



Treasury Minutes on the Twenty-First, the Twenty-Second, and the Twenty-Fourth Reports from the Committee of Public Accounts 2006-2007

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**Presented to Parliament by the Financial Secretary to the
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TREASURY MINUTES DATED 5 JULY 2007 ON THE
TWENTY-FIRST, THE TWENTY-SECOND, AND THE
TWENTY-FOURTH REPORTS FROM THE COMMITTEE
OF PUBLIC ACCOUNTS, SESSION 2006-2007

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Twenty-First Report

Ministry of Defence

Progress in Combat Identification

1. Combat Identification is a complex military capability that spans all military environments (land, maritime and air) and the interfaces between them. It is the means by which friend is distinguished from foe or non-combatants in military operations and is vital to combat effectiveness. Combat Identification capability is a system of systems with three elements – situational awareness, target identification and the tactics, techniques and procedures used to organise operations – with human factor considerations playing an important part. Robust capability is made up of a balance of these elements, together with good training, and must be resilient to climatic conditions, equipment failure and enemy interference. Capability is delivered by an integrated combination of many equipment systems and the non-equipment means encompassed by tactics, techniques, procedures and training.
2. Overall spending on Combat Identification is part of wider Defence spending and is difficult to identify separately. The Ministry of Defence (the Department) envisages that future operations will be predominantly conducted in coalition with allied and partner forces, making interoperability of equipment and the harmonisation of tactics, techniques and procedures increasingly important.
3. Failures in Combat Identification can result in fratricide. There were six UK service personnel killed in four fratricide incidents during Operation TELIC in Iraq in March 2003. The Department's Boards of Inquiry investigated each of the incidents and concluded they were caused by a varying mixture of technical factors, failures in communication and procedures and issues related to doctrine and training.

PAC conclusion (i): The Department has failed to develop viable Combat Identification solutions to counter the risks of friendly fire incidents, despite their devastating effects, and despite the recommendations made by the Committee of Public Accounts in both 1992 and 2002. Some improvements have been made, for example for air and naval operations, but the Department needs to address the outstanding areas without further delay.

4. The Department fully recognises the importance of Combat Identification in enabling the Armed Forces to conduct military engagements quickly and decisively with the minimum overall casualties and to minimise the risk of fratricide in combat. The Department notes for example the historically very low overall level of combat casualties in war fighting operations in Iraq in 1991 and 2003 as an important measure of military effectiveness to which Combat Identification contributes. However, the Department accepts that there is more that can be done to improve the Combat Identification capability of the Armed Forces. To this end, a Senior Responsible Owner for Combat Identification was appointed in 2004 to lead the Department's Combat Identification programme in a step change improvement in the Department's capability. The Department also identified priority areas for improving Combat Identification capability, broadly the challenging ground to ground and air to ground environments and when fighting alongside coalition partners.

5. The Department has a well defined policy on Combat Identification and continues to invest heavily in a range of equipment systems that contribute to Combat Identification capability, to play a leading role in co-ordinating Allied efforts on interoperable technical and procedural solutions and to pursue improvements across all elements of military capability, including organisation, concepts and doctrine, information and training as well as equipment. The Department's view is that, given the nature of warfare, the complete elimination of the risk of fratricide is not a realistic aim.

6. The Department's Combat ID programme is addressing current operations and establishing enduring capability for the long term. Improved capability, such as the Bowman secure tactical radio communications system, has been deployed on operations, as well as equipment to meet specific operational requirements such as blue force tracking systems, improved targeting pods for ground attack aircraft and ground-to-air radios which enable UK ground patrols to talk directly to Coalition aircraft. Improved equipment for forward air controllers is also being delivered and improved tactics; techniques and procedures for air-to- ground operations have been introduced. It is also planned to introduce into theatre later this year a significantly enhanced reconnaissance and surveillance capability using the Reaper (formerly known as Predator B) and Hermes 450 Unmanned Aerial Vehicle (UAV) systems.

7. For the longer term, the introduction over the next few years of new capabilities such as the ASTOR airborne radar surveillance system will improve enduring capability. To guide longer-term activity, a full-scale audit of Combat Identification capability to identify current capability and shortfalls is being conducted, building on earlier work. This, together with more use of operational analysis and human factors research will help to address balance of investment issues and inform decisions to be made on investment in new or enhanced capability. The Department continues to work closely with the United States and NATO partners on achieving interoperability within Combat Identification. For example, the Department is actively involved in Exercise BOLD QUEST, a multinational technology demonstration in the United States in September 2007 that will help to inform UK decisions on investment in interoperable air-to-ground capability and will explore a more networked approach to Combat Identification.

