House of Commons

Committee of Public Accounts

Ofwat: Meeting the demand for water

Twenty–fourth Report of Session 2006–07

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/pac. A list of Reports of the Committee in the present Session is at the back of this volume.

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Contents

Summary

Ofwat is responsible for setting price limits that allow the 22 principal water companies in England and Wales to meet future demands for water at the lowest cost to the consumer. Following the dry winters of 2004–05 and 2005–06 eight companies applied water restrictions.[1] Predictions of housing growth mean that, despite the wet winter of 2006–07, future demand for water is likely to exceed supply in many parts of England and Wales unless action is taken. To meet these challenges, Ofwat needs to make changes to its regulatory system, in particular on water efficiency, data quality, and enforcement.

Ofwat does not understand clearly how consumers use water and has not collected enough robust evidence on which water efficiency projects are most effective in helping consumers to use less water. Ofwat needs to divert more of its attention to water efficiency and gain a better understanding of consumers' behaviour.

Ofwat currently depends on unreliable data with regard to both supply and demand. It has made some progress since the Committee's 2002 recommendation that Ofwat examines how estimates of leakage—and the economically acceptable level of leakage—can be made with more consistency and precision. But there is still too much uncertainty. Ofwat also needs much better data on per capita consumption. Estimates for this, even within the same region, range between 124 and 177 litres per person per day.

Ofwat has had some success in encouraging sustainable investment by companies. It has been weak, however, in using sanctions against companies that under-perform against their commitments to meet all reasonable demands for water, while limiting environmental impacts. It was, for example, very slow in taking action against Thames Water for persistently failing to meet its leakage targets and decided against imposing a fine on the company, despite having the powers to do so.

On the basis of a Report by the Comptroller & Auditor General, the Committee took evidence from Ofwat on its role in regulating the water companies in England and Wales, focussing in particular on water efficiency, data quality, and enforcement.

1 C&AG's Report, *Ofwat—Meeting the demand for water*, HC (2006–2007) 150, figure 7

Conclusions and Recommendations

1. **Only 28% of UK households have a water meter.** Consumers without a meter pay a fixed sum for their water supply and have no financial incentive to use water efficiently. Ofwat should press companies to encourage more consumers 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. **Since 2000 Thames Water has persistently missed its leakage targets, but Ofwat took no enforcement action until 2005–06, and even then did not apply its new powers to impose financial penalties.** 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.

3. **Research shows that 62% of consumers will save water in a drought if they believe that their water company is doing the same**. 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.

4. **Consumption data are unreliable.** Consumption estimates vary substantially, even within the same region. Three Valleys Water estimates that each individual uses 177 litres of water per day, while nearby Tendring Hundred estimates the corresponding figure as 124. Ofwat should require companies to use consistent methods for measuring consumption, so that it can secure better data on per capita consumption.

5. **Ofwat cannot explain fully the variations in consumption.** Research eight years ago suggested that 60% of the difference was due to socio-economic factors. 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.

6. **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.

7. **Since the Committee's 2002 recommendation Ofwat has made some progress in improving the consistency and accuracy of leakage estimates and in calculating the economic level of leakage.** 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.

8. **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.

9. **All the water companies are monopolies in their regions**. There is therefore no market to determine the price that consumers are willing to pay for a particular standard of service. Ofwat should co-ordinate research to establish whether consumers would be willing to pay more for an improved service.

10. **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% 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.

1 Water Efficiency

1. Eleven of the 22 principal water companies in England and Wales are predicting that demand for water will increase in their region over the next four to five years. Most of the eleven are in the South East of England. This increase is due to predicted growth in the number of households and higher average consumption. At the same time, EU directives aimed at protecting the environment will reduce the amount of water that can be abstracted from ground and surface water sources. The Environment Agency has predicted that this will cause future demand to exceed supply in many parts of England and Wales unless new measures are put in place.

2. The Water Services Regulation Authority is responsible for setting price limits that allow water companies to meet future demand. The Authority came into being on 1 April 2006, taking over the powers from the Director General of Water Services. The Director General was supported by the Office of Water Services, known publicly as Ofwat, a name which the Authority has retained.[2]

Water efficiency projects

3. Promoting the efficient use of water by consumers can help water companies maintain a safe margin between the demand for water and the amount they can supply. It can also keep water companies' costs down, for example by removing or delaying the need to develop a new source of water such as a reservoir.[3] This in turn helps to keep consumers' water bills down.

4. To be effective, Ofwat needs information on the water saved by water efficiency schemes and their effect on consumers. In 2002 the Committee recommended that Ofwat should identify which water efficiency measures are most effective in helping consumers waste less water and share this information with water companies.[4]

5. A wide range of water efficiency programmes can help consumers to use less water. These include toilet cistern devices that reduce the amount of water used when the toilet is flushed, rainwater collection devices, and systems that re-use bath water for flushing the toilet.[5] Consumer education and publicity are also important elements of a water efficiency programme.

6. Work has been done internationally on the effectiveness of water efficiency measures, most notably in Australia. For example, Sydney Water provides grants to consumers who take effective measures to save water. To date over 300,000 households have taken part in this programme, saving, on average, 20,900 litres of water per household per year.[6] There is

2 C&AG's Report, paras 1.2–1.7; Q 7.

3 C&AG's Report, Appendix Two, page 24

4 C&AG's Report, Appendix Two, page 25

5 Qq 10, 53, 93

6 Q 134

however no direct comparison of these figures to England and Wales as little evidence has been gathered on water savings in the UK.

7. Ofwat has only recently started to take some steps to address the Committee's 2002 recommendation. In 2006 it established a good practice register of water efficiency initiatives and it is working with water companies to ensure that the information collected is available for the next periodic price review. Ofwat is also co-funding and participating in research projects to determine the cost effectiveness of demand management schemes.[7]

8. Five years after the Committee's recommendations on water efficiency, however, Ofwat still does not have enough robust evidence on which water efficiency projects are the most effective.[8] Furthermore, a majority of water companies believe that Ofwat has not been very effective in encouraging them to promote water efficiency; several of them find Ofwat's approach to allowing extra funding for water efficiency projects confusing.[9]

Consumer response to water efficiency

9. During the drought in 2006, both consumers and water companies responded to non-financial incentives to save water. Consumer demand in the Thames region was 8% less than the norm for the summer. Anglian Water and Southern Water made efforts to repair all visible leaks to demonstrate that they took water efficiency issues seriously.[10] But other companies did not do so.

10. Recent research by the Consumer Council for Water shows that consumers will save water in a drought, especially if they believe that their own water company is also doing all it can to reduce wastage.[11] Water companies therefore play an important role in giving a lead and setting an example to consumers.[12] Ofwat does not, however, require the companies to alter their operating practices during a drought.

Impact of metering on water efficiency

11. Consumers who do not have a meter pay a fixed sum regardless of how much water they use. There is therefore no financial incentive for them to use less water.[13] By contrast, metered consumers do have a financial incentive to reduce consumption (**Figure 1**). Research by UK Water Industry Research (UKWIR) shows that metering can reduce household consumption by between 9% and 21%.[14]

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7 Qq 50–51

8 Q 10

9 C&AG's Report, para 2.24; Q 56

10 Q 9

11 C&AG's Report, para 3.18

12 Q 9

13 Qq 25–26

14 C&AG's Report, para 2.17

12. A water company increases its revenue for every unit of water used by a metered consumer. The incentive for a company therefore is to encourage metered consumers to use more rather than less water.[15] There is no evidence that water companies are doing this, but as metering becomes more widespread, the economic incentives on companies to do so will increase.[16] A revenue cap, as opposed to the current system of a price cap, would limit the amount of total revenue that a water company can earn and therefore reduce the incentive to promote water use. Ofwat has begun to investigate using a revenue cap to complement the current price cap regime.[17]

Figure 1: Economic incentives on the consumer and company

	Incentive on consumer	**Incentive on water company**
Metered consumers	**Conserve water** The less metered consumers use the less they pay	**Sell more water** The more water a consumer uses the more revenue the company receives.
Unmetered consumers	**Consume freely** Consumers pay a fixed charge for water regardless of how much they use. Therefore there is no financial incentive to conserve water.	**Conserve water** The company receives a fixed sum from the consumer but bears the cost of treating the water consumed. The company therefore has an incentive to encourage the consumer to use less water, as costs will fall but revenue remains constant. Increasing consumption may also require additional infrastructure.

Source: National Audit Office

15 Q 52

16 Q 25

17 Q 52

2 Data Reliability and Adequacy

13. To determine the price limits that enable water companies to deliver the required outputs, Ofwat needs reliable information on the characteristics of supply and demand and the amount that consumers are willing to pay for a specified level of service.[18] There are currently weaknesses and inconsistencies in these data.

Leakage data

14. To produce a reliable estimate of the water lost from its water system, a company needs to know how much water it puts into the system and how much water has been consumed. The difference between these two amounts is leakage.[19] The Committee raised concerns in its 2002 report over the lack of reliable leakage data. Ofwat has made progress in improving measurements of leakage and now requires companies to use two separate approaches to measurement, which then need to be reconciled to within 5% of each other.[20] However, leakage estimations rely on consumption data which themselves lack consistency and precision.

15. The economic level of leakage is the point at which the cost of saving one unit of water through fixing a leak is the same as the cost of providing one unit of water through a new supply.[21] Calculations of the economic level of leakage do not yet fully reflect the costs of environmental or social issues, such as the consequence of digging up a road, despite concerns raised by the Committee in 2002.[22]

Consumption data

16. Consumption data underpin Ofwat's regulation of security of supply and its setting of price limits. Accurate and reliable consumption data are particularly important in areas of the country where there is predicted housing growth, such as the south east and east of England. But only 28% of households are metered, and most of the consumption data rely on estimates of unmetered water use meaning that they are unreliable.[23]

17. Estimates of water consumption vary widely between water companies even within the same region (**Figure 2**). Three Valleys Water estimates that each individual within the region uses 177 litres of water per day, while nearby Tendring Hundred estimates that its consumers use 124 litres of water per day. Tendring Hundred has the highest proportion—64%—of metered customers of any of the water companies. Furthermore, Ofwat believes

18 C&AG's Report, para 2.1

19 C&AG's Report, para 2.3, Q 6

20 Q 81

21 C&AG's Report, para 3.11

22 Q 72

23 Q 5

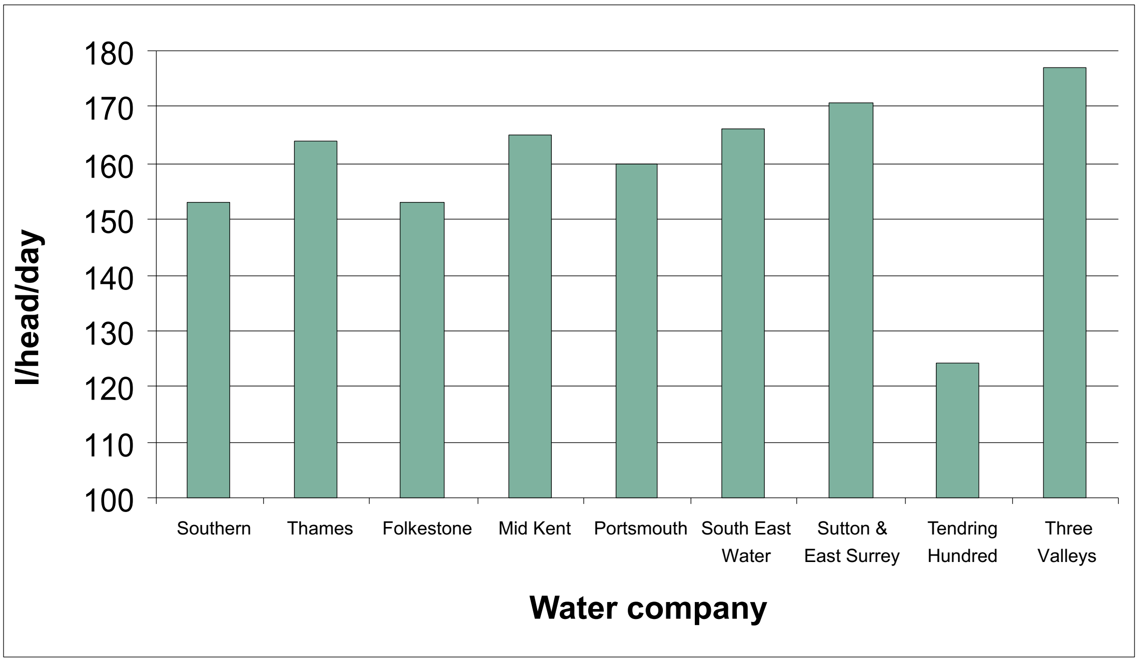
that, as one of the smallest companies, it may have a closer relationship with its customers and therefore be better able to promote water efficiency.[24]

18. The difference between estimated and measured consumption also varies widely between companies. South East Water, for example, estimates that unmetered customers use the same amount of water as metered customers. By contrast, Sutton and East Surrey Water estimates that unmetered customers use 32% more than those with meters.[25]

19. Companies have different methods for estimating consumption levels for the 72% of unmetered consumers.[26] Independent reporters are responsible for ensuring data quality but they do not assess whether a company's approach is comparable to that of the other companies.

