevant parties.

Much of the detail of Ofwat’s proposal is still to be developed, but it does appear to be a constructive move towards more effective consumer engagement which should help to ease some of the problems discussed above. The development of the detail will be important, particularly in relation to the decision as to which companies should qualify for “fast track status” and how the separate planning processes that exist in the sector, which have their own timetables and opportunities for customer engagement, will be reflected. Ofwat may need to take some risks to avoid setting the qualification level too high to be realistic. If subsequent experience suggests that it was too generous, Ofwat can take this into account in setting subsequent price limits.

Ofwat, the quality regulators and the companies need to work together closely to develop the detailed operation of this process. Ofwat will need to ensure that the feedback loop will operate so that companies have the opportunity to improve their plans having sought additional consultation with the group responsible for assuring the quality of the plan. As part of this feedback, Ofwat should provide clarity generally over how it has come to its decisions and in particular on how it has taken various planning processes, other regulators’ requirements and the outcome of the quadripartite process into account. In cases in which its decisions do not fully reflect the outcomes of these processes, Ofwat should clearly explain the rationale for its decision.

If the process is effective it should reduce the instances of companies being caught between conflicting requirements of different regulators and should also reduce the scope for companies to play regulators off against each other.

This type of approach also needs to be adopted more widely. Ofwat needs to engage more effectively in processes that shape the companies’ business plans. We are aware that Ofwat does participate in some form in these processes. For example, during the development of the water companies’ WRMPs during 2008/09, Ofwat commented on each company’s draft WRMP and provided views to Ministers regarding the plans. However, it is clear from the evidence submitted that there is scope for Ofwat to engage more effectively in this process²². In particular, where these planning processes provide opportunities for scrutiny of their outcomes by others (such as via technical review or public consultation) Ofwat should engage fully in these processes rather than undertaking a full separate assessment later.

Earlier engagement does not mean committing to price review decisions at this stage. We considered such an approach and concluded it was not feasible or desirable. However, plans such as the

²² The WRMP process is the subject of a separate review which is considering this issue in detail.

WRMPs are important inputs into the development of the companies' business plans and Ofwat involvement while they are being developed and consulted upon should allow Ofwat to satisfy itself about the robustness of the proposed outcomes. This may involve some narrowing down of Ofwat's flexibility at later stages of the price review but the benefits to the efficiency and clarity of the process, by enabling Ofwat scrutiny (and company justification) to focus on the cost, rather than the outcomes of these processes, should justify this. There must be some risk that decisions are made that, with the benefit of hindsight, look incorrect but one of the advantages of regular price reviews is they provide regular opportunities to learn from previous experience and improve the arrangements for subsequent periods.

More generally, the regulators need to work together to see how their various scrutiny and challenge processes complement each other and identify where the gaps are. Ofwat should then ensure that its assessment of plans or proposals is appropriate in the light of work being carried out by the other regulators. Where there are multiple regulators, some duplication is inevitable. Ideally, though, companies should not have to justify the same programme on more than one occasion in different processes.

Effective working together by the regulators must involve mutual and explicit consideration of the impacts of their actions on the ability of other regulators to deliver their outcomes. A good example is the point raised in the evidence about overlapping or duplicated enforcement action. It seems obvious that regulators should work together to ensure that their enforcement action does not cut across others' enforcement action, but the points made to us in responses on this subject suggest that this process has not been fully effective. Such issues will become increasingly important as Ofwat adopts a risk-based approach to regulation as this will require clear and consistent messages to companies regarding compliance.

Recommendation 1: In view of the complex regulatory landscape, all the regulators in the water sector should undertake their regulatory responsibilities in a joined up fashion. Government objectives for the water sector should be specified in a way that minimises the scope for conflict between the regulators.

Recommendation 2: The role of the Quadripartite Process/Wales PR09 Forum should be strengthened and formalised as part of the price review process. In principle, Ofwat decisions should be consistent with the outcomes of the quadripartite process. If this is not the case Ofwat should explain the rationale for its decision.

Recommendation 3: Where water companies are subject to separate planning processes or to obligations required and enforced by other regulators, Ofwat should engage effectively in these processes and ensure that its price review decisions take due account of the outcomes; in particular, where these have been subject to wider scrutiny, public consultation and formal approval processes. In the event that Ofwat's decisions do not fully reflect the outcomes of these processes, it should explain the rationale for its decision.

We recognise that we are not offering the final answer here. We do not want to impose solutions on the regulators; rather we are exhorting them to improve. It is important that the regulators themselves develop improved working arrangements so that they feel committed to them in practice.

Co-operation is needed from all parties but, if Ofwat's approach does not change it is unlikely that progress will be made. We recognise that this will not be easy. Ofwat clearly feels that maintaining its independence and avoiding regulatory capture are key to fulfilling its duty to protect the consumer interest. However, independence should not mean isolationism. Ofwat's independence should contribute to better outcomes for customers. It is not in customers' interests for regulatory processes to conflict and for time and money to be wasted.

Chapter 2:

Ofwat's approach to regulation

Summary

We were asked to look at Ofwat's approach to minimising the burdens from its regulatory activity, rather than its general approach to regulation, but responses to the call for evidence identified a number of potential areas of concern that we wanted to address.

Most importantly, we found a strong consensus of opinion that the burden imposed on the companies by Ofwat's approach to regulation is disproportionate and damaging. Ofwat has recognised this issue and has begun taking action to address it. This will require substantial changes of approach both in Ofwat and the companies and effective leadership on both sides. We recommend that Ofwat sets clear targets and timescales for a reduction in the burden of regulation and we would like to see independent monitoring by the National Audit Office of progress towards these goals.

We also recommend that Ofwat's current review of its use of incentives should seek to achieve the best balance between rewards and penalties with a view to encouraging behavioural changes on the part of the companies. We hope that by following our recommendations on incentives and on reducing the burden of regulation Ofwat will encourage the companies to take a more proactive and innovative approach to addressing the challenges the sector faces.

In this chapter we also suggest actions Ofwat could take to improve the service provided by the companies to third parties such as housing developers and recommend changes in the framework for handling complaints which the existing legislation requires Ofwat to resolve.

Finally, we support Ofwat's ambition to reform the companies' licences and suggest some measures to help with this.

Burden of regulation and compliance

Evidence

One of the most consistent messages in responses to the call for evidence was that the burden imposed by Ofwat's approach to regulation was disproportionate and damaging. Most of the companies' responses referred to the scale of the annual reporting requirements (the June Returns) and the information required for the five-yearly price review (PR). However, the impression given of a detailed and intrusive approach to regulation applied more generally across Ofwat's activities.

Many of the companies provided examples of the costs they incur in connection with the price review process and the June Returns. They also drew attention to the increasing burden since privatisation. Some examples are given below. As well as the scale of the formal submissions to Ofwat, companies pointed to several related issues which worsen the impact of those reporting requirements:

- the impact on management time from having to sign off the accuracy of data at board level;
- the requirement to have all data checked and confirmed by outside parties (known as "reporters");
- the extent of follow-up questions from Ofwat; and
- uncertainty over how some of the data was used or whether it is used at all.

The review team asked Water UK to provide an estimate of the incremental costs of compliance with the June Return process. Water UK reported that the incremental cash costs estimated by industry were approximately £6.5 million last year. However, it noted that since much of the data collection and data assurance overlaps with processes which companies would undertake anyway for management reporting purposes, it is difficult to identify an accurate estimate of the additional costs of completing the June Return.

We asked the companies how much of the data associated with the June Return they would collect if there was no requirement to do so. Responses ranged from all of it to less than half, but most companies also pointed out that some of the data would be collected less frequently or to a lesser degree of accuracy than Ofwat required. The resulting reduction in the effort involved would therefore be significantly greater than this simple comparison would suggest. There was general agreement that the formal Board level sign-off of the June Return submission to Ofwat would not be undertaken if Ofwat did not require this.

Some respondents identified an underlying lack of trust between Ofwat and the companies and a resulting adversarial approach to regulation. They felt this led to intrusive and detailed reporting requirements and unnecessary complexity. In discussion, some acknowledged that this may be the result of deliberate mis-reporting of information by some companies to Ofwat in the past.

A proliferation of new and complex incentives such as the Capital Incentive Scheme (CIS) and Revenue Correction Mechanism (RCM) added to the volume of reporting. While some companies agreed with the principles and rationale for these mechanisms, they criticised Ofwat for not being clear when they were implemented as to what the mechanisms were for, and the mechanisms themselves for being unnecessarily complicated and requiring significant data reporting.

One particular example cited by a number of companies was Ofwat's requirement in PR09 for companies to revalue their assets on a current cost basis. This was a costly exercise (Severn Trent Water quoted c. £2 million for their own revaluation) which the companies felt added little value.

Examples of the cost of the regulatory burden

Water UK stated that *"Companies estimate they spent approximately £100 million in additional costs and directly employed additional labour equivalent to over 500 employee-years in order to comply with the regulatory requirements of PR09"*.

Severn Trent Water stated that their *"2,000-page Final Business Plan needed to be supplemented by responding to around 100 Ofwat queries and submitting a 500-page Draft Determination representation....Our total programme costs for PR09 were c. £20m. This excludes the indirect costs, such as employee time"*.

South West Water highlighted the increased length of the June Return: *"As an example, SWW's June Return for 2009/10 comprised 129 tables and 748 pages of commentary. This compares to the June Return submitted in 1993/94 which comprised 38 tables and 51 pages of commentary. The increase is therefore in the region of ten-fold"*.

Welsh Water stated that *"completing and submitting the June Return has become a costly data exercise and now comprises 76 tables and around 1,000 data cells and takes some 250 man days to complete, more than twice what was required five years ago"*.

Ofwat reports that the cost of the reporter function (paid for by companies) is the equivalent of £1.5 million a year and about £6 million in a price review year²³.

23 Getting it right for customers: How can we make monopoly water and sewerage companies more accountable? Ofwat (2010) p.12. http://www.ofwat.gov.uk/publications/focusreports/prs_web_1011regcompliance.pdf

Some companies acknowledged that they shared some of the responsibility for the increase in the volume of material, as they had a natural tendency to provide too much in justification for their plans, and they recognised that change was needed on both sides.

Several companies mentioned the Drinking Water Inspectorate (DWI) and its risk-based approach to regulation as a model for Ofwat to follow.

"We believe that a gradual move to a risk-based approach, as taken by the Drinking Water Inspectorate is an appropriate future model for the UK water sector...In practice DWI will focus its attention on areas where it perceives there is high risk, and/or where performance drops. We strongly support the general principles of this type of regulation as being in the best interests of the customers that we serve." **Semcorp Bournemouth Water**

Consumer bodies were worried about the costs mentioned above being passed on to customers. They also raised concerns about Ofwat micro-managing the companies and appearing to take ownership of their business plans. This was thought to lead to a culture of compliance rather than innovation, with companies focussing on meeting Ofwat's requirements rather than their customers'.

There was general consensus in these responses that the adoption of an outcome-focussed approach by Ofwat would be a positive move, resulting in greater attention on customer engagement.

Ofwat's response to the call for evidence and its own follow-up to PR09²⁴ show that it recognises the problem. In the latter, Ofwat admits that the price review process has become increasingly burdensome, with ever expanding data requirements, analysis that is not related to risk in

a systematic way, unintended consequences such as the five-year cycle of investment (discussed in Chapter 3) and disproportionate resource requirements. It also acknowledges that some of the incentives it has introduced are complex and may not send clear signals and that the focus on five-year price limits seems to discourage long-term planning. These findings have been fed into the project teams considering Ofwat's approach to Future Price Limits (FPL).

Ofwat has also begun a process to reduce the scale of the June Returns. It intends to move towards a system of risk-based regulation focussing on higher level outcomes of the regulatory process rather than detailed individual outputs. As a first step it informed the companies in October that they will not have to provide the detailed commentaries for each chapter of the 2011 June Return and that it would not publish unit cost and relative efficiency information for 2009/10²⁵.

The companies generally acknowledged that Ofwat had recognised the problem, but were sceptical of its ability to achieve any major change. In particular, they questioned whether the desire for less intrusive data collection was consistent with Ofwat's desire for greater disaggregation of regulation across different parts of the value chain.

Discussion

Regulatory compliance is a feature of all sectors. The crucial role of the water sector in supplying our most essential need, combined with the sector's strong monopoly characteristics, make it vital that a robust and comprehensive compliance monitoring framework is in place. Respondents to the call for evidence did not question this. Similarly, respondents did not question the need for an appropriate level of support and justification being provided for the companies' business plans in the price review process.

24 Lessons from our approach to setting price limits (PR09), Ofwat (2010). http://www.ofwat.gov.uk/pricereview/pr09phase4/pap_pos_20101217pr09lessons.pdf

25 IN 10/01, Ofwat (2010). http://www.ofwat.gov.uk/publications/prs_in1001regcompliance.pdf

The absolute scale of the various reporting requirements would not necessarily be a problem if it was proportionate to the scale and complexity of the industry. However, as outlined above, there is clear evidence that the burden imposed by Ofwat's approach to regulation is very large and has grown substantially since privatisation – particularly in the last ten years. Despite the history of mis-reporting it is difficult to see that the industry has changed in any way that justifies this.

There was general agreement across industry participants including Ofwat, water companies, and customer groups that as well as the direct costs incurred by companies (which are ultimately passed through to customers) the regulatory burden impacts on senior management and board time forcing them to focus on data assurance rather than on service delivery. It also leads to a tendency for companies to become Ofwat-dependent and to focus on responding to Ofwat's requirements rather than to customers, contributing to the risk-averse nature of the industry and a lack of initiative or innovation.

This second point is important. The cycle of data provision seems to have become self-reinforcing. The more Ofwat demands, the more the companies want to provide, in order to ensure Ofwat accepts their business plans. The resulting highly detailed specification of the business plan leads to a lack of flexibility in implementation as the companies are concerned about Ofwat penalising them for diverging from it. So, rather than assessing an appropriate amount of money required for the company to meet a reasonable assessment of its obligations, the price review process effectively leads to a very detailed specification of a business plan that then becomes very inflexible. The end-result is a loss of "ownership" of business plans by companies. This impact on the way companies behave is potentially much more important than the direct cost to consumers of the data and reporting requirements.

Given the degree of consensus on the nature and impact of the problem the question is not whether something should be done about reducing the regulatory burden, but how this should be achieved.

Ofwat's Regulatory Compliance project is considering explicitly the ways to reduce regulatory reporting and move to a less intrusive risk-based approach. Ofwat commissioned a paper on this topic²⁶ which provided a coherent and sensible summary of the problem and potential solutions. Ofwat's Future Price Limits project is considering ways in which price reviews could be made substantially less onerous for companies that produce well-supported business plans. The ambition of Ofwat's thinking in this area is to be commended. However, the degree of scepticism, expressed by the companies as to Ofwat's ability to achieve this is understandable and Ofwat's early efforts in the area have demonstrated the difficulty and scale of the challenge that exists.

For instance, rather than welcoming Ofwat's initial steps to reduce the scale of the June Returns, some companies expressed concerns that the removal of commentaries may simply result in more follow-up queries. Several companies also said that they and their investors found the annual unit cost and relative efficiency information published by Ofwat useful and would have liked it to be retained. We understand that these proposals were discussed with the companies in advance, in working groups and in individual meetings, without serious objections being raised, so it seems that either the implications of the changes were not understood by the companies or that there was a lack of communication and agreement within the companies. Whatever the explanation it is clear that the process did not work well.

Similar problems may well arise around the proposed changes to the price review process. The challenge of achieving a significant reduction in the regulatory burden whilst introducing disaggregated regulation across the value chain is

²⁶ Improving regulatory reporting and compliance, Keith Harris (July 2010).
http://www.ofwat.gov.uk/publications/commissioned/rpt_com_20101020reporting.pdf

substantial. On a like-for-like basis, disaggregated accounting would inevitably require more information. Ofwat's recent publication²⁷ setting out its initial thoughts on Future Price Limits did not directly address this challenge. To us, this was a missed opportunity to engage with the companies, and build confidence that Ofwat will reduce the regulatory burden.

Proactive engagement is crucial here. Any substantial reduction in the regulatory burden will require major changes to processes and culture within both Ofwat and the companies. DWI told the review team that its risk-based approach to regulation, which is widely praised by the companies, took ten years to introduce.

Effecting such a change in Ofwat and the companies will require very effective leadership on both sides. Developing a shared understanding of the objectives and the process at senior levels must be the critical first stage. Then both Ofwat and the companies must work hard to ensure that the necessary changes in culture and approach are achieved.

So, in summary, as Ofwat moves forward with its project to reduce the regulatory burden we think it should address some key principles:

- The process should be ambitious in scale, with objectives and means to achieve them agreed at a senior level between Ofwat and the industry.
- Consideration should be given to how Ofwat's new proposals (in respect of Future Price Limits and any other new initiatives) are consistent with reducing the burden of regulation.
- A reduction in reporting requirements should not simply move the burden elsewhere (for instance through ad hoc queries replacing structured reporting) or result in a reduction in the transparency of the sector, particularly for customers and investors.

- The Drinking Water Inspectorate, Environment Agency and the Consumer Council for Water (CCWater) should be fully involved to ensure that their requirements are met and to learn from their experience, particularly that of the DWI in terms of the transition to risk-based regulation.
- Key milestones should be set, together with mechanisms for monitoring progress, consistent with its duty under the Regulatory Enforcement and Sanctions Act 2008.

We see a strong argument for external monitoring of progress as a sign of commitment on Ofwat's part and to give the companies confidence to undertake their own changes. In Chapter 4 we discuss Ofwat developing outcome-based measures of performance to improve its accountability. A clear target for a reduction in the burden of regulation should be one of Ofwat's main objectives and we suggest that the National Audit Office (NAO) should assess progress after the conclusion of the next price review, PR14.

Recommendation 4: Ofwat should set clear targets and timescales for a reduction in the burden of the price control and compliance processes and enter into a joint project with the industry to achieve these. The National Audit Office should be involved in monitoring progress on these targets and report on them.

Incentives

Evidence

The companies highlighted various issues relating to the incentive mechanisms they are subject to. These included the complexity of incentives, together with the scale of the associated reporting burden, and an imbalance towards compliance and penalties rather than encouragement toward positive behaviour. Several respondents linked these issues to the overall burden of regulation,

²⁷ Future price limits – a preliminary model: informal consultation, Ofwat (2011).
http://www.ofwat.gov.uk/future/monopolies/fpl/pap_con110405fpl_prelimmodel.pdf

arguing that the combination of the two resulted in excessive risk aversion and a lack of incentives for water companies to innovate.

Even where Ofwat was working to boost positive incentives, companies expressed doubts on their effectiveness:

“Ofwat has sought to increase incentives – a laudable objective – but some of the mechanisms have become so complex that they are unlikely to be effective in practice. People do not respond well to incentives they struggle to understand.” Northumbrian Water

Many companies raised concerns about Ofwat’s implementation of new incentives and, in particular, highlighted perceived problems with the introduction of the Capital Incentive Scheme (CIS) in PR09. These included its complexity, a degree of confusion as to its purpose and unhelpful interactions with the quadripartite process and other inputs into the business plans.

Discussion

The review team is aware that as part of Ofwat’s Future Regulation programme it is reviewing its use of incentives and has released a discussion paper on this topic²⁸. UK Water Industry Research (UKWIR) and the water companies are also undertaking work in this area. We are not seeking to duplicate this work, nor review it in detail, but on the basis of the evidence received and further discussions with Ofwat and industry participants, we have sympathy with many of the points made by respondents to the call for evidence.

While we welcome Ofwat’s approach to the issue in examining the role of incentives from first principles as set out in their discussion paper, Ofwat must ensure that the existing knowledge and experience of incentives within the sector, along with work in other sectors (e.g. Ofgem’s RIIO work²⁹) is properly taken into account. The

discussion document on incentives looked only at possible future approaches, with no detailed ex-post analysis of the impact of existing incentives in the sector. While we understand that the purpose of the paper was not to undertake this kind of analysis, it is crucial that Ofwat’s consideration of incentives while forward-looking is informed by a detailed understanding of how existing incentives have performed in practice i.e. what worked, what did not and why. This will require the involvement of companies and the other regulators in order to understand the practical consequences, intended and unintended, of Ofwat’s existing incentive mechanisms.

In this context the CIS provides an interesting example. We do not see the CIS as an inherently complex concept. Ofgem has successfully integrated a similar concept into its price review process. However, it does appear that in the water sector it was implemented in a way that caused considerable confusion among the companies. In particular there appears to have been some lack of clarity as to its intention, with the focus moving from menu regulation (providing the companies with a choice of different levels of capital programme with differing incentive strengths applied) to incentivising the companies to provide realistic business plans which minimised the cost of the investment programme. This led to an unhelpful interaction with the quadripartite process and instances where the companies felt they were penalised, particularly in the draft determinations, for putting forward investment plans which had been supported by customer groups and the quality regulators. This demonstrates the need for Ofwat to consider fully both the concept and the practical application of incentive mechanisms before they are introduced. The responses to the review indicate that the post-PR09 development of the CIS may involve more substantive work than the ‘fine-tuning’ that Ofwat identified in its report on PR09.

28 The role and design of incentives for regulating monopoly water and sewerage services in England and Wales – a discussion paper, Ofwat (2010). http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf_1010fplinc.pdf

29 RPI-X@20 review and the RIIO model for network regulation, Ofgem (2010). <http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx>

More generally, we are sympathetic to the suggestion that the balance of risk and reward is tilted too far towards uncertain and potentially large penalties for failure, with relatively limited rewards for outperformance or innovation. This may be partly a feature of changing circumstances. When Ofwat's focus was primarily on improving efficiency in the industry, and rewards for outperformance were potentially greater, the approach may have been appropriate. It seems less well suited to the newer challenges set out in Ofwat's Sustainable Water strategy where the need to encourage more flexible and innovative behaviour on the part of the companies is much more evident.

In this respect we see strong linkages between the use of incentives and the burden of regulation. Companies need more ownership of their business plans and more flexibility to change them, within the overall price control constraint, without feeling the need for case-by-case Ofwat approval and without detailed Ofwat monitoring. There is clear scope to link a reduction of the burden to positive incentives for behavioural change and innovation and we would like to see the two approaches moving ahead in tandem.

