



House of Commons
Environment, Food and Rural
Affairs Committee

Water Pricing: Government Reply to the Committee's Report

Fourth Special Report

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The Environment, Food and Rural Affairs Committee

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The current staff of the Committee are Gavin Devine (Clerk), Fiona McLean (Second Clerk), Dr Kate Trumper and Jonathan Little (Committee Specialists), Andy Boyd and Louise Combs (Committee Assistants), Anne Woolhouse (Secretary) and Rebecca Flynn (Intern).

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FOURTH SPECIAL REPORT

The Environment, Food and Rural Affairs Committee reported to the House on *Water Pricing* in its First Report of Session 2003–04, published on 18 December 2003 as HC 121. The Government's Reply to the Report was received on 25 February 2004.

Government response

Introduction

The Government welcomes the report of the Environment, Food and Rural Affairs Committee into water pricing, as a constructive and timely contribution to the debate on the Periodic Review of water limits for 2005-2010. The Review is currently in progress, with the Principal Guidance from the Secretary of State to the Director-General of Water Services now expected to be issued in February 2004.

The Government's policies seek to address the needs of everyone—whether as customers of water services or as users of the water environment. The Government also recognises that the sustainability of the water industry is important if it is to continue to provide a high quality service to customers, whilst having regard to the environment. This requires a stable policy and regulatory context.

Recommendation 1

We welcome the introduction of draft business plans produced by the water and sewerage companies themselves and the greater scope for scrutiny and debate that this allows at an early stage in the price review process.

We are pleased the Committee recognises the value of draft business plans. The production of these has allowed early debate of the issues arising from the business plans and the prospects for future price limits. This is particularly important in a climate where it is likely that a majority of customers in England and Wales will face increases in their water and sewerage bills.

The publication of summaries has put the companies in the lead in presenting and explaining their plans. Production of the draft business plans has also enabled Ofwat to understand, at an early stage, the companies' strategies. It is working closely with the companies to ensure that the business plans they are due to submit in April 2004, which will be used to set price limits, meet regulatory requirements.

The information in the draft business plans, including the reference plans, has provided all stakeholders with an indication of the effect on bills of various factors, including different environmental and quality programmes. We have used the information included in the draft business plans extensively in developing the Secretary of State's

Principal Guidance to the industry on what we expect the companies to deliver in 2005–10, including improvements to drinking water and the environment.

Recommendation 2

We welcome the introduction of joint customer research, as it has limited the degree to which stakeholders have made competing and conflicting claims about what customers really want.

We agree with the Committee. The joint stakeholders—Defra, Ofwat, the Welsh Assembly Government, WaterVoice, Water UK, the Environment Agency, the Drinking Water Inspectorate, English Nature and the Wildlife and Countryside Link—commissioned two surveys, one between May and August 2002 and another in September and October 2003. The first survey involved 10 focus groups as well as 2,076 face-to-face interviews with people representative of the population of England and Wales. The second survey involved a sample of more than 6,000 customers. The results of this research were published jointly in August 2002 and December 2003.

The second survey collected information on attitudes towards current services and proposed future water and sewerage services, as defined in each company's draft business plan. This included details of proposed changes to current service levels, and their effects on bills. Respondents were presented with information that was specific to their supplier/s.

The results of the first survey¹ revealed that satisfaction with water and sewerage services is high throughout England and Wales. Nearly nine in ten are satisfied and one in fifteen dissatisfied. The key results of the second survey² again showed that satisfaction with current water and sewerage services is generally high. More than half of customers consider that current services offer good value for money. The Government is taking on board customers' views when making decisions for the Principal Guidance.

Recommendation 3

We recommend that Government, Ofwat, the regulators, water companies and consumers examine together ways of taking into account long-term issues for the water industry.