8. The Department is also reviewing the implementation of its Combat Identification programme to ensure that it conforms to the Office of Government Commerce best practice model for change programmes.

PAC conclusion (ii): Over half of the equipment programmes for Combat Identification have been delayed, deferred or re-scoped during the last four years. A Battlefield Target Identification System will not be available until early in the next decade. Equipments such as Blue Force Tracker and Bowman communications system may improve situational awareness in the meantime, but the inevitable time lag in analysing and collating information from these systems will restrict their potential for positive target identification. The Department therefore needs to develop a timetabled plan for introducing a credible target identification system.

9. Improvements in situational awareness through developments such as Bowman will undoubtedly contribute significantly to Combat Identification; but the Department accepts that introducing such capability to provide reliable positive identification in near real time in the complex ground and air-to-ground environments within the foreseeable future is not realistic, given the challenges involved. Target identification systems are likely to remain a pillar of Combat Identification capability. The Department accordingly continues to work on improving target identification systems with a focus on the priority areas of the ground and air-to-ground environments. Technical solutions have been slow to mature and while the Battlefield Target Identification System concept was initially seen as promising, it has been clear for some time that such a target identification system would not on its own effectively address the risk of fratricide across the priority areas.

10. The Department has therefore identified, in close co-operation with allies, a range of potential target identification technologies (including the Battlefield Target Identification System) that could provide interoperable solutions across the priority areas. Coherent programmes for credible target identification systems based on interoperable technologies will be considered as part of the Department's routine planning process and, subject to normal scrutiny and prioritisation, timetabled plans will be developed.

PAC conclusion (iii): Progress in procuring the Battlefield Target Identification System has been held up for six years awaiting allies' decisions. The Committee recommended in 2002 that the Department develop methods of co-operation with allies on Combat Identification, but preliminary decisions are yet to be made. The Department needs to reach agreement with allies on procuring a system, or introduce, as an interim, a more limited national programme, focusing on the key risk areas such as ground-to-ground combat.

11. The Department accepts that – partly as a result of the technical complexity of the problem – it has taken longer than we would have wished to reach a common position with allies on the technology to be used for the Battlefield Target Identification System. Following active engagement by the Department, the principal allies have now reached consensus on a technical solution. The United States for example now has funding for a programme that is compatible and aligned with the UK's continuing Battlefield Target Identification System programme. The Department currently expects the UK programme to proceed to Initial Gate in early 2008 with a primary focus on the ground environment. Other allies are moving towards acquiring similar capability. Given that the risks associated with the international solution are being overcome, the Department therefore does not intend to proceed with a limited national solution, which would provide no benefit in coalition operations.

12. As indicated in the previous response, the Department continues to work actively with the United States and other allies to reach agreement on technical and procedural solutions for other aspects of the priority areas with current efforts focused mainly on air-to-ground combat. This reflects the increasing emphasis on air-to-ground combat in contemporary coalition operations and that air-to-ground fratricides have historically resulted in greater loss of life.

PAC conclusion (iv): The Department's Senior Responsible Owner on Combat Identification has no budgetary or line management responsibility. The Department should identify what impact the Senior Responsible Owner has been able to make since the role was established in 2002, and determine whether giving greater management authority would increase the effectiveness of the role.

13. It is the Department's policy that large and complex projects or groups of projects have a Senior Responsible Owner appointed on behalf of and accountable to the Defence Management Board. Although the Senior Responsible Owner may not have full financial or command/line management authority over all those delivering the capability, he or she will be empowered, have a good knowledge of the requirement, be competent to resolve conflicting priorities and be able to exert influence outside traditional management or command chains. This is consistent with Office of Government Commerce guidance.

14. Since the Combat Identification appointment was made in 2004, the Senior Responsible Owner has made a number of important interventions. In particular, he has represented Combat Identification as a discrete and important enabling capability within the Department's planning process, ensuring that proper consideration is given to its priority. He has represented the UK internationally and particularly with the United States as the key ally on Combat Identification. For example, he attended a senior US Army and Marine Corps meeting during a crucial discussion of the way ahead. The Senior Responsible Owner was the focus for UK hosting of the important multinational exercise URGENT QUEST in 2005, which paved the way for decisions on Battlefield Target Identification System technology and is playing a similar role for UK participation in the multinational US-hosted exercise BOLD QUEST in September 2007, which will look at air-to-ground Combat Identification issues. The Senior Responsible Owner is leading the review of the implementation of the Combat Identification programme.

15. The Department believes that the current arrangements for the Combat Identification Senior Responsible Owner role are working well but will keep the position under review as the programme progresses.