Recommendation 5: As part of its review of incentives in its Future Regulation programme, Ofwat should seek to ensure that the future framework of incentives provides the right balance between rewards and penalties in the context of the challenges facing the companies, with increased emphasis on incentives for behavioural change.

Relationships between the companies and third parties

Evidence

We received several responses on water companies' relationships with developers and how Ofwat's regulatory approach affects these relationships. The Home Builders Federation (HBF) and other developers raised concerns with

water companies' attitude toward, and delivery of, upgraded infrastructure necessary for new housing. They also raised concerns with the speed at which Ofwat deals with complaints about this issue and the clarity and effectiveness of their guidance to water companies. Developers raised concerns about the transparency and consistency of the current system of charging for new connections and potential cross-subsidies inherent within it.

"house-builders are often sandwiched between Companies who apply their own spin and interpretation to legislation and the guidance/direction from Ofwat, who often seem somewhat reluctant to challenge or take forward issues in a proactive way."

Home Builders Federation

In a related area, holders of and potential applicants for New Appointments and Variations ("new appointments" or, previously, "inset appointments") also suggested that Ofwat was not interested in the promotion of competition for operation of parts of the network. Both developers and applicants for new appointments noted a contrast with the position in energy network utilities where they felt that the process for gaining a connection to the network and for competition in construction and/or operation of new network infrastructure was much more amenable to their interests.

Background

There is a long history of dissatisfaction on the part of housing developers and others seeking new connections to the water and sewerage networks and the delivery of new infrastructure to support such connections. Ofwat's response has been to encourage competition in this area in two respects:

- In the provision of new infrastructure, giving developers the ability to use independent contractors rather than the incumbent utility (known as "self-lay"); and

- Granting new appointments for the ownership and operation of new infrastructure.

Self-lay allows the developer to obtain a quote from an independent contractor or “self-lay organisation” (SLO). Ofwat sets out detailed guidance to water companies on how they should behave in their dealings with SLOs and how SLOs should be able to operate. This requires water companies to publish their self-lay policies and includes a detailed specification of required levels of service to the SLO, setting out the time period in days within which various services should be provided by the company to the SLO. The intention of the guidance is to ensure that developers have a meaningful choice between self-lay and requisitioning a connection from the incumbent company. Ofwat has powers to determine disputes about the provision of new mains, sewers and lateral drains and may consider appeals about the adoption of water mains.

The new appointments regime was created as a means of introducing competition for the ownership and operation of parts of the networks. New appointments have the same duties and responsibilities as the existing companies for their specified area and have to meet a number of tests to ensure that they have the ability to comply with their legal duties. In considering new appointments Ofwat ensures that domestic customers as a whole should be no worse off as a result of the appointment. New appointments were recognised in the Cave review as an important mechanism for enabling market entry.

Much of the detail of both the system of charging for new connections and the new appointments regime are set out in legislation and is therefore not in Ofwat’s gift to amend.

Discussion

Respondents acknowledged the guidance to the companies about SLOs, but felt that the service provided by companies fell short of the requirements set out and that the guidance was not enforced. The HBF and others made comparison with the energy sector in which there is a similar approach to competition for new connections. But, in energy, the network companies must comply with certain service standards³⁰ in relation to developers and the companies are subject to licence conditions requiring achievement of specified minimum levels of overall performance in relation to these standards. The standards allow for payments to customers or developers in the case of individual failure to meet a standard, while the licence condition allows Ofgem to take enforcement action in cases of failure to meet the minimum overall performance levels. The latter power has been used to impose substantial fines on network operators³¹.

Ofwat’s view is that the arrangements between the companies and developers are business arrangements between commercial companies and that it would not be appropriate to extend more detailed regulation to this part of the sector. However, experience in the energy networks sector suggests that improved service is not achieved without active intervention by the regulator. The current arrangements in energy networks are the result of a long process driven by Ofgem to introduce competition in the sector and to improve the performance of the network companies.

On the basis of the evidence presented to us we feel that there is considerable scope for improvement in the performance of the companies in respect of SLOs and that further action by Ofwat will be required to achieve this. Ofwat should consider the merits of moving towards an

30 New standards for network connection services, Ofgem (October 2010). <http://www.ofgem.gov.uk/Media/FactSheets/Documents1/ConnectionsFS.pdf>

31 Press release: Promoting choice and value for all gas and electricity customers, Ofgem (2011). <http://www.ofgem.gov.uk/Media/PressRel/Documents1/Connections%20Press%20Release%20Feb%202011.pdf>

approach such as that applied in energy networks, where minimum standards are set out in the companies' licences. We recognise that this is linked to the question of licence reform (discussed later in this chapter). This raises a question of timescale, as reform of licences to facilitate the introduction of new conditions of this type will take some time.

We also feel there is scope for improvement in the process for handling complaints in the area of connections and self-lay. This is considered further in the casework section later in this chapter.

Recommendation 6: Ofwat should introduce measures to improve the standards of service provided to developers and self-lay organisations including potentially the introduction of Guaranteed Standards of Service combined with licence conditions requiring a minimum standard of overall performance in respect of these standards.

Responses from companies holding new appointments suggest that the main problem in their case is the complexity of the qualification or licensing process. This is done on a site by site basis and a holder of a new appointment in one area must still go through the whole process to gain another appointment elsewhere. Again, respondents pointed out the contrast with the energy sector when an independent network operator, once licensed, is qualified to operate anywhere in the UK.

Ofwat has recently published a review of its policy towards new appointments³². In this, it points out that the Water Industry Act 1991 does not allow national appointments. It only provides for appointment for specific geographic areas. National appointments would potentially be possible under the Cave review's proposals for market reform, which would introduce the concept of a network licence. Ofwat has indicated

that it expects to review its policy and process in respect of new appointments again in 2014 in the light of Government's decision on market reform and the outcome of its own work on Future Regulation.

We are not making a formal recommendation in the case of new appointments as this matter has been addressed by the Cave Review and Ofwat has undertaken to review it again once the position on market reform and future price limits is clearer. However, as the problem appears to be at least partly concerned with restrictions imposed by the nature of the existing legislation it will be necessary for Ofwat and the Department for Environment, Food and Rural Affairs (Defra) to ensure that this is adequately addressed in any new arrangements.

Landowners

We found an interesting parallel in the way water companies deal with landowners over land access. The companies have very strong powers, under section 159 of the Water Industry Act 1991, to gain access to private land in order to install new pipes or maintain existing ones. The landowner has no right to object and little negotiating power in agreeing compensation. In contrast, gas companies have no such rights of access and have to rely on compulsory purchase. This is difficult and time consuming, so in practice we understand that they tend to enter into negotiation with the landowner. Electricity companies have slightly stronger rights, but these are more comparable to those of gas companies than water companies.

The review team received submissions on this issue from the National Farmers Union (NFU) and the Central Association of Agricultural Valuers (CAAV). They stated that, although water companies are required to publish Codes of Practice regarding land access, these are widely ignored by the

³² New appointments and variations – a statement of our policy, Ofwat (2011). http://www.ofwat.gov.uk/competition/inset/pap_pos110228navpolicy.pdf

companies and their contractors. Landowners have a right to appeal to Ofwat. However, the NFU and CAAV told us that Ofwat shows little enthusiasm for pursuing such complaints and that any resulting awards of compensation to landowners, if any, are far too small to have any effect. The result is that few landowners now bother to complain.

The experience of landowners and developers suggests a more wide-ranging issue concerning the relationship between the companies and parties who may not strictly be customers in relation to the matter concerned, but, in the case of developers, could be argued to represent future customers and, in the case of landowners, customers in a different guise.

Recommendation 7: In view of the similarities between the issues raised by housing developers and landowners, Ofwat should consider the issues relating to access to land in combination with the review of its approach to self-lay and the treatment of developers.

Casework

Evidence

The Home Builders Federation (HBF) reported that the feedback they had received from their members was that a determination to Ofwat often takes a protracted time to resolve:

“The only other route of challenge to any issue is through a Determination to Ofwat. However this comes at a risk and with a protracted time period in getting the issue resolved because of the length of time it takes for Ofwat to determine an issue...[The] reality is that determinations take the best part of a year or more. We would therefore conclude that there needs to be some serious

consideration to these stated levels of service for determinations. That said this process does seem to be made worse by the attitude of those Companies who constantly miss deadlines for responses and seek extensions of time as a matter of course.” **Home Builders Federation**

The time taken to resolve a dispute is critical for developers because, once on site, they have limited ability to wait for a response from Ofwat, as costs mount up. As a result the HBF reports that many developers do not even bother referring the case to Ofwat and are left to negotiate with often unhelpful and obstructive companies.

Discussion

Ofwat is required to handle, or consider handling, cases referred to it under a wide range of provisions of the Water Industry Act 1991. The list goes well beyond the issues raised by developers and includes a range from large and complex Competition Act cases and price determinations, to mains and sewer requisitions, and then down to individual customer disputes³³.

The review team asked Ofwat for its performance statistics in handling casework. In response Ofwat stated that it deals with approximately 2000 enquires a year, of which about 200–450 turn into investigated cases. Ofwat also provided the data in the table below. While this shows that Ofwat responds to the majority of enquiries within ten days, there is no indication of the level of satisfaction of the enquirer. The performance on resolving enquiries is similarly unclear, both in terms of satisfaction and the percentage of cases eventually resolved overall. What is clear is that there is a substantial “tail” of cases that are taking longer than six months to resolve.

33 <http://www.ofwat.gov.uk/consumerissues/complaints/compswehandle/>

Performance against targets: April 2010 – November 2010

| | No. responses | No. responses within target | % within target |
|---|---------------|-----------------------------|-----------------|
| 95% of written enquiries responded to within 10 days | 373 | 371 | 100% |
| 80% of non-investigated complaints to be responded to within 10 working days | 467 | 444 | 95% |
| Provide initial response to 95% investigated cases within 10 days | 160 | 156 | 98% |

Performance for resolving investigated cases: April 2010 – November 2010

| | | |
|--|-----|-----|
| Number resolved | 164 | |
| Investigated complaints resolved within 3 months (65 working days) | 108 | 66% |
| Investigated complaints resolved within 6 months (130 working days) | 126 | 77% |

These figures suggest that there is a problem with timely resolution of cases and that the reaction of developers and landowners is understandable. We would like to see a substantial improvement, with a strong focus on resolving a substantial majority of cases within a period which is more helpful to developers and other parties raising complaints.

Ofwat recognises the problem and has recently implemented a work programme to try and deal with the backlog, particularly in respect of a number of cases that have been open for more than a year. This is a welcome, if somewhat belated, response and, even so, it will take a considerable time to persuade developers that an appeal is a commercially viable option for them.

In connection with this Ofwat raised two issues which it felt would help it to address the underlying cause of the problem and improve its overall approach to handling casework.

First, Ofwat would like greater discretion to choose the casework it takes on. At present it has very limited flexibility and is required, under the Water Industry Act 1991, to take on most cases referred to it. Exceptions are Competition Act cases, section 40 bulk supply determinations, and section 56³⁴ price determinations which it can choose whether or not to pursue. Ofwat would like some degree of discretion over all its casework in order to focus on cases of wider importance to the industry. Cases it did not take on could be referred to CCWater, or to independent arbitration as appropriate, or simply not be considered.

³⁴ The discretion under section 56 allows Ofwat to appoint an arbitrator. In the absence of appointing an arbitrator, Ofwat is still required to make a determination.

This would represent a significant change of approach. The standard position would be that most individual customer cases go to CCWater and most developer and landowner cases go to arbitration. Ofwat would retain for itself cases that involved wider issues of principle or precedent. In principle, we consider this to be a sensible approach, providing a clear separation of roles between the regulator and other methods of dispute resolution. The difficulty is that, as a result, there may be some categories of dispute that would simply fall out of the system altogether, with no formal dispute resolution mechanism available. This would be unacceptable.

We are sympathetic to Ofwat's proposals but before the UK and Welsh Governments are asked to implement the necessary legislative changes Ofwat and CCWater should jointly review the position of cases that would not be considered under this approach and recommend a suitable solution to this issue after appropriate consultation with interested parties.

Secondly, Ofwat has asked for greater powers to gather information from organisations other than water companies. At present it has powers through the company licences to require them to provide it with timely, evidence based information. This power does not extend to other parties subject to a determination or an appeal. Ofwat has found that informal information gathering has not always been effective and has resulted in delays in resolving casework. Again, the review team are sympathetic to this request.

Recommendation 8: The UK and Welsh Governments should favourably consider the request from Ofwat for strengthened powers to gather information and discretion to choose the casework it takes on. In developing these proposals, Ofwat and the Consumer Council for

Water must ensure to Government's satisfaction, that all customer complaints can still be addressed by an appropriate body and that the route for complaint is clear.

Enforcement

Water companies have a duty to meet their statutory obligations and to comply with conditions set out in their appointment. Where they fail to meet these obligations Ofwat can take enforcement action.

Ofwat has a power to require information from a company that is or may be breaching its obligations. At present Ofwat's power does not extend to information where a company may be failing to achieve the minimum standards of performance set out in the Guaranteed Service Standards³⁵.

In the draft Flood and Water Management Bill the UK Government proposed to extend the power to require information to ensure that the regulator and Ministers could seek information from companies where they have failed or are failing to achieve any Guaranteed Service Standards³⁶, which would also include any adopted for services to developers and those requesting a connection (see above).

The draft Bill also proposed extending the time limit for imposing a financial penalty from one year to five years, to fully reflect the duration of the contravention and the full extent of any detriment to customers that has occurred across a price review period.

³⁵ Customers of water and sewerage companies are entitled to guaranteed minimum standards of service, as laid down by the Government. Where a company fails to meet a standard then it is required to make a specified payment to the customer affected.

³⁶ Draft Flood and Water Management Bill, Defra and Welsh Government (April 2009) pp.90-91.
<http://www.official-documents.gov.uk/document/cm75/7582/7582.pdf>

Recommendation 9: At the next legislative opportunity, Government should enact the changes to Ofwat's enforcement powers proposed in the draft Flood and Water Management Bill.

Ofwat also has several competition powers:

- Ofwat has, concurrent with the Office of Fair Trading (OFT), jurisdiction to apply the Competition Act 1998 and Articles 101 and 102 of the Treaty on the Functioning of the European Union;
- Ofwat is a 'designated enforcer' under the Enterprise Act 2002, and has the power to obtain an enforcement order to take action against breaches of specified pieces of consumer protection legislation; and
- Ofwat also has concurrent powers with the OFT under the Enterprise Act to make a market investigation reference to the Competition Commission.

The aim of the concurrency regime was to establish a regulatory system in which, as competition develops in a liberalised sector, the need for economic regulation in that sector would diminish over time, with concerns about the competitive process in the sector being addressed under general competition law. However, competition has been slow to develop in the water sector and so Ofwat is still heavily dependent on its regulatory powers.

In its response to the call for evidence, the OFT was concerned at the rare use of Ofwat's competition powers:

"Ofwat has only ever issued two 'decisions' under CA98 and both were for non-infringement. When consumers and potential new entrants have complained under CA98, Ofwat has used its regulatory powers or issued industry guidance (for instance on 'access charges' to allow new entrants to

utilise monopoly assets). This reluctance to arrive at infringement decisions (and utilise the CA98 ability to fine businesses) might be interpreted by some businesses as a sign that anti-competitive practices will not be tackled."

Scottish and Southern Energy suggested that use of its competition powers was one option Ofwat might have pursued in better opening up the water market to new entrants like themselves.

In March, the Department for Business, Innovation and Skills launched a consultation on 'A competition regime for growth'³⁷. This is considering reforms to the existing competition regime across all sectors, to maximise the ability of the competition authorities to secure vibrant, competitive markets, in the interests of consumers and to promote productivity, innovation and economic growth. Therefore the review team has refrained from making recommendations on this issue.

Licence reform

In its response to the call for evidence Ofwat requested support for a process of reform of the Instruments of Appointment (licences) of the companies. These are the documents that set out each company's obligations in detail. Ofwat had previously commissioned a report from Wragge & Co. which concluded that:

- the licences are in need of substantial modernisation and simplification;
- certain aspects of consumer protection measures are missing from water company licences in comparison with other regulated sectors; and
- reform is necessary if the UK or Welsh Government pursues the Cave recommendations for the introduction of retail and upstream competition.

³⁷ A Competition Regime for Growth: A Consultation on Options for Reform, BIS (June 2011). <http://www.bis.gov.uk/Consultations/competition-regime-for-growth?cat=open>

Ofwat also suggested that some licence conditions are unnecessarily restrictive. For example condition B sets out the timing and nature of the five-year price review, while condition N sets out a detailed framework for recovery of Ofwat, CCWater and Competition Commission costs. Ofwat felt that such conditions either should not be in the licence at all or should be more flexible.

Ofwat's proposals for reform go further and seek:

- changes to the licences to allow Ofwat to implement more targeted regulation of the core utility business; and
- a collective licence modification process to simplify the implementation of consistent licence changes across the companies.

In its response to the call for evidence, Ofwat suggested that the best approach would be for Government to introduce legislation allowing Ofwat to redraft the licences from scratch.

Provisions for the Secretary of State to introduce standard conditions and for Ofwat to vary these conditions, as well as a provision for introducing a collective licence modification process were included in the draft Flood and Water Management Bill published for consultation in April 2009. These provisions were not included in the substantially slimmer Bill introduced into Parliament that November, due to pressures on Parliamentary time.

The companies, in general, are nervous of licence reform, largely because they have concerns about the policies which such reform would be intended to facilitate. They are also concerned that any significant changes to the effect of the licences (as opposed to simplification and modernisation) would have implications for financing arrangements which, in general, include covenants restricting their ability to undertake certain actions and allowing repayment or renegotiation of the terms of the loan in the case of any material adverse change.

In response to the draft Bill consultation, Water UK argued that the provisions were unacceptable to the industry as the case for change had not been articulated. It felt that standardisation should be through agreement rather than imposition, and that Ofwat could already pursue change through appeal to the Competition Commission, but had not tested this approach in practice.

Some of the companies' reservations about licence reform are understandable, particularly where, for instance, costs could arise from the need to renegotiate the terms of financing arrangements which appeared reasonable in the context of the licence conditions applying at the time. However, the case for modernisation and simplification is clear. One of the main benefits of licences (as opposed to codifying regulation in legislation), is that they give the regulator and the regulatory regime the flexibility to react to new circumstances. The water sector licences are too inflexible to be used in this way. It is not reasonable for the companies to resist simplification simply to frustrate Ofwat's ability to introduce changes it wants, such as the introduction of financial ring fence conditions to protect the regulated companies. In practice, Ofwat has only been able to achieve such changes as part of a negotiation when companies have themselves wanted a licence change to facilitate, for example, a corporate transaction or a refinancing.

Licence reform has precedent in other sectors. Ofgem, for instance, has in recent years, undertaken extensive reviews of the electricity supply and distribution licences, modernising their language and substantially reducing them in length and scale of content.

Since its initial request Ofwat has been consulting the industry about modernisation and simplification, including the introduction of standard form licence conditions. Ofwat appears to have made some progress and is no longer seeking legislative support for these aspects of licence reform. This seems appropriate, as

we could see no good reason to suggest that this could not be done by agreement with the companies.

The proposals for licence changes to facilitate business separation and the introduction of competition do require legislation and this will have to be considered by the UK and Welsh Governments once Ofwat's proposals are finalised. In principle, if the two Governments are comfortable with the proposed approach we would support proposals for legislation in support of this.

If the licences are standardised we would also support the idea of a collective modification procedure.

These changes, taken as a whole, would in our view represent a major improvement on the current arrangements. They would also potentially make it easier for Ofwat to seek to introduce licence changes that might be unwelcome to the companies. For instance, reform would be necessary to allow the approach we suggest towards enforcement of minimum standards of service for housing developers and SLOs (discussed in the previous section on relationships between the companies and third parties), which would bring with it the risk of financial penalty for companies falling short of the required level of service.

This is not a good reason for frustrating licence reform. The companies have, in effect, rights of appeal against changes they regard as unacceptable. They can refuse to accept the changes and force Ofwat to decide whether to refer them to the Competition Commission. A collective licence modification process would to some extent reduce this protection for individual companies but only if a substantial majority of companies had agreed to accept the proposed change.

Recommendation 10: Ofwat and the companies should work together on a process of standardising and simplifying licences. The UK and Welsh Governments should facilitate the introduction of a mechanism for collective licence modification, and consider legislating for licence changes in the light of its decisions on the introduction of further competition in the sector and Ofwat's further work on Future Price Limits.

Chapter 3:

Sustainable development

Summary

The Terms of Reference asked us to consider the extent to which Ofwat has contributed to the achievement of sustainable development. The views expressed to us on this subject varied widely. Understandably, most responses focussed on specific areas where respondents felt Ofwat could do more and some, including the Welsh Government, felt that Ofwat's duty to contribute to sustainable development should be strengthened by elevating it to the status of a primary duty.

In several of the specific areas we agree that there are issues to be addressed. In particular, we recommend that Ofwat should be clearer about how its price control decisions fit into a longer-term strategic framework and we suggest a more formal role for the Consumer Council for Water (CCWater) as a consultee on significant changes to charging arrangements. However, in many cases we feel that improvements will be better pursued through recommendations we make elsewhere in the review rather than through calls for specific action by Ofwat on the issue concerned.

The perceived bias towards capital investment and the need for more innovative approaches by the companies are important issues which we would expect to be addressed, at least in part, through changes to the way in which Ofwat approaches its price reviews (PR). The extraordinary degree of cyclicality in business flows from the water companies to the sector supply chain, which appears to be largely a response to the price review process, is obviously undesirable. We hope that our proposals to make regulation less intrusive and give companies more ownership of their business plans will improve the position, but it may also be necessary to consider some more proactive approaches in the shorter-term.

We do not agree with the suggestion that Ofwat's sustainable development duty should be elevated to primary status, partly because we do not believe such a change would have the effect

that its proponents are looking for. However, we do recommend that Ofwat should review its interpretation of the existing duty with particular reference to the areas we have highlighted in this chapter.