20. A study in 1999 by UKWIR found that 60% of the variation in per capita consumption was due to socio-economic and climate factors. Ofwat cannot explain the remaining 40% nor has it commissioned any updates to the 1999 research.[27] Consequently, it is not clear how much of this remaining variation is due to differences in the methodologies used by companies for calculating per capita consumption, or to the unreliability of demographic data available.[28]

Figure 2: Average household consumption for water companies in the South East 2005–06



Source: Ofwat, Security of Supply report 2005–6

24 Q 123

25 Q 90

26 Qq 85, 88

27 Qq 1–2

28 C&AG's Report, para 2.7; Q 5

Pricing information

21. All the water companies are monopolies in their regions.[29] There is therefore no market to determine the price that consumers are willing to pay for a particular standard of service. Ofwat does not know whether consumers will pay more for better service, for example, to fund a new reservoir to reduce the probability of hosepipe bans.

22. Prior to the last price control in 2004, Ofwat co-ordinated two national surveys to establish the security of supply level required by consumers. However, there has been little co-ordinated research on how much consumers are willing to pay for a particular level of security.[30]

29 Qq 37–39, 48

30 C&AG's Report, para 2.15

3 Enforcement and Consumer Protection

23. If a water company fails to deliver its promised level of service to customers Ofwat can apply a range of sanctions, including revoking a company's licence.[31] Ofwat has these powers to protect the interests of the consumer in the absence of effective competition in the water industry.[32]

Leakage

24. In 1995, Ofwat identified high levels of water leakage which contributed to serious difficulties in maintaining supplies during the drought of that year. To tackle the problem it introduced leakage targets and a range of sanctions in the event of a company's failure to meet its target (**Figure 3**). In 2005, Ofwat gained the power to impose financial penalties on companies who contravene their licence conditions. As a result, it can now fine companies up to ten 10% of turnover if they miss their leakage target.

Figure 3: Regulatory Sanctions

Naming and shaming—applies to every company failing to achieve its leakage target. The failure is detailed in Ofwat's annual report *Security of supply, leakage and water efficiency* and may also be highlighted in a separate press release.

Extra reporting—companies usually report their performance on leakage annually. However, Ofwat can require more regular reporting outside the annual system. It has taken this step against a number of water companies including Anglian, South East Water, Thames and United Utilities.

Investigations—involves detailed examination of a company's performance and data quality. For example, Severn Trent, Southern and Thames have been subject to investigations relating to customer service data.

Enforcement order—under the 1991 Water Industry Act Ofwat can apply an enforcement order against a company where it is not complying with the terms of its licence. This major sanction has never been used.

Fines (power introduced 1 April 2005)—this has not yet been used although Ofwat has now published its intent to apply fines following recent investigations, and has proposed to fine one company.

Source: Ofwat

25. Ofwat's leakage targets have resulted in reduced levels of leakage across the industry. Since 2000–01, however, Thames Water has persistently failed to meet its targets.[33] In 2001–02 and 2002–03 its targets were suspended due to unreliable data. Despite an

31 C&AG's Report, para 4.1

32 Q 48

33 Q 29

agreement in 2000–01 that Thames Water would put in place an action plan to meet its leakage target within 3 years, it still missed this target in 2003–04 by more than 10% and has missed it ever since.[34]

26. Ofwat could have taken action, including enforcement orders under the 1991 Water Industry Act to force Thames to improve its performance. However, it only required more regular reports from the company, and investigated the company's customer service data.[35] Ofwat considered taking legal action but decided against this or imposing an enforcement order on the company.[36]

27. Finally, in 2005–06, after Thames had missed its targets for six consecutive years, Ofwat decided to accept a legally binding undertaking instead of imposing a fine on the company. The undertaking requires Thames Water to replace about 370 kilometres of water mains, costing some £150 million and to improve its security of supply position. These measures are to be met entirely at the expense of Thames Water's shareholders with no cost falling on their customers.[37] If Ofwat had fined the company, the maximum fine would have been £66.4 million. Ofwat considered that the alternative solution of an undertaking ensured that Thames Water addressed the crucial issues such as its low security of supply, as well as tackling its leakage problems.[38] By not imposing a fine, however, Ofwat risks sending a message to the industry that it will not readily use sanctions where appropriate. More recently, however, in April 2007, Ofwat has proposed fining United Utilities 0.7% of its annual turnover for repeated and serious breaches of its licence conditions between November 2005 and March 2007.

Sanctions to protect the consumer

28. Ofwat considers that the scope for economies of scale in the water sector is small.[39] Furthermore, many of the smaller companies provide very good levels of service to consumers.[40]

29. Thames Water is one of the largest water companies and should be able to benefit from economies of scale, to the extent that they exist in the water industry. However, Thames has a range of problems in areas such as the serviceability of its infrastructure and its security of supply. Ofwat considers that the size of the company may be responsible for its inefficiencies and the current poor quality of service.[41]

30. Ofwat can refer a water company merger to the Competition Commission if it believes the merger is not in the interest of the consumer. But it is not clear whether Ofwat can

34 C&AG's Report, Appendix 5

35 Q 11

36 Qq 10, 15–18

37 Q 29

38 C&AG's Report, para 4.9

39 Q 111

40 Q 110

41 Q 112

promote a de-merger if a large company is performing poorly and not benefiting from economies of scale. Despite the ongoing problems at Thames Water, Ofwat has never imposed an enforcement order or fined the company. Nor has it used any sanctions or action that may encourage the company to change its corporate structure to become more efficient.[42]

Consumer compensation

31. If a company's performance is well below expected standards of service, Ofwat has the power to fine the company a maximum of 10% of its turnover. But any fines imposed would go to the Treasury and not benefit the consumer.[43] This means that consumers are not compensated for poor company performance. Furthermore, during a hosepipe ban, consumers do not receive compensation for the lower level of service they have endured.

42 Qq 113–115

43 Qq 147, 152

Formal Minutes

Monday 23 April 2007

Mr Edward Leigh, in the Chair

Mr Ian Davidson
Mr Sadiq Khan
Mr Austin Mitchell
Mr Alan Williams
Mr Iain Wright
Derek Wyatt

Draft Report

Draft Report (Ofwat: Meeting the demand for water), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 31 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Twenty-fourth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 25 April at 3.30 pm.

Witnesses

Monday 29 January 2007

Regina Finn, Chief Executive, and **Philip Fletcher CBE**, Chairman, Ofwat.	Ev 1

List of written evidence

List of Reports from the Committee of Public Accounts Session 2006–07

First Report	Tsunami: Provision of support for humanitarian assistance	HC 25 (Cm 7018
Second Report	Improving literacy and numeracy in schools (Northern Ireland)	HC 108 (Cm 7035)
Third Report	Collections Management in the National Museums and Galleries of Northern Ireland	HC 109 (Cm 7035)
Fourth Report	Gas distribution networks: Ofgem's role in their sale, restructuring and future regulation	HC 110 (Cm 7019)
Fifth Report	Postcomm and the quality of mail services	HC 111 (Cm 7018)
Sixth Report	Gaining and retaining a job: the Department for Work and Pensions support for disabled people	HC 112 (Cm 7019)
Seventh Report	Department for Work and Pensions: Using leaflets to communicate with the public about services and entitlements	HC 133 (Cm 7020)
Eighth Report	Tackling Child Obesity—First Steps	HC 157 (Cm 7020)
Ninth Report	The Paddington Health Campus Scheme	HC 244 (Cm 7076)
Tenth Report	Fines Collection	HC 245 (Cm 7020)
Eleventh Report	Supporting Small Business	HC 262 (Cm 7076)
Twelfth Report	Excess Votes 2005–06	HC 346
Thirteenth Report	Smarter Food Procurement in the Public Sector	HC 357
Fourteenth Report	Ministry of Defence: Delivering digital tactical communications through the Bowman CIP Programme	HC 358
Fifteenth Report	The termination of the PFI contract for the National Physical Laboratory	HC 359
Sixteenth Report	The Provision of Out-of-Hours Care in England	HC 360
Seventeenth Report	Financial Management of the NHS	HC 361
Eighteenth Report	DFID: Working with Non-Governmental and other Civil Society Organisations to promote development	HC 64
Nineteenth Report	A Foot on the Ladder: Low Cost Home Ownership Assistance	HC 134
Twentieth Report	Department of Health: The National Programme for IT in the NHS	HC 390
Twenty-first Report	Progress in Combat Identification	HC 486
Twenty-second Report	Tax credits	HC 487
Twenty-third Report	The office accommodation of the Department for Culture, Media and Sport and its sponsored bodies	HC 488
Twenty-fourth Report	Ofwat: Meeting the demand for water	HC 286

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number.

Oral evidence

Taken before the Committee of Public Accounts

on Monday 29 January 2007

Members present:

Mr Edward Leigh, in the Chair

Annette Brooke	Mr Don Touhig
Mr Sadiq Khan	Mr Alan Williams
Mr Austin Mitchell	Mr Iain Wright
Dr John Pugh	

Sir John Bourn KCB, Comptroller and Auditor General, **Mr Tim Burr**, Deputy Comptroller and Auditor General, and **Mr Ed Humpherson,** Director, National Audit Office were in attendance.

Paula Diggle, Treasury Officer of Accounts, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

OFWAT—MEETING THE DEMAND FOR WATER (HC 150)

Witnesses: **Regina Finn,** Chief Executive, and **Philip Fletcher CBE,** Chairman, Ofwat, gave evidence. **Dr Melinda Acutt**, Director of Network Regulation, Ofwat, was in attendance.

Q1 Chairman: Good afternoon, and welcome to the Public Accounts Committee, where our hearing today is on the Comptroller and Auditor General's Report *Ofwat meeting the demand for water*. We welcome Regina Finn, Ofwat's Accounting Officer and Chief Executive, and Philip Fletcher, the Chairman of Ofwat. Unusually, he is also the former Accounting Officer and Director General and so we have both the present and former Accounting Officers. We are also joined by the president of the Spanish Tribunal de Cuentas, whom I shall also be seeing tomorrow. You are very welcome. We are looking at estimates of consumption, Ms Finn. I will direct my questions to you as the present Accounting Officer but of course, Mr Fletcher, you can come in whenever you want. I presume that you know quite a lot about this subject; you have been around a long time, have you not?