PAC conclusion (v): During Operation TELIC the Department produced 60,000 Aide Memoire cards to raise awareness of Combat Identification, but failed to distribute them to front line troops. The Department regretted this failure, which it attributed to more general difficulties with supplies in Iraq. Cards are now given to personnel before deployment. The Department should determine how successful they have been in raising awareness among the troops concerned.

16. The content of the original Combat Identification aide memoire cards has now been subsumed into the generic All Arms Tactical Aide Memoire to which theatre specific tactical aides memoir are addenda. It is generally very difficult to assess the operational benefit of a specific element of training in a rigorous way, but no incidents of fratricide involving UK forces similar to those that occurred during Operation TELIC in March 2003 are known to have occurred since that time. However, the Department agrees that the scope for assessing the general effectiveness of tactics, techniques and procedures for Combat Identification should be investigated. This will be pursued by the Senior Responsible Owner for Combat Identification.

PAC conclusion (vi): As the Committee recommended in 2002, the Department has developed a database on the fratricide incidents, but does not collate data on fratricide rates of our allies or on non-combatant casualties. The Department should update the database regularly and expand it to include data on allied fratricide rates and non-combatant casualties. The Committee also recommended in 2002 that the information gathered in the database be analysed and disseminated appropriately within the United Kingdom and to allies. The Department should share the database with our allies to promote greater joint interest in finding effective solutions.

17. The Department agrees that collating; analysing and sharing information about casualties resulting from fratricide incidents is an important research activity that underpins work on improving Combat Identification capability. The Department maintains research data on fratricide incidents and has participated in international collaborative research on the subject with key allies to promote greater collective understanding of the issues. For reasons explained to the Committee (supplementary memorandum submitted by the Ministry of Defence 27 July 2006), the Department's research data does not include non-combatant casualties.

PAC conclusion (vii): It took between eight and 28 months to conclude the Boards of Inquiry investigations into the four friendly fire incidents during Operation TELIC, and in one case it was a further 27 months before the findings were made publicly available. There will inevitably be variations in the time taken to complete investigations due to differing levels of complexity and the possibility of criminal prosecutions. But once complete, the Department should make every effort to publish the findings of Boards of Inquiry within one month of the investigation being concluded.

18. The Department accepts that every effort should be made to publish as soon as possible the findings of Boards of Inquiry dealing with high profile cases. Following a recent review of policy, Departmental guidance has been issued on the proactive publication of information about the reports of Boards of Inquiry in cases where there is likely to be significant public interest, such as operational and training fatalities or serious injuries and major equipment loss or damage.

19. This guidance responds to the requirements of the Freedom of Information Act 2000 and requires the convening order, terms of reference, findings, recommendations and Convening Authority/Reviewing Authority comments of such Boards of Inquiry to be published as a defined class of information in the MOD Publication Scheme under the Act. The Department therefore expects that Board of Inquiry reports that fall into this category will normally be made available to the general public via the MOD website within two months of completion of the report to allow time to brief the next of kin on its contents and to prepare the report for publication.

PAC conclusion (viii): It took the Department over six months to inform the Committee that it could not provide information on allied fratricide rates and non-combatant casualties requested at the hearing. The Department should in future provide promised information no later than four weeks after the hearing. Where more time is required, the Department should agree an appropriate timetable for delivery within a week of the hearing.

20. The Department accepts the need for timely responses to requests for information made during Committee hearings. In line with Treasury guidance, the Department will aim to send such follow up information to the PAC Committee normally within a fortnight of the hearing. If it is likely to take longer, perhaps because further research is required, the aim is to provide information by a month after the hearing. If additional information needs to be sent later or if it has proved impossible to gather, the Department will inform the PAC Committee as soon as possible.

Twenty-Second Report

HM Revenue and Customs

Tax Credits

1. HM Revenue and Customs (HMRC – the Department) distributed £17.3 billion in child tax credit and working tax credit in 2005-6. Tax credits benefit some 6 million families and 10 million children. On the basis of a report by the Comptroller and Auditor General, *Standard Report on the Accounts of the HM Revenue and Customs 2005-6* (HC 1159, Session 2005-06) the Committee examined HMRC on tax credits overpayments, the cost of the Pre Budget Report package, and error and fraud in the tax credits system.

PAC Conclusion (i): £5.8 billion was overpaid to claimants in the first three years of the current tax credits scheme. The Government has made changes to the scheme, which it estimates will eventually reduce overpayments by one third. The Department does not have complete information on the causes of overpayments and is uncertain about how far each measure will reduce overpayments. The Department should include the actual cost and effect of these changes in its annual report to allow Parliament to evaluate their success.