Evidence

Ofwat has a secondary duty under the Water Industry Act 1991 (as amended) to exercise and perform its powers and duties in the manner it considers is best calculated to contribute to the achievement of sustainable development. In the call for evidence we asked for evidence on how far Ofwat's decisions are leading to sustainable outcomes. Respondents expressed opinions on the issue in general terms and in relation to a series of specific issues.

On the general question the responses varied widely. Some respondents felt that the high level of investment by the companies since privatisation aimed at compliance with environmental and quality standards, and the resulting improvements in performance, demonstrated that Ofwat had been very successful in this regard. Others took the view that these improvements were driven by legislation, often in response to European Union directives, and that Ofwat had no proactive role. Indeed, some respondents felt that Ofwat had been driven primarily by economic considerations such as efficiency and cost-benefit analysis and had hindered the achievement of sustainable outcomes.

At the specific level most respondents understandably focussed on areas of criticism rather than giving examples of where Ofwat had been successful in this regard. In our interim findings, we set out several issues which respondents had identified as evidence that Ofwat's approach was not leading to sustainable outcomes, particularly over the longer-term.

These included:

- the five-year regulatory cycle, driving a focus on the short-term rather than a consideration of the longer-term requirements and obligations of the sector;
- a bias towards capital investment solutions including lack of support for catchment based approaches and preference for end of pipe solutions;
- a lack of measures to stimulate investment in renewable energy and water efficiency;
- inflexibility over the introduction of social tariffs;
- a lack of measures to stimulate innovation in the industry;
- the growing level of debt in the water companies;
- the impact of the five-year cycle on the supply chain; and
- a relative lack of concern for housing development and for the interests of developers in their dealings with water companies.

Before considering the general issue of Ofwat's contribution to sustainable development it may be helpful to discuss the various specific issues raised by respondents. As this chapter deals with a diverse range of issues, we have included the detailed evidence in the relevant sections of the discussion.

Discussion

The need for longer-term solutions

A common theme in the responses was the criticism that the five-year price control cycle led to a focus on short-term solutions and inhibited longer-term investment planning. The water sector is clearly a long-term industry. Climate change is projected to have profound effects on future water resources, population growth will affect demand, asset lives are long in comparison with other industries, even in the regulated sectors, and the planning cycle is therefore similarly long-

term. Significant change in the nature of the network and the natural environment can only be achieved over a considerable period. Respondents argued that these characteristics mean that policy objectives, particularly for environmental improvements, could only be achieved by way of long-term investment plans. A common suggestion from respondents was that the price control cycle should be lengthened from the current five years. Many of the companies agreed with this assessment.

"First, the price reviews that occur every five years currently involve the entire investment programme being reconsidered from scratch. Replacing this with a 10-20 year investment programme aligned with the Strategic Direction Statement would bring greater continuity, enable the pace of investment to be set at an affordable rate and provide the opportunity to test more sustainable approaches before large amounts of capital investment are committed." **Wessex Water**

"Outputs are set only five years ahead, which encourages a short-term focus and leads to inefficient fluctuations in levels of investment. Targets set beyond five years would lead to better long-term planning and strengthened links to the Strategic Direction Statement rather than focusing on meeting the current year's target through standard solutions. This would lead to more efficient delivery and increased innovation."

Severn Trent Water

Ofwat has recognised this issue and, in PR09, it asked each company to produce a Strategic Direction Statement (SDS). The purpose of the SDS was to provide a long-term context or framework within which investment plans could be considered not just by Ofwat but by other stakeholders, in particular those represented in the quadripartite process.

Government has also sought to introduce a longer-term approach to planning through a statutory duty on the companies to develop Water

Resource Management Plans (WRMPs). A WRMP shows how a water company intends to maintain the balance between supply and demand for water in its operating area over the next 25 years. As part of this, companies should consider the impact of climate change on supply and forecast the required level of headroom to allow for uncertainty in the assessment.

Although the SDSs were generally seen as constructive in themselves, some respondents felt that Ofwat's PR09 final determination did not take them into account.

The review team agree that long-term considerations could be better reflected in Ofwat's approach. A longer price control period could be part of the answer and, in its Future Price Limits project, Ofwat is considering the possibility of a longer-term control (say of eight or ten years) for core network assets. However, the length of the price control also needs to be driven by practical considerations such as typical lead times for planning and construction, and also the period over which conditions may change in such a way as to invalidate the planning assumptions used in the review. There is therefore a practical limit on the extent to which the control period can be lengthened without simply opening up the need for more intra-period review mechanisms.

Ofwat itself recognised this when it reviewed the issue five years ago:

"We consider it extremely unlikely that there will be sufficient certainty about the key elements of operating costs, the capital programme, opportunities for efficiency gains, or revenues and financing costs to make practicable an extension much beyond five years. The risks of creating additional uncertainty and instability arising from overuse of interim determination mechanisms and big adjustments made at each review are too great³⁸."

The review team are more attracted to the suggestion that price review decisions should be set more firmly within the context of the SDSs and the other longer-term plans in the sector. That is not to say that Ofwat should formally approve long-term plans for the companies; that would in effect lengthen the control to, say, twenty years with the disadvantages mentioned above. However, investment proposals for the review period should be set specifically in the context of the various longer-term plans. Ofwat, in turn, should consider the proposals in that context and, in approving or rejecting company proposals, it should comment on the longer-term considerations it has taken into account.

Such an approach should improve the ability of other parties, particularly consumer representatives, to set Ofwat's decisions in a longer-term context and to understand the longer-term implications for water prices, thereby improving the consideration of inter-generational issues among consumers.

Recommendation 11: In future price reviews Ofwat should explain how its determinations have taken account of the long-term issues set out in companies' Strategic Direction Statements.

The perceived bias towards capital investment

Many respondents argued that the companies have an incentive to pursue capital investment schemes, rather than potential alternatives, in order to enjoy the long-term return on the resulting addition to Regulatory Capital Value (RCV). The companies generally accept there is some truth to that view but also express a concern that they cannot rely on not being penalised for inefficiency if they choose solutions involving operating costs rather than investment – therefore they tend to prefer to invest.

³⁸ Setting water and sewerage price limits: Is five years right? Ofwat (January 2006) p.14.
[http://www.ofwat.gov.uk/legacy/aptrix/ofwat/publish.nsf/AttachmentsByTitle/pr_length_cons310106.pdf/\\$FILE/pr_length_cons310106.pdf](http://www.ofwat.gov.uk/legacy/aptrix/ofwat/publish.nsf/AttachmentsByTitle/pr_length_cons310106.pdf/$FILE/pr_length_cons310106.pdf)

“Capital investment increases companies’ regulatory capital value, on which they earn a return. Operating cost solutions earn no return and higher operating costs lead to a lower comparative efficiency ranking, which adversely affects a company at price reviews. Therefore companies have an incentive to develop capital-based solutions rather than adopting solutions which might be potentially more innovative, or more cost-effective, but are operating expenditure based.” **Severn Trent Water**

This is a cause for concern because a number of respondents regard the bias towards capital investment as environmentally unfriendly – in the sense of encouraging “high carbon” solutions. It is also seen as discouraging solutions which may be preferable for other reasons, such as overall lifetime cost and impact on the local environment.

Ofwat has explored the issue in more detail in its recent discussion paper: *‘Capex bias in the water and sewerage sectors in England and Wales – substance, perception or myth?’*³⁹ The paper agrees that there is a potential for a capex bias – at least in the behaviour of the companies. It suggests that the possible causes go wider than Ofwat’s financial incentives, ranging to company culture, investor preferences and other regulator’s approaches; and that the exact causes are therefore difficult to identify. It also observes that it would be extremely difficult for Ofwat to be certain of equalising separate incentives across opex and capex.

The review team considers that the evidence of a bias towards capital investment is convincing, (not least in that several companies clearly perceive there to be one and this is a self-fulfilling belief), that a wider behavioural issue plays a part and that such a bias is undesirable for the reasons mentioned above. As discussed under the “burden of regulation” in Chapter 2, the

companies seem very Ofwat-dependent and risk-averse. Ofwat, in turn, effectively controls their investment programmes down to quite a small level of materiality. The risk-averse approach is therefore always to go for an investment solution because it can be defined clearly and approved by Ofwat. We would expect our recommendations in Chapter 2 to help to address this behavioural bias, but the underlying issues as identified above, would remain.

Various potential solutions were suggested by respondents, many of which in effect entailed excluding schemes which involve a trade-off between capital and operating costs from the assessment of operating costs in the price review and from the related efficiency incentive. Our view is that while such solutions could potentially achieve the desired effect they would also add to the complexity of the current regulatory regime – an outcome that would itself be undesirable and would act against our recommendations for simplification set out in Chapter 2.

An alternative way of looking at the issue is to say that the incentives for capital and operating expenditure are not symmetrical. In the price review process Ofwat sets allowances for capital and operating expenditure separately; it then assesses actual spending against these allowances separately and applies incentives to encourage efficiency or penalise overspend. The incentive mechanisms are different and the companies appear to regard the incentive on operating costs as more powerful than the incentive on capital investment. Faced with a choice between incurring incremental capital or operating costs they therefore naturally favour the former.

Ofwat has set out several options to improve the situation which it says will work better in some combination than individually. Ofwat will confirm its proposed approach in its autumn consultation on the methodology for setting price limits.

³⁹ Capex bias in the water and sewerage sectors in England and Wales – substance, perception or myth? A discussion paper, Ofwat (2011). http://www.ofwat.gov.uk/future/monopolies/fpl/pap_tec1105capex.pdf

Other regulators have considered this issue and have in general also concluded that equalising the strength of separate incentives for operating and capital costs is too difficult to achieve in practice. Ofgem, in particular, considered this question in its recent review of network regulation in the energy sector (RIIO⁴⁰) and concluded that it should adopt an approach which combined the treatment of operating and capital costs, capitalising a fixed percentage of total costs and thereby equalising the incentive effects. This has the disadvantage of removing the direct link between actual capital expenditure and the RCV but Ofgem concluded that this was outweighed by the benefits of equalisation of incentive strength.

This is a highly technical area in which it is clearly for Ofwat to decide on the appropriate approach. However, the review team's assessment is that this issue is both real and important and that the Ofgem approach as set out in RIIO appears to have considerable attractions.

Renewable energy

Companies, and other respondents, told us that Ofwat is unsympathetic to proposals for renewable energy developments associated with water or sewerage plants. They argue that Ofwat's approach is unnecessarily restrictive and limits the companies to specific types of scheme that are clearly related to mainstream regulated activities such as hydro-generation or combined heat and power linked to sludge treatment. Other approaches, such as wind or solar power, are not allowed even though many companies have sites that are very well suited to these forms of generation.

The companies argue that electricity is likely to continue to be a growing component of their costs and a more facilitative approach by Ofwat would allow them to minimise costs and contribute towards their carbon reduction targets.

To a great extent Ofwat does not dispute the companies' description of its approach. In PR09 it argued that:

"There is a competitive market for energy generation and our starting presumption is therefore that companies' renewable energy activities should not be part of the appointed business subject to price controls, unless there are compelling reasons for this."

For investment in renewable generation to be considered as part of the core utility business, Ofwat requires the technology to have natural synergies with the utility business, such that it would not make sense to separate the energy generation function from the core business. In practical terms this does largely limit the companies to hydro-generation or generation related to sludge treatment. On this basis Ofwat argues that in PR09 it allowed all 33 stand-alone renewables schemes that the companies put forward. The companies argue that many more schemes would have been proposed, particularly for wind or solar power, if Ofwat had been prepared to consider them.

The main issue therefore relates to forms of generation not related to the core business. In the core business there may be some issues to resolve but, broadly speaking, the companies seem to feel that the regulatory process works reasonably well. (One example of a potential issue mentioned to us related to the potential replacement of an incinerator with an anaerobic digester with a generation facility incorporated in the plant. The company's concern was that Ofwat would treat such investment as asset maintenance. It would therefore not be incorporated in the RCV and any related cost saving would be passed straight through to customers. There would therefore be no incentive for the company to propose such a scheme.)

40 Revenue=Incentives+Innovation+Outputs, Ofgem (2010). <http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx>

Outside of the core business Ofwat is clear that it does not prevent the companies from investing in other forms of renewable generation. So, for instance, a wind turbine could be constructed on a site owned by the core business if it was owned by a separate unregulated company that paid a fair rent for the use of the land and there was an arms-length agreement on a fair market price for the power consumed by the core business. Ofwat would expect the unregulated business to retain the sales proceeds from the power together with any other economic benefits (specifically the associated Renewable Obligation Certificates or ROCs). There is no limit on the size of the unregulated business and Ofwat adopts a “dual till” approach so there is no balancing revenue deduction in the regulated business.

This is a difficult issue. It seems clear that there is considerable scope for a wider range of renewable generation on sites owned by the regulated companies. However, such generation is already incentivised quite separately through the Renewables Obligation (or, in future, by successor measures proposed in the Electricity Market Reform project by the Department of Energy and Climate Change). It is not obvious that such investment needs to be incorporated within the RCV of the water and sewerage companies with the added protections that would entail.

This appears to be another example of the risk-averse nature of the companies and their distrust of the regulatory regime. It would be understandable if the owners of the companies saw an unregulated generation business as a high risk activity to enter into; but the risks could be mitigated, for instance by way of a joint venture with a renewable generation specialist. Part of their reluctance to do this seems to be related to uncertainty over how the interface between such schemes and the regulated business will be treated by Ofwat in the future.

We would encourage Ofwat to keep its approach to renewable generation under review to ensure that the regime is not imposing any unnecessary

restrictions in this area. However, the basic approach that investment that is not intrinsically associated with the core business should not be included in the RCV, seems reasonable. If Government wants Ofwat to take a different view it could consider introducing specific guidance on this.

Water efficiency

Companies are required through their Water Resource Management Plans to maintain the balance between supply and demand for water in their operating area. However, Government and the regulators have also set up other interventions to drive water efficient behaviour by companies and their customers.

In ‘*Future Water*’ the UK Government set out in its vision for 2030, a reduction of per capita consumption of water to an average of 130 litres per person per day. Respondents stated that it is not clear how Government expects this vision to translate into water company’s actions:

“The 130 pcc aspiration set in Future Water is not currently being delivered comprehensively through either the Price Review or Water Resource Management Plan process, because it is not formally linked to them.” **Waterwise**

This confusion was reflected in the WRMP process. While some companies have followed the 130 litre aspiration in their WRMPs, Ofwat did not consider the outcomes as statutory obligations when it came to funding decisions.

Since 1996, each water company in England and Wales has had a duty to promote the efficient use of water by its consumers. To ensure they fulfil this duty Ofwat has set them annual activity-based water efficiency targets. The target comprises first: a base service element requiring companies to deliver annual reductions in household consumption of 1litre per property per day through water efficiency activity including

advice to consumers and research to improve the evidence base, and secondly: the “sustainable economic level of water efficiency” whereby Ofwat invites companies to propose additional activity, above the base level, which would form part of a sustainable, economic approach to balancing supply and demand.

However, Ofwat has put in place further incentives by publicising companies’ performance and by taking action against companies which fail their targets. These actions are likely to drive extra expenditure by water companies to be certain of avoiding reputational harm.

To remove a previous disincentive which meant that water companies were financially penalised if customers used less water, Ofwat introduced a revenue correction mechanism. Ofwat can also exclude unusual significant expenditure on water efficiency projects from its relative assessment of water company efficiency. However, Waterwise does not feel this is sufficient to overcome the capex bias discussed earlier in the chapter.

“This bias acts as a barrier to large-scale water efficiency – this is despite the Revenue Correction Mechanism which Ofwat has introduced, which is welcome, but will only bite every 5 years, so does not drive year-on-year supply-demand investment decisions.”

Waterwise

In its recent consultation following up the Walker Review, the Welsh Government suggested that it expects Ofwat to review the impact of the revenue correction mechanism on the use of demand management measures.

Ofwat follows a separate but parallel approach with leakage – establishing the “sustainable economic level of leakage” as the standard which water companies should seek to meet and the same framework of targets, reputational incentives and follow-up action on failing companies.

While publicising leakage performance may serve to combat the knock-on effect of company leakage potentially harming customer willingness to save water if they see companies wasting water, such publicity also fosters the perception that companies are performing inefficiently providing an excuse for individuals not to act.

While it is not for this review to decide policy on water efficiency there are several principles stated elsewhere in this report which could apply equally to future policy decisions around water efficiency:

- Planning processes should work in harmony. The WRMP should be a key input to the company business plan and accepted as such by Ofwat (discussed in Chapter 1).
- Government should set clear guidance to Ofwat and move away from setting aspirations with unclear status (discussed in Chapter 5).
- Government and Ofwat should allow companies greater freedom in meeting their obligations. Regulations and company incentives should be focused on meeting the supply demand balance in the most cost-effective manner. Companies should not be constrained by imposed targets on individual options such as leakage management, but instead be free to follow the broader options appraisal considered in their WRMP.

Charging and social tariffs

A number of respondents felt that Ofwat should proactively support the development of social tariffs to assist vulnerable customers. Water charges, particularly in relation to affordability, have been reviewed in great detail in the Walker Review, in the development of the Flood and Water Management Act 2010 and in the current public consultations⁴¹ by the UK and Welsh Governments on the outcomes of the Walker Review. It is not the purpose of this review to revisit these issues in detail. However, we discuss

41 <http://www.defra.gov.uk/consult/2011/04/05/water-affordability-1104/> and <http://wales.gov.uk/consultations/environmentandcountryside/walkerreview/?lang=en>

the need for a clear statement of Government policy on these issues in Chapter 5.

A related issue, which was not mentioned in responses to the call for evidence, and was not covered in the Walker Review, but is relevant here, is the role of the charging governance framework in providing and assessing information on the potential effects of changes in the companies' approach to charging on customers generally and on specific customer groups.

Ofwat currently monitors and approves each water company's water and sewerage charges each year. Its stated objective in doing this is to check that companies stay within the price limits set and that their charges are fair to customers as a whole. Ofwat is looking at ways to streamline the process in order to improve it and align it with its broader strategic aims⁴². The review team agrees with Ofwat's objectives here, which include keeping the regulatory burden associated with charging to a minimum.

Ofwat does require companies, when submitting information about their proposed charges, to identify any significant proposed changes, the impact of these changes on specific customer groups and how the company will communicate changes to affected customers. However, there is no requirement on companies to consult on such changes, or to provide any information to customers in advance of the change being formally implemented.

In light of the recent controversy around surface water drainage charges we considered whether there may be a role for more active and widespread consultation on significant changes to charging structures to highlight concerns and provide advance warning of significant distributional issues. There are various reasons to consider that other such contentious changes could arise in the future. In particular:

- the implementation of Cave's recommendations would require more focus on ensuring that network charges to the competitive sector are cost reflective and non-discriminatory;
- the continuing introduction of metering will, during the transition period, inevitably lead to changes in the relative burden of charges on different customer groups;
- the same is true of other measures to promote demand side response or water efficiency; and
- social tariffs, following guidance from Ministers, may involve a degree of cross subsidy from other domestic customers.

The common feature of these changes is that, given that the total revenue to be recovered is fixed by the price control, any changes in one aspect of charging will have knock-on effects elsewhere. Moreover, in the current structure there are significant differences of approach to charging between companies, the rationale for which is not clear.

We therefore considered whether companies should be put under an obligation to consult on any significant proposed changes to their charging structures. This would help to highlight any contentious distributional issues in advance and would allow consideration of whether any mitigating steps, such as phasing in, should be considered.

The review team discussed these issues with the Consumer Council for Water which confirmed that it has no formal role in the approval of charging schemes. However, some companies do consult CCWater on their charging schemes on an ad hoc basis. This appears to be a useful process and we concluded that there is a case for strengthening the role of consultation with the consumer representative, particularly in the case of proposals that could have a significant distributional effect.

⁴² The details on their approach for the next charging year are set out in RD 06/10 and RD14/10.

http://www.ofwat.gov.uk/regulating/charges/ltr_rd0610charges and http://www.ofwat.gov.uk/regulating/charges/ltr_rd1410approvalcharges

Such an approach would be consistent with the findings of the EFRA Select Committee Report on PR09⁴³ which, in reference to the surface water drainage issue, highlighted the importance of “companies having sufficient information about their customers and taking account of their needs when implementing changes in charging policy”. It would also be consistent with the principles outlined in Ofwat’s recent document on customer engagement⁴⁴ where it is seeking that companies involve customers in the development of their business plans.

Recommendation 12: As part of its design of a new charging governance framework, Ofwat should introduce an explicit role for the Consumer Council for Water. This could involve placing a requirement on companies to consult with the consumer representative on their proposed charging schemes before submitting them to Ofwat for approval.

Innovation

The question of innovation was covered in some detail in the Cave Review, which observed that there was evidence of an abnormally low level of Research & Development (R&D) activity in the sector. It concluded that there were significant weaknesses in the sector’s approach to R&D, including weak incentives for innovation, lack of alignment of the incentives that did apply, and a lack of funding at key points in the innovation chain. The Cave Review recommended the formation of a national water R&D body, with an element of funding from water company customers. It also recommended that Ofwat should be given a statutory duty to support innovation and proposed a number of changes designed to introduce more flexibility to the water abstraction regime.

Concerns about the lack of incentives for innovation were raised in responses to our call for evidence both in general terms, in the sense that the regime is seen as suppressing R&D activity, and in particular in relation to Ofwat’s approach to particular issues such as catchment management schemes.

The general issue of spending on R&D applies to any regime imposing strong incentives for efficiency in operating costs. In such a regime companies will tend to see R&D expenditure as an easy area in which to cut costs, particularly if there is no strong driver for innovation at the time or if the potential returns are not clear. The level of R&D intensity suggests that this has happened in the water sector, as in other regulated infrastructure sectors. However, it is not necessarily true that the water companies are best placed to pursue R&D activities. This may be a more natural activity for supply chain companies who may have a wider national and international market in which they can benefit from innovation in design of equipment etc. To the extent that specific R&D investment is required, the Cave proposals (on a new R&D vision, research body supported by funding, and excluding R&D expenditure from comparative efficiency tables) seem to be an appropriate response⁴⁵.