Philip Fletcher: I was examined at a previous PAC meeting on similar issues, too.

Q2 Chairman: Okay. You can share the answers between you as you like. Figure 3 on page 11 shows average household consumption for water companies. Why do the estimates of water consumption vary so widely between companies?

Regina Finn: Perhaps I can give an initial high-level answer and Mr Fletcher can support it if he likes. The variation in the per capita consumption between different companies is in part due to socio-economic factors and climate. A study in 1999 estimated that 60% of the variation was due to those factors. The remaining variation is due to a number of factors, such as different levels of metering penetration in the different areas and the different level—

Chairman: I am afraid that you will have to speak up; the acoustics in this room are not—

Regina Finn: I beg your pardon.

Chairman: Speak slowly and speak loudly, please.

Regina Finn: I beg your pardon. I will do my best. I was saying that 60% of the variation is because of socio-economic factors and climate differences in the different companies'—

Q3 Chairman: You say climate differences. Let us look at the figures. There is a 41% difference between Tendring Hundred and Three Valleys. That cannot be anything to do with climate, for a start. How can it be possible that the customers of the Three Valleys company in Hertfordshire use 41% more water per day than those of Tendring Hundred in Essex?

Regina Finn: In the first instance, Tendring Hundred is considered an outlier. It is certainly very much at the bottom of the range. However, if we look at the difference in the metered consumption, because metered and unmetered consumption are different, and at the difference between metered customers in Tendring Hundred and in Three Valleys, there is also a wide variation, which implies that much of the variation is due to socio-economic and climate factors; in other words, to different types of customers. It is also due to the fact that the Tendring Hundred area is quite small whereas the Three Valleys area is bigger. Therefore there is likely to be more averaging in Three Valleys between different types of customers. Most of that can be—

Q4 Chairman: So, you are reassuring the Committee that you can accurately measure consumption?

Regina Finn: I was answering the question about the differences.

OFWAT

Q5 Chairman: I am asking you a question now. Leakage is obviously based on consumption. Are you telling us that you can accurately estimate consumption?
Regina Finn: As the vast majority of household customers, and that is who we are talking about, do not have meters—only 28% do—we have to estimate consumption.

Q6 Chairman: Exactly. That is the point that I am making. If we look at paragraph 2a, it tells us that leakage estimates are based on consumption. If you cannot accurately estimate what their customers use, how can the companies accurately measure leakage?
Regina Finn: Leakage measurements are not solely dependent on calculations of *per capita* consumption. Various methods are used to arrive at the leakage figures. Some are estimates but, as the report notes, the data underpinning the estimates have improved over time and as a result we believe that the leakage estimates are getting better.

Q7 Chairman: There are big plans for massive house building, for instance in the south-east of England. If we cannot accurately estimate consumption—and, indeed, waste—how can we know how to respond? All those new houses will need water, will they not? It is an important question, one that has to be answered.
Regina Finn: There are two aspects to that. First, we can estimate demand; however, as metering increases it will be easier as we will have more measured consumption. However, from the point of view of major developments in certain parts of the country, all the companies, as part of their water resource plans and business plans, must estimate and allow for demographic changes, and building, and increases in population. We will be forecasting and estimating those issues as the companies develop their water resource plans and business plans.

Q8 Chairman: Would it be unfair to say that the inaccuracy of the leakage data make your leakage targets rather meaningless? You simply do not know what is going on to an accurate extent, so your targets do not mean a great deal either.
Regina Finn: We would not accept that. As the report says, the data has improved significantly and is continuing to improve. We think that the measurement of the leakage targets, although based to a degree on estimates and assumptions—by its nature, it will have to be based on estimates and assumptions—has improved. That allows us to set targets that are appropriate for each of the companies in their area—that is, the economic level of leakage target.
Philip Fletcher: Chairman, may I say a word?
Chairman: Please butt in.
Philip Fletcher: As both the industry and its regulator were effectively caught out in the mid-1990s by the high levels of leakage, the regulator and the industry together have been working solidly by various means to improve those estimates. Your starting point—it has been made by Ms Finn—is that we cannot know consumption exactly when, with the exception of the Republic of Ireland, only nearly 30% of domestic consumers are metered. That is a real handicap in appraising consumption, but by looking at it top-down and bottom-up we have various different takes on what is to be done. We have developed those over a decade, and we now have a great deal of confidence in the leakage targets, which for the 22 companies represent the economic level of leakage that they need to reach by 2010.

Q9 Chairman: Mr Fletcher, you might be able to help with my next two or three questions, because they are more historic. Paragraph 3.14, at page 16, shows what Anglian Water, my water company, was doing during last summer's drought. It sought to fix all visible leaks. If Anglian Water can do it, why did you not require all water companies to do the same thing?
Philip Fletcher: We said to all water companies that when there is a drought they need to work much harder in order to set a lead for their consumers. The reaction of consumers in a drought is absolutely crucial to the effective response. Consumers will not respond in a co-operative way, looking at their own consumption, unless they can see their water company setting a lead. Anglian was not alone. For example, Southern Water also prioritised visible leaks. One could argue from an economic point of view that that is not sensible, because the visible leaks are often much smaller than what is going on underground, which never becomes apparent. If companies are going to enlist their consumers, all of them need to do it. Throughout last summer, Ofwat, the Environment Agency and all participants were urging the companies to set a lead for their consumers. Most of them responded to that.

Q10 Chairman: We will talk about urging and action in a moment. You said that you have appeared before the Committee before. Presumably, if we make recommendations and you agree to them, you think that they should be carried out. However, page 5 of the executive summary states that "the evidence does not yet enable Ofwat to say which projects are most effective in helping consumers waste less water, despite a specific Committee of Public Accounts recommendation in 2002." Why do you still not know the most effective water efficiency measures, despite your agreeing to our recommendation?
Philip Fletcher: Of course we take the recommendations entirely seriously. When we responded to the PAC last time round, we made the point that it is not a matter only for Ofwat; the companies have a duty to promote water efficiency, and Ofwat should not come between them and their statutory duty to their consumers. Yes, implementation has taken longer than we would have hoped. Immediately after the last Report, Ofwat commissioned work from the industry research body

called UK Water Industry Research, or UKWIR. The first results of that were published in the following year, in 2003. We have also been working on the problem solidly since. To illustrate some of the difficulties in coming up with the most cost-effective measures, one thing that we do is to insist that all companies maintain a basic level of work on water efficiency. One crucial element of that is education, particularly the education of children and young people, because they are the people who will value water as a resource in years to come. How do you precisely assess the effectiveness of that? In my view, it is very difficult to do so, but that does not stop us for a moment from insisting that companies must have an education programme as part of their basic expenditure, not by adding to the bills of customers. Several other things are becoming more clearly cost-effective, such as what are sometimes rather pompously called cistern-displacement devices; that is, something that is put in an old-fashioned cistern with too big a flush in order to reduce it. It is better still to get another cistern, but that is another story.

Q11 Chairman: My last question is about your historic failure, Mr Fletcher, to do anything about Thames Water's record. If colleagues are interested, this is dealt with in paragraph 4.8 on page 21. You did nothing to act on Thames Water's repeated failures until 2006. That is six years after it first missed a leakage target. Why did you not do anything effective in that time? Again, if colleagues are interested, appendix 5 on page 34, which is headed "Ofwat action on Thames Water leakage levels", shows this sorry saga of targets continuously being missed and Ofwat's flabby response during all that time—and you were in charge.

Philip Fletcher: Indeed I was, from 2000 onwards. In the light of what happened in winter 2000-01, when you may recall we experienced a series of freezes and sudden thaws, it became apparent that although Thames had apparently been doing well with its leakage hitherto—we should remember that the industry has reduced leakage overall by almost one third since that peak in the mid-'90s—it had a real problem both in measurement and in actual leakage. From the very first year when that problem became apparent, Ofwat has considered legal action to enforce leakage targets. As well as considering legal action, we have taken practical action on behalf of consumers to ensure that Thames got on top of its problem. Yes, it is taking Thames a long time, but our action culminated last year in the action, which the National Audit Office on the whole appears to endorse, of requiring a section 19 undertaking, as it is called. However, that could only be achieved, first, when Ofwat had, thanks to Parliament, the power to fine companies, which came into effect only in 2006, giving us the leverage to insist on this section 19 undertaking; and secondly, through the steady accumulation of evidence and regulatory leverage, which included the application of targets, enshrined in price limits from the 2005 price limit onwards. That was the first year in which we had targets that, instead of being generalised, were signed up to by the companies as part of their agreement to the price limits that we had set.

Chairman: I am going to stop your there, because others want to come in, but we can perhaps return to this later.

Q12 Mr Khan: What is the annual budget for you as a regulator?

Regina Finn: It is in the region of £12.5 million to £13 million a year.

Q13 Mr Khan: Do you think that the taxpayer is getting value for money?

Regina Finn: I do.

Q14 Mr Khan: How do we assess whether or not we are getting value for money?

Regina Finn: Ofwat costs the water customer less than 50p a year and through setting price limits and efficiency targets has saved the water customer several hundreds of millions of pounds in efficiencies that companies have been required to meet.

Q15 Mr Khan: Those efficiencies would otherwise not have happened?

Regina Finn: No, we do not believe so.

Q16 Mr Khan: How many enforcement orders have you made?

Regina Finn: We have not issued any enforcement orders.

Q17 Mr Khan: When did you first have the power to make enforcement orders?

Regina Finn: Enforcement order powers were granted to Ofwat in 1991.

Q18 Mr Khan: How many fines have you ordered?

Regina Finn: We have published our intention to fine three companies, but have not yet imposed any fines.

Q19 Mr Khan: In part two of the report there is reference to inherent weaknesses and inconsistencies in the information on the demand for water and in the amount of water lost through leakage. Is that acceptable for a regulator that costs us £13 million a year?

Regina Finn: The inherent weaknesses arise because only 28% of households are metered in England and Wales. That is an inherent weakness and that lack of metering leads us to have to estimate the data.

Q20 Mr Khan: What are you doing about that?

Regina Finn: The roll-out of metering is something that Ofwat encourages and allows for where it is economic in relation to the price limits. We are also working with the water saving group, which was set up by DEFRA Ministers, to develop metering. We support the approach of the water saving group to make it easier for companies to gain water stressed status so that they can roll-out metering on a compulsory basis.

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Q21 Mr Khan: Which of the water companies are doing well in your eyes as far as water metering is concerned?
Regina Finn: The level of metering varies from company to company and depends on the individual company. It may not always be appropriate for the area covered by the company to be metered.
Mr Khan: Which ones are doing well?
Philip Fletcher: Companies doing well include Anglian Water, where the number is more than 50%, and South West Water, where it is now more than 50%. However, that is a very different situation as there are very high bills in the south-west.

Q22 Mr Khan: How many water companies are there?
Philip Fletcher: There are 22 apart from one tiddler.

Q23 Mr Khan: Two are doing well out of 22?
Philip Fletcher: No. With respect that is not what we are saying. We are saying that all companies are pressing on and we have seen the level of metering rise from the early 1990s when it was 3% to nearly 30%.[1]

Q24 Mr Khan: They are all doing well in your eyes?
Philip Fletcher: Most companies are doing well, but some of them could do a lot more to use their own discretion in order to get more customers metered—Thames is one of those.