2. The Department notes the Committee's recommendation. As the Department has explained in its evidence to the Committee before, it is difficult to produce a reliable breakdown of the effect of each element of the PBR 2005 package on the level of overpayments because they interact – for example, the effect of limiting the size of end of year adjustments to tax credit payments is affected by the increased size of the disregard as this affects whether adjustments would need to be made in the first place. It is therefore unlikely to be able to produce an analysis, which it could include in its annual report.

PAC conclusion (ii): In response to repeated questioning, the Department eventually told the Committee that increasing the income disregard to £25,000 would cost the Exchequer an additional £500 million each year. The Committee requested information on the cost of the increased disregard shortly after the decision was first announced in the 2005 Pre-Budget Report. But the Department disclosed its estimate only during the Committee's most recent hearing and after the National Audit Office produced its own estimates of the potential cost. The Department said that greater confidence in its estimates had allowed it to release this information. But if it was confident enough to increase the disregard it should have been able to give an estimate of the cost when the decision was first announced.

3. The Department notes the Committee's conclusion. The Committee asked for the costs of the disregard and Treasury officials wrote to them before the October 2006 hearing with the figures. As officials explained to the Committee, when the decision was first announced the Department had only limited information on which to base this costing. While the Department was confident of the aggregate cost of the package, because of interactions between the elements it was not possible to disaggregate. At the time of the October hearing the Department had two years of overpayment statistics to inform this costing and the first stage of the finalisation process for 2005-06 had been completed in August 2006. Consequently, it was in a much better position to estimate the cost of the disregard.

4. Although, as the Treasury made clear in its letter, there are still some uncertainties surrounding the costing. In particular, it remains the case that while the overall cost of the package is not affected by the order with which the changes are modelled, these interactions mean that the costs of the individual elements of the package are affected by the assumed order with which the changes are modelled. For example, the effect of limiting the size of in-year adjustments to tax credits payments is affected by the increased size of the disregard as this affects whether payments need to be made in the first place.

5. It is worth emphasising that the NAO provided an estimate of the increase in entitlement rather than exchequer cost.

PAC conclusion (iii): Tax credits suffer from the highest rates of error and fraud in central government, undermining HMRC's reputation for accuracy, fairness and proper handling of taxpayers' affairs. In 2005, the Committee concluded that the Department's effectiveness in managing the tax system depended on maintaining public confidence in its administrative competence. Yet the Department neither produces routine estimates for error and fraud nor sets targets for reducing levels. It needs to demonstrate to taxpayers that it maintains its capacity for the proper handling of their tax affairs by setting targets for reducing the level of error and fraud and producing routine estimates to validate its performance against the targets.

6. The Department shares the Committee's desire to reduce substantially the level of error and fraud in the system. The Department has an active programme to reduce error and fraud, both by HMRC and customers. *Tackling Error and Fraud in the Child and Working Tax Credits*, published on 11 July 2006, sets out how the Department tackles error and fraud.

7. The overall level of error and fraud is lower than Working Families' Tax Credit which had levels of fraud and error of 10 to 14 per cent by value, and around the same level as figures relating to social security benefits when the Government first collected data on a systematic basis.

8. The improved performance of the tax credits system has meant that fewer overpayments are being caused by IT or administrative error. This is demonstrated by improvements made to accuracy in processing and calculating awards, which rose from 78.6 per cent in 2003-04 to 97.7 per cent in 2005-06.

9. Information on organised fraud shows that HMRC successfully stopped the majority of claims identified as being submitted by organised fraudsters. HMRC successfully prevented the vast majority of attempted fraudulent claims, stopping in 2005-6 £409 million and in 2006-07 £212 million from being paid out.

10. The Department accepts the Committee's recommendation on targets. It needs at least two good years worth of data from the random enquiry programme before setting these targets.

11. HMRC is continuing to develop appropriate measures of performance in this area.

PAC conclusion (iv): The Department does not have up to date information on levels of claimant error and fraud in tax credits. In the absence of up to date information the Department cannot assess the effectiveness of its efforts to combat tax credit error and fraud. From 2007-08 most tax credits awards will now be finalised in the July following the year to which they relate. The Department should make earlier estimates of the overall levels of error and fraud and assess these as a basis for more timely and targeted action to bring the trend down.

12. Estimates for error and fraud in the Department will always be retrospective. The random enquiry measures error and fraud for a representative sample of awards that have been finalised – which for most cases has not happened until the September following the award year and for some not until the following January. The law allows HMRC up to a year to begin these enquiries. Enquiries then take time to be worked through and a robust estimate has to be produced. This means that the estimate of error and fraud will always be in arrears. The Department agrees with the Committee that it would be useful to have earlier estimates of error and fraud. It is looking to see how it can speed up the random enquiry programme and also develop real time measures of error and fraud to guide its future actions.