The more specific point relating to catchment management schemes seems to be part of a rather different issue. The question here is whether the companies are sufficiently flexible and imaginative in considering their available options and whether the regulatory regime incentivises them to be. In this case it seems likely that the regime does have an inhibiting effect, resulting in the degree of caution we observe in the companies in their approach to the regulator and the regulatory regime.

43 Ofwat Price Review 2009, House of Commons Environment, Food and Rural Affairs Committee (2009) p.22.
<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmenvfru/554/554i.pdf>

44 http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf1104fpl_customer.pdf

45 Independent Review of Competition and Innovation in Water Markets, paragraphs 7.36 and 7.37, Professor Martin Cave (April 2009) pp.90-91.

Specific aspects of the regime that seem relevant here are the bias towards investment and the threat of penalties for “inefficient” operational expenditure (discussed above) and the focus of the regulatory process on individually specified capital schemes (discussed in Chapter 2 – burden of regulation). The review team feel it is likely to be more effective to address these specific issues rather than to introduce any separate incentives for innovation on top of the existing approach.

Ofwat has already signalled its intention to move towards outcome-based regulation rather than a focus on detailed inputs or outputs and is examining options for further incentives as part of its Future Price Limits work. Ofwat will need to work with the quality regulators in its development of an outcomes-based approach in order to maximise the benefits that this approach could deliver. We hope that this move, combined with measures to address the bias towards investment and to reduce the burden of regulation so that the companies feel more ownership of their business plans, would help to change the behaviour of the companies significantly. Any moves to introduce further competition into the water sector should also stimulate innovative behaviour. Once the impact of these combined changes becomes clear it might be appropriate to review whether any further incentive for innovation would be helpful.

Debt

Some respondents questioned whether the increasing level of debt in the companies represented a sustainable approach to financing the industry and whether the level of debt represented an unsustainable burden on future consumers. Concerns were also expressed that the existence of highly geared structures could place restrictions on the freedom of action of the companies and on Ofwat’s ability to pursue change.

“Continuing to finance the capital programme through increased borrowing does not look sustainable, in that costs of financing will rise and there will be an increasing risk of difficulties in obtaining finance. There is potential transfer of risk to consumers from financial distress – a company being in financial difficulties would lead to pressure to relax the regulatory contract and would also have implications for financing costs for utilities generally. In addition, highly-g geared companies may be too risk-averse, which will discourage much-needed innovation, and high gearing is in conflict with the objective of increasing competition.” **Severn Trent Water**

Financing investment was seen as a major challenge for the sector at privatisation. The companies were privatised with no debt and were provided with a “green dowry” of cash to assist in financing the investment required to comply with new European legislation and a backlog of capital maintenance. At the time the increase in investment requirement was seen as a temporary feature following which debt levels would stabilise.

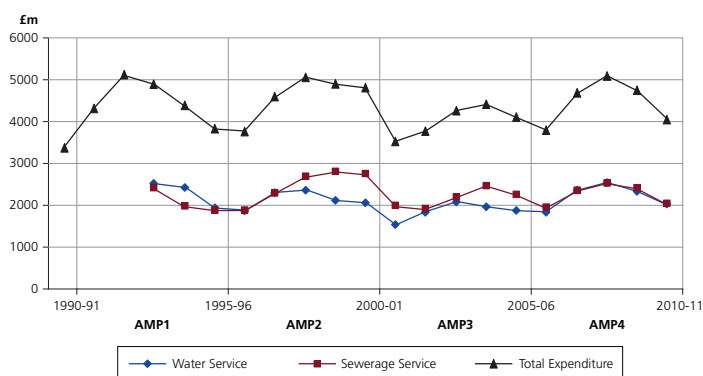
In practice, investment has continued at consistently high levels since privatisation and the companies have continued to finance it largely with debt. Total debt in the sector is now about £37 billion compared with total Regulatory Capital Value of about £54 billion. In common with many respondents, we see this as a success of the regulatory regime. Confidence in the regime has allowed the companies to access large quantities of relatively cheap debt and to finance a level of investment that would otherwise have been unsupportable. This has been an important factor in allowing the improvements in water quality and environmental measures which have been seen over the past 20 years. Looking to the future, the financing challenge seems likely to persist and retaining confidence in the regime to facilitate further debt and, if necessary, equity financing will continue to be very important.

High debt levels do place some restrictions on companies' freedom of action and these will have to be taken into account by Ofwat in considering the implications of any structural changes under its Future Regulation programme. To the extent that such changes lead to the companies incurring costs to renegotiate financing arrangements these would need to be taken into account in assessing the net benefits of the proposed changes; but it is also important to recognise the substantial benefits to customers and investors that these financing arrangements have brought over the last 20 years.

Supply chain

Responses from the supply chain and its numerous representative bodies gave a consistent message that the price review cycle has had a profound impact on them. It is clear that capital expenditure tends to be concentrated towards the middle of the five-year funding period. This cyclical pattern is clearly illustrated when looking at water companies' returns to Ofwat:

Capital Expenditure 1989/90 – 2009/10



Source: Ofwat 2009/10 prices

In its response, British Water referenced its own survey showing that the number of employees in surveyed organisations at the start of the price review period in 2005 (Asset Management Period 4) was 40 per cent less than at the peak in 2008. A similar number of jobs were lost from the supply chain between the peak and the end of AMP4. British Water calculated a cost to the industry of approximately £650 million in AMP4, £2.6 billion since privatisation and well over £3.25 billion before the end of AMP5 in 2015. These figures do not include hidden costs and intangibles such as maintaining facilities for peak staffing levels and the permanent loss of sector expertise to more stable industries.

This exacerbates a potential problem raised with us by Energy & Utility Skills that many of the skilled employees in an ageing industry will need replacing over the next 10-15 years as they approach retirement. The review team believe that the level of skills within the workforce is an issue that should primarily be managed by the industry as part of their strategic risk management. If there is a problem with funding training and recruitment of new skills because of pressures on the operational expenditure, the companies need to make their case to Ofwat that without special allowance they would otherwise be unable to meet their licence obligations.

The Environmental Industries Commission also felt that this diminution of expertise has a detrimental effect on the competitiveness of the supply chain in securing business abroad. The rush of contracts being tendered at the start of the price review obviously puts pressure on the procurement teams both in the companies and in the supply chain. This is exacerbated by inconsistent procurement processes between the companies asking for the same information in different formats.

It is bizarre that such a long-term stable industry with relatively consistent supply and demand has such a cyclical pattern of investment. No-one has suggested to us that there is any intrinsic reason for the flow of business to the supply chain to be

cyclical at all. Instead, the observed pattern seems to be driven almost entirely by the companies' reaction to the incentives and pressures introduced by the regulatory process.

There appear to be several specific reasons why the five-year price review process has this cyclical effect on investment. Wessex Water pointed to evidence from the companies' draft business plans projecting the cycle of expenditure, which suggests that the volatility exists in these initial company submissions, rather than being introduced by Ofwat or the companies at a later stage.

The prevailing attitude in the companies seems to be that all investment proposals need to be "signed off" by Ofwat; proposals once signed off need to be delivered within the five-year period; and it is too risky to pursue any project that has not been signed off. The companies seem nervous that the balance of a scheme initiated in year 5 (and funded for year 5) would not then be funded in the subsequent period. Ofwat, in turn, worries about allowing for the same project twice. This is probably tied up with the general lack of trust respondents pointed to between Ofwat and the companies. The desire to demonstrate delivery of the agreed schemes and to avoid risk of over-run will lead to investment projects being planned for completion comfortably before the end of the five years.

Wessex also suggested that companies are naturally cautious in their spend on more controllable items, like capital maintenance, early in a period in case they find they cannot deliver the later enhancement programme for the amount assumed in the determination or to guard against other uncertainties, such as adverse movements in the Construction Outputs Price Index.

In addition, the Civil Engineering Contractors Association and some of the larger companies, pointed to the burden of the price review process diverting significant staff resource away from the development and delivery of capital programmes.

In principle the cyclical effect should be capable of being balanced out by new projects initiated in years 4 and 5 of the price control if companies and Ofwat could find confidence in proposing and allowing such schemes. Ofwat introduced the Early Start Programme at the start of AMP4 in an attempt to do this; however the initiative does not seem to have been successful. As UK Water Industry Research (UKWIR) reported when it reviewed *'The Regulatory Cycle and its Impact on the Efficiency of Supply Chain Delivery'* in 2007⁴⁶:

"Only one of the fourteen [water] companies responding to our questionnaire felt that [the Early Start Programme] had been significantly beneficial. That company together with many others ended up being under-spent in year one of AMP4...to a significant degree...If the industry is minded to move to a longer term continuous planning and delivery model then the idea of introducing an enhanced early start programme seems both redundant and counter-productive."

The Early Start Programme was not repeated for AMP5. UKWIR suggested instead a "Late Finish" approach – allowing an extended delivery period, resulting in overlapping six or seven year programmes – and a series of detailed smaller scale actions. However, it is notable that four years on, the problem remains and we received little reference from stakeholders to the report or its recommendations.

Other solutions suggested to us in response to the call for evidence involve either lengthening the period of the investment programme and aligning it with the Strategic Direction Statement or somehow staggering it, either by reviewing water and sewerage companies and water only companies separately, or reviewing the sewerage business separately from the water supply business.

46 The Regulatory Cycle and its Impact on the Efficiency of Supply Chain Delivery, UKWIR (2010) pp.71-72.

The UKWIR report dismissed lengthening the price control period as the desirability of less frequent troughs in the expenditure cycle would not outweigh the uncertainty in predicting costs over the longer period. The review team agrees and believes that any lengthening of the price control period should be considered as part of Ofwat's wider look at appropriate timescales for reviewing separate parts of the regulated business. The risk that separate price controls for different business units could increase the regulatory burden on companies also holds true for the idea of staggering the review cycle.

The review team believes that some of our other recommendations in this report and indeed Ofwat's own proposals which move the regulator away from its current hands-on approach, will help to encourage companies to flatten their investment profiles.

If Ofwat is able to change its approach such that the companies feel they have ownership of their business plans within an overall financial constraint set by Ofwat, then companies will worry less about having funding available into the next price control period. Companies that qualify for Ofwat's proposed "fast-track" status through the price review (as discussed in Chapter 1) should feel able to set a reasonably consistent capital maintenance budget across the full five-year control period.

This change will take time and will require the involvement of the quality regulators. For the short-term, and for the next price review in particular, the regulators might consider whether changes to the existing approach could help.

For instance where Ofwat and the other regulators are less able to move away from specific scheme approvals in the quality programme then the Environment Agency could be encouraged to look at a seven-year period and Ofwat could provide funding that would specifically extend into the subsequent control period.

Alternatively, Anglian Water has proposed that where companies effectively bring schemes forward into the end of a price control period that Ofwat allow funding for such schemes at the next price control (subject to the same scrutiny and risk of non-funding as other schemes) and avoid punishing the company for technical overspend in the previous period.

Developers

One respondent queried how proactive Ofwat is in supporting housing growth and encouraging companies to engage with planning authorities, on the assumption that it should do so under its sustainable development duty. It was also suggested to us that Ofwat should allow funding for the companies to permit any level of infrastructure requirement potentially arising from local plans.

On the whole we are keen to avoid encouraging Ofwat into a more hands-on role. Water companies already have clear duties to supply water and provide effective drainage in their areas of responsibility. They also have to forecast the future demand for water in their area through the WRMP process which is open to public consultation and can be taken to public inquiry. A more efficient handling of complaints from developers and proper enforcement of these duties, as discussed in Chapter 2, should provide incentive enough to the water companies to engage on housing plans coming forward and make the case to Ofwat for funding to meet obligations arising from housing growth.

If a reasonable business case is put forward for additional work required by water companies to engage with planning authorities, for example in areas with high housing growth planned, then Ofwat should look favourably on it. But if Ofwat do not, it is still within water companies' interest to engage and this should not be used as an excuse for companies not to deliver necessary infrastructure.

The sustainable development duty

As will be clear from the previous sections, the review team see some merit in many of the specific criticisms of Ofwat in regard to its approach to sustainable development. However, in most cases the position could be improved by targeted changes to the existing regime – and should be improved by recommendations elsewhere in the report. Also in many cases the need for change has been acknowledged by Ofwat and work is in hand to consider alternative approaches.

The question that arises therefore is whether there is a deep-seated problem with Ofwat's attitude to sustainable development and whether a change in the hierarchy of duties is necessary to change this.

Sustainable development is a central policy objective of both the UK and Welsh Governments and some respondents suggested that, to reflect its importance, Ofwat's duty to contribute to sustainable development should be elevated to the status of a primary duty.

This is also the position of the Welsh Government. Sustainable development has been established as the central organising principle of the Welsh Government and as such it believes that contributing to sustainability should be a primary duty for Ofwat. The Welsh Government has made clear that it does not see sustainable development as simply implying an environmental or "green" agenda. In the Welsh Government's view it involves identifying the long-term outcomes that are needed to improve people's wellbeing. It is the long-term focus on maximising wellbeing for the future and making the necessary hard choices that the Welsh Government sees as missing in Ofwat's current approach.

Some respondents saw a fundamental problem with Ofwat's attitude towards achieving sustainable outcomes. Others suggested that sustainable development was not a concept well understood in the industry, and that Ofwat needed

to incentivise and facilitate more constructive behaviour by the companies. Others suggested it was not clear how Government expected Ofwat to interpret its sustainability duty.

The review team does not disagree that regulation of the water industry should be conducted under the framework of sustainable development. However, as discussed in Chapter 1, we also see value in the separation of responsibilities between the economic regulator, the quality regulators, consumer representatives and, indeed, Government. Development of policy on the major aspects of sustainable development is clearly for Government. The other regulators have clear roles in implementing and enforcing the quality and environmental aspects. An economic regulator, focussed on protecting the consumer interest in this respect, seems to provide an appropriate balance of powers and responsibilities. Ofwat's approach to this in seeking to ensure that sustainable outcomes are delivered as efficiently as possible also seems broadly appropriate. There are areas of friction between the various organisations but the balance appears about right.

Nor is it clear to us that a change in the status of the sustainable development duty would necessarily have the effect intended by those proposing it. Ofwat's position has been developed in the context of its existing duty. It has been thought through and is clearly articulated. The concept of "Sustainable Water" certainly appears to be at the heart of Ofwat's strategy documents and underlies much of its current activities.

"We want the companies to challenge themselves to improve and respond proactively to the challenges ahead. We also want them to view being sustainable as a key part of their success. To achieve this, we will make sure our overall approach to regulation promotes socially responsible, economically efficient and environmentally-friendly choices by companies and customers alike⁴⁷."

⁴⁷ Delivering sustainable water – Ofwat's strategy, Ofwat (2009) p.24.
http://www.ofwat.gov.uk/aboutofwat/reports/forwardprogrammes/rpt_fwd_20100303ofwatstrategy.pdf

Furthermore, the introduction of Strategic Direction Statements and a process of customer engagement, which were respectively initiated and encouraged by Ofwat, do allow issues of sustainability to be taken into account more clearly in the price review process.

Against this background it is not obvious that a change to the hierarchy of duties would necessarily change Ofwat's approach. Instead it might simply reinforce Ofwat in its current position.

The question therefore is how the commitment to sustainable development is turned into individual regulatory policies and decisions. The essence of many of the criticisms that we have heard seems to be that, at the decision stage, Ofwat is driven too much by a desire to introduce market mechanisms and by cost-benefit analysis which focuses on the ratio of quantified benefits to quantified costs, and does not take into account the unquantifiable benefits considered under a broader impact assessment and the longer-term policy goals these might contribute to. Ofwat might usefully consider whether it properly takes such wider impacts into account in its analyses.

There are other possible approaches that could potentially improve the position. Government could be more specific in its guidance to Ofwat as to how it should interpret its sustainable development duty. Guidance does not have statutory force but the regulator must have regard to it and the more clearly the guidance is expressed, the more likely it is to have effect. We consider Government's social and environmental guidance to Ofwat further in Chapter 5.

Another approach could be for Ofwat to undertake a review of its interpretation of its sustainable development duty and look for areas where its emphasis may be inappropriate. Both of these ideas seem to us to have merit and seem more proportionate than to introduce another primary duty.

Recommendation 13: Ofwat's duty to contribute to the achievement of sustainable development should remain, as a secondary duty, in its current form. However, Ofwat should review its interpretation of the duty with particular reference to the areas and issues we have highlighted in this chapter.

Chapter 4:

Governance and value for money

Summary

Our review of Ofwat's governance and Board arrangements suggests that the current arrangements are working well. The Board is well informed on the major issues to be addressed and is in a position to exercise effective scrutiny of Ofwat's activities. We did not find any instances in which Board decisions appeared inconsistent with Ofwat's statutory duties. However, we did find a perception among stakeholders of a lack of transparency in the way that Ofwat and the Board make their decisions. To address this, we recommend that the non-executive directors should be more involved in engaging actively with stakeholders.

This issue is related to wider criticism of Ofwat's approach to consultation and engagement. Although Ofwat clearly puts considerable effort into consultation processes there is a widespread feeling that stakeholders' views are not properly taken into account. Ofwat needs to do more to involve key stakeholders in the development of its proposals and to be transparent in how it has considered responses to its consultations.

A number of respondents felt that the arrangements to hold Ofwat to account for its decisions were inadequate and that a more effective process to oversee its activities was required. This is, in many respects, a wider question, applying to all economic regulators, and goes beyond the remit of the review. However, we feel that Ofwat could make it easier for Parliament to hold it to account by publishing a set of objectives, or desired outcomes, against which its actions could be assessed. This would also assist the National Audit Office in assessing Ofwat's value for money.

Governance

Evidence

A common theme arising from the call for evidence was the perception of a lack of transparency in the way Ofwat makes its decisions, especially the role played by the Board.

"Ofwat now publish minutes of the Board meetings but these have tended to be short on detail and have not generally added to the transparency of decision making."

Veolia Water

Other respondents were more concerned that the basis of Ofwat's decisions should be more clearly set out in its published documents and linked more explicitly to its statutory duties. Respondents were clearly concerned that decision making needed to be more transparent at price reviews (PR).

"We believe Ofwat's decision making process needs to be more transparent. There appears to be no public record of the rationale behind the decisions to exclude (or include) water company schemes from the periodic review determinations. This makes it difficult to understand why a particular, apparently useful, scheme has been excluded. A more transparent approach would enable lessons to be learnt and applied by the water companies and the other regulators in future price reviews." **Natural England**

Some respondents suggested that an annual evaluation of the Board's performance and effectiveness should be made public and that more technical expertise on the Board, or a better balance of experience, would be welcome. A number of respondents, particularly water companies, also desired better access to the Board during price reviews and at other times. This was particularly evident among the smaller companies.

Discussion

The responsible body for economic regulation of the water sector is the Water Services Regulation Authority (WSRA), which is supported by Ofwat. For simplicity, and to reflect the way that Ofwat and the WSRA were referred to throughout the responses to the call for evidence, the review normally refers to Ofwat and its "Board" respectively.

The WSRA, or Board, was established by the Water Act 2003. The Board is currently led by a non-executive Chair, Philip Fletcher, who is supported by five other non-executive directors (NEDs). Four of the NEDs, including the Chair, are due to stand down and be replaced by the end of 2011.

The Board also includes three members of the executive team: the Chief Executive, Director of Finance and Networks and Director of Markets and Economics.

Ofwat's governance framework is set out in the *'Rules of procedure for the Water Services Regulation Authority (Ofwat)'*⁴⁸. This describes procedures in relation to conflicts of interest and disclosable interests, identifies matters reserved to the Board for decision, sets out the Terms of Reference of Board committees and includes a code of conduct for directors.

Ofwat is not specifically required to adhere to the Financial Reporting Council's UK Corporate Governance Code ("the Code") or the corresponding document for Government departments, the Treasury's Code of good practice for corporate governance in central Government departments. But these nonetheless provide a useful reference point for assessing good practice.

The review team considers that Ofwat's approach, as set out in the rules of procedure, complies well with the main requirements of the Code where these are relevant. The responsibilities of the Board and the respective roles of the Chair, the NEDs and the executive seem well defined. The Terms of Reference of the Audit and Remuneration Committees are clearly set out and procedures are in place for assessment of risk and internal controls.

The review team held interviews with each of the NEDs, including the Chair. These broadly supported the conclusions mentioned above. The impression the review team received from these interviews was that the Chair and the NEDs had built good relationships with each other, and with the Ofwat Executive. The NEDs were confident that their decisions were consistent with, and made in the context of, the existing statutory framework. It also came across strongly that the NEDs felt well informed and fully engaged in decision making on Ofwat's strategic direction.

It was clear that the NEDs were fully aware of, and in many cases driving forward, the major work programmes currently being undertaken by Ofwat, including reducing the regulatory burden and introducing more competition in the sector.

In order to provide further assurance on this point, David Gray was given access to a range of Board papers relating to Ofwat's market reform project. These were extensive, with regular Board papers and discussions dating back to April 2006. From late 2008 the Board meetings and papers were supplemented by a series of workshops and challenge sessions designed to allow the Board to understand proposals at an early stage and to input their views.

The overall impression gained from the papers was that the Board had been actively and extensively engaged in developing the market reform project. It seemed clear that the Board had been kept well informed of the options being developed for the project. The Board was thus in a position to make effective strategic decisions on the direction of the project and to provide effective challenge to the executive team.

⁴⁸ Rules of procedure for the Water Services Regulation Authority (Ofwat), Ofwat (2010). http://www.ofwat.gov.uk/aboutofwat/structure/gud_pro_100616rulesofprocedure.pdf

Responses to the call for evidence contained few specific examples of decisions made by Ofwat that were felt to be inconsistent with its statutory duties or guidance. Those examples that were provided primarily related to Ofwat's duty to contribute to the achievement of sustainable development and to have regard to social and environmental guidance issued by the UK and Welsh Governments. Some respondents also questioned how well Ofwat followed its duty to adhere to the five principles of better regulation, particularly proportionality.