Q25 Mr Khan: Bearing in mind that a water company makes larger profits if there is more consumption of water *vis-à-vis* a water meter, what incentive is there within a company to encourage its users to use less water when there are meters?
Philip Fletcher: That is obviously a problem that is growing as the number of meters rapidly rises. That is why, as raised in the National Audit Office's Report, we are considering the possibility of a revenue cap, which would be in conjunction with what is, at present, a price limit. The downside of that is that it is obviously more complicated. The potential upside is to give the incentive you are seeking to avoid a company wanting to push more water on to its consumers wastefully rather than focusing on its duty to have water efficiency.
Mr Khan: I am not sure what you mean.
Philip Fletcher: I will try again.

Q26 Mr Khan: If you could do so briefly. You are considering doing something, but you are concerned about the negative side of your plans—is that a fair summary?
Philip Fletcher: It would be fair to say that as metering reaches over 50%—at the moment that is only true of three or four companies—it becomes more of an incentive for the company to push water on to its consumers and thereby to be water inefficient. We recognise that danger, but do not yet believe that it has materialised—no evidence is shown for that in the NAO Report. For the next review, which takes effect from 2010, we acknowledge that that is something that we and the other stakeholders should work on.

Q27 Mr Khan: The Chairman referred to Thames Water, do you know how much profit it made last year?
Philip Fletcher: Yes.
Mr Khan: Round it up to the nearest £10 million.
Philip Fletcher: It would have to be to the nearest £100 million. We have not got the figure with us. We will provide it for you.[2]

Q28 Chairman: You do not know to the nearest hundred million what their profit is?
Mr Khan: In the House on Thursday a question was raised about regulators generally being a waste of money. Bearing in mind that Thames Water made a profit of £347 million last year, and that a whole section of the report is dedicated to Thames Water, I think that you are not helping your case when I ask a question about it.
Philip Fletcher: I acknowledge that we should have had the figure at our fingertips.

Q29 Mr Khan: I was so concerned about the water leakage that I went out with Thames Water during the night with their teams who detect water leakages. There are 13 teams, I am told, in south London that detect leakages. They have missed the target set by Ofwat. What has been done about that?
Philip Fletcher: The remedy applied in 2005-06 was to require the company to replace a year's worth—going at full tilt—of their water mains. That is about 370 km of water mains, costing about £150 million, entirely at the expense of their shareholders; no cost falling at all on the consumers.

Q30 Mr Khan: Quite. Now why is not a responsible water company investing in their pipes anyway?
Philip Fletcher: They are already doing so.

Q31 Mr Khan: You chose to get a binding agreement for them to invest in their pipes, as opposed to a £70 million fine. Why were not they investing anyway, and you fining them anyway?
Philip Fletcher: They were investing anyway. They had been investing—we would argue—very late, which goes back to my answers to the Chairman. It had taken them a long time to wake up to the fact that their Victorian cast iron water mains under London were starting to fail significantly, so that it was no longer enough to go on repairing them bit by bit. They needed a big replacement programme. They embarked on that up to 2005, spending about £200 million at the expense of the company up to then.

Q32 Mr Khan: The impression that you give is that, had it not been for your generosity in waiving the £70 million fine, they would not have invested in their pipes. Is that an unfair summary of the impression that you are trying to create?

[1] *Note by witness:* Please refer to response to Question 8.

[2] Ev 19-23

Philip Fletcher: We would not have been able at one and the same time to fine the company and to insist on £150 million extra investment at their own shareholders' cost.

Q33 Mr Khan: Why are they not doing that anyway?
Philip Fletcher: They are already doing roughly £150 million worth of investment each year under the price limits set in 2004 for 2005 onwards. It is a major programme, which is probably going about as fast as is now conceivable. The initial part was going well. They were doing it quickly, therefore there is room, but not in the price limits, for them to do this extra £150 million worth. That is what they are now doing at their own cost.

Q34 Mr Khan: What message do you think this sends to the other 21 water companies?
Philip Fletcher: It sends them a message that they need to be very serious about controlling leakage.

Q35 Mr Khan: You have let them off a £70 million fine. Do you think that gives an impression that you are—
Philip Fletcher: Can I just elaborate on the £70 million fine? It would have been a £66 million maximum water service fine.
Mr Khan: £66.4 million.
Philip Fletcher: Sorry?
Mr Khan: £66.4 million. That is quite important.
Philip Fletcher: Well, rounded to the nearest million, a £66 million fine. That would have been imposed only in the most egregious circumstances—without any part of mitigating circumstances. Thames, although they do fail, do have some mitigating circumstances.

Q36 Mr Khan: My time is almost up. If one of my constituents tells me that they are unhappy about Thames Water, what options do they have? Can they change suppliers?
Philip Fletcher: No, not unless they are a very big business consumer.

Q37 Mr Khan: Because of the monopoly that Thames has?
Philip Fletcher: Because Parliament decided in passing the Water Act 2003 that they would not extend competition to domestic consumers.

Q38 Mr Khan: So, it is a monopoly that Thames Water have?
Philip Fletcher: So, it is a monopoly and its regulator must regulate it well.

Q39 Mr Khan: So, that constituent would look to a regulator to protect his or her interests?
Philip Fletcher: Yes.

Q40 Mr Khan: Do you think you are discharging your responsibilities?
Philip Fletcher: Yes.
Mr Khan: You do?
Philip Fletcher: But—

Q41 Mr Khan: Do you think there is any scope for improvement?
Philip Fletcher: Can I finish my "but"? Of course there is scope for improvement.

Q42 Mr Khan: How will you improve?
Philip Fletcher: We will go on steadily improving the regulatory system, which, as Ms Finn has said, is delivering much better and more efficient services for water customers than they had—

Q43 Mr Khan: What does a water company have to do to be fined by you?
Philip Fletcher:—20 years ago before privatisation. I am sorry I did not hear your question.
Mr Khan: What does a water company need to do to be fined by you?
Philip Fletcher: Well, the threat for three companies, at the moment is failure to supply the regulator with accurate, reliable and complete information. A fourth one might find itself liable to a fine for the offence known as transfer pricing.

Q44 Mr Khan: What does a water company need to do to receive an enforcement order from you?
Philip Fletcher: It will receive an enforcement order if it so fails in its duty that there is no sensible alternative remedy. An enforcement order is a draconian measure, which is, of course, appropriate if a company is completely failing and is showing no signs of remedying its position. But if a company is taking appropriate action—we believe a binding legal undertaking is appropriate action in the Thames case—

Q45 Mr Khan: If we had the power either to serve an enforcement order or fine you as a regulator, we might do that. That is the end of my questions.
Philip Fletcher: You would, of course, at that point, be rightly subject to the courts, as Ofwat is. We have contemplated an enforcement order in every year since Thames first started failing. We believe it is more appropriate to get an agreement—a negotiated but legally binding undertaking—than have the uncertainty of the courts.

Q46 Mr Khan: Sorry, Chair, but that leads me to one more question: how many times have you imposed a fine or an order and it has been successfully appealed in the courts?
Philip Fletcher: Well—
Mr Khan: None.
Philip Fletcher: As we have already made it clear, we have not yet served an enforcement order and therefore we have not set a fine.

Q47 Mr Khan: So your earlier comment was ridiculous. You have not given any fines or enforcement orders to be appealed. Is that correct?
Philip Fletcher: That is correct.
Mr Khan: Fine. Thank you, Chair.

Q48 Chairman: The point that arises from this is that you are supposed to hold the balance between these companies and consumers—us the taxpayers,

who pay your salary. The kid gloves with which you have handled Thames Water, despite the fact that it has missed its target every single year, leads us to wonder whether you are not just a complete soft touch for these companies. These are monopolies, and you are supposed to represent our interests. Your history with Thames Water Utilities has been a sorry saga of delay and inaction. You were responsible as the Accounting Officer and it is to this Committee that you must account.
Philip Fletcher: I agree, although our salaries—

Q49 Chairman: And there is the hundreds of millions of profits that Mr Khan was talking about. You did not even know what the profits were.
Philip Fletcher: I had not got the precise figure, and I apologise for that. May I just underline that in each of the years in which we have examined Thames' performance, we have contemplated but—
Chairman: We are not interested in contemplation; we are interested in action.
Philip Fletcher: That was a pause in my sentence. We have taken action in each year. In each year, we have ensured that Thames is spending money to get on top of its leakage problem. It has spent about £200 million at its own cost—not included in price limits—before 2005 getting going, admittedly late, on replacing its Victorian mains. It is now spending on a large programme. That is partly at customers' cost—what was in price limits—and partly the extra £150 million, which is purely at shareholders' cost. It is also at last getting its leakage down. Once it got on the back foot, when Victorian cast iron mains in London clay seriously started to fail, it was not going to recover instantly. The programme to which it is now committed by its own legally-binding undertaking will take it below—that means better than—the leakage targets that were firmly set at the price review in 2004.

Q50 Mr Wright: May I follow up some of the stuff that has already been mentioned, in particular paragraph 2.21 in the Report about water efficiency? Is this not reflective of the fact that water companies earning hundreds of millions of pounds have not provided Ofwat with the information because they just see you as a minor irritant and as being weak in terms of being able to enforce anything? Is that a reasonable summary?
Regina Finn: No, we would not agree with that. As Philip Fletcher said, it is necessary to gather evidence on which water efficiency measures will achieve benefits for customers. Following our previous appearance at the Public Accounts Committee in 2002, we have been working hard with the companies to achieve that.

Q51 Mr Wright: "Working very hard", but it is five years since the previous Public Accounts Committee report on this.
Regina Finn: It is. It takes a certain amount of time to gather evidence on what succeeds in terms of water savings. The evidence base has improved. We managed to publish a good practice register at the end of last year that sets out the various measures and the amount of water that they save, and we hope to add the cost-effectiveness of those projects as soon as that information comes out of the work that is being done with the industry as part of the UKWIR study that Philip Fletcher mentioned.

Q52 Mr Wright: Moving on, paragraph 2.22 says that "At present, there is a lack of information", as you said, and it goes on to state: "In our structured interviews with companies, the majority told us that water savings generated from water efficiency projects are both uncertain and likely to be insubstantial." Is it not the case that water companies have a vested interest in higher consumption and therefore are not really interested in efficiency because it would have an impact on profits—that was the point made by Mr Khan earlier—and that you are not in a position to do anything about it?
Regina Finn: At present, water efficiency measures that reduce consumption do not have an impact on profits. If there were to be widespread metering such that the majority of customers were being charged on a volumetric basis, there could be a perverse profit incentive. We are conscious of that, and that is why we are looking at measures such as a revenue cap along with a price cap to prevent that, were it to come about in the future. However, it is not the case now.

Q53 Mr Wright: The Institute for Public Policy Research produced a report called "Every Drop Counts" in September 2006. The executive summary states that: "total expenditure and attributable water savings from companies' water efficiency activities have declined since 1997." I believe I heard Mr Fletcher correctly when he said that Ofwat insists on water efficiency. You are not doing a very good job of insisting, are you?
Philip Fletcher: We report each year on what the companies are doing. One aspect that has declined over the years is cistern-displacement devices—Hippos, as they are sometimes called. There are only so many that can be sent out. We are looking, first, for the basic level of activity and then, on top of that, specific costed and output-related projects to be included in price limits.

Q54 Mr Wright: Sorry, what does "output-related projects" mean?
Philip Fletcher: In the interest of protecting consumers, we will not listen to soft soap from water companies that say, "We want to do another water efficiency scheme. Please give us the money at customers' expense to do it", without asking them, "What will the water efficiency project do?" For example, if they want to change 50,000 cisterns to low-flush loos, we want evidence coming out of that to help inform water efficiency across the sector as a whole.