The Government, the companies and all the regulators recognise that water and sewerage is a long-term industry, and are working, both separately and together, to embed this in approaches to industry issues. In *Directing the Flow—Priorities for future water policy*, published by Defra in November 2002³, the Government set out water policy issues in the context of long-term sustainability. The Committee mentions good examples of where a long-term and sustainable approach is called for. In their approach

¹ available at: <http://defraweb/environment/water/industry/research/index.htm>

² available at: <http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/pn5103>

³ <http://www.defra.gov.uk/environment/water/strategy/index.htm>

to Natura 2000 sites, cited by the Committee, Defra, the Environment Agency and English Nature are working together to ensure that, where these sites are impacted by water company operations, solutions will be implemented within the period covered by the price review. On the Water Framework Directive, Defra, and the Environment Agency as the competent authority, are working on the long-term integrated planning implicit in River Basin Management Plans. Periodic Reviews of water prices take account of the long-term nature of the industry, particularly the need to maintain assets now and in the future. In 2005, Ofwat proposes to review the appropriate period for price determinations from 2010.

Recommendation 4

We are confident that Ofwat itself has taken note of concerns about the financial profile of water companies and will act to address such concerns. It is obviously important that the cost of financing investment is kept as low as possible, but the weighted average cost of capital assumed by the regulator must not be so low that it threatens the credit ratings or even the solvency of water companies. There is a place for equity funding and the price limits set must reflect this.

Ofwat and the Government agree that an appropriate balance needs to be struck between keeping the cost of financing investment as low as possible and maintaining companies' access to the capital markets at reasonable rates.

At this Periodic Review, Ofwat has recommended that there is no strong case for setting the cost of capital for the industry as a whole any lower than it did in 1999, as set out in Setting water and sewerage price limits for 2005-10: Overview of companies' draft business plans. Although debt finance is currently available at historically low interest rates, Ofwat believes a cautious view towards current market data on the cost of debt is necessary. It has also indicated that there is evidence to suggest that the return required from equity investors has risen since 1999.

At this Periodic Review, as at the last review, Ofwat will set the cost of capital as a weighted average between debt and equity, designed to allow efficiently run companies to maintain access to the debt and equity capital markets. It will make an industry-wide assumption about the weighted average cost of capital and ensure that only the efficient costs of raising finance are passed on to customers.

The companies will need to demonstrate robust financial indicators to reassure providers of finance that water companies remain a reliable long-term investment. If these indicators are not maintained lenders could potentially demand higher rates of interest. The indicators include the gearing ratios used by investors and shareholders to judge the companies' financial health and as a key factor to be taken into account when credit ratings are assigned by the independent credit rating agencies. Ofwat takes the view, which accords with the Committee's conclusion, that credit ratings will need to remain comfortably in the investment grade, i.e. above junk bond status, in this long-term industry facing significant ongoing programmes of investment.

Recommendation 5

We encourage Defra to come to an early conclusion about the best ways of reducing diffuse pollution to water bodies and how the costs of doing so will be met.

The Government accepts this recommendation. Defra is currently undertaking two policy reviews to develop proposals for addressing both agricultural and non-agricultural diffuse pollution. By Spring 2004 Defra intends to publish, for consultation, a draft Action Plan for tackling agricultural diffuse pollution. By then Defra will also have held a series of workshops with stakeholders from other industries to help to develop a strategy for tackling non-agricultural diffuse pollution, which it intends to consult on later in the year. Also, as part of Defra's work to implement the Water Framework Directive, it will consult in 2004 on detailed proposals for new powers to prevent and control diffuse pollution. Its policy reviews are considering the full range of policy instruments that could help to tackle diffuse pollution most cost effectively, including economic instruments and voluntary initiatives as well as regulation.

Recommendation 6

Ofwat should pay particular attention to the methods and assumptions that companies have used when calculating the costs of environmental and other improvements to ensure that only fair and reasonable charges are included.

The Government agrees that this is a vital part of the process. Ofwat accepts the Committee's conclusion. It has set out the approach it intends to take to companies' costs in *Setting water and sewerage price limits for 2005-10: Framework and approach*. The criteria it will apply in considering schemes put forward in the companies' business plans are set out below:

- the scheme is required by the quality regulators and confirmed by Ministers, or it is a new obligation under current legislation;
- it delivers a measurable defined output, which is enforceable;
- it has a clearly defined timetable and due date for delivery in line with regulations or other legislation;
- there are defined asset improvements or changes to operational procedures to deliver the output and
- the costs are identified and the proposed solution has been challenged and validated by the company's reporter (an independent professional who scrutinises and gives his opinion on the company's business plan to Ofwat).