The issues raised in relation to sustainable development are discussed more fully in Chapter 3. In the main, the question is one of emphasis: whether Ofwat places sufficient weight on its duty to contribute to sustainable development relative to its other duties, or has sufficient regard to the social and environmental guidance. Our conclusion is that Ofwat does take its sustainable development duty into account but, in a number of the specific areas raised by respondents, it could potentially do more.

The question of proportionality, in relation to the principles of better regulation, is discussed in more detail in Chapter 2 in which we make recommendations aimed at encouraging Ofwat to reduce the burden of regulation substantially.

The review team also looked at the section of the annual report where Ofwat explains how its decisions are aligned with the social and environmental guidance issued by the UK and Welsh Governments. Whilst it is useful to see which of Ofwat's publications and projects reflect the guidance, the UK and Welsh Governments do not see this as sufficient in showing how guidance has been taken into account. However, they have power of direction with respect to what should be covered in the annual report, so do have the opportunity to specify the content more closely should they choose.

Recommendation 14: Ofwat should be more explicit in its annual report about how its decisions have followed the guidance issued by the UK and Welsh Governments, highlighting where it has departed from the guidance and the rationale for that decision.

Conclusion

Taken as a whole, our review of Ofwat's governance and Board arrangements suggests that the current arrangements are working well. There are no obvious issues with the way the Board operates, either in terms of relationships within the Board or with Ofwat as a whole, or in terms of its processes for making decisions in the context of its statutory powers and duties. The Board is well informed on the major issues to be addressed and is in a position to exercise effective scrutiny of Ofwat's activities.

Nonetheless, it was clear from the evidence that a perception exists among stakeholders of a lack of transparency in the way that Ofwat and the Board make decisions. This may be related to the negative feedback we received on the effectiveness of Ofwat's consultation processes (discussed later in this chapter).

The position could probably be improved if both the Board minutes and Ofwat's decision documents were to provide a fuller explanation of the decisions made by the Board. The minutes should be published immediately after their approval.

Another, possibly more effective, response to both issues could be to increase the degree of direct interaction between the NEDs and stakeholders. A number of water companies commented positively on the increased engagement by Ofwat's NEDs with companies during the last price review.

"Since Ofwat assumed a formal Board structure, the role of its non-Executive Directors has become more critical. It is important that those individuals have sufficient direct exposure to the issues and

concerns of the industry, since all important decisions are now taken at Board level. There was some limited evidence of non-Executive Director involvement towards the latter stages of the 2009 Price Review and, in our experience this ensured a welcome degree of challenge both to companies and to the executive management within Ofwat. We would like to see this role of the non-Executive Directors continued and, if possible, expanded such that they are able to form their own independent view of the issues facing the sector, not always mediated by Ofwat management." **United Utilities**

The Welsh Government also told us that its relationship with Ofwat had improved significantly after a meeting between the former Minister for Environment, Sustainability and Housing and Ofwat's Board. However, the Welsh Government believes that more still needs to be done and would like the Ofwat Board to continue to engage with Welsh Ministers and Assembly members. This engagement is even more crucial in the context of the recent referendum in Wales which gave the Welsh Government the ability to make its own laws on certain policy areas, including water.

The review team is confident that the NEDs are thoroughly involved in policy formation and are able to make decisions on the basis of a good understanding of the issues. So it would seem likely that greater engagement with stakeholders would increase confidence in those decisions. Greater involvement with stakeholders might also remove or reduce any sense that their case was not adequately being made to the Board or that Board members may not fully understand the implications of their decisions.

The review team considered a number of possible options:

- **Greater involvement in price control reviews.** In PR09 Ofwat assigned each NED to a group of companies to ensure that the companies felt they had a means of direct

contact with the Ofwat Board. Each company was visited by the relevant NED, who also took a particular interest in the assessment of its business plan and was involved in the representation meeting on its draft determination. The companies generally saw this as a positive step, but views on the effectiveness of the process were mixed. One possible option for the forthcoming price review, PR14, would be for Ofwat to extend NED involvement through a Board committee that could meet companies and other stakeholders at key points throughout the price review. The review team recognises the level of time commitment this would require, considering the number of companies in the sector, but feels that the benefits could be significant.

- **Involvement with other stakeholders more generally.** In view of the positive feedback on Board engagement, it might be helpful for the full Board to meet more regularly with the companies and other stakeholders outside of the price review process.
- **An Ofwat "AGM".** Ofwat could hold an open Board meeting once a year, giving an opportunity for the industry and other stakeholders to hear from the Board about strategy or individual topics of interest.

A consequence of any these options would clearly be to increase the time commitment required of the NEDs. At present they commit to, and are paid for, two days a month. This increases to three days a month (with a corresponding adjustment to remuneration) during the price review process.

Recommendation 15: The Ofwat Board should recognise active stakeholder engagement as a key part of the non-executive director role, particularly during price reviews, and it should agree how to achieve greater exposure to stakeholders.

The review team also considered the suggestion that Ofwat's annual reviews of the effectiveness of the Board should be made public. That the

results are not currently made public is consistent with other economic regulators' practice. The changes to the Board later this year, involving the appointment of a new Chair and three new NEDs, provide a good opportunity for a thorough review of the Board's role and performance, including whether a greater time commitment is required. Our view is that the concerns expressed by stakeholders, particularly about the transparency of Board processes, strengthen the case for an externally facilitated review once the new team is settled, and we would encourage the Board to make the results public.

Recommendation 16: The new Chair of Ofwat, once appointed, should undertake to carry out and publish a full review of the Board's effectiveness.

Accountability

Evidence

Many respondents felt that the existing system of accountability to Parliament was not effective or sufficient.

*"Currently there is no independent annual review of Ofwat's performance, other than a requirement for Ofwat to present its annual report to Parliament, and it is unclear whether there is anybody who is in a position to effectively challenge the effectiveness of Ofwat and assess value for money." **South West Water***

Specific issues were also raised around how Ofwat acted in accordance with the principles of better regulation set out in the Regulatory Enforcement and Sanctions Act 2008. Some respondents wanted to see a full assessment by Ofwat of the actions it has taken to reduce the regulatory burden, echoing the very clear message about the burden of regulation from the review evidence. This topic is covered in more detail in Chapter 2.

Discussion

The House of Lords Select Committee on the Constitution identified accountability as having three elements: duty to explain, exposure to scrutiny and the possibility of independent review. The Committee went on to say that the purpose of accountability is to provide a system of control which helps Government achieve efficient and effective regulation⁴⁹.

Ofwat is a non-Ministerial department, independent from Government and therefore held to account by Parliament. In practice, this means that Parliament sets the statutory duties within which Ofwat operates. It requires Ofwat to set out each year its objectives and work plan and measures Ofwat's success in achieving these through its annual report, scrutiny by the National Audit Office (NAO), and appearances before the Environment, Food and Rural Affairs Select Committee, the Public Accounts Committee and other Committees as appropriate.

Although Parliament is the formal body to which Ofwat is accountable, Ofwat is also held to account less formally by a number of other stakeholders. These include Ministers, Government departments, consumers, consumer bodies, and water companies and their investors.

Ofwat already undertakes a number of activities to ensure accountability. It publishes an annual report, consults informally and formally on its work programmes and its strategy, publishes Board minutes, and holds events for a wide range of stakeholders. But many respondents felt that this was not effective enough.

The question of how to hold economic regulators to account is not new and is not unique to the water sector. The House of Lords Select Committee on Regulators' report on UK Economic Regulators in 2006-07 stated that *"The question of who regulates the regulators has not been answered and will not go away"*⁵⁰. The responses

⁴⁹ The Regulatory State: Ensuring its Accountability, House of Lords Select Committee (2003-04).

to our call for evidence suggest that this statement is still valid. The report went on to recommend that a Joint Committee of both Houses be set up in order to conduct a wider and continuing review of economic regulators.

This recommendation has not been adopted by Parliament, nor was it addressed directly by 'Principles for Economic Regulation' recently published by the Department for Business, Innovation and Skills. Instead the principles focus on the need for transparency as the main tool for accountability.

"Effective accountability of a regulatory framework therefore depends on transparency, a requirement to explain decision making, exposure to scrutiny and the right to challenge decisions⁵¹."

Respondents wanted to see these aspects of accountability working effectively, with some wanting a more formal mechanism for holding Ofwat to account, perhaps along the lines of that suggested by the House of Lords Select Committee on Regulators' report. However, this is a wider question applying to all the economic regulators and is not within the remit of this review.

An alternative approach to accountability would be to focus on the recent work by the NAO on the value for money provided by economic regulators. In its study on Ofcom published in November 2010⁵² it concluded that an effective measure of Ofcom's value for money could not be undertaken without Ofcom first articulating measurable outcomes against which its work could be assessed. Since then the NAO has been working informally with other economic regulators, including Ofwat, to encourage them to develop performance measures relating to desired outcomes.

This approach to value for money fits well with the approach outlined in 'Principles for Economic Regulation'. If clear objectives are set, linked to defined and measurable outcomes, they could also be used more widely to provide a framework against which the regulator's effectiveness could be assessed, aiding scrutiny by Parliament, the NAO and other stakeholders. In Chapter 2 we recommend Ofwat should set clear targets and timescales for a reduction in the burden of the price control and compliance processes and enter into a joint project with the industry to achieve these. We would expect this to be one of Ofwat's main objectives in such an approach.

The review team is encouraged to see that Ofwat has already started developing outcome measures. In view of the degree of interest in this issue expressed by stakeholders we suggest that, in due course, as part of its assessment of the value for money Ofwat provides, the NAO should undertake an evaluation of Ofwat's progress.

Recommendation 17: Ofwat should develop outcome-based performance measures. One of these measures should focus on reducing the regulatory burden, as set out in Recommendation 4. The NAO, in its independent role in scrutinising the value for money of the regulator, should be involved in monitoring Ofwat's performance against these measures.

Consultation and engagement

Evidence

A common theme in our discussions with respondents and other sector players was concern about Ofwat's approach to consultation and engagement with stakeholders, and the transparency of its processes. These concerns

50 UK Economic Regulators, House of Lords Select Committee on Regulators (2006-07) p.8.
<http://www.publications.parliament.uk/pa/ld/ldrgltrs.htm>

51 Principles for Economic Regulation, BIS (2011) p.6.
<http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/principles-for-economic-regulation>

52 Ofcom: The effectiveness of converged regulation, NAO (November 2010).
<http://www.nao.org.uk/publications/1011/ofcom.aspx>

were raised by a wide cross-section of industry participants including companies, investors, public bodies, and customer groups. As mentioned in the previous section, *'Principles for Economic Regulation'* stresses the importance of transparency to accountability.

Responses to the call for evidence had earlier identified these issues. A number of respondents characterised their relations with Ofwat as lacking trust. Some noted that Ofwat's management of its important relationships could be improved. Water UK highlighted problems with Ofwat's dealings with the investor community in particular, describing a perception of Ofwat as "*unresponsive and distant*". Investors themselves commented negatively on Ofwat's engagement with the financial markets on matters relating to the introduction of competition.

On consultation, respondents commented on the number of discussion documents that Ofwat has published in recent years and highlighted the difficulty in responding due to their sheer number. Moreover, the nature and status of the documents were often unclear. Respondents were uncertain as to exactly what was being consulted on, when Ofwat's decision points were and when final decisions would be published. Some felt that the documents were more a statement of Ofwat's proposed approach than a genuine consultation. Respondents recognised the role of workshops in the consultation process, but felt there was a lack of clarity about their purpose and how the outcomes would be taken forward. Some felt that important points raised in discussion were not apparent in its subsequent thinking and that options were not fully considered in consultation documents. These documents were characterised as either covering concepts at a very high level or considering just one option in narrow detail.

Discussion

It is important to be careful in interpreting this feedback. Regulatory decision making is not a process of developing consensus. The regulator must be, and be seen to be, independent and avoid any impression of capture by the companies it regulates or other stakeholders. After assessing consultation responses the regulator must make decisions in the context of its own statutory duties and objectives. In many cases suggestions in consultation responses will not be taken up and acted upon. This means that the relationship between Ofwat and water companies will quite properly have areas of tension and disagreement.

Ofwat is in the course of a wide-ranging reassessment of regulation in the water sector involving the potential introduction of competition in some segments of the sector and new approaches to regulation in others. Some of its proposals are not popular with many of the companies and have caused concern among investors. Our call for evidence was bound to pick up the undercurrent of these debates.

That stated, the consistency of message from a wide range of stakeholders suggests there is more to this than disagreement over policy. In the case of companies, it is unrealistic to expect regulation to proceed on the basis of mutual trust. The point at issue is the predictability of relationships. Ideally, the companies should feel that they are able to predict Ofwat's decisions with a reasonable degree of confidence and they should not feel at risk of arbitrary action after the event. In turn, Ofwat needs to feel able to move towards a risk-based approach to compliance and away from detailed checking of all company information.

The danger is that the absence of this confidence undermines the effectiveness of Ofwat's relationships with the companies and other stakeholders. We note that the Competition Commission (CC) in its determination of Bristol Water's price limit for PR09 commented that the relationship between Ofwat and Bristol Water was not as effective as it should have been and

that “effective communication and understanding were prerequisites of an effective periodic review process”⁵³.

For other stakeholders the issue is slightly different. Ofwat needs to distinguish between the companies it regulates and other parties that are involved in the wider arrangements for regulation of the sector. With these organisations Ofwat should engage more proactively and at an earlier stage. In particular, the proposals under development in Ofwat’s Future Regulation programme could have a significant impact on the activities of the quality regulators. It would be desirable for Ofwat to engage proactively with the other regulators throughout the process and take their views into account in formulating its thinking rather than waiting for them to respond to consultation documents. If Ofwat changes its approach, the other regulators will need to respond constructively. This issue is directly related to our recommendations in Chapter 1 about more “joined up” regulation.

The review team discussed with Ofwat the concerns that had been raised and sought further information about its approach. In the case of its Future Regulation programme, it is clear that Ofwat has undertaken a wide-ranging process of consultation including publishing a large number of documents and organising several workshops and other events. The problem is not lack of information or lack of contact. However, despite the level of activity, there is still a clear sense among stakeholders that their views are not properly considered.

The heterogeneous nature of the water industry in England and Wales inevitably means that effective consultation and engagement will be difficult. Nevertheless, we feel that Ofwat could improve the perception of its consultation process by increasing the transparency of its decision making. More effective use of impact assessments, including a range of options which are consulted

upon and subject to a robust assessment of the related benefits and costs, should help, as should a fuller explanation of why certain options have not been pursued. Our suggestions for greater involvement of non-executive directors, discussed in the previous section, could also be relevant here.

It is worth noting that a contributing factor could be the sheer scale and ambition of Ofwat’s current set of projects. Ofwat has tried to engage stakeholders with a series of high level concept documents before pulling its ideas together into specific proposals. It has recently begun to focus in on clearer options or proposals, but there are still significant concerns amongst many stakeholders about the substance of the proposals.

In summary, we think it is important that Ofwat seeks, as far as possible, to take its stakeholders with it in an appropriate fashion as it develops regulatory policy options. Stakeholders should be able to understand the rationale behind proposals, and Ofwat should make it clear how stakeholder views have been considered before a final decision is made.

In addition, Ofwat should ensure that it engages effectively and seeks to learn lessons from other regulators; particularly to inform the development of its future approach to regulation where others have experience in addressing similar issues to those being considered by Ofwat already or in response to this review.

Recommendation 18: Ofwat should acknowledge the criticism of the effectiveness of its consultation and engagement and take steps to address it. We expect Ofwat to be proactive in involving its key stakeholders in the development of its work and show transparency in how it has considered responses to its formal and informal consultations.

53 Bristol Water plc: A reference under section 12 (3)(a) of the Water Industry Act 1991, Competition Commission (2010) p.60.

Value for money

Evidence

The Terms of Reference asked us to consider the value for money that Ofwat provides, particularly in comparison with other economic regulators and in the light of broader trends in the public sector.

Most of the responses on this subject referred to the increase in Ofwat's costs rather than assessing the value for money it provides. Companies, in particular, focussed on the 62 per cent increase in Ofwat's total costs (equivalent to a 40 per cent increase in real terms) between 2005/06 and 2009/10.

Discussion

Ofwat provided us with the following cost data for the last 11 years. For the period to 2004/05 the costs include Watervoice, which was subsequently separated out from Ofwat as the Consumer Council for Water (CCWater)⁵⁴. For the years to 2004/05 the estimated costs of Watervoice have been deducted to provide a more consistent data series. The figures for Ofwat alone show a 118 per cent increase (66 per cent in real terms) over the period. Figures for Watervoice/CCWater show a 104 per cent increase (55 per cent in real terms) over the same period.

| | Ofwat (DGWS) and Watervoice | | | | | | Ofwat (WSRA) | | | | |
|-------------------------------|-----------------------------|-------------|-------------|-------------|-------------|-------------|--------------|-------------|-------------|-------------|-------------|
| | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
| | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| Pay | 6 | 5.9 | 6.4 | 7.3 | 8.4 | 9.2 | 7 | 7.2 | 8.3 | 9 | 10.7 |
| Consultancy | 0.9 | 0.7 | 0.6 | 0.6 | 1.1 | 0.9 | 0.8 | 1.1 | 2 | 2.8 | 2.2 |
| Accommodation | 1 | 1.1 | 1.1 | 1.2 | 1.2 | 1.2 | 0.9 | 0.9 | 0.9 | 0.8 | 0.9 |
| Other | 2.8 | 3.2 | 2.7 | 2.7 | 2.9 | 3.3 | 1.9 | 2.3 | 2 | 2.3 | 3.4 |
| Total | 10.7 | 10.9 | 10.8 | 11.8 | 13.6 | 14.6 | 10.6 | 11.5 | 13.2 | 14.9 | 17.2 |
| | | | | | | | | | | | |
| | | | | | | | | | | | |
| Watervoice (estimated) | | | | | | | | | | | |
| Pay | 1.8 | 1.8 | 1.8 | 1.9 | 1.9 | 2.0 | | | | | |
| Consultancy | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | | | | | |
| Accommodation | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | | | | | |
| Other | 0.6 | 0.6 | 0.7 | 0.7 | 0.7 | 0.7 | | | | | |
| Total | 2.8 | 2.8 | 2.9 | 3.0 | 3.0 | 3.1 | | | | | |
| | | | | | | | | | | | |
| | | | | | | | | | | | |
| Ofwat | | | | | | | | | | | |
| Pay | 4.2 | 4.1 | 4.6 | 5.4 | 6.5 | 7.3 | 7.0 | 7.2 | 8.3 | 9.0 | 10.7 |
| Consultancy | 0.7 | 0.5 | 0.4 | 0.4 | 0.9 | 0.7 | 0.8 | 1.1 | 2.0 | 2.8 | 2.2 |
| Accommodation | 0.8 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 | 0.9 | 0.8 | 0.9 |
| Other | 2.2 | 2.6 | 2.0 | 2.0 | 2.2 | 2.6 | 1.9 | 2.3 | 2.0 | 2.3 | 3.4 |
| Total | 7.9 | 8.1 | 7.9 | 8.8 | 10.6 | 11.5 | 10.6 | 11.5 | 13.2 | 14.9 | 17.2 |

54 In CCWater's audited accounts 2005/06, WaterVoice's costs in its last full year for 2004/05 were £3.3 million and were £2.2 million for the first six months of 2005/06.

Ofwat provided us with a more detailed breakdown of costs between functions, but noted that this was not auditable and in some places based on estimates because the data had not been captured consistently over the period and there had been some significant restructuring of the organisation during the past 11 years. The review team considers that Ofwat should be able to provide such data in a consistent form.

Over the period shown there have been some changes to Ofwat's role and the scope of its work which Ofwat told us have driven an increase in costs. These include, in particular, the changes to its duties under the 2003 Water Act which included elevating the consumer duty to a primary duty and the introduction of duties in relation to sustainable development and better regulation. The introduction of concurrent powers under the Competition Act 1988 and establishment of the Water Supply Licensing Regime also significantly extended Ofwat's area of responsibility.

The more detailed breakdown indicates that the major increases in costs between 2005/6 and 2009/10 related to:

- price control and monitoring, reflecting the build up of activity in relation to PR09 during the last two years of the period;
- markets and economics, reflecting the substantially increased programme of work in this area Ofwat initiated following the escalation of the consumer duty to a primary duty through the 2003 Act;
- HR, IT, finance and general office costs, including improving IT services and developing systems in-house to improve the price review process for companies; and
- significant restructuring expenditures beginning in 2009/10 which are expected to deliver material savings in the future.

Ofwat also provided data showing some cost comparisons with other economic regulators. These data demonstrate that it has the lowest

salaries and employment costs as well as the lowest accommodation costs of the UK economic regulators. This is in large part due to its decision to remain based in Birmingham whilst many other economic regulators are based in London or have chosen to relocate there.

Ofwat has recently begun a significant reorganisation affecting a large proportion of the roles within the organisation. This will see a net removal of 45 of its 226 full time posts. Ofwat considers that these changes are necessary to deliver its strategy and, in particular, to begin to address the significant cultural change that is needed.

The trends in Ofwat's costs over the last 10 years clearly pose some questions as to value for money, but it is impossible to answer these without looking at the other half of the equation, the added value that Ofwat was trying to achieve. The key difficulty in assessing value for money for any economic regulator is the fact that they are usually trying to incentivise or facilitate the actions of other players and the lack of any quantitative measure of the results of their activities.

Comparisons can be made between the amount of money regulated companies initially suggest is required for a price control period and the amount eventually allowed. However, this is of very limited value as it is generally acknowledged that companies will tend to "overbid" in their initial submissions.

Ofwat uses a different indicator, which it believes gives a better indication of its actual impact, by looking at the effect of the efficiency challenges it applies in the price review process. This approach seeks to strip out the effect of overbidding and assess the impact of the ongoing efficiency improvements required by Ofwat relative to the companies' own plans. On this basis Ofwat estimates that customer bills are now, on average, £110 lower than they would otherwise have been. The equivalent cumulative savings for customers since privatisation would be about £2.5 billion.