Q55 Mr Wright: Let me come on to the House of Lords Science and Technology Committee Report on water management from last summer. Paragraph 3.52 states that "water companies were disappointed

that proposed water efficiency measures submitted as part of the 2004 water price review were (with a few exceptions) excluded from price limits by Ofwat". Again, you do not seem to be promoting efficiency. Everybody is aware of the environmental considerations of increased consumption of gas and electricity, and therefore wants to sweat out every single unit. I do not get that impression at all in respect of water, and one of the main reasons for that is the weakness of Ofwat, is it not?
Philip Fletcher: No, we do not accept that. The point that I was making is that you would expect the companies to say, "We want more on the price limits", but you would also expect Ofwat to say, "Not unless you can show that it is value for money". That is what we have been doing in respect of water efficiency. We expect the basic level of activity, for example, an education programme and advice to customers, especially in a drought, on what they can do to help, including cistern-displacement devicesand, on top of that, well-costed projects that are related to output, rather than merely aspirations. That is what we have been doing.

Q56 Mr Wright: But paragraph 2.24 of the NAO Report states: "Sixteen out of 22 companies in our survey believe that Ofwat has not been very effective in encouraging them to promote water efficiency, with 10 companies citing confusion over Ofwat's approach to assuming additional expenditure for water efficiency projects in price limits."
Regina Finn: That is exactly the point. The additional expenditure is customers' money. At the last price review, we approved six of the proposed 13 water efficiency projects to go ahead. Those companies came to us with costed projects and demonstrable water savings, and we considered that their projects would provide value for money for customers. The other companies did not put forward a robust case so, in the consumer interest, we would not allow them to charge their customers for their projects. They could not show that they would deliver value for customers.

Q57 Mr Wright: So you disagree with the House of Lords conclusion that "Ofwat has placed insufficient importance on the promotion of water efficiency by water companies"? Is the House of Lords wrong?
Regina Finn: We are saying that we are working on Ofwat's water efficiency duty in conjunction with the other players. Ofwat has a very important role, and we are working with the Environment Agency and the companies to maximise our input into the water efficiency agenda.

Q58 Mr Wright: So the report from the Lords is wrong?
Philip Fletcher: There is room for a degree of view on all this. We entirely accept that this is an area we need to be involved in, but when the water companies—

Q59 Mr Wright: But do you think that you need to be involved a lot more in terms of increased strategic priority?
Philip Fletcher: In terms of the strategy, one of the key things that we need to do is to move towards more metering in the water-stressed areas, because only when customers really see a link between their use and their bills shall we see really effective water efficiency. We need the companies to pay attention to the supply pipes that belong to the customers—the bit that links the customer's home to the company's mains—where a great proportion of the leakage takes place. We also need continuing focus on education—specific devices and improvements in water fittings—we have already mentioned water closet cisterns, for example, but there are also dishwashers, washing machines and so on. All that needs to be looked at from a variety of different angles to get a strategic answer. That is why we are very supportive members of the water saving group established by the Government for just that purpose. This is not just about Ofwat, although we must play our full role.

Q60 Mr Wright: On a different topic, do you know what the level of bad debt is among domestic consumers, because it varies from water company to water company?
Philip Fletcher: Yes, Mr Wright. The household revenue outstanding for the last year for which we have the full data and excluding write-off—2005-06—was £831 million.

Q61 Mr Wright: Bad debt is £831 million?
Philip Fletcher: Yes. That compares with turnover of approaching £8 billion.
Mr Wright: It is about 10%.
Philip Fletcher: It is a lot of money, and it is something that does concern us because, of course, bad debt must be taken into account in setting the price limits, as long as the companies are managing their bad debt efficiently. If they are managing it efficiently, that is what we target them for, and we must allow for the bad debt. If they are inefficient, that is their own cost and their shareholders' expense. Why has bad debt risen? A whole host of things are at work—there are all sorts of socio-economic factors—but a key one is that it is not open to a company to disconnect, or to threaten to disconnect, a domestic consumer for being in debt.

Q62 Mr Wright: What is Ofwat's role in trying to reduce that bad debt? It astonishes me that it is close to £1 billion. What can be done to reduce it?
Philip Fletcher: We work within the framework that Parliament has given us—the statute—which is that there is to be no domestic disconnection. Beyond that, we say, "Right, you need to follow good practice." We see it as part of our role to act as a facilitator, gathering and then disseminating good practice. Good practice includes distinguishing clearly between the "can't pays"—the vulnerable customers who, for various reasons, find it extremely difficult to pay their bills—and the "won't pays", who are perhaps exploiting the fact that they cannot be disconnected. We are looking to all companies, through our good practice register in this area, to improve their performance. We made the

assumption at the last price limits that bad debt would not get worse, and so far—just about, despite bills having gone up overall—companies have seen some deterioration, but it is nothing like proportionate to the overall increase in prices.

Q63 Dr. Pugh: I want to start by talking a little about leakage targets. Presumably, they ought to vary, depending on how great the leaks are and how limited the supply is. Are those factors taken into account, or are across-the-board figures plucked out of thin air from time to time?
Philip Fletcher: They are certainly not plucked out of thin air. The NAO Report rather suggests that this broad approach is correct, although it needs refining.

Q64 Dr. Pugh: I am sorry, but which broad approach do you mean?
Philip Fletcher: It is the approach that we call—it is probably the wrong title—the economic level of leakage. "Economic" to a generalist sounds as if it is penny-pinching, a minimum spend. It is not that; it is trying to hit the point at which it costs the customer the least to achieve the most economic and most effective level of leakage control. Yes, it does vary from company to company. For example, Northumbrian Water has a very good supply in Kielder Water, which was built to accommodate heavy industry on the Tyne.

Q65 Dr. Pugh: So it is allowed to waste a bit more?
Philip Fletcher: It should not be spending as much at the customers' expense to control leakage, but Thames Water should. Thames is in the dry south-east. It really needs to get its act together on controlling leakage, and it has not hitherto done so. It is well away from its true economic level of leakage. However, 18 out of 22 do now hit their economic level.

Q66 Dr. Pugh: You would be less severe on a Welsh water company with plenty of water?
Philip Fletcher: Interestingly, even Wales has lots of different areas, including very dry areas up in Anglesey.
Mr Williams: It is also close to Liverpool.
Philip Fletcher: I will try to avoid the politics of Welsh water going to England; it is well above my head.

Q67 Dr. Pugh: We will not go there.
Leakage can occur from reservoirs, from pipelines and from domestic piping. Have you any feeling as to how it varies across the country, or are the same causes in place for more or less every water company?
Philip Fletcher: It varies with ground conditions. London clay, working on cast iron, is a particularly vicious environment. But that is not to excuse Thames, which could and should have seen it coming. Thames was well behind other companies in developing what are called district metered areas—effectively breaking down each area to villages where you can assess the leakage much better, and thereby control it much better than a very big area.

Q68 Dr. Pugh: Are there any big disparities—areas where it is not generally the pipe work causing the leakage but something else? You say that in London, it is by and large the pipes?
Philip Fletcher: I highlighted the pipes in London particularly, because if Thames Water was represented here, that is what it would be doing. However, we do not accept that as a long-term excuse. Thames has now demonstrated that it needs to replace its mains, and it is getting on with that. It is costing customers a lot, even though £150 million is at the shareholders' expense, but I am afraid that it will need to keep on doing it for the next decade or more. That is the only way; and it is the only company that has hitherto needed to embark on a wholesale replacement of its old mains.

Q69 Dr. Pugh: When leakage targets land on the desk of a chief executive of the water company, he has to decide what to do. Presumably, he is looking at a major capital programme in any case. All water companies have major capital programmes for a variety of reasons, not simply to prevent leakage. Are you able to monitor how influential your leakage directions are, given that we are talking about substantial programmes, commissioned over a number of years, that involve local authorities and cause appreciable upheaval throughout the country?
Philip Fletcher: We are, because when the Committee last looked at the question in 2002, it found that 18 out of 22 companies were not hitting their economic level. Now, 18 out of 22 are hitting that level. Last year, one failed by only a small margin, so only three companies, admittedly large ones, are in severe trouble for failing to hit their leakage targets—Thames, United Utilities and Severn Trent. We focused particularly on them.

Q70 Dr. Pugh: I wonder whether they can park your request and get on with other things, such as improving water quality or other desirable objectives.
Philip Fletcher: They can never park it, especially at this time of year. However, you are quite right that, having got to their economic level, it should require less senior management time; because they will have established a good process, and have the right technology and the right techniques in place to do it, they can move on to other things. However, they are at risk if they forget leakage as a key factor.

Q71 Dr. Pugh: In my constituency, the water company is digging up every road where it has identified leakage, but pedestrianisation schemes are taking place simultaneously, which has consequently created maximum upheaval. I was probing to try to find out whether it was a sudden directive from you that had prompted this rather antisocial behaviour by United Utilities.

Philip Fletcher: That is one of the dilemmas and something to be taken into account as we develop the concept of the level of leakage to take account for example of carbon footprint issues. Digging up the road causes congestion, frustrates motorists, and leads to more carbon.

Q72 Dr. Pugh: You take that into account, do you?
Philip Fletcher: We need to do more on it. At the moment we are not sufficiently sophisticated with the target. We have embarked on improving that target. We are likely to finish up—it will partly be a response to the House of Lords Committee report on this—with something that will be the sustainable level of leakage. In developing that—and we are working with the companies and the other stakeholders on it—we shall want to make sure that we are taking full account of the environmental and social costs, not simply the pounds and pence, in arriving at the dynamic concept, still underpinned by dynamic, varying things.

Q73 Dr. Pugh: How do you do that? If, for example, a local authority is suddenly confronted with United Utilities or some other water board arriving and digging up in a way that does not help whatever they are trying to do—generation or whatever—saying simply that they have a directive to do something about leakage, that in a sense trumps every other consideration, does not it?
Philip Fletcher: From a narrow Ofwat point of view.

Q74 Dr. Pugh: Legally it does, does not it?
Philip Fletcher: Well it does not, quite; this is the awkwardness. Parliament has passed the Traffic Management Act 2004, which is not yet fully in force, as you will know, which will bring in various means of co-ordinating interventions by utilities in the highway. There is clearly a tension between the absolutely desirable objective of ensuring utilities only come in once, and do not keep coming back and digging the road up, on the one hand, and the extreme desirability on the other hand of ensuring that you do not have visible leaks on top of the road, eventually causing the road surface to fail, and certainly, meanwhile, adding to the leakage for the company. There is a real dilemma there. I suggest that a large part of the answer lies in very close working—in your case between United Utilities and Southport metropolitan borough council.

Dr. Pugh: There is not a Southport metropolitan borough council, unfortunately.
Philip Fletcher: I beg your pardon. I am out of date.

Q75 Dr. Pugh: Oh that there were.
Can we just turn away from the supply side to the consumption side? There are an awful lot of details of consumption that varies across the country quite remarkably. To be absolutely honest it does not mean a lot to me, because I cannot explain why consumption is higher in one area rather than another. My thought is that an organisation like yours, or some organisation, ought to do some sociological research to try to find out why people are using water in differential patterns across the country in the way they do. Have they got more cars, more people in the house, more young people taking showers, or more old people taking baths? Has anybody done that sort of work?
Regina Finn: We are.

Q76 Dr. Pugh: You are?
Regina Finn: We are engaging in a piece of research which is designed to update the work that was done to clarify why there are differences in regional per capita consumption—the work that attributed 60% to socio-economic and climate reasons and 40% to other reasons. We have engaged consultants to carry out a piece of work on that to help further explain it.