PAC conclusion (v): The design of the internet system for tax credits was deficient from the outset and left it vulnerable to attack by organised criminals. The system, which was opened in August 2002, did not conform to mandatory requirements on security set down by the Government's e-envoy. Only after sustained fraudulent attacks did the Department acknowledge that it could no longer manage the risks arising from the inadequate design, and it was forced to close the system in December 2005. The internet channel has been closed for well over a year and is unlikely to re-open before the summer of 2008.

13. The Department notes the Committee's conclusions but does not agree that the internet system was deficient from the outset. The system was always designed to be secure. The E-envoy sent his guidance in August 2002 after the system was launched. There is a trade off between accessibility for customers and the need to protect the system against the risk of fraud. A balance has to be struck between putting additional security measures and delaying the programme unacceptably.

14. The Department monitored those risks and during 2005, it detected an increase in the number of organised attacks on the tax credits system, predominantly via the internet. The Department continued to monitor the situation closely. In November, new information came to light about what appeared to be a specific and unprecedented attack on the system. In the light of the virulent and highly organised nature of the attack, the Department judged the balance of risks had changed significantly, and a decision was taken to suspend the internet service from 2 December 2005.

PAC conclusion (vi): The Department failed to design the tax credits scheme to give proper protection against error and fraud. In its efforts to make the scheme accessible to claimants, it relied too much on detecting false claims after payment had been made. This approach of ‘pay now, check later’ left the scheme vulnerable to fraud. The Department is now increasing its testing of claims before they are paid, focussing on claims considered to present the highest risk. The effectiveness of this approach demands appropriate risk criteria, and the ability to identify emerging trends in the claimant population. It should supplement this work by testing a sample of claims below its risk threshold to confirm that its risk assessment criteria are soundly based.

15. The Department notes the Committee’s conclusion but disagrees that it failed to design the scheme to give proper protection against error and fraud. HMRC have established powers to pursue and prosecute fraudsters as part of the Tax Credits Act, built in checks and risk assessments into the procedures for claiming tax credits and employs significant numbers of compliance staff to tackle fraud.

16. It is not correct to say that the Department relies on “pay now, check later”. HMRC have a range of measures in place to combat fraud including:

- verification checks of all claims before payment;
- risk assessment on all claims and reported changes with examination of cases where sufficient risk is identified;
- disruption or termination where organised fraud is suspected; and
- financial penalties and prosecution for the most serious cases

17. It is not possible to identify all non-compliance in pre-award checks – a combination of pre-and post-award checks will always be required. A balance needs to be struck between ensuring that potentially vulnerable members of society receive their due entitlement as quickly as possible and that incorrect claims are not put into payment which needs to be kept under review to reflect changing circumstances.

18. The Department keeps the risk rules used to identify potentially incorrect claims constantly under review, and this work is informed by the outcome of the random enquiry programme. There is not one single risk threshold so it is not practical to test a sample of claims just below a single figure, so different approaches have to be adopted. The risk rules only act as a guide to the investigator and do not automatically indicate that a claim is non-compliant. Ultimately, it is up to the skill of the compliance officer to decide whether it is appropriate to take up a case for investigation. In order to strike the right balance between accessibility for claimants and balancing the risk to the system, checks are carried out post-award as well as pre-award. This allows claimants to access support quickly and, any irregularities to be subsequently identified.

PAC conclusion (vii): The Department has increased the number of tax credits compliance staff from 1,200 to 1,400 in 2006/07, allowing it to examine a further 20,000 claims. The increase in the number and the change in focus of compliance tests by HMRC in 2005-06 resulted in significantly increased yields. The Department should regularly reassess the resourcing of compliance work on tax credits against its effectiveness in helping to reduce the unacceptably high levels of incorrect claims.

19. The Department agrees with this recommendation. It regularly assesses the resources it needs to undertake compliance work.

PAC conclusion (viii): The Department applies the same risk assessment process to all tax credit claimants, without distinct procedures for migrant workers. Migrant workers do however present an additional risk of failing to notify the Department when they leave the United Kingdom and cease to be eligible for tax credits. The Department needs to manage the risk of making incorrect payments to claimants who have left the country permanently without telling it.

20. The Department agrees with the conclusion that the risk of making incorrect payments to claimants who have left the country permanently should be managed. There will always be a risk that someone might not tell HMRC when they go abroad and the level of this risk is being evaluated.