We agree that this is a more realistic approach, and it does help to demonstrate the value to customers of economic regulation over the last 20 years. Ofwat also noted that its enforcement action had delivered £385 million of net benefit to consumers since April 2005 (when it was given powers in this area). These are helpful indicators, but they do not provide an assessment of the effectiveness of the organisation in achieving these benefits for consumers.

The difficulty of assessing value for money is not unique to Ofwat. As discussed in the Governance section above, the National Audit Office found it difficult to assess Ofcom's value for money without a clear specification of the outcomes to be achieved. The lessons from the NAO report on Ofcom apply equally to Ofwat. A framework for assessing value for money must be based on two key components:

- a clear statement of the objectives or outcomes that Ofwat is seeking to achieve combined with a framework for assessing performance against these outcomes; and
- a management information system that allows costs to be allocated to those outcomes.

Neither of these is available to us at this stage and we therefore do not feel able to provide a view on the value for money that Ofwat provides, or has provided in the past.

Ofwat has acknowledged the need to define its objectives and establish a framework to allow a more realistic assessment of its success and the value for money it provides. The review team have seen evidence that Ofwat is taking steps to address both of these issues. Its move towards outcome-based regulation and its development of measures on this should provide a clearer statement of the outcomes and objectives that it is seeking to achieve. Similarly, its move to project based working and the introduction of cost reporting against those projects should lead to a management information system that allows costs to be allocated to outcomes.

We would encourage Ofwat to seek the advice of the NAO in establishing outcome-based objectives against which its performance can be assessed in the future. As discussed in Chapter 2, we would expect one of these objectives to relate to a reduction in the burden of regulation on the companies and there will clearly be others related to the major initiatives in its Future Regulation programme.

It will take time for this framework to be established and the timing of any future review of Ofwat would be for the NAO and Ofwat to decide. However, our preference would be that a review should be carried out relatively shortly after the completion of the next price review, PR14, as this would allow progress to be assessed in the context of Ofwat's main project for the next few years and would allow refinements to the value for money framework to be introduced if needed.

Recommendation 19: To allow a more effective assessment of its value for money, Ofwat should ensure that its management information systems can provide data on the costs associated with seeking to achieve its outcome-based objectives.

Chapter 5:

Ofwat's statutory duties and Governments' relationship with Ofwat

This chapter considers the overall framework within which Ofwat works, including Governments' objectives for economic regulation, the boundary of responsibility between Ofwat and Government, Ofwat's statutory duties and Governments' social and environmental guidance.

We found a widespread desire for clarity on the Governments' policy towards the sector and on the respective roles and responsibilities of Ofwat and Government, which we urge the respective Governments to satisfy through the forthcoming White Paper and any future policy statements by the Welsh Government.

We did not identify any strong case for changes to Ofwat's statutory duties. The main issues raised in this area related to the sustainable development duty which we considered in Chapter 3.

We do see a role for more explicit guidance from Government on social and environmental matters and on how Ofwat should balance its duties in areas in which they may conflict. We considered whether Government should have the power to direct Ofwat in exceptional circumstances, but concluded that the negative impact on the perception of Ofwat's independence would outweigh any potential advantages.

Finally, we recommend that Ofwat should publish a report setting out progress on responding to our recommendations in line with its annual reporting processes.

Evidence

The call for evidence asked for responses on:

- Ofwat's application of its statutory duties and Government guidance in its decision making;
- whether future challenges will require changes to the way Ofwat operates; and
- what the risks to changing Ofwat's duties and the respective roles of Government and independent regulator are.

Many respondents requested greater clarity on the respective roles of Government and Ofwat. In some cases this appeared motivated by a wish to see a Government approach to competition and market reform that would be less ambitious than Ofwat's approach.

"The area of greatest uncertainty surrounding consumer protection is how far and how fast Ofwat should be promoting effective competition as a means to further the consumer objective. Ofwat appear to be pursuing recommendations from the Cave Review, but as yet we do not think these have been formally approved by government... We would expect that the forthcoming Defra white paper on water will help to resolve this uncertainty and give greater guidance to Ofwat in how it should be discharging its duty towards effective competition." **Veolia Water**

In other instances it was prompted by a desire on the part of the water companies to receive a clear steer on more specific issues such as the introduction of company social tariffs or Government's role in setting the level of ambition for metering roll-out.

"Similarly we observe Ofwat "taking the lead" on issues such as smart metering. We strongly believe such policies should be led by government." **Cambridge Water**

Some companies suggested this was less a result of conflicting views from Ofwat and Government, as simply the lack of a firm policy from Government:

"In recent years there has also been a tendency for some 'policy creep' as the regulator has, with the best of intentions, adopted a broader view of its functions. Ofwat has argued, with some justification, that this was partly a response to a perceived policy vacuum. Whilst we understand how this situation has developed it has resulted

in unhelpful lack of clarity regarding where decisions are taken.” **Northumbrian Water**

Northumbrian’s response was confirmed by Ofwat’s own:

“On the wider social issues around affordability, bad debt and metering set out in the Walker review, we would welcome more clarity from the Government about these policy issues.” **Ofwat**

There were few calls in the evidence for any change to Ofwat’s existing statutory duties. Some respondents felt that the financing duty could in some cases unduly swing the balance against the consumer, but most respondents were very clear, particularly among companies, that the position of the financing duty as a primary duty was crucial to continued investment in the sector. This view was echoed in our meetings with investors themselves.

Several responses pointed out the difficulty for Ofwat in balancing potentially conflicting duties. The tone of the evidence on this issue was generally positive, and many respondents stated that they thought the balance and interpretation by Ofwat of the duties was good. But the question of trade-offs between the duties was often linked to the need for greater clarity of the roles between Government and the economic regulator.

Ofwat itself felt that its duties were practical and appropriate and that it was able to make effective decisions within the framework, and make the appropriate trade-offs between the duties should it be required.

“We consider that our current statutory duties are pragmatic, appropriate and provide a sensible framework, attracting large-scale investment.”

Responses to the call for evidence also included several suggestions for new duties, such as an innovation duty, a duty to protect the supply chain

or a duty to promote water conservation and efficiency.

There were no strong views on the current guidance from Government to Ofwat, though some water companies suggested that Ofwat did not give sufficient regard to it, calling for greater clarity in its drafting, thereby providing less opportunity for interpretation.

The question of whether the challenges facing the sector are new and require a new approach produced a variety of views in the call for evidence. Many respondents argued that the challenges were not new, although they may be increasing in scale. This view was often allied to a desire for a more cautious approach to competition and market reform. Others felt that the challenges in terms of security of supply and sustainable development were such as to require a new approach. These views were often linked with a desire to increase the importance of sustainable development in Ofwat’s hierarchy of duties.

Discussion

Part of the genesis of this review was cross-UK Government work on the role of economic regulators and their relationship with Government. This work was a key input to the Terms of Reference for the review. The work culminated in the publication of *‘Principles for Economic Regulation’*⁵⁵ in April. This makes clear that the role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services by ensuring the operation of well-functioning and contestable markets where appropriate, or by designing a system of incentives and penalties that replicate as far as possible the outcomes of competitive markets.

The document also includes a series of UK Government commitments which are relevant to this review. In particular:

55 <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/p/11-795-principles-for-economic-regulation.pdf>

“Commitment 1: The Government commits to ensure that responsibilities are clearly divided between Government and regulator on the basis that high level decisions that involve political judgement are taken by Government and day-to-day regulatory decisions are undertaken by regulators.

“Commitment 2: The Government will preserve the independence of economic regulators.

“Commitment 3: The Government therefore commits to put in place, for each regulated sector, strategy and policy statements for the individual regulators to provide context and guidance about priorities and desired outcomes.

“Commitment 5: The Government will ensure that regulators’ objectives are clear and appropriately prioritised (including through broader guidance) to reflect the issues that the regulators should take into account in their decisions.

“The Government will take opportunities to simplify and clarify regulators’ objectives where appropriate as and when the frameworks are reviewed.

“The Government will not seek to add objectives, responsibilities or duties to regulators’ remits without detailed consideration of the impact of the addition on the overall framework, and consideration of cross-sector impacts and even then only when it is clear that the addition is the optimal way to achieve the outcome sought⁵⁶.”

Through its Arms Length Bodies review the UK Government has also set out a policy that decisions must, wherever possible, be taken by the Ministers elected to do so and not passed on to the unaccountable boards of public bodies. For example the Department for Environment, Food and Rural Affairs’ (Defra) Business Plan states that:

“The Department will no longer...allow key policy issues to be determined by democratically unaccountable bodies. We will reform our public bodies to bring policy functions in-house, where appropriate⁵⁷.”

A process of repatriating policy making into central Departments has been underway since the General Election. While arms length bodies might then act as expert advisors on Government policy and have a privileged position in its formation, they are expected to cease policy lobbying activity and not exploit public fora to make their point. However, what constitutes policy making is sometimes unclear and regulators including Ofwat have statutory duties which may cause them to cut across areas of policy.

These policy developments provide a clear framework in which the questions of Government’s objectives for economic regulation and the boundary of responsibility between Ofwat and Ministers can be addressed. Defra has committed in its business plan to publish a Water White Paper by December 2011. This will provide an opportunity to make a clear statement of its policy objectives for the sector and the role of Ofwat in relation to these.

Prior to the recent Welsh election, the Welsh Government published an updated Strategic Policy Position Statement on Water⁵⁸ which set out its position on key water issues including those covered by the Cave⁵⁹ and Walker⁶⁰ Reviews.

56 Principles for Economic Regulation, BIS (2011) pp.6, 7, 8-9, 12, 14.

57 Business Plan 2011-2015, Defra (May 2011) p.4. <http://www.defra.gov.uk/corporate/about/what/business-planning/>

58 <http://wales.gov.uk/topics/environmentcountryside/epq/waterflooding/publications/statement2011/?lang=en>

59 <http://archive.defra.gov.uk/environment/quality/water/industry/caverreview/index.htm>

60 <http://archive.defra.gov.uk/environment/quality/water/industry/walkerreview/index.htm>

It also subsequently published a consultation on the recommendations contained in the Walker Review⁶¹. It is anticipated that the new Welsh Government will confirm its intentions in relation to developing Welsh policy on these matters.

The issues raised in responses to our call for evidence seem to demonstrate the need for these statements to cover two issues in particular: competition and social issues.

(i) Competition

Martin Cave recommended a measured approach to the introduction of further competition in the water sector. Some of the companies, and their investors, have been concerned that Ofwat seemed to intend more extensive and rapid moves towards markets and competition than was envisaged by the Cave Review.

Most respondents to the call for evidence clearly regarded the approach to competition as a policy matter for which Government should therefore take responsibility. In this case, however, there is a default policy setting already reflected in Ofwat's existing duties. The consumer duty requires it to protect the interests of consumers, wherever appropriate by promoting effective competition. The dividing line between Government and Ofwat is therefore less clear than the simple statement that policy is for Government would suggest. If Government does not wish Ofwat to pursue the introduction of competition it would need to change that primary duty.

As an extension of competition is likely to require legislation, Ofwat needs to work closely with the UK and Welsh Governments to implement their proposals. In setting out its policy statement it would seem reasonable for Government to be clear as to its interpretation of the qualification "wherever appropriate" by setting out its views on how far and how fast competition should be

introduced. Government should also express views on any protections it might see as appropriate for particular groups of customers.

(ii) Social issues

On social issues, again almost all respondents felt that it was for Government to set policy in this respect. However, some felt that Government needed to make its policy more clear while others felt that the issue was Ofwat not responding sufficiently to existing policy.

Since the call for evidence closed in October, events have moved on. In April, Defra published *'Affordable water: a consultation on the Government's proposals following the Walker Review of Charging'*⁶². This stated that *"the Government believes that it is essential to have a robust framework in place to protect households from unaffordable bills before taking decisions around metering policy"*⁶³ and that a fuller response to the Walker Review, Martin Cave's Review of competition and innovation in water markets as well as this review would be set out in the autumn Water White Paper.

The UK Government also gave a clear steer on where it saw the responsibilities for social policy lying:

"The Government is aware that some stakeholders are of the view that social policy, and any measure to tackle water affordability, is the Government's responsibility. The Government agrees that it has a key role to play, both by specifying the basic safety net provided by WaterSure and by providing a broad policy framework and providing guidance on social policy and company social tariffs. We intend to meet this responsibility. At the same time, we are firmly of the view that companies are best placed to take decisions around the design of company social tariffs as part of their

61 <http://wales.gov.uk/consultations/environmentandcountryside/walkerreview/?lang=en>

62 <http://www.defra.gov.uk/consult/2011/04/05/water-affordability-1104/>

63 *Ibid*, p.4.

charges scheme that can take account of local circumstances and the needs and views of their customers⁶⁴."

The Welsh Government is consulting separately on Anna Walker's recommendations. This consultation covers common ground on affordability with the consultation for England, and also goes wider in covering water efficiency and metering in more detail. For the moment the Welsh Government has clearly reserved metering policy to itself:

"We do not expect to see Ofwat placing any additional requirements in respect of metering for companies wholly or mainly in Wales until the Welsh Government has set its policy on the subject."

Section 44 of the Flood and Water Management Act 2010 requires the UK and Welsh Governments to issue guidance to Ofwat and/or water companies on the introduction of social tariffs including, amongst other things, the factors to be taken into account in deciding whether one group of customers should subsidise another. Ofwat and/or companies are required to have regard to the guidance that is issued. Both consultations invite views on what the guidance should cover and on possible changes to the WaterSure tariff. The UK Government consultation states that the guidance could include:

- the level of cross-subsidy which is acceptable;
- which households should benefit;
- social tariffs under universal metering;
- offering a concession to unmetered households;
- what concession to offer; and
- the role of Ofwat.

Should this ground be covered then the uncertainty around social tariffs should disappear. However the review team feels it is important for Government to be clear and explicit in its views in order to set a framework within which the

companies and Ofwat can work. In particular, Ofwat is likely to need guidance from Government as to how it feels the non-discrimination duty should be interpreted in this context.

Similar considerations may apply in other areas, for example the extent to which a further roll-out of metering should be encouraged and how far other policy measures to encourage water conservation should be pursued.

The forthcoming Water White Paper provides an opportunity for the UK Government to provide a clear statement of policy in remaining areas of uncertainty and to meet the third commitment of 'Principles for Economic Regulation' set out above. The Welsh Government will need to be equally clear in its policy positions and the roles it sees for the regulators.

Recommendation 20: The UK Government should take the opportunity of the forthcoming Water White Paper, to set out clearly its future policies for the water sector and the roles of the regulators in implementing those policies. The Welsh Government should also clarify any changes to its policy position since the Welsh Assembly election.

Ofwat's statutory duties

(i) Primary duties

While 'Principles for Economic Regulation' recommends that Government should take opportunities to simplify and clarify regulators' objectives, there was little or no push from stakeholders for removal of any of the primary duties or any change in their status. Against this background, we took the view that any change to the primary duties or to the status of individual duties would need a very clear justification and requirement. In that context we looked at the existing duties in turn.

64 Ibid, p.20.

The Consumer duty⁶⁵, even if only one of four primary duties, sets out Ofwat's main objective in policy terms. The evidence was very clear, and the review team agree, that this duty should remain. The companies are still monopolies, and will largely remain so on any likely approach to competition, so there is still a clear need for protection of the consumer interest against potential abuse. Regulation of the monopoly activities of the water companies should still be the primary role of the economic regulator in a framework where policy on quality and environmental issues is implemented by other bodies. The review team considers the wording of the duty relevant and appropriate for the future and it will remain so unless the Government does not want Ofwat to pursue the introduction of competition at all.

The Financing duty recognises the importance of investment and hence the importance of a realistic approach by the regulator to allowing a reasonable rate of return on the assets purchased on privatisation and on funds invested subsequently. This issue was seen as particularly important for the water sector at privatisation and therefore the financing duty was given primary status whereas it is a secondary duty in other regimes. The need to fund investment is still a major feature of the water sector and the status of the financing duty has taken on great symbolic importance in the financial markets.

The Functions duties require Ofwat to ensure that water companies carry out various activities properly, in compliance with the terms of their licences, and they form the basis of the enforcement regime. At privatisation this degree of emphasis was seen as reflecting the importance of the services provided by the companies and this importance has not changed. The review team considered initially whether this duty was a contributory factor to the burden of regulation. It seemed plausible that the duty could have pushed Ofwat down the path of excessive regulatory

burden and line by line approval of company business plans. However, in further discussions, particularly with Ofwat's Board members, the review team did not discover evidence for this.

(ii) Secondary duties

The secondary duties are in many cases discussed elsewhere in this report, and are set out in full in Annex C. The only secondary duty to attract specific comment in responses was the sustainable development duty. We have discussed this question in Chapter 3 and concluded that we did not recommend any change to its wording or status.

In discussions with the companies, some expressed the view that after twenty years of regulation the scope for further efficiency gains was now limited, but none suggested any change to this duty. The scope for cost efficiency may now be less significant but the importance of restricting the increase in customers' bills means that this must remain a focus for Ofwat.

The non-discrimination duty requires the companies to adopt a fair approach to charging and is also important in setting the framework for competition. Without such a duty the companies would be able to use discriminatory pricing to fend off competition from new entrants. However, it has also had the effect of pushing Ofwat to a position in which it does not allow any social tariffs that would entail a net transfer between groups of consumers. This was at the nub of the issue over the introduction of concessionary schemes for surface water drainage charges. Ofwat's interpretation of the duty is perfectly reasonable, but it conflicts with Government's clear desire for the companies to introduce measures to protect certain consumers from higher charges. We have discussed the need for clear guidance on this issue, but we do not believe that the issue of social charges justifies or requires a change to the non-discrimination duty.

⁶⁵ See summary of Ofwat's statutory duties on p.10.

The better regulation duty contains a clear statement of the principles of best regulatory practice. The better regulation duty was supplemented by the Regulatory Enforcement and Sanctions Act 2008 which requires Ofwat to review its functions and, unless disproportionate or impracticable, to remove burdens that are not necessary. As we discuss in Chapter 2, Ofwat's approach to compliance and the price review (PR) process raises issues in relation to these principles and requirements, particularly around proportionality and targeting. We have made recommendations aimed at improving the position in these respects and involving the National Audit Office in monitoring progress. It is not clear that changing the wording of the duty would assist this process and we would prefer to allow Ofwat some time to implement changes before considering whether any change is required to the framework of duties. The other two duties set out in the Act cover technical areas of regulation.

The review team does not believe any major alterations to Ofwat's duties would benefit the sector or necessarily improve the way that Ofwat currently regulates. Whilst proposals for creating additional duties may at first sight appear enticing, the evidence provided to the review team did not warrant their adoption. However, it is important that in the context of its existing duties Ofwat achieves some progress in reducing the regulatory burden and demonstrating its commitment to addressing the issues set out in Chapter 3.

Recommendation 21: Ofwat's duties as currently set out in legislation should remain as they are.

The effectiveness of the Governments' guidance to Ofwat

The *'Statutory Social and Environmental Guidance to the Water Services Regulation Authority (Ofwat)'*⁶⁶ was issued in August 2008 under the Secretary of State for the Environment, Food and

Rural Affairs powers in the Water Act 2003. It was timed to assist Ofwat in the PR09 process, but applies more generally to all of Ofwat's activities. The Welsh Government also issued its *'Social and Environmental Guidance to Ofwat'*⁶⁷ in December 2008.

Ofwat is required to have regard to this guidance when discharging its statutory functions. However, Ofwat's decisions must still be made in the context of its statutory duties. In the preface to the 2008 guidance it is described as a high level policy steer rather than a "direction" by Ministers. If Ofwat judges that the guidance is inconsistent with its statutory duties, the statutory duties will prevail. This was underlined in a judicial review against Ofwat's decision to grant an inset appointment in Wales to Scottish and Southern Electricity.

Ideally such inconsistency should be avoided through discussion between the Government and Ofwat before the guidance is issued, but there will inevitably be instances where the position is not that clear or where circumstances arise that were not envisaged when the guidance was formulated. In these cases the effectiveness of guidance is likely to be determined by its clarity.

Some suggested that the guidance should be clearer about how Ofwat should balance its various duties and that the guidance should be firmer.

The review team feels that there is scope for the guidance to be more clear and specific, particularly around the question of social tariffs and non-discrimination, and around the interpretation of sustainable development and the various issues we discuss in Chapter 3 such as, for instance, its aspiration for the involvement of the companies in developing renewable generation. Such guidance should be provided in good time to be taken properly into account in the next price review.

66 Statutory Social and Environmental Guidance to the Water Services Regulation Authority (Ofwat), Defra (August 2008).

67 Social and Environmental Guidance to Ofwat, Welsh Government (December 2008).

In response to suggestions that the guidance was insufficiently effective we also considered the possibility of Government taking a power to direct Ofwat in exceptional circumstances; a question which was also considered in the Department of Energy and Climate Change review of Ofgem.

The conclusion of the Ofgem review was that the Government's goals for the energy sector should be set out in a new statutory '*Strategy and Policy Statement*' and the Government would seek legislative provision to require Ofgem to take its independent regulatory decisions within the context of these goals. Under these new arrangements Ofgem will be required to demonstrate how its decisions support the successful delivery of the policy outcomes defined in the statement and will be expected to set out annually how it plans to deliver its contribution to these outcomes. The new statutory statement will replace the existing guidance in the sector, which is equivalent to the Social and Environmental Guidance issued by Defra to Ofwat.

The review team do not feel that such an approach is necessary in the water sector. The ability of the Environment Agency and the Drinking Water Inspectorate to regulate water companies directly enables Government more easily to achieve its objectives. The presence and statutory remit of the quality regulators should give Ofwat the appropriate context within which it makes its regulatory decisions.

Recommendation 22: The UK and Welsh Governments should update their social and environmental guidance to Ofwat in good time for the next price review and, through the formal consultation process with Ofwat and other stakeholders, ensure as far as possible that the drafting will allow Ofwat to implement it without ambiguity.