Q77 Dr. Pugh: One last question. We talked about meters before. Clearly when people think about meters they tend to think of the cautious pensioner who needs to count the pennies and so on, but meters by and large are an enormous boon to young people living alone and also to households that have no children, and students. Clearly someone ought to do the job of marketing to them because they are hard-pressed, they need the cash and the saving would be well worth while. Whose job do you think that is?
Regina Finn: I think that the companies have a responsibility to inform customers that they are entitled to have a meter installed at no charge—so it is actually quite an attractive proposition for the sort of customers you are talking about.

Q78 Dr. Pugh: Who chases them when they do not? Do you chase them when they do not?
Regina Finn: Do we chase the companies when they do not market it?
Dr. Pugh: Yes.
Regina Finn: Really this is a matter for the companies in the first instance, and their marketing strategy, but we do query them in terms of what they are doing with regard to metering, and as part of the water saving group we are looking at mechanisms that will make it easier for companies to push the metering out further and compulsorily meter customers, particularly in water-scarce areas, as well.
Philip Fletcher: Could I just add that we do insist on all of them giving basic levels of information on metering including the right to opt for a meter in association with the bill information that goes out each year; so we insist on the minimum but companies have quite a lot of discretion; for example about whether to meter on change of occupier, which they have the right to do—something on which Thames is now embarking, one might argue, a bit late.

Q79 Dr. Pugh: But if they have no targeted campaigns, essentially nothing happens, really, much?
Philip Fletcher: South West did not need a great marketing campaign because bills needed to go up so much there—I am afraid—that a lot of customers have clearly won by opting for a meter. Indeed, the great majority of consumers will actually gain by

switching to a meter, but there is inherently much suspicion. I am afraid that the counterpart to that is that some consumers will lose out seriously when, or if, compulsory metering comes in.

Q80 Chairman: Our Clerk just told me that he has been trying for three years to get a meter from Thames Water without success.
Philip Fletcher: Please will your Clerk write to Ofwat or the Consumer Council for Water? Like all of us who are Thames consumers, your Clerk has a right to a meter unless for technical reasons it cannot be installed. Thames should have installed it within a maximum of six months. If it has failed, it has failed again—I am afraid. There are some technical circumstances in which it is not practical to have an individual meter such as in high-rise blocks of flats. In those circumstances, your Clerk—and everyone else—should be charged what he would have been if he had had a meter.
Chairman: I am sure that he heard that.

Q81 Mr Touhig: Why is Ofwat's data collection on water demand and usage, and on leakage so poor?
Regina Finn: We do not think that it is very poor. In fact, we use a number of methodologies—top-down and bottom-up methods, as Mr Fletcher said—to get companies to collect data on consumption, leakage and other usage, and the water distribution system, and to reconcile those methods.

Q82 Mr Touhig: So you do not agree with section 2A of the report, on page 4, which reads: "There are inherent weaknesses in information on demand for water and leakage."
Regina Finn: As I mentioned earlier, we agree that there are inherent weaknesses because it is necessary to make estimates. We cannot measure every customer's usage because only 28% of customers are metered. That is an inherent weakness and we must use estimating techniques.

Q83 Mr Touhig: We have established that you cannot tell us how much water is being consumed, which means that you cannot calculate the level of leakage, can you?
Regina Finn: We know how much water is being used—

Q84 Mr Touhig: I thought that the Chairman had been told that they are estimates.
Regina Finn: They are estimates. It will always be necessary to use estimates to some degree. Certainly until there is 100% metering in this country we will have to estimate usage. However, our data and estimating techniques are robust and continue to improve.

Q85 Mr Touhig: But they are so different because, as the Report points out, every water company uses a different methodology for calculating consumption and leakage. You have not even got that right. Why have you not at least got them to use one method?
Regina Finn: That is not the case. There are some differences between companies in some of their assumptions and methodologies, but we have been involved in developing best practice.

Q86 Mr Touhig: Is there a common, standard method?
Regina Finn: There is best practice.

Q87 Mr Touhig: So the Report is incorrect when it says that there is not.
Regina Finn: That is not what I am saying. A best-practice approach has been developed, and companies are encouraged to use it.

Q88 Mr Touhig: Encouraged to use it?
Regina Finn: We review what they do and challenge them on their estimates, but some differences remain in the way in which companies arrive at their assumptions and make their estimates. On the one hand, we need to remove as many inconsistencies as possible, and on the other, we need companies to continue to innovate and improve their estimation techniques. We do not want to stop them doing that.

Q89 Mr Touhig: I am sure that you would not, but it appears from your answer that the Report is accurate—there is no uniform method of calculating water usage and leakage.
Philip Fletcher: Mr Touhig, it is an advantage to have 22 companies each exploring the best way to do this. That is one way in which to develop best practice, rather than sticking with one absolutely rigid, uniform practice for everybody that might not be as appropriate for a company with 30,000 as for one with 8 million customers.

Q90 Mr Touhig: Companies do things quite differently. South East Water says that metered and unmetered customers use the same amount of water, but Sutton and East Surrey Water says that metered customers use 24% less water. Both cannot be right.
Philip Fletcher: Some differences will be attributable to the different characteristics of the customers of those two companies. But yes, I am sure that you are right—both extremes cannot be right.

Q91 Mr Touhig: South East Water is the only company that says that there is no difference. Have you had the chairman in for a chat?
Philip Fletcher: Well, yes, we talk to each company individually each year as they develop their approach to leakage—above all as we move towards the next periodic review—to test that each company has the system that is appropriate for it. When it comes to the extent to which they are not observing common best practice, they have to have a very good reason why not.

Q92 Mr Touhig: But they have explained to you why they believe that there is no difference?
Philip Fletcher: They have not persuaded us that there is no difference, so they need to go on working on it.

Q93 Mr Touhig: In his opening questions, the Chairman referred to previous Reports of this Committee. The Report points out that so far as water efficiency projects are concerned, you do not really know which is most effective.

Philip Fletcher: This goes back to the problem; many drives to create water efficiency will not have a single effective outcome. To use an example from last summer's drought, we believe that an effective device used by a group of the companies working with the Environment Agency was a cinema campaign to help customers to understand the simple things that they can do to save water in a drought and to make it clear at the same time that the companies were also doing their bit and spending extra money to bring leakage down below the normal economic level of leakage to reflect the extreme value of water in a drought. Although the effectiveness of that can be measured as any advertising campaign can be measured, and generally came through well, it was a short-term measure and does not lend itself to a precise output all the time.

Q94 Mr Touhig: But you have co-funded a number of projects to improve efficiency. Indeed, the appendix on page 25, from a previous report, states: "Ofwat should identify which water efficiency measures are the most effective in helping customers waste less water, and share this information with water companies." You do not know which is the most effective. How much money have you spent on all this? You have invested money; you have co-funded this work. How much have you spent on what outcome?

Philip Fletcher: We are spending only a few thousand pounds, because we are co-funding a report that is produced by the industry's water research institution backed by companies with a turnover of £8 billion. We need to spend only what is necessary to give us the leverage to ensure that the studies are being properly conducted and are delivering the right results. It is not the amount that we at Ofwat are spending but the effectiveness of the outcomes.

Q95 Mr Touhig: So, you have spent only a few thousand pounds. You have not spent a lot of money on co-funding projects to find out the most efficient way to save water.

Philip Fletcher: On the basis that this cannot be solved overnight, we need steadily to develop the effectiveness. The next report on the issue, which is one of a continuing series of reports, will come through in summer of this year—in June, we believe.

Q96 Mr Touhig: But you seem to me to be very laid-back. The questioning from colleagues today suggests that you have a very hands-off approach. It has been suggested that you might perhaps be a bit of a soft touch; you would deny that, I am sure?

Philip Fletcher: We would.

Q97 Mr Touhig: As Mr Khan thoroughly explored, you can impose fines but you have not. You can take action against water companies but you have not.

Philip Fletcher: On the fines, we have only been able to apply them for the first time to the evidence that we received just under a year ago—

Mr Touhig: I wish you were my bank manager.

Philip Fletcher: Since that time, four companies are under notice of a possible fine—Thames twice over—in respect of leakage, though the outcome was a different one. Three companies—again, including Thames—are under notice in respect of failure to provide good, reliable, accurate, and complete information to Ofwat. Another, United Utilities, may—we do not know yet—be at risk of a fine for its action on transfer pricing. It seems to me that that is quite prompt use of a new power given by Parliament, bearing in mind that the leverage that it affords us—we are grateful to the House for giving us that power, because even if we do not use a fine it enables us to get a much more effective outcome—

Q98 Mr Touhig: You do not use a fine; we have established that pretty well.

Philip Fletcher: When we have a legally binding undertaking, as we do from Thames, it brings us a better outcome from customers than when we did not have the fining power, even though we do not use the fines.

Q99 Mr Touhig: A special part of the report is on Thames, and you have had the embarrassment of the Chairman explaining that the Clerk of this Committee has been waiting three years to get a meter. I assume you will be on the telephone tonight to the chairman of Thames to say what a hell of an embarrassment he has caused you in the PAC this afternoon.

Philip Fletcher: If Thames is not monitoring this hearing, it is failing even more than I would have expected; but we will make sure that the point is drawn to Thames's attention.

Q100 Mr Touhig: So you do not believe that Ofwat is toothless?

Philip Fletcher: We do not believe that Ofwat is toothless, and we believe that the overall gains in efficiency—I do not mean water efficiency, not alone, anyway, but cost efficiency—that the industry has seen over the period since privatisation in 1989 is evidence partly at least of Ofwat's effectiveness. Bills, I know, will have gone up by 2010 by approaching 40% in real terms; but for that money, customers will have seen approaching £70 billion worth of capital investment to improve security of supply, increasingly important as we face global warming, to improve service to customers on issues such as sewer flooding, to deliver the environmental improvements that we need—

Q101 Mr Touhig: I wish my constituent Mr Westcott could have something done about his flooding. He has been suffering this sort of problem for 20 years. He has just spent £700 on a new wall that has been under water 12 times since Christmas. I really do not think that he would have much to say about flooding.

You say that you are not toothless and that you do have powers. We seem to be in doubt that you are exercising those powers. Perhaps you are wearing false teeth and you have them out a lot—you do not have much bite with the companies?
Philip Fletcher: We are not doing this overnight. We are getting a consistent regime that has steadily been ratcheting down the inefficiency of the companies since 1990. You may say that it should be quicker. We all want it to be quicker, but a consistent regime that steadily improves the efficiency and effectiveness is—we would suggest to the Committee—very much in consumers' interests. That is our sole concern: the protection of consumers is our primary duty.

Q102 Mr Touhig: I am sure that we would all like it quicker; of course we would. But we have evidence that you have not acted on recommendations made in January 2002.
Philip Fletcher: We have acted, but the issue is could we and should we have done more. We are always open to the fact that we could and should always be open to the challenge of doing more.

Q103 Mr Touhig: Ofwat is not a religious order by any chance?
Philip Fletcher: Not to my knowledge.

Q104 Mr Touhig: You just contemplate a lot; you do not take much action.
Philip Fletcher: No, sorry. Always a difficult word.