21. To be lawful the Department has to identify a significant risk to the exchequer from those nationalities, which was not shared by others. The Department continues to evaluate the extent of the risk drawing on a range of information sources including Home Office data. It will act on information that suggests a claim is invalid.

PAC Conclusion (ix): The Department does not have a gateway to request information held by the Home Office on migrant workers who are claiming tax credits. This information would assist the Department in verifying information provided on income and circumstances. It should explore with the Home Office the scope for receiving information held on migrant workers.

22. Home Office can, and do, rely on their common law powers to disclose information to HMRC to help establish entitlement to tax credits and tackle fraud. For example, they supply HMRC with information about workers registered under the Workers' Registration Scheme. Therefore a statutory gateway permitting information to flow from Home office to HMRC is unnecessary.

PAC Conclusion (x): The administration of tax credits has not been effective and Members of Parliament continue to receive too many complaints about the quality of service provided. Administrative errors made by the Department continue to generate incorrect payments, but it does not know how much is involved. This type of information is routinely prepared by the Department for Work and Pensions in connection with its administration of benefits. HM Revenue and Customs should calculate and publish information on the value of incorrect payments caused by administrative error.

23. The Department appreciates the importance of delivering a high quality service to tax credit claimants. Staff working on tax credits are committed to ensuring families receive their correct entitlement, helping and assisting claimants in, sometimes, difficult circumstances and resolving complaints. Improvements have been made to the service offered to claimants in a number of areas. For example, accuracy in processing and calculating awards rose from 78.6 per cent in 2003-04 to 97.7 per cent in 2005-06. In 2005-06 98 per cent of callers were answered on the day that they were called, and the Tax Credits Office now routinely delivers a decision to most claimants within 4 weeks of an overpayment being disputed.

24. A new version of the award notice, reflecting comments from the voluntary and community sector, has also been introduced giving claimants a much clearer summary of their award. The Department is also making good progress in implementing the package of measures announced at PBR 2005, and this is already making a significant improvement to the way in which the tax credit system operates and to the outcomes for families.

25. The Department is continuously improving the service it provides. Building on the work of recent years it has set up a separate programme, as part of the overall transformation programme of the Department to accelerate this further.

26. HMRC is working on an improved operational business design to deliver tax credits in the future. It has started to tailor the service it offers to claimants to suit different circumstances and is piloting new arrangements.

27. The Department agrees with the Committee that more work should be done in quantifying official error. From April 2007, the Department started collecting information on official error from disputed overpayments systematically. The Department is also considering other ways of improving information made available on official error.

Twenty-Fourth Report

Ofwat

Meeting the demand for water

1. Ofwat is responsible for regulating the water and sewerage industry in England and Wales. This includes setting price limits that allow the principal water companies in England and Wales to meet future demands for water at the lowest cost to the consumer.

PAC conclusion (i): Ofwat should press companies to encourage more customers to use meters by, for example, promoting the benefits of metering to consumers as well as routinely installing meters when there is a change of building occupancy.

2. Ofwat does this where it represents best value for customers. Metering is the fairest way to charge customers. Ofwat welcomes the proposals in the Department for Environment, Food and Rural Affairs' (DEFRA) consultation *Water metering in areas of serious water stress*¹ to make it easier and more cost effective for companies in areas of water stress to meter their customers compulsorily. Currently metering on change of occupancy is encouraged where this is cost effective.

3. All companies inform un-metered customers (on bills or as part of their billing literature) of their right to opt for a free meter. Ofwat assessed compliance and included allowances in price limits for the installation of over 350,000 selective meters in the period 2005-2010 (mainly on change of occupancy). An accelerated programme compared to what was sought in companies' business plans.

PAC conclusion (ii): Ofwat should take enforcement action against companies who do not meet their targets by applying the maximum financial penalties, and it should clarify its legal position should it wish to use a stronger sanction such as revoking a company's licence.

PAC conclusion (x): Ofwat has been slow to use its full enforcement powers. It was for example content to accept undertakings from Thames Water after the company missed its leakage targets for six consecutive years, rather than to impose a fine. It has now proposed to fine United Utilities just 0.7 per cent of its turnover for repeated and serious breaches of its licence conditions. Ofwat has yet to demonstrate that it has the necessary determination to secure adequate compliance from the companies.

4. Ofwat has taken and will continue to take appropriate regulatory action, including enforcement action, against companies that do not meet their targets. Where fines are an option, Ofwat applies its published *Statement of policy with respect to financial penalties*². This states that the maximum penalty will be applied in the most severe cases. In accordance with the normal principles of administrative law and good governance, Ofwat considers each case on its merits and will apply the maximum fine appropriate in each case. The power to impose a financial penalty has been in force since April 2005 and Ofwat could not impose fines for any breach before that date.