One other area in which we feel guidance may be required is in the event of significant policy differences emerging between the UK and Welsh Governments. While it is difficult to tell

how significant an issue this could be for Ofwat, it is clear that there is a real possibility of such differences emerging. In these circumstances we feel that where possible the two Governments should establish an agreed position on how Ofwat should respond to such differences in interpreting its duties and guidance.

However, Ofwat should recognise that devolution arrangements have changed since its inception, and that it is the regulator's role to respond appropriately to the guidance set out by each Government.

Memoranda of Understanding

Clear statements of policy and guidance from the UK and Welsh Governments should go a long way to resolving the issues over the boundary of responsibility between Ofwat and Government but, realistically, there will also have to be some sort of practical division of responsibility in some areas. This can be set out to some extent in the policy statement itself, but unpredictable issues, with no clear divide between Government and regulator, are likely to arise again.

The answer must lie in effective working relationships to allow discussion of the issues on a case by case basis. Each of the parties should be taking proactive steps now to build robust working relationships able to withstand whatever challenges come. Working relations with Government and the other regulators will be a key test of the success of Ofwat's new Chairman and non-executive directors, but all sides must be willing to make things work.

However, recent experience of working relationships between the various bodies also suggests that some clear ground rules would be in order. Memoranda of Understanding (MoUs) exist between Ofwat and Defra and between Ofwat and the Welsh Government – but they are expressed in fairly general terms. One possibility would be for Government and Ofwat to agree more specific MoUs setting out rules of engagement – including who does what in specific areas.

The review team considers the way Ofwat and the UK Government work together in Europe as a good example of what a revised MoU could usefully cover. With the potential for Ofwat to provide a unique voice in Europe representing the customer interest, but also with the risk that the UK speaks with two voices, establishing an agreed and pragmatic set of working practices for joint engagement with the European Union would benefit all parties involved. This has worked well in other sectors, such as energy and airports, where Government and the economic regulator work well together on established ground rules.

As *'Principles for Economic Regulation'* recognises, it is important for consumer protection that the independence of the economic regulators is preserved. However, as a MoU will only determine working practices on specific projects or areas of policy, and will have to be agreed by both sides, we do not see any threat to Ofwat's independence in this proposal. Indeed, we see some merit in setting out exactly the framework within which that independence exists. Ideally, Government should not seek to revise either the policy framework or the practical division of responsibilities set out in the MoU very often – and only where there is a very clear case to do so.

Recommendation 23: Defra and the Welsh Government should agree more detailed and effective Memoranda of Understanding with Ofwat to set out the required division of responsibility and the expected working arrangements between them.

Conclusion

We recognise that we have made a large number of recommendations for Ofwat in the preceding chapters, some of which will take longer to implement than others. Some of the recommendations go beyond the remit of Ofwat alone and, where this is the case, we expect to see all parties work together to take forward the suggested approaches in an effective fashion.

The recommendations do not always propose specific tasks or targets for Ofwat, because many of the problems and solutions identified are behavioural. Where possible we have tried to make the suggested approach fit with the programme of work Ofwat has already started. This reflects the overall tone of our recommendations, that major changes are not needed but some of the current processes and relationships should be improved.

We would expect Ofwat to feel able to respond positively to this review and weave the recommendations into its developing work programmes, not least the Future Regulation project. We recognise that time will be needed for the new Chairman and non-executive directors to consider Ofwat's response, and for the changes to become embedded in Ofwat's activities, but we would like to see a response from Ofwat setting out progress towards meeting our recommendations in line with its annual reporting processes.

Recommendation 24: Ofwat's new Chair should publish a report on Ofwat's progress in responding to the issues and recommendations in line with its annual reporting processes.

Chapter 6:

Consumer representation in the water sector

Summary

The Consumer Council for Water (CCWater) currently provides advice to water company customers, handles their complaints and represents their views to Government and the regulators. We found a high degree of support for these functions and approval for CCWater's role in providing them.

After the review began, the Secretary of State for Business, Innovation and Skills announced his intention to make a number of changes to the institutional landscape concerned with consumer and competition policy. Subject to the agreement of the Departments concerned this would include transferring the consumer-related advocacy functions in the regulated sectors to the Citizens Advice service.

We consider it essential, in view of the monopoly position enjoyed by the water companies in most of their activities, that the functions currently performed by CCWater should be preserved in any new institutional arrangements. While we accept that there are viable alternative models for achieving this we also see some important arguments for retaining CCWater in its current role and some significant risks in changing the approach to consumer representation at a time when substantial changes to the regulatory process are under consideration by Government and Ofwat.

Our recommendation is that the current arrangements involving CCWater should be retained.

The Consumer Council for Water

CCWater is the statutory consumer organisation representing water and sewerage consumers in England and Wales. Its role is to represent the interests of customers of both the water and sewerage companies and licensed water suppliers.

Although its main focus is on domestic customers, it also provides representation for business customers, particularly small and medium sized companies.

CCWater has an English regional and Welsh structure to reflect the significant geographic variations in water and sewerage provision and to keep in touch with consumers in their local communities. Its headquarters are in Birmingham and it has four committees in England and one in Wales. It has offices in Cardiff, Cambridge, Birmingham, Darlington, Manchester, London, Bristol and Exeter. CCWater has 75 staff in total.

CCWater was established as a non-departmental public body co-sponsored by the Department for Environment, Food and Rural Affairs (Defra) and the Welsh Government on 1 October 2005 replacing the WaterVoice committees.

CCWater's predecessors originated in April 1990 when Ofwat's own predecessor, the Director General for Water Services created ten statutory regional Customer Service Committees (CSCs) each with its own support staff. The Director General's office provided the CSCs with legal and technical advice, communications support, and personnel and office services, as well as funding for their staff and activities.

Three years later, the non-statutory Ofwat National Customer Council (ONCC), comprising of the Chairs of the ten regional CSCs, was created. To help enhance their effectiveness as a consumer advocate the CSCs and the ONCC were rebranded as WaterVoice in 2002. The number of committees has since been reduced to their present number.

The Water Act 2003 gives CCWater the following functions and duties:

- to have regard to the interests of consumers of water and sewerage services in England and Wales, including certain vulnerable customers and customers that are not able to switch suppliers under the Act's competition measures;
- to handle and investigate consumer complaints in respect of water and sewerage companies;
- to obtain and keep under review information about consumer matters and the views of consumers on such matters;
- to make proposals, provide advice and information and represent the views of consumers to public authorities, water and sewerage companies and others whose activities may affect the interests of consumers;
- to provide advice and information to consumers;
- to publish statistical information about complaints to and about water companies; and
- to investigate any matters of interest to consumers that are not necessarily the subject of a complaint.

CCWater also has super complainant status under the Enterprise Act 2002.

The role of the consumer representative

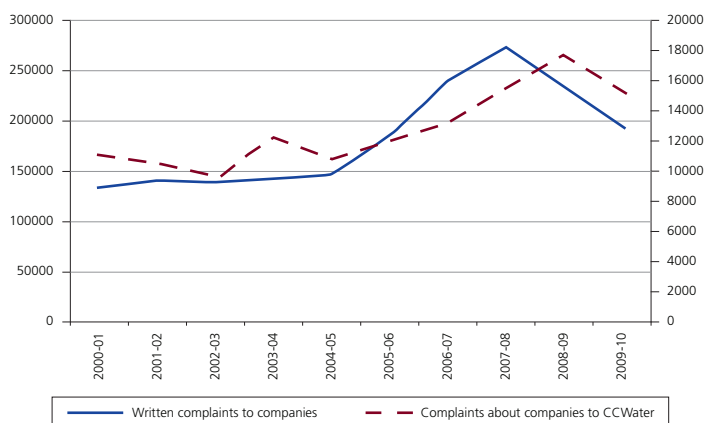
The main functions of a consumer body in a regulated sector are providing advice and information; handling complaints, either informally or through a formal dispute resolution mechanism; and providing consumer input to policy development generally and the price review (PR) process in particular. CCWater currently carries out each of these roles save for formal dispute resolution in some specific areas which lie with Ofwat.

Advice – CCWater acts as a source of advice to consumers in the sector. It has powers to provide and publish information and advice to consumers about consumer matters. For example, it publishes information on customer bills and charging schemes including help on paying bills, customer service, vulnerable customers, the environment, sustainable development, competition, water efficiency, water and sewerage supply and infrastructure and sewer flooding.

Complaint handling – The primary responsibility for handling complaints in the sector lies with the companies themselves. They are required to have a complaints handling procedure, having consulted with CCWater, which must be approved by Ofwat. CCWater has a duty to investigate complaints that water and sewerage companies do not resolve themselves.

In 2009/10 the companies received nearly 200,000 written complaints from customers. The vast majority of these were resolved by the companies themselves, while 15,389 were referred to CCWater (in the same year CCWater received 22,802 enquiries which includes 7,479 Consumer Support site contacts). Most of the written complaints were resolved informally as a result of CCWater's intervention. In cases in which a service failure remains unresolved, or if it considers the company should do more, then CCWater undertakes a formal investigation. In 2009/10 CCWater initiated 635 complaint investigations.

Complaints to companies and the Consumer Council for Water 2000/01 – 2009/10



CCWater does not have powers to impose a resolution of a complaint on either the consumer or the company concerned. However, most investigations lead to a resolution of the complaint and in 2009/10 almost 75 per cent of complainants were satisfied with the quality of CCWater's service. A customer who is dissatisfied with the complaint handling process may make a complaint about CCWater's handling of it to the Parliamentary and Health Service Ombudsman (PHSO). There were three such referrals in 2009/10, on all of which the PHSO confirmed CCWater's handling of the complaint.

Ofwat is responsible for dealing with certain specific categories of complaint. These are:

- allegations of breach of duty or licence condition by the companies;
- issues where it has specific powers to determine disputes;
- complaints about work by companies on their pipework in private land; and
- complaints about Ofwat policy.

Advocacy and policy input – CCWater has an important role in representing the views of customers to the UK and Welsh Governments, Ofwat and the other sector regulators, and the companies themselves. It bases its views on consumer research and on information gained from its complaint handling role.

During the last price review, CCWater and others established quadripartite groups with each water company. These groups (CCWater, the water company, the Environment Agency (EA), the Drinking Water Inspectorate (DWI), and in some cases Natural England or the Countryside Council for Wales⁶⁸) enabled water companies to test and agree their plans and to ensure customers' views were fully taken into account⁶⁹ in deciding the company's priorities and the trade-offs between investment and customers' willingness to pay. The Wales PR09 Forum carried out a similar role.

CCWater was also a member of the regulation group with Ofwat, the Welsh Government, Defra, EA, DWI and Natural England.

Evidence

Broadly speaking the responses to the call for evidence fell into three main groups: companies, consumer bodies and others. None of the responses specifically supported the abolition of CCWater although some commented on alternative approaches.

Companies responding to the call for evidence gave a clear message that primary responsibility for customer relationships should lie with the companies themselves and that Ofwat's duty to further the interests of consumers should not mean that Ofwat should be responsible for establishing what the interests of consumers are. This should be done by a consumer body (or by

68 See Introduction p.10.

69 Quadripartite Groups (QGs)/Wales PR09 Forum – their role, achievements during the 2009 Price Review and potential for the future, CCWater (June 2010). http://www.ofwat.gov.uk/publications/commissioned/rpt_com_1010fplquad.pdf

the companies themselves with a consumer body providing “quality assurance”) and Ofwat should not over-ride valid consumer input.

“Ofwat sometimes gives the impression that it knows what customers want better than the customers themselves.” **Wessex Water**

The companies generally saw a clear requirement for the functions carried out by CCWater to continue and gave a favourable view of CCWater’s performance in carrying out those functions, although some of the smaller companies felt that CCWater’s regionalised structure was too broad to properly reflect the specific wishes of small water company customers. Northumbrian Water suggested that CCWater could restructure its regional representation along the lines of Passenger Focus relying on its board members’ regional lead responsibilities rather than having separate regional committees. Some companies advocated reform of specific aspects of CCWater’s activities while recommending that it should continue to act as the consumer representative for the sector.

In the event of CCWater’s abolition, the companies were largely against Ofwat resuming the role of consumer representative.

In the light of the Department for Business, Innovation and Skills (BIS) preferred approach to consumer representation outlined above, responses from other consumer organisations generally looked at other means of consumer representation and their own potential involvement in this. Consumer Focus set out the arguments for strong consumer representation in sectors of the economy subject to economic regulation and argued that there would be significant benefits from having a single consumer advocate covering all the regulated sectors. The Ombudsman Service urged Defra to review good practice in the communications and energy sectors, both of which have moved to a redress model.

Other respondents generally saw a clear need for a consumer representative in the sector and were supportive of CCWater’s role. Some respondents, particularly representatives of small business customers, criticised what they saw as an overlap of roles between CCWater and Ofwat and a consequent duplication of activities. There were also suggestions that CCWater should extend its activities in some areas, such as providing advice on water efficiency and promoting the consumption of tap water rather than bottled water – although CCWater already does both of these.

Ofwat expressed no strong view on the role of CCWater as such, but recommended that a firm decision should be made on consumer representation as soon as possible. Whoever was to be responsible for consumer representation, Ofwat also wished to be able to have direct access to complaint data to allow it to understand developing trends in customer experience and company behaviour.

The Welsh Government was strongly supportive of CCWater’s role. Powers under the Consumers, Estate Agents and Redress Act 2007 provide for the merger of CCWater with Consumer Focus and the setting up of an ombudsman scheme for water customers, but a transfer of CCWater’s functions could not take place without the consent of the Welsh Ministers. The Welsh Assembly has since obtained powers to make primary legislation on consumer representation in water and sewerage services.

Discussion

The current arrangements

Most of the responses to the call for evidence commented on the current model of consumer representation rather than suggesting alternatives. The evidence we received suggests that, on the whole, the current arrangements are working well and are providing effective consumer representation in the sector. We heard no significant complaints about CCWater’s role in providing advice and

handling complaints and CCWater's internal benchmarking suggests its customer satisfaction ratings are generally good and on a rising trend. The feedback we received from all sides was that CCWater's role in the quadripartite process worked particularly well at the last price review. The Walker Review advised that:

"In the past, companies were incentivised to 'overbid' in their initial proposals, but with greater customer input on willingness to pay at an earlier stage it seems that companies were able to self-regulate to a greater extent, delivering plans that were more in line with customer's priorities. Compared with the last price review, the bids which companies made were £1 billion lower overall, equivalent to £40 to £50 per customer. This bears out the value of early and in-depth local customer involvement in the price control process to ensure that customer preferences are properly reflected in decisions⁷⁰."

There appeared to be a consensus that the functions carried out by CCWater are necessary. The main issue raised in responses concerned a lack of clarity around the respective roles of the companies, Ofwat and CCWater – and, hence, whose views should carry most weight in the decisions of Ofwat and the other regulators.

There does appear to be an element of duplication of effort in the existing arrangements. The companies assess their customers' views and seek to reflect those views in their business plans. CCWater carries out its own research and provides separate input, in effect as a check on the companies' work. Ofwat reserves the right to carry out its own research and to take the final decisions on approval of investment in the light of consumer input.

To a great extent this is healthy. The major part of the companies' investment plans is non-discretionary, consisting of necessary maintenance

work and projects to comply with requirements of the quality regulators. However, companies have more flexibility, certainly as to timing, over a significant element of their investment plans. Effective customer engagement in the development of the business plans and input into the price control decisions should therefore be very helpful in assessing which projects should go ahead and which should not. The argument about who should reflect the customer view is therefore, to a great extent, one about whose views on investment and customer service should prevail.

Ideally, as they suggested in their responses, water companies would own their relationship with their customers, with minimum involvement from other players. However, in the absence of any ability for domestic customers to switch supplier, competitive pressure in the sector is unlikely to provide the necessary stimulus for companies to respond to customers' wishes without additional regulatory incentives. It seems unlikely that moves toward competition will change this position other than perhaps in the longer-term. This strongly suggests CCWater's main functions should be retained in one form or another.

This also suggests a continuing degree of overlap between the consumer representative, the companies and Ofwat. As a practical matter, however, there may be some areas for improvement and cost saving. There does seem to be scope for customer survey work to be undertaken jointly and to avoid duplicating efforts to garner business customers' views.

On the question of whose views should prevail, the final decision, at least in terms of price reviews, must be for Ofwat, but Ofwat should be careful about substituting its own views for those expressed by or through the consumer representative. This point is closely related to our recommendations in Chapter 1 where we recommend that Ofwat should provide a clear explanation in cases where it does not

⁷⁰ The Independent Review of Charging for Household Water and Sewerage Services, Anna Walker CB (December 2009) p.146. <http://archive.defra.gov.uk/environment/quality/water/industry/walkerreview/documents/final-report.pdf>

allow funding for proposals arising from the planning processes separate to the price review or obligations required and enforced by other regulators.

Potential for expanded role

In the course of our discussions the review team identified some areas in which CCWater could potentially take a more active role. The review team met with small business representatives who were concerned that their interests may be ignored as competition is introduced and the companies focus on competing for large customers and improving their performance in response to regulatory incentives in the domestic sector. Business representatives were also concerned at the potential for mis-selling as experienced in the energy sector. Although CCWater already has a role in respect of small businesses we feel that this is an area in which it may need to raise its activity and profile, particularly as competition for a larger share of the market is introduced.

As discussed in Chapter 3, we also see a potential role for the consumer body as a formal consultee on significant tariff changes. This would be to ensure a clear and rigorous assessment of distributional impacts on different social groups had been carried out before Ofwat gives clearance on the tariff.

For future price reviews CCWater has asked that the Government consider instituting a right of appeal to the Competition Commission for the consumer body on price determinations. In the energy sector, Department of Energy and Climate Change (DECC) has announced that it proposes that Consumer Focus should have a right of appeal in relation to licence decisions that materially affect consumers.

Ofwat has considered CCWater's suggestion in its recent publication *'Involving customers in decisions about water and sewerage services'*

and recommends against such a change, instead suggesting a revised approach to customer engagement⁷¹.

There are arguments for and against CCWater's suggestion. Appeal rights in the price-regulated sectors were restricted initially to the regulated companies who could reject the price control if they felt the revenue allowed by the proposals was insufficient to allow them to meet their licence obligations and earn a reasonable return. The regulator could then either adjust its proposals or refer the matter to the Competition Commission. There is no such specific requirement for protection against a regulatory decision on the consumer side; indeed Ofwat's primary duty is to protect the interests of the consumer. It can be argued that, with the increasing degree of consumer engagement in the price review, there may be a case for providing a right of appeal if the consumer representative feels its input is not being adequately taken into account. On the other hand, the existence of symmetrical rights of appeal would raise the possibility of regular appeals leading to a position in which the Competition Commission, rather than the regulator, in effect becomes the final decision maker.

An alternative approach might be to regard any perceived failure to protect the consumer interest as a governance issue that could be addressed at a subsequent review of the effectiveness of the regulator. Were the Government minded to provide a right of appeal to a consumer representative this would also suggest the retention of a specialist sector body to carry out such a role.

Alternative model of consumer representation

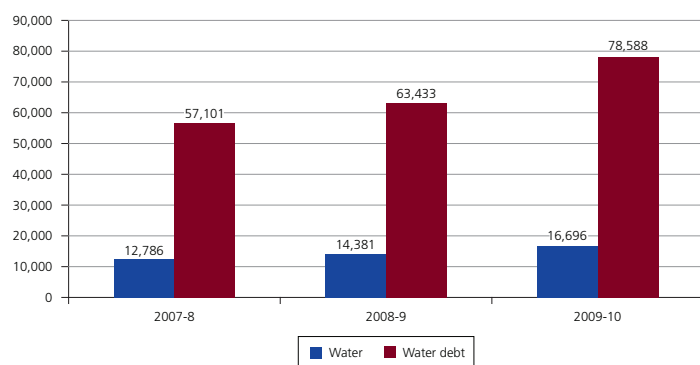
As BIS has put forward a proposal to transfer CCWater's functions into other bodies and signalled an upcoming decision for Defra and the Welsh Government on this, the review team has

⁷¹ *Involving customers in decisions about water and sewerage services*, Ofwat (2011). http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf1104fpl_customer.pdf

considered the potential alternatives for handling CCWater's functions, both as proposed by BIS and otherwise.

In BIS's proposed landscape the Citizens Advice service would take over the advice and advocacy functions currently undertaken by CCWater. Advice is possibly the most straight-forward of the functions and could be handled wherever the advantages in cost efficiency and a strong brand identity lie. This suggests that the Citizens Advice service would be a good alternative to existing arrangements. Citizens Advice is an acknowledged source of expertise on debt advice in particular. Transferring CCWater's functions to Citizens Advice could provide an even greater local reach for consumer services. Citizens Advice has some experience of dealing with water issues, though this is largely focused on advice and help on customers' debt problems.

Water problems dealt with by Citizens Advice Bureaux in England and Wales



On the other hand CCWater told us that it already has a good working relationship with Citizens Advice and cases are passed between the two organisations appropriately to where the greater expertise lies, so it is not clear that the existing approach is inadequate.

The BIS model proposes that Citizens Advice would establish a specialist unit to provide an advocacy role for the regulated sectors. There are arguments for a single organisation operating across all the regulated sectors. Many of the issues, such as billing, affordability and treatment of vulnerable consumers are common to all the regulated sectors and there could be operational synergies in having a specialist team to handle these and to provide input to price control reviews.

The review team would also like to note the proposals set out by Consumer Focus in its document *'Regulated industries and the consumer'*⁷². This supports the need for a cross-sector advocacy function, the like of which is proposed by BIS in its model. However, the review team consider that if this move were to take place it might be more effective as an independent body focussed on the considerable challenge of inputting to the various sectoral price reviews. Therefore, a variant to the BIS model would be for Citizens Advice to take on the advice functions, for consumer redress to be taken on by an ombudsman and advocacy to be taken on cross-sector by an independent body, carrying out the function described by Consumer Focus.