Q105 Annette Brooke: I shall change the order of my questions, following the statement that the customer is the highest priority. Can you tell us why the percentage increase for unfortunate customers in the South West Water area was nearly 13%, and 11.2% in the Wessex Water area? I have to tell you that the day those bills dropped through people's doors my office was brought to a halt—not surprisingly, given the percentage increase in pensions. Is that putting the customer first, particularly pensioners on fixed incomes?
Philip Fletcher: The duty on Ofwat is, while protecting consumers, to enable efficient companies to carry out and to finance their functions. Putting that together—where the functions placed on them by Parliament, the European Union and the facts of life, which include the need to maintain their assets properly—will drive a very much larger capital expenditure programme than was applied in the 1980s before privatisation, someone has to bear the cost. There is only one person to bear the cost, and there is no taxpayers' money in it, so the water consumer bears the cost. It is Ofwat's job to ensure that the consumer is not spending on his or her water bill a penny more than is necessary to do that job properly. That is our endeavour. In South West's case, very significantly it has the highest bills in the country. I accept that it is a really significant issue. The reason for it, as you are probably already well aware, is that the south-west has a fairly small but not very prosperous consumer base, but that, under a series of European directives, it has a very large capital expenditure investment task to carry out. It has a very long coastline, which is subject particularly to coastal, bathing and freshwater directives.

Q106 Annette Brooke: I am sure that that is fine, but the pensioner does not appreciate the increase on the bill. So can you tell me whether those companies were required to send out full details about how to get a water meter, for example? Should not that have been a requirement?
Philip Fletcher: Yes, they were, and they did.

Q107 Annette Brooke: And they did?
Philip Fletcher: And they did.

Q108 Annette Brooke: And was there a significant uptake?
Philip Fletcher: Yes. I do not have the exact figures, but in South West Water's case the rate soared from somewhere near 30% to more than 50% almost instantly, over the past two to three years. South West has had very high volumes, although perversely that costs consumers more, because although the price of the meter is free at point of installation, the cost is borne by the body of consumers as a whole. We had to take that into account in setting the price limits.

Q109 Annette Brooke: I am tempted to ask you what the profits of those two companies were, but perhaps you do not have those figures.
Philip Fletcher: We will supply the Committee with a full table of the profits as recently announced, as I have already undertaken to Mr Khan.[3]

Q110 Annette Brooke: The other water company that supplies part of my constituency is Bournemouth and West Hampshire Water, which seems to get lots of stars for its performance. Can you tell me what it is doing so right and what all the other companies should learn from it?
Philip Fletcher: All the companies need to deliver a basic level of service to their customers. We need to measure that under common indicators that are applicable to all the companies, such as the number of sewer flooding incidents—a point raised by Mr Touhig—the times customers get cut off, especially without forewarnings, and the overall number of bursts in pipes. All those are measured and all have greatly improved over time. That is why we can say with confidence that customers are getting a much better service than 15 or 16 years ago. But again, this is not an area about which we are at all complacent. Customers expect a good service; interestingly they have told us that they do not want to pay a lot more for it. That is understandable, but it means that it is probably not worth trying to ratchet up prices to squeeze out the last very expensive benefit. That is the same sort of issue that applies with leakage.

[3] Ev 19-23

Q111 Annette Brooke: Bournemouth and West Hampshire Water is a relatively small company, whereas Thames is one of the largest. So can I just ask you briefly: is small beautiful in the supply of water?
Philip Fletcher: Interestingly, there is no evidence that economies of scale apply. That is an issue that Miss Finn and her colleagues are busy explaining to the Competition Commission in a live case about a merger at the moment. Therefore, the small companies do have a value to consumers at large in England and Wales, in helping providers with comparative information, which underpins all our pressure on the companies to become more efficient. It is having 22 companies—monopolies, admittedly—that enables us to say that company A, which could be Bournemouth, is doing much better than company C, and that we know that company C can do better.

Q112 Annette Brooke: So is Thames Water too big to provide a good service?
Philip Fletcher: Thames Water is very large. It has an awful lot of problems wherever we look. It has problems with the serviceability of its infrastructure that are worse than most. Its security of supply is worse than that of any other company except little Folkestone and Dover Water Services. Thames has an awful lot of problems.

Q113 Annette Brooke: That is quite an indictment, given your position as the monitor and regulator. Are you making representations about where the inefficiencies are coming from and about the size of those?
Philip Fletcher: Yes, absolutely. We talk to Thames, and this is not mere contemplation—

Q114 Annette Brooke: But don't you need to be talking to the Competition Commission?
Philip Fletcher: We do. Where a merger comes up, in this case a proposed merger between Mid Kent Water and South East Water—

Q115 Annette Brooke: No, I am focusing just on Thames.
Philip Fletcher: There is no point in our talking to the Competition Commission. At the moment it has no locus or role in respect of Thames Water. It is our job as the economic regulator, working with the environmental regulator, the Environment Agency, to ensure that Thames carries out its obligations to achieve, for example, full security of supply with headroom by 2010, which Thames has undertaken to do in exchange for the price limits that were imposed in 2005.

Q116 Annette Brooke: Can I just change the emphasis slightly? Since April 2005, I understand that Ofwat has had a duty to exercise and perform its duties in the manner best calculated to achieve sustainable development—I am on page 9 of the NAO report. Paragraph 1.11 says: "We found that some companies had reflected the expected impact of climate change in their current water resource plans, but others felt they had insufficiently detailed information and had not attempted to do so." That refers to the current plans, but are you making sure that that information is really going to be built in? There is a complete lack of information reported in the report. Are the companies going to have the information for the next round of reports?
Regina Finn: Yes. Guidance was given to the companies after being developed by both Ofwat and the Environment Agency, which clearly also has a strong role. We are working with the Environment Agency to develop that guidance to provide more detail to the companies for the next price review, which will set prices for the period 2010 to 2015, to enable them to take climate change issues into account in their business plans. Of course, we would argue that the companies should be doing that in any event, but we are developing the guidance still further.

Q117 Annette Brooke: It does seem to be quite a time lag. Following on from that and from part of Dr Pugh's question, the 2002 recommendations from this Committee made the point, "Where reducing leakage would enable environmental damage to be reduced OFWAT should consider setting companies targets below their economic level of leakage." In other words, not just the tarmac but the reservoirs, which are another consideration relating to Thames and whether its leaks should be pursued more rigorously. That was a 2002 recommendation. Have you really moved on from that point?
Regina Finn: Yes, we have. Straight after the 2002 recommendations, what was called the tripartite report was produced by the Department for Environment, Food and Rural Affairs, Ofwat and the Environment Agency. That developed further for the companies how they should include environmental and social costs in the dynamic leakage calculation, which is another way of achieving the same thing—ensuring that those costs are fully taken into account. We have commenced a further review of the inclusion of environmental and social costs, following the House of Lords report, to further develop that and take into account recent developments on climate change and carbon footprints. We have acted on this, and we are going to go a step further in the next review.
Annette Brooke: It still seems to me that there is some time lag.

Q118 Mr Austin Mitchell: You are really a soft touch, aren't you? Sweet and loveable but soft—like me. We were told that come privatisation water companies would be able to raise money on the markets for the huge investment bills that they faced. In fact, they have been inordinately profitable and the investment has been paid for by increased prices to the consumer—they have gone up very substantially—and you have just gone along with it all.
Philip Fletcher: We would not accept that, Mr Mitchell.

Mr Mitchell: Of course you wouldn't.

Philip Fletcher: But beyond that we have evidence, not least from the National Audit Office Report itself, that in respect of leakage the consumer evidence is that the right thing is being done. Consumers do not want to spend a lot more to get beyond the economic—

Q119 Mr Mitchell: But the consumer is paying a lot more for his or her water.

Philip Fletcher: Right, but the other bit of evidence that I would adduce is in the report produced by the respected consultants Oxera for the National Audit Office in respect of this Report. It says in its first sentence on conclusions that "Ofwat has been developing a regulatory framework that overall appears to provide the right incentives for companies to address the demand for water in an efficient and sustainable manner."

Q120 Mr Mitchell: Yes, but it is only now developing, after several years of privatisation. You are only now doing the research that allows you to find out a lot of the basic factors of the industry. Some of that research is financed with the companies in a co-partnership. Why so late?

Philip Fletcher: We all get impatient about this. We would love to have a list of what are the most cost-effective things. For the moment we have produced—and it is new—a best practice register that clearly identifies particular projects that we think have a lot of mileage in them. It is extremely difficult to attach a precise effectiveness figure to any individual project.

Q121 Mr Mitchell: If you do not know basic figures, such as wastage, usage, population and the effects of metering, on which Don Touhig has said estimates vary, how on earth can you enforce investment?

Philip Fletcher: It is a fundamental frustration that we have only 28% of consumers metered. We hope, especially in the water-stressed areas, to get it much higher.

Q122 Mr Mitchell: Metering is your answer to everything—it gives you greater control. Let us deal with the situation as it is now. There is a table on page 31 of the Report, "Company *per capita* consumption estimates." The estimates for unmeasured households vary wildly. The highest is Three Valleys and the lowest is Tendring Hundred—wherever that is. Similarly, for metered water, there is a huge difference in estimates of usage per litre per head per day. The highest is South East and the lowest, again, is Tendring Hundred. What does that mean? Why is that? Can you explain those differences in usage? Are people in the south-east clean smelling and wholesome, whereas the people in Tendring Hundred stink? Have people in the south-east got big gardens? Are they washing bigger cars? Why are there such basic, big differences in usage?

Philip Fletcher: Tendring Hundred is another example of a small company that can help to give a lead to others. It has only around 24,000 consumers, so if you compare that with Three Valleys—

Q123 Mr Mitchell: Okay, take Severn Trent. The usage is low there—it is 118 litres per head, compared with 166 in the south-east. Why?

Philip Fletcher: Although we believe that Severn Trent's leakage figures are now much better, it had a period three or four years ago when its leakage figures needed to be fully recalibrated. Therefore, in some circumstances, there may be continuing queries about a particular company's figures.

Just before we leave Tendring Hundred, let me say that another very relevant factor is that 64% of its customers are metered. That is a very high proportion—the highest in the country by far—and the metering is making a difference. Another factor is that the customers of Tendring Hundred—in Essex—are, on the whole, in different socio-economic categories from those in the rather more opulent Three Valleys area, and more opulent people use more water.

Q124 Mr Mitchell: Are you satisfied that you can explain these wide differences in usage of metered and unmetered water?

Philip Fletcher: Until we have universal metering—even then it will not be perfect—

Q125 Mr Mitchell: No, the differences in usage for metered water. You have to be able to explain that to have a rational basis for your calculations, but you cannot?

Philip Fletcher: Therefore we need a series of different takes to help us, especially when we are talking about things such as leakage and per capita consumption. We do not rely just on per capita consumption to assess leakage; we also have, for example, minimum night-time flows, which, as Mr Khan will have experienced when he went out with a Thames team, look for the lowest point of the night to get a basic minimum consumption, which will help to give them a different take on leakage.

Q126 Mr Mitchell: This is now, so many years into privatisation.

Philip Fletcher: And it is getting better.

Q127 Mr Mitchell: This is quite basic, but you do not know the answer.

Philip Fletcher: But we cannot know it precisely. I absolutely share your frustration, but steadily, under pressure, the companies are getting better at this and using different ways of appraising things, so we can now have confidence that we know the economic level of leakage. That enabled us to set the precise targets at the last review.

Q128 Mr Mitchell: I wonder whether the companies are also getting better at fiddling the figures. After one of our sessions with you, when I was on the Environment Committee, I accidentally found myself sitting on the train next to a manager, not an executive, from Yorkshire Water. We had been talking about the wastage figures. He had not been drinking water, because he could not get Yorkshire water on the train in London, so he had been drinking a substitute for water. He became quite frank and open with me, as people do on these occasions, and he said, "We fiddle the figures."

Philip Fletcher: Well, I will put that point to Yorkshire Water.