¹ <http://www.defra.gov.uk/corporate/consult/water-metering/consultdoc.pdf>

² [http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/penalties-statement240305.pdf/\\$FILE/penalties-statement240305.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/penalties-statement240305.pdf/$FILE/penalties-statement240305.pdf)

5. Ofwat has announced its intention to impose an £8.5 million penalty on United Utilities for breaches of its licence condition designed to ensure arm's length trading with its associates. The proposed fine only relates to breaches since Ofwat has been empowered to impose fines. In this case Ofwat had ensured (using other regulatory powers) that customers were protected from any overcharging by reducing the company's price limits at the reviews in 1999 and 2004. Before a final decision is taken Ofwat must and will consider representations received on its proposal.

6. In respect of Thames Water's failure to hit leakage targets, Ofwat has applied appropriate sanctions in successive years (including those years when Ofwat had no legal power to fine the company), culminating in requiring a legally binding agreement that commits the company to renew an additional 368 kilometres of mains which we estimate will cost around £150 million by 2010 at no additional cost to customers. This sanction addresses the problem directly and secured benefits to customers of more than double the maximum possible fine (10 percent of the company's turnover for the water service) even assuming that such a fine could have been justified. The National Audit Office acknowledged in section 4.10 of *Ofwat – Meeting the demand for water*³ that '...by adopting the alternative solution of an undertaking, Ofwat has ensured that Thames addresses other issues of concern, such as its low security of supply, as well as tackling its leakage problems. The level of investment that Ofwat has secured is much higher than the fine that it could have levied so this agreement directly benefits consumers'.

7. The statutory provisions for revoking a company's licence are set out in the Water Industry Act 1991. Either Ofwat (with the Secretary of State's consent) or the Secretary of State himself must apply to the High Court for a Special Administration Order which would allow the company's undertakings to be transferred to another company or companies so that its functions continue to be carried out. A Special Administration Order can only be sought in certain sufficiently serious circumstances where it would be inappropriate for the existing company to continue to hold its appointment, for example where the company was unable to pay its debts. As yet, no set of circumstances has arisen which would justify such extreme action.

PAC conclusion (iii): Ofwat should require water companies to take specific action during periods of water scarcity, such as repairing all visible leaks, in order to demonstrate the companies' commitment to saving water.

8. Ofwat agrees that companies must provide a lead to customers in saving water and companies are best placed to identify and implement the actions best designed to achieve this at least cost.

9. Ofwat requires water companies to take cost effective action to balance their supply and demand at all times, especially during periods of drought. Companies should balance the needs of customers and the environment. The actions of all stakeholders during the drought of 2004-2006, including customers and water companies, demonstrated a commitment to saving water and minimised the risk of serious supply problems. Actions by companies included promoting water conservation, enhanced leakage activity and developing new sources of water. Ofwat strongly encouraged water companies to do this, and most did so.

³ http://www.nao.org.uk/publications/nao_reports/06-07/0607150.pdf

PAC conclusion (iv): Consumption data are unreliable. Ofwat should require companies to use consistent methods for measuring consumption, so that it can secure better data on per capita consumption.

PAC conclusion (v): Ofwat cannot explain fully the variations in consumption. Ofwat has not commissioned more recent research. Ofwat needs to gain a much better understanding of consumption before it determines price limits in the next periodic review.

10. Ofwat agrees that there is a continuing need to improve understanding of water consumption. Ofwat guidance to companies provides two alternative but consistent methods for measuring consumption – a sample based on households with individual meters or a sample of houses metered as one group.

11. As the National Audit Office acknowledged in recommendation (A) of *Ofwat – Meeting the demand for water*, some of the uncertainty in the sampling approach arises from factors such as demographic trends. Because there is little that the water companies or Ofwat can do directly to reduce the unreliability of demographic data Ofwat requires companies to corroborate consumption data by alternative approaches where possible. This improves the data and increases understanding of variations.

12. In January 2007 Ofwat commissioned with the EA Tynemarch Systems Engineering Ltd as part of a wider leakage methodology review to complete a study entitled, 'Variation in per capita consumption estimates'. The study is examining the reasons for variations in the current estimates focussing particularly on differences in the application of best practice guidance and the impact of external factors such as weather and socio-economic factors. It will recommend any areas where consistency and accuracy can be improved. It will be published in July 2007. Ofwat will issue guidance based on the study's findings in advance of the next price review.