Ofwat will also look at expensive individual schemes to ascertain whether they are necessary, that companies have explored different ways of achieving the outputs required, and have taken into account technological innovations.

Owat will test the costs of companies' schemes based on both the relative efficiency of each company and the continuing efficiencies expected of the industry as a whole during the period 2005-10. It will also test the companies' relative capital procurement efficiency using information on the costs for typical projects collected in its cost base exercise.

Recommendations 7 and 8

We agree that sustainable management of water resources is in the interests of water consumers and we endorse the application of the 'polluter pays' principle in the provision of water and sewerage services: to the extent that water and sewerage companies cause environmental problems they—and by extension their customers – should pay for the solutions to those problems.

We add two caveats to this conclusion. First, where a particular problem has several causes and action by the water company alone would not be enough to significantly improve the situation, there is a case for delaying the requirement on the water company to act until the other causes are also addressed. Second, while the requirements for environmental improvements are likely to keep increasing, customers' willingness and ability to pay ever larger bills are not. Ofwat, the water companies, the regulators and Government must begin to seek other ways of addressing some environmental problems.

The Government is pleased that the Committee agrees with its objective to manage water resources in a sustainable way. The main principles of Government policy in this area were set out in *Directing the Flow*. The Environment Agency aims to manage water resources in a sustainable way and works with abstractors, as part of the abstraction licensing regime, to prevent or minimise damage to the water environment. The Agency uses a holistic approach to identify and remedy any environmental damage caused by abstraction.

The Government also welcomes the Committee's endorsement of the application of the 'polluter pays' principle to water companies. The Environment Agency and English Nature, when drawing up their advice on the water quality environment programme, carry out technical appraisals and other assessments to ensure that the pollution issues to be addressed are correctly attributed to water company discharges and that the solutions proposed are timely and effective.

The Government and the Agency accept that 'end of pipe' solutions are not always the most appropriate or cost-effective mechanisms for tackling water pollution. Defra's approach to dealing with diffuse pollution is explained above. In other cases, for example, the most effective solution might be for water companies to take action to reduce pollution by controlling trade discharges to sewer rather than by later treatment to remove or reduce the polluting effects of the effluent. A parallel approach, tackling

water company discharges as well as diffuse and other point sources of pollution is central to achieving the desired outcomes for water quality.

Recommendations 9 and 10

Fixing bills at the level that the poorest in society can afford to pay would jeopardise the improvements in services and quality that have undoubtedly been made and would fail to emphasise that water is a valuable resource. But the difficulties some customers face in paying their water bills are a matter of great concern to the Committee. Measures to help vulnerable customers do not appear to have been effective.

People suffering from serious difficulty in paying their bills should be helped through the benefits and tax credits system. The Government should review the way in which poorer households are helped with their water and sewerage charges. It should ensure that mechanisms to help people pay their water bills take account of the regional variation in those bills.

The Government shares the Committee's concerns about the affordability of water. We are giving careful consideration to a review of the way in which poorer households are helped with their water and sewerage charges and will invite views from interested parties in due course.

Current benefit levels are intended to help meet general household bills, including water. The Third Party Deduction Scheme enables companies to collect payments or recoup debts out of customers' benefit payments, where the criteria are satisfied. There is no regional variation of benefits.

The benefits system does provide help to those people who satisfy the qualifying criteria. No separate amounts for specific items are included in the income-related benefit rates - beneficiaries are free to choose for themselves how they spend their benefit. The Government does consider relevant research, like that produced by the Family Budget Unit, when setting benefit levels, but we also need to take into account other objectives like work incentives and controlling public expenditure.

Ofwat is under a duty to set price limits at a level that will allow efficient companies to continue to finance their functions, while also seeking to protect the customers of monopoly utility companies. It will endeavour to set price limits that ensure that customers do not have to pay more than is necessary to provide an efficient service.

The Government recognise that debt levels in the water industry are rising and that some customers may face difficulties in paying their bills. We expect companies to have measures in place to allow them to deal effectively and sensitively with customers in debt.

Recommendation 11

The Government should also issue its response to the Vulnerable Groups Consultation as soon as it is practicable. It should advise the Committee of its response to the National Consumer Council's charge that the scheme reached only 1.4% of eligible customers and cost more to administer than was paid out. If the charge is correct, the Government should inform the Committee how the proposed amendments to the Regulations will resolve the problem and by what date we can expect a more effective scheme to be in place.