Another alternative would be for Ofwat to make its own arrangements for domestic consumer input into its decision making processes. This is an approach taken by some regulators. Ofwat already holds a regular business customer forum. Ofcom has a standing consumer panel while Ofgem has a standing panel and also sets up specialist groups to provide input into specific projects such as price control reviews. Issues of independence of the consumer view could be addressed by contracting out the organisation of the panel, as is the case at Ofgem. When part of Ofwat, CCWater's predecessor bodies – the ONCC and the CSCs – argued that their structural integration with Ofwat afforded them a close and productive

⁷² Regulated industries and the consumer, Consumer Focus (March 2011). <http://www.consumerfocus.org.uk/publications/regulated-industries-and-the-consumer>

relationship with the regulator, gave them access to the technical expertise and knowledge of Ofwat staff, and allowed them to influence policy at an early stage⁷³.

In the BIS model with Citizens Advice only offering advice and information alongside its advocacy work, new arrangements would have to be made for consumers seeking redress:

“If the relevant Departments decide that the functions of CCWater or Passenger Focus should transfer to the regulated industries unit, redress schemes in the respective sectors would have to be considered as these bodies have the handling of complaints by consumers as part of their functions⁷⁴.”

In this type of scheme, complaints that had reached deadlock or were not settled within a specified time limit would be referred automatically to an ombudsman for resolution. The companies would continue to have an obligation to establish a complaints handling mechanism approved by Ofwat. Funding for the ombudsman role could be provided partly by subscription from the companies and partly by a charge on each company for each complaint referred for decision, which would provide a strong incentive for complaints to be resolved efficiently. This would be similar to the system that currently applies in the communications and financial services sectors. Powers to introduce such a system in the water sector already exist under the Consumers, Estate Agents and Redress Act 2007.

One argument for this approach is that it places the onus for complaint handling firmly on the companies. The danger with a body such as CCWater being involved is that the companies may get into the habit of sending difficult cases to the consumer body as the default

mechanism. If the companies see this as the easy option the pressure on them to resolve complaints expeditiously is reduced. On the other hand it would be possible under the existing arrangements to incentivise the companies to improve their performance. Ofwat has recently introduced the Service Incentive Mechanism which aims to incentivise companies to resolve customer complaints more effectively. This incentive could be increased if necessary or Ofwat could introduce a licence condition specifying minimum standards and take enforcement action against it; although as discussed in Chapter 2 introducing consistent licence conditions is not currently a straight-forward process.

Water UK suggested that CCWater itself should gain the powers of an ombudsman. This would be an unusual approach and there are strong arguments against it. For instance, the Ombudsman Service argued that the final adjudication role for complaint handling is better handled separately from the consumer advocate role to avoid an inherent bias against the companies. Currently there are no consumer bodies with an ombudsman role. Some like CCWater and Passenger Focus assist consumers with complaints, but they do not have powers to determine a decision. Over the years, however, several of CCWater’s predecessor customer service committees negotiated written agreements on binding mediation with the companies in their regions. Despite not having the powers of an ombudsman, CCWater reported to us that it has delivered nearly £12 million of compensation to customers since its inception.

Costs

CCWater is funded by grant-in-aid from Defra and the Welsh Government. Defra and the Welsh Government both claim back the grant-in-aid

73 Consumer representation in Europe: policy and practice for utilities and network industries, University of Bath (January 2002) p.10. http://www.bath.ac.uk/management/crri/pubpdf/Research_Reports/11_Simmonds.pdf

74 Empowering and Protecting Consumers: Consultation on institutional changes for provision of consumer information, advice, education, advocacy and enforcement, BIS (June 2011) p.46. <http://www.bis.gov.uk/Consultations/empowering-and-protecting-consumers>

from Ofwat which in turn collects its own and CCWater's costs through water company licence fees. Ultimately these costs are passed onto customers.

In CCWater's audited accounts 2005/06, WaterVoice's costs in its last full year for 2004/05 were £3.3 million and were £2.2 million for the first six months of 2005/06. Ofwat was able to provide us only with estimated costs for WaterVoice before this point due to the difficulty of splitting shared services and accommodation. CCWater started with an annual licence fee of £5.6 million in 2005/06, an increase in costs of 70 per cent over the previous year as WaterVoice. This increased in line with inflation until 2009/10. For 2010/11, the organisation reduced its costs by 10 per cent to £5.7 million, or the equivalent of 23p per year in licence fees for each water bill payer. This was 11 per cent lower than financial projections prepared on behalf of Defra prior to CCWater's inception.

CCWater's overall costs and headcount are broadly equivalent to those of Passenger Focus which has a similar role.

One argument for moving to a new approach would be the potential scope for cost savings. We have not seen any analysis of the potential costs and benefits of an approach involving the transfer of CCWater's functions to Citizens Advice and an ombudsman and are therefore not in a position to make a comparison with the status quo. However, it is likely that there could be transitional costs, which would need to be factored into any assessment of the costs and benefits of the BIS proposals.

In view of the importance we place on maintaining the functions currently performed by CCWater it would be important to ensure that any cost comparison was on a genuinely like-for-like basis taking account of the costs of maintaining the desired level of consumer input – including, for instance, any increase in costs that might be incurred by Ofwat or the companies in consumer research or the establishment of consumer panels.

Equally, any such comparison should take into account the scope for cost savings at CCWater. CCWater has announced plans to reduce its costs by a further 10 per cent in 2011/12, following the reduction in 2010/11, by reducing its executive team by one person, reducing the resources devoted to complaint handling in line with the declining trend in complaint volumes, reducing the costs of operating its local committees and running its offices.

If CCWater is to continue in its role, it should continue to consider the potential for further cost reductions. CCWater has told us that it has put off any plans for further cost savings, which would require a two year payback, as a result of the continued uncertainty over its existence.

The review team is supportive of the role of CCWater's regional committees while the industry is made up of locally-based regional monopolies. However, there may be scope to consider how regional activities are best supported.

CCWater and Ofwat should also explore potential for returning to a greater sharing of back office costs. Should agreement not be reached, CCWater should continue to explore potential savings through sharing services with other public sector bodies.

Conclusions

CCWater has argued that it helps Ofwat to have an external and independent challenging voice representing the customer interest to balance the voices of other strong groups such as the companies and the environmental lobby who might be swayed more by other considerations.

The review team agrees that there is considerable value in this balancing voice. We share the view, expressed by Consumer Focus in its paper on the regulated industries and consumers, that good regulatory decision making requires effective input from all stakeholders, including consumers, and that the regulator should not itself take on

the advocacy role⁷⁵. In price reviews, in particular, the regulator is involved in a long and intensive process of interaction with the companies and is lobbied by outside groups who may see it as convenient to have the consumer pay.

A strong voice clearly representing the interests of consumers should provide helpful balance, particularly in the heavily monopolistic water sector.

The presence of CCWater in the quadripartite process in PR09 seems to have been a helpful step. Not just in terms of ensuring that the consumer view was taken into account in Ofwat's decisions but also in encouraging the companies to take consumer views fully into account in formulating their initial business plans. The review team believe that this process is valuable and should be built on as we discuss in Chapter 1.

The general trend in economic regulation is clearly towards a greater degree of stakeholder engagement and potentially towards negotiated settlements overseen by the regulator rather than the conventional price control process. Ofwat has recently consulted on how to improve consumer engagement and it does not recommend a move to negotiated settlements or to a constructive engagement process such as that introduced by the Civil Aviation Authority, at this time. Ofwat feels that it is unlikely that sufficient challenge would be added to justify the additional cost although it may revisit this decision in future should the retail functions of companies be legally separated. However, Ofwat clearly sees an increasing role for consumer input.

A strong consumer view will also be important in relation to the forthcoming challenges in the sector such as:

- The ongoing roll-out of compulsory metering programmes;
- The introduction of social tariffs; and

- The need to encourage newly eligible business customers to test the retail market, and to combat mis-selling, supplier failure and inappropriate cross-subsidy.

We have also identified some areas in which the role of the consumer representative could be expanded. These include acting as a formal consultee on significant tariff changes and, potentially, having a right of appeal to the Competition Commission on price control decisions.

The question is whether the degree of specialist input involved in both the existing and potential roles could realistically be provided by a non-sector specialist body. There seem to be three features of the water sector which differentiate it from other regulated sectors and which argue for a sector specialist body.

The first is the limited extent of competition in the sector. Ofwat's current proposals do not envisage any near-term move towards competition in the domestic sector and it seems unlikely that any such move would be contemplated until there is some established evidence of the successful operation of a competitive market for business customers. In the energy sector the introduction of competition was phased over an eight year period with the opening up of the domestic market as the final stage. In the absence of any ability to switch supplier, the importance of a specialist representative voice for domestic consumers takes on greater importance. Even if competition was eventually introduced for the domestic market the regulated core network business would still represent a much greater proportion of the final price to consumers than in the energy sector, where the commodity price is a much more important factor.

Linked to the relative lack of competition is the absence of any commercial organisations that could be said to represent the consumer view.

75 Regulated industries and the consumer, Consumer Focus (March 2011) p.14.

In other sectors there is a debate about the extent to which non-regulated companies can be taken to represent the consumer view (e.g. energy supply companies in respect of network regulation and airlines in respect of airport regulation), but in water that possibility does not currently exist.

The third feature is the complexity of trade-offs required between water quality and environmental issues and water prices. In Chapter 1 we support the current arrangements in the sector, with clearly defined roles for the Drinking Water Inspectorate, the Environment Agency and Ofwat. We also recommend that the role of the quadripartite process in price reviews should be strengthened to ensure an effective consumer input into the price review process. This approach clearly requires consumer representation in the sector to be based on sufficient specialist expertise to be able to understand these trade-offs and contribute a measured view on their discussion and resolution.

The review team doubts whether a body with no history of taking on the advocacy role in water could perform the role as effectively as CCWater does at present. At the very least there would be a danger of less effective consumer representation during the next price review, PR14, as the consumer responsibility was transferred to Citizens Advice.

In these circumstances it seems likely that Ofwat would feel it necessary to build up its own access to consumer input for PR14, perhaps following the lead of Ofgem and establishing a specialist consumer panel.

As Ofwat stated in its evidence *“We will work closely with whichever party carries out this function, and – as described earlier – put in place arrangements to hear from these customers directly if we think that is needed.”*

This would be understandable but could increase the risk of lack of clarity discussed above and increase costs.

More generally, at a time of major change in Ofwat’s approach to regulation in the sector, including market reform, a new approach to setting price limits and a major effort to reduce the burden of regulation, we see real value in continuity of consumer representation to ensure that the interests of consumers are clearly and strongly put forward at all stages.

While it seems clear that a viable alternative model for consumer representation is the BIS model or an alternative thereof as set out above, the review team considers that some significant problems remain. First, there is the lack of specialist expertise necessary as we have discussed above, to input to the price review process.

Then there was a particular concern raised with us that in dealing with clients’ multiple debt problems CAB encourage clients to prioritise other bills over water bills as there is no threat of disconnection for non-payers. That this raises costs for the majority of water customers does not sit comfortably with the customer advocate role. Another concern to be addressed would be the representation of small and medium sized business customers. Representing business customers is not a central part of Citizens Advice current role, but it would be necessary to ensure that it was included in the new arrangements either by Citizens Advice or otherwise.

Recommendations

The review team is strongly of the view that effective consumer representation will be required in the sector for the foreseeable future and that the functions currently undertaken by CCWater should be maintained and protected in any new approach. Indeed, we can see areas in which the consumer role could be extended.

We accept that there are alternative models for providing such representation. There is no definitively correct answer and the approach must be assessed in the context of the circumstances prevailing in the sector and at the time.

The advantages of retaining CCWater would be:

- Maintaining a strong specialist focus for consumer representation in this monopoly sector;
- Having one organisation handling all of the water consumer functions, ensuring knowledge gained from one activity is transferable to another;
- Retaining legitimacy in the eyes of the other sectoral players during the price review as a true customer representative with the necessary expertise;
- Potentially providing a vehicle for other functions; and
- Maintaining an approach which has been shown to work well in practice.

The advantages of moving to an alternative approach would be:

- Bringing consumer representation together in a larger cross-sector body, taking advantages of scale and common learning across sectors;
- Putting the focus of complaint handling more squarely on companies; and
- Potentially achieving a lower cost approach.

We also see some potentially significant risks in the transition to any new arrangements; either in the sense that consumer representation proves to be less effective in the new model or there is a temporary loss of effectiveness during a period in which Ofwat is pursuing major changes to the way it regulates the sector.

On balance, and in view of the particular features of the water sector referred to in the previous section, we feel that the advantages of maintaining a specialist sector body outweigh the potential benefits of change. We also see strong arguments for continuity of consumer representation at a time of major changes in Ofwat's approach to regulation of the sector. We would not wish to see the effectiveness of consumer representation be diluted during the

transition to any new approach. We therefore conclude that CCWater should continue in its current role.

If this is not the Government's decision we would see some attractions in the approach recommended by Consumer Focus involving the establishment of a strong advocacy function covering all of the regulated sectors. Consumer Focus does not express a view on where this function should sit but we see this as a function which would benefit from being undertaken by a separate body focussed on inputting to the numerous sectoral price reviews.

In any arrangement in which the functions of CCWater are transferred elsewhere there should be transparent arrangements to ensure that water company funding, which is ultimately provided by water company customers, is transparently used to the benefit of those customers and not for other activities.

Recommendation 25: The Consumer Council for Water should continue to represent consumers in the water sector. In the event of Government adopting a different approach, the functions currently carried out by CCWater should be maintained and protected.

Recommendation 26: The Consumer Council for Water should continue to consider the potential for further cost reductions and explore with Ofwat the potential for returning to a greater sharing of back office costs.

Whatever the decision over CCWater's future, the review team recommends that it is made quickly and that as much forward certainty is provided as possible. If CCWater is to continue in its current role it needs the confidence in its position to be able to develop and implement a long-term strategy. In the absence of such confidence there must be a risk that efficiency initiatives will not be pursued and that resources will be diverted to producing evidence to support its role rather than acting in support of customers during a period of significant challenges to the sector.

Annex A:

Terms of Reference

The review will consider:

- The Governments' objectives for independent economic regulation of the water sector, including how far Ofwat's remit should extend beyond pure economic regulation;
- The boundary of responsibility between Ofwat and Ministers, reflecting the need for clarity, accountability for political choices, and the need for Ofwat to retain the level of independence which is critical to investor confidence in the stability and predictability of the regulatory framework;
- Ofwat's statutory duties and whether they are fit for purpose to meet future policy challenges;
- The effectiveness of the Governments' guidance to Ofwat;
- How effectively the statutory duties and guidance are translated through Ofwat's decision making;
- The extent to which Ofwat has contributed to the achievement of sustainable development;
- Ofwat's relations with other water regulators and water and sewerage companies;
- How effective the current arrangements, involving Ofwat and the Consumer Council for Water, are in protecting water consumers and ensuring that their views influence the way the water sector is managed and regulated;
- The value for money Ofwat provides, particularly in comparison with other economic regulators;
- The effectiveness of Ofwat's governance arrangements;
- Ofwat's approach to minimising the burdens from its regulatory activity; and
- The scope for learning lessons from good practice by other economic regulators, particularly to address issues raised in the course of this review.

Annex B: Call for evidence

The Ofwat Review was launched on 26 August 2010 with a call for evidence. This closed at the end of October 2010 with responses from 59 organisations and individuals. This included most water companies, Ofwat and the Consumer Council for Water.

Following the close of the call for evidence meetings were arranged with key stakeholders who had submitted evidence, including all water companies and over 60 other interested parties including organisations from certain sectors under-represented in the response to the call

for evidence – most notably investors, business customers and consumer representative bodies.

This process culminated in the review team sharing their emerging findings with invited stakeholders at an event at Defra's offices on 20 January 2011. Emerging findings were also shared with the All Party Parliamentary Water Group at a meeting on 25 January 2011.

The responses are publicly available from the Defra library⁷⁶. The below table lists the questions asked in the call for evidence.

| | |
|----------|--|
| 1 | <p>Statutory Framework and decision making</p> <ul style="list-style-type: none"> – Ofwat's application of its statutory duties and reflection of Government guidance in its decision making. – Will future challenges require changes to the way Ofwat operates? – What are the risks to changing Ofwat's duties and the respective roles of Government and independent regulator? |
| 2 | <p>Sustainable Development</p> <ul style="list-style-type: none"> – How far are Ofwat's decisions leading to sustainable outcomes? |
| 3 | <p>Relations with other regulators and water and sewerage companies</p> <ul style="list-style-type: none"> – Experience of dealing with Ofwat, and of the way Ofwat works with other regulators. |
| 4 | <p>Protecting, serving and representing customers</p> <ul style="list-style-type: none"> – The effectiveness of the current arrangements involving Ofwat and the Consumer Council for Water. |
| 5 | <p>Value for money</p> <ul style="list-style-type: none"> – Ofwat's approach in comparison to other regulators both in England and Wales, and in other countries. |

⁷⁶ <http://archive.defra.gov.uk/corporate/contacts/library.htm>

List of respondents

NB: the names of individual customers who submitted evidence have been left out of this list.

Albion Water

Anglian Water

Bristol Water

British Water

BT

Cambridge Water

Cholderton and District Water

Civil Engineering Contractors Association (CECA)

Consumer Council for Water

Consumer Focus

Environment Agency

Environmental Industries Commission (EIC)

Environmental Industries Commission's Water Management Working Group

Environmental Sustainability Knowledge Transfer Network (ESKTN)

Envision UK

ESRC Centre for Competition Policy

Greater Norwich Development Partnership

Group Against Reservoir Development (GARD)

Hewdon Consulting

Home Builders Federation

Institution of Civil Engineers (ICE)

May Gurney Ltd.

Mayor of London

Natural England

National Farmers Union (NFU)

Northumbrian Water and Essex & Suffolk Water

Office of Fair Trading

Ofwat

Ombudsman Services

PCS

Portsmouth Water

SBWWI

Scottish and Southern Energy

Sembcorp Bournemouth Water

Severn Trent Water

South East Water

South Staffordshire Water

South West Water

Southern Water

Thames Water

The Anaerobic Digestion and Biogas Association (ADBA)

The Central Association of Agricultural Valuers (CAAV)

The Chartered Institution of Water and Environmental Management (CIWEM)

UKWIR

Unison

United Utilities

Utility Regulator (NI)

Veolia Water

Water UK

Waterwise

Welsh Water

Wessex Water

WWF

Yorkshire Water

Annex C:

Ofwat's statutory duties

Primary duties

The Authority (Ofwat) shall exercise and perform [its] powers and duties in the manner best calculated:

- to further the consumer objective, by protecting the interests of consumers, wherever appropriate by promoting effective competition;
- to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales;
- to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
- to secure that the activities authorised by the licence of a licensed water supplier and any statutory functions imposed on it in consequence of the licence are properly carried out.

When carrying out its duties to further the consumer objective, Ofwat shall have regard to individuals who are disabled or chronically sick, individuals of pensionable age, individuals with low incomes, individuals residing in rural areas, and customers whose premises are not eligible to be supplied by a licensed water supplier (but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer).

Secondary duties

Subject to its primary duties the Authority (Ofwat) shall exercise and perform [its] powers and duties in the manner best calculated:

- to promote economy and efficiency on the part of companies holding an appointment under Chapter 1 of Part 2 of this Act in the carrying out of the functions of a relevant undertaker;

- to secure that no undue preference is shown, and that there is no undue discrimination in the fixing by such companies of water and drainage charges;
- to secure that consumers are protected as respects benefits that could be secured for them by the application in a particular manner of any of the proceeds of any disposal (whenever made) of any of such a company's protected land or of an interest or right in or over any of that land;
- to ensure that consumers are also protected as respects any activities of such a company which are not attributable to the exercise of functions of a relevant undertaker, or as respects any activities of any person appearing to the Secretary of State or (as the case may be) the Authority to be connected with the company, and in particular by ensuring—
 - that any transactions are carried out at arm's length;
 - that the company, in relation to the exercise of its functions as a relevant undertaker, maintains and presents accounts in a suitable form and manner;
 - that, if the person is a licensed water supplier, its licence does not authorise it to carry on any activities in the area of the company;
- to contribute to the achievement of sustainable development.

In exercising any of the powers or performing any of the duties mentioned [above], the Authority shall have regard to the principles of best regulatory practice (including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed).

Annex D: Glossary

| | |
|-------|--|
| AMP | Asset Management Period |
| BIS | Department for Business, Innovation and Skills |
| CA | Citizens Advice |
| CAA | Civil Aviation Authority |
| CAB | Citizens Advice Bureau(x) |
| Capex | Capital expenditure |
| CBA | Cost-benefit analysis |
| CC | Competition Commission |
| CEAR | Consumers, Estate Agents and Redress Act |
| CIS | Capital Incentive Scheme |
| CSC | Customer Service Committee |
| DD | Draft determination |
| DECC | Department for Energy and Climate Change |
| Defra | Department for Environment, Food and Rural Affairs |
| DWI | Drinking Water Inspectorate |
| EA | Environment Agency |
| EMR | Electricity Market Reform |
| FD | Final determination |
| FPL | Future Price Limits |
| GSS | Guaranteed Standards of Service |
| HMT | Her Majesty's Treasury |
| IA | Impact Assessment |
| MoU | Memorandum of Understanding |
| NAO | National Audit Office |
| NAV | New Appointment and Variation |
| NED | Non-executive director |
| NEP | National Environment Programme |
| NGO | Non-governmental organisation |
| ONCC | Ofwat National Customer Council |
| Opex | Operational expenditure |
| PHSO | Parliamentary and Health Service Ombudsman |
| PR | Price review |
| R&D | Research and Development |

| | |
|------|---|
| RBMP | River Basin Management Plan |
| RCM | Revenue Correction Mechanism |
| RCV | Regulatory Capital Value |
| RIIO | Revenue=Incentives+Innovation+Outputs |
| ROC | Renewable Obligation Certificate |
| SDS | Strategic Direction Statement |
| SEG | Social and Environmental Guidance |
| SELL | Sustainable, economic level of leakage |
| SEMD | Security and Emergency Measures Direction |
| SIM | Service Incentive Mechanism |
| SLO | Self-lay organisation |
| WaSC | Water and Sewerage Company |
| WFD | Water Framework Directive |
| WIA | Water Industry Act |
| WoC | Water only Company |
| WRMP | Water Resources Management Plan |
| WSRA | Water Services Regulation Authority |



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