PAC conclusion (vi): Ofwat has failed to identify which water efficiency measures are the most effective despite a recommendation from this Committee in 2002. Collecting robust evidence on water efficiency should be one of Ofwat's top priorities. It should commission research into different approaches to water efficiency and encourage water companies to provide advice to consumers on the best way to save water. The results should be available for the next setting of price limits in 2009.

13. Ofwat has engaged in a series of work programmes, initiated following the PAC 2002 recommendation, to develop a robust evidence base on the effectiveness of water efficiency measures. This evidence will be available for the price review. The National Audit Office acknowledged in section 2.21 of *Ofwat – Meeting the demand for water* that '...Ofwat is working with companies to ensure that this information is available for the next periodic review'. Ofwat's work on water efficiency includes.

- funding by Ofwat (with EA, Defra and the water companies) of research into the cost-effectiveness and sustainability of demand management measures. This UK Water Industry Research project has been carried out in three stages (stages one and two were published in 2003 and 2006) and will culminate in a report and database detailing the cost-effectiveness of demand management activities in July 2007. The web based database which is part of stage three will contain over 100 water efficiency examples both from the UK and further afield;

- identifying and publishing a best practice register to demonstrate those water efficiency measures that are most effective. This was published in November 2006 and is kept updated with new information, techniques and experience;
- monitoring all companies' activities as part of their statutory duty to promote the efficient use of water by their customers. Annually companies spend around £25 million carrying out a range of water efficiency measures; and
- contributing as a member of the Water Saving Group (WSG) chaired by Defra Ministers to other workstreams such as the development of targets for water use and consumption, product labelling, communication strategies with consumers and further research and evidence gathering

PAC conclusion (vii): Since the Committee's 2002 recommendation Ofwat has made some progress in improving the consistency and accuracy of leakage estimates and in calculating ELL. But the assessment of the economic level of leakage does not yet take sufficient account of social or environmental costs. Ofwat should develop a sustainable level of leakage based on the current economic level of leakage measure.

14. Ofwat accepts this recommendation. The leakage targets set as part of the 2004 price review included assessments of social and environmental costs. However, Ofwat recognises this is an evolving area of work and will improve its guidance to companies on how to complete a robust economic level of leakage (ELL) analysis including taking fullest account of social and environmental costs.

15. Ofwat has commissioned, jointly with the EA, RPS Water Services Ltd to investigate how companies can improve the incorporation of economic and social costs and benefits in the ELL. This study will offer guidance on how to measure and value the key externalities associated with leakage and leakage management, including the carbon cost of leakage. Companies must take account of the RPS report as they complete their Statutory Water Resource Management Plans that are due to be submitted in draft to Ministers in December 2007.

PAC conclusion (viii): Consumers do not automatically receive any direct compensation for water restrictions imposed by a water company. Ofwat can fine a company for poor levels of performance but the fines do not result in compensation for consumers. Ofwat should investigate whether the compensation arrangements that other regulators use, for example in the postal sector, could be applied to the water sector.

16. Customers receive payments where water companies fail to meet certain guaranteed standards of service, which are laid down by the Government. This includes.

- the making and keeping of appointments;
- response times for billing enquiries;
- planned and unplanned interruptions to customers' supplies;

- flooding of a customers' home by wastewater; and
- failure to maintain minimum standards of water pressure

17. During a drought companies may in defined circumstances place restrictions on water use in accordance with their statutory drought plans. In those circumstances, compensation is not paid to customers, since the event is outside the control of company management. However, under Condition Q of their licences, companies may, in specific circumstances, be required to make payments to customers where essential household water supplies are cut off under the authority of an emergency drought order.

18. Ofwat co-ordinates research before each periodic review to test the willingness of customers to pay the additional costs that would allow the companies to improve their supplies and thereby reduce the likelihood of restrictions during a drought. The research undertaken before the 2004 price review indicated that customers were not in general prepared to pay such additional costs. Ofwat, the companies and other stakeholders will undertake further research in preparation for the next price review in 2009

PAC conclusion (ix): Ofwat should co-ordinate research to establish whether consumers would be willing to pay more for an improved service.

19. Ofwat accepts this recommendation, which is in line with its existing practice.

20. Consumers play an important role in the decisions Ofwat takes about future water and sewerage charges. Ofwat undertook consumer research when it last set prices in December 2004. This enabled consumers' priorities to be taken into account in calculating the price limits for 2005-10.

21. At the review in 2009 Ofwat will take into account research to investigate consumer's priorities, including willingness to pay for improved levels of service. A steering group has been set up to co-ordinate this work involving Ofwat, CCWater, EA, Defra, Welsh Assembly Government, Natural England, Water UK and the Drinking Water Inspectorate. Results of the first stage of this research are expected in early 2008.



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