The Government is currently examining the responses received to the Vulnerable Groups Consultation and will publish its response shortly. Any changes to the Regulations will come into effect in April 2005, to coincide with the new pricing period.

Recommendation 12

We encourage the Government and water companies further to examine ways of managing and reducing the usage of water and the leakage of water from the system.

In 2003, Ofwat and the Environment Agency began a joint review on the current and potential future role of customer demand management measures in balancing the supply and demand for water. This will take a broad, strategic look at leakage and water efficiency issues, although a good deal of activity is already underway in these areas.

The Government undertakes a range of activities to facilitate more sustainable water use. The Envirowise programme provides advice to businesses to help reduce their water consumption and the Enhanced Capital Allowance scheme was recently extended to include designated water efficient technologies. The Sustainable Buildings Task Group, launched at the Better Buildings Summit, has been tasked to identify how to improve the environmental performance of new and existing buildings. One of its aims will be to identify specific measures to improve the water efficiency of new development. Defra is also considering the feasibility of introducing a product labelling scheme to help consumers identify water efficient fittings and appliances. This will complement the existing statutory duty on water undertakers to promote the efficient use of water by their customers, under which they provide a range of information and assistance, including water saving devices.

The Water Act 2003 also contains provisions to advance water conservation by placing new duties on water undertakers, public authorities and the Government. Water companies will be required to further water conservation in carrying out their functions. Public authorities will have to take water conservation into account in their own use of water and where their functions might have an impact on the water use of third parties. The Secretary of State will be required to take steps to encourage water conservation and report to Parliament on progress.

Ofwat has set annual leakage targets for water companies in England and Wales, which have served to reduce total leakage by about 880 megalitres per day (20%) since 1997. Most companies are now at their economic level of leakage, which is the level at which it

would cost more to make further reductions than to produce the water from another source.

Ofwat reports companies' leakage performance annually in a press notice each July, followed by the annual report entitled *Security of supply, leakage and the efficient use of water*. It keeps companies' economic leakage appraisals under review to account for changing economic, environmental and social factors. However, the Government does not expect water companies to allow leakage to rise, as it is very difficult for companies to regain control of leakage once it has been allowed to increase. All companies should continue to examine the scope for additional leakage reductions over the longer-term.

The Government considers that further improvements in leakage management can be achieved by fully implementing the recommendations of the Tripartite Leakage Study⁴ (Defra, Ofwat and the Environment Agency). Companies should, for example, establish and maintain economic levels of leakage in each resource zone. They should constantly be seeking to improve their performance, within the framework of economic leakage rates, through improved leak management techniques and new technology.

The Government expects the growth of household water metering to contribute to improved demand management. The tariff framework should also encourage people to use water wisely, while providing social and health safeguards. Legislation already allows water companies to require metering in a wide range of circumstances including on change of occupier and where households use water for non-essential purposes. Companies may also apply for areas with limited water availability to be designated areas of water scarcity, where metering may then be imposed.

Conclusion

The Government is planning for the long-term interests of the water industry and water customers, as set out in *Directing the Flow*, and expects companies and regulators to do the same.

We recognise that a balance needs to be struck between the interests of water customers and the needs of the water industry. This means both protecting customers from high water bills unless they can be justified, and ensuring the future viability of companies by allowing prices to finance company functions. Equally, the industry has to continue to be an attractive long-term investment if it is to be able to attract sufficient finance, at sustainable rates, to enable it to continue to invest in asset improvements and maintenance.

Ofwat will consider companies' final business plans, due to be submitted in April. It will review them in the light of its statutory duties, guidance from Ministers and from the Welsh Assembly Government and other relevant issues including the Committee's

⁴ Future approaches to leakage target setting for water companies in England and Wales, March 2003

report. It will publish draft determinations for consultation before issuing final determinations in November 2004. Companies have the right to refer those determinations to the Competition Commission, which would examine the issues and make its own determinations.

The Government welcomes the Committee's interest in water pricing and will take account of its conclusions.

Department for Environment, Food and Rural Affairs
February 2004