Q129 Mr Mitchell: Oh no. There is infinite scope for these figures to be fiddled if you do not know consumption.

Philip Fletcher: I must not get too far into it, because we must not prejudice a possible case—the Serious Fraud Office is investigating, as we speak, whether there was something seriously wrong with Severn Trent's figures, and that is mentioned in the National Audit Office Report. However, we believe that the scope for fiddling—to the extent that it ever existed—is becoming smaller and smaller as we track over the years precisely what has happened.

Q130 Mr Mitchell: How many years are we into privatisation and into your reign as Ofwat?

Philip Fletcher: We are into 17 years since privatisation and six years since I became involved at Ofwat.

Q131 Mr Mitchell: Other Members have put the point that you are very soft on Thames, and you are soft on Thames, are you not? You did not obtain from them for several years a legally binding undertaking to increase investment. You did not fine them when you had the power to do so. If they are profitable enough to be a takeover target, they must know something that you do not know about their profitability.

Philip Fletcher: They are a very profitable company at the moment. They have to carry out a whole series of things to fulfil their obligations by 2010; that includes this enormous mains replacement. They are at risk of damage to their profits to the extent that they do that inefficiently; they are at risk to the extent that they do not put enough money into leakage control and fail their target. They know that if they were to fail their target this year Ofwat, in the face of another failure, would be likely either to fine them, which means the money goes straight to the Exchequer, not to the benefit of consumers, or get something very major to the benefit of consumers from Thames. Again, I will not anticipate because one might always have judicial trouble if one anticipates, but I can assure the Committee on behalf of our board that a very severe view would be taken if Thames were to fail again. They have to do a whole series of things to improve their service to consumers which is at their cost if they do not deliver.

Q132 Mr Mitchell: Why is it that their report indicates that 16 of the water companies believe that you are not effective in promoting programmes to improve efficiency?

Philip Fletcher: Mr Mitchell, that is the Mandy Rice-Davies answer—they would, wouldn't they.

Mr Mitchell: They know.

Philip Fletcher: They are the subject of regulatory action. They would love to have an excuse.

Q133 Mr Mitchell: Mandy Rice-Davies knew human nature. Why don't you know the nature of the beast?

Philip Fletcher: Well, we do know the nature of the beast. We do not take as gospel what a company tells us. We have a whole series of checks to ensure that the company boards are taking their legal duty very seriously subject to a criminal penalty to provide us with accurate information, auditors—

Q134 Mr Mitchell: Well, why don't you do something like they do in Sydney, where they provide consumers with the money to install effective ways of saving water? The most they do in Britain is to recommend that you put half a brick in the cistern. My cistern is full of half bricks because I am with Yorkshire

Philip Fletcher: Yorkshire Water, of course—

Mr Mitchell: Sorry, I am with Anglia in Grimsby.

Philip Fletcher: But Yorkshire Water, having failed very badly in the drought in the mid-1990s has actually raised its game, subject to your point about fiddling, very considerably on almost all fronts on consistent bases and is now setting the tone for the other companies in a way that benefits consumers. The leading company helps us drive efficiency for all the rest of them. We have looked, of course, at Sydney Water, as is also brought out in the NAO Report. Without taking anything away from the work they have done, it is worth nothing that their consumption is still around twice the level of consumption in England and Wales. They had a very bad position to start with.

Q135 Mr Mitchell: Let me stop you there. I can remember the day when Mark Thomas, the comedian, rolled up at Yorkshire Water during one of their periodic droughts with a tanker of water donated by Saudi Arabia, which I thought was a good gesture. It says in the Report that Yorkshire Water solves its problems by transfer of water within the area. I think at one time they were taking water from Kielder. It is also argued that that kind of link up is very expensive; too expensive, the impression is given, for it to be widely used. Which is the truth?

Philip Fletcher: Yorkshire Water was tankering water, which is about the most expensive way to do it. But that is necessary in a real crisis. At the same time they established a sort of emergency link, which is only for emergencies—it is not a fully robust standard link. Raising the wider question, what about a national grid that would enable the customers from the south-east to benefit from something coming from the north?

Q136 Mr Mitchell: That was certainly envisaged in the 1970s.

Philip Fletcher: It is interesting that in 1973 the then predecessor of the Environment Agency forecast all sorts of major engineering schemes. The only trouble was that it forecast double the level of demand that there is now. Demand has been pretty well constant for the past 10 years. However, we are not complacent; a lot of work is going on to strengthen supply. Last year, the Environment

Agency carried out a desk study to reappraise work done by its predecessors. That came up with the figure of some £16 billion to bring water from the north to the south. That is at least four times the cost of strengthening supply within the south if that proves necessary, possibly including a new west Oxfordshire reservoir.
Chairman: I have to stop you there.

Q137 Mr Williams: May I declare an interest, in that while I am in London I am a minor contributor to the profits of Thames Water. If, as a result of today's hearing, our Clerk gets his meter, will our witness ensure that a member of the serious fraud squad goes along to check its calibration? We do not want to see him penalised for undue influence.
Philip Fletcher: Mr Williams, on the whole, meters tend to under-record. It is a bit like the police setting the cameras just slightly over the speed limit in order to ensure that, if a fine is issued, there cannot be any quarrel as to whether the reading was the right or the wrong side of the line. The Clerk, like all metered customers, can be reassured that he is not being fiddled.
Mr Williams: That is interesting. I did not know that.
Philip Fletcher: There are checks to ensure that the companies are not fiddling. Apart from the criminal duty, the auditors owe a duty of care to Ofwat and a group of professional engineering consultants called reporters check independently for Ofwat and for the company on things such as metering and customer service issues. We are strengthening that now, in consequence of the nasty shock that we had on finding that some of the information provided by companies was less reliable and complete than it should have been.

Q138 Mr Williams: You made the point that before 2005, Thames spent £200 million on dealing with the problems of leaks and so on. Over how many years was that?
Philip Fletcher: Let me give you a very brief history. At the 1999 price review, Thames did not include any significant mains replacement plans. Following the significant deterioration of the mains, under pressure from us and from events, it embarked on a major programme of mains replacement, roughly from 2002-03 onwards. That had cost about £200 million by the start of the new regime in April 2005. Since then, it has been committed to a programme costing about £150 million a year, plus the extra £150 million that it has to cram into the five years at its own cost.

Q139 Mr Williams: So, effectively, the £200 million was similar to what you could have fined it over the same three years—£66 million a year.
Philip Fletcher: It was not subject to the statutory undertaking in the same way, but it was clearly necessary to deliver what we call serviceability, or to start to do so. That is, to ensure that the assets of the companies are maintained in a way that is not extravagant, but which maintains them as fit for purpose. Roughly, maintenance spending has doubled and more since the pre-privatisation period, when the Treasury's hand was on it all. We believe that it was entirely necessary that there was no extravagance in the maintenance programme. We monitored—
Chairman: You must keep your answers short. It is not fair on others.
Regina Finn: Also, we could not fine. We did not have the power to do so during that period.

Q140 Mr Williams: You could not have done it. I assume that the targets take account of the difficulties. You have made the point about the great difficulties faced by Thames, but it cannot use those as an excuse for not meeting targets because the targets take account of the difficulties.
Philip Fletcher: That is absolutely right, and it is a long way from achieving the long-term economic level of leakage, which will be achieved only when it has replaced a lot of mains.

Q141 Mr Williams: And it makes a profit of £347 million a year, I gather from the report.
Philip Fletcher: With a turnover of about £2 billion.

Q142 Mr Williams: That does not make sense, because it says here that you can have a fine of 10% of turnover and the fine could be £66 million, which makes the turnover £660 million.
Philip Fletcher: That shows me that my £2 billion was too high. It is about £1.2 billion. The fine can relate only to the relevant service.

Q143 Mr Williams: What does that mean?
Philip Fletcher: On the one hand, the drinking water service, and on the other hand, the waste water and sewerage service, which is roughly the same size again. We would be looking at an approximate turnover of £1.2 billion for Thames.

Q144 Mr Williams: For how many years has it failed to meet its targets?
Philip Fletcher: It has not hit its meter targets since 2000-01. We had to suspend its targets while it was in a mess and was frankly unable to set good targets because its data were simply not good enough. For the past three years, it has failed to meet its targets—that is up to and including 2005-06.

Q145 Mr Williams: And during this time have the directors received performance bonuses?
Philip Fletcher: I am sure that they have, but they have also been under an obligation. This relates to their company; we do not set performance bonuses for managers, because it is for the company to do so. They must be answerable to their owners, their shareholders and their customers for what is paid.

Q146 Mr Williams: Well, they are not answerable to their customers, because their customers cannot do a thing about it. We are talking about a company that has failed to reach its targets for all these years and that has been making massive profits—£347 million was the latest figure—for failing to do what you have told it to do, yet whose directors all get a

performance bonus. Could you provide us with written figures about the bonuses received by the directors? I am sure that you have that information available.[4]
Philip Fletcher: We have most of that information.

Q147 Mr Williams: It seems rather one-sided, does it not? The directors fail and get bonuses, whereas the public lose out and do not get any compensation. Should there not be some sort of scheme in the event of their letting their customers down? You say that they are answerable to their customers. Nothing would make them more answerable than having to give a 10% reduction in the bill, instead of a 10% reduction in turnover.
Philip Fletcher: There is such a mechanism.

Q148 Mr Williams: There is?
Philip Fletcher: There is indeed such a mechanism.

Q149 Mr Williams: Who operates it?
Philip Fletcher: It is operated by the company, subject to monitoring by Ofwat.

Q150 Mr Williams: Subject to monitoring by Ofwat, but Ofwat cannot tell them—
Philip Fletcher: Yes it can.

Q151 Mr Williams: Why haven't you?
Philip Fletcher: They are subject to certain standards of consumer performance, as I outlined in my reply to Ms Brooke. For example, if they interrupt the consumer, without giving proper warning, for a given period of hours, they owe that customer an amount of money. It is a small amount of money, but average bills are still less than £300. There is a signal that they have failed to deliver a good service to the customer.

Q152 Mr Williams: Well, you have this power to fine 10% and the power to influence compensation, so in future you could tell them that they have to use the 10% for a reduction in bills? That would be a fairer deal for the customer.
Philip Fletcher: There is always a balance to be drawn between the severity of the penalty and the demanding character of the targets set. The more demanding the target, the more it is reasonable for a company to say, "Well, give us a bit of a margin. For example, on leakage, allow for the fact that we might have a severe winter." We want to set the target in as demanding a way as possible and say that the winter is for the company to manage.

Q153 Mr Williams: But you have already said that the target takes account of the difficulties. Now you are saying that it does not.
Philip Fletcher: We are saying that when we are fining, for example, we would look at the circumstances. If we had a winter such as the one in 1962, which was severe and caused a lot of damage to the pipes beyond what could reasonably have been expected, I believe that a court would say, even if Ofwat did not, that that should be taken into account when setting a proportionate fine for a failure. We do not want to set targets that constantly allow a cushion or a great margin towards failure, as that would lead to soft targets. We would much prefer a demanding economic level of leakage target that suits the customers.

Q154 Mr Williams: On the other hand, in a good winter that means that the company makes more profits and therefore the directors get more bonuses. It seems a very one-directional arrangement. You talk in terms of the rights of the customer, but the customer has no rights whatsoever. They do not get any compensation yet the directors do not lose in any way and get bonuses whatever happens.
Philip Fletcher: The remedy under the section 19 legal undertaking directly benefited customers—unlike a fine, which would have gone to the Chancellor—in that it directly addressed the problem of excessive leakage through carrying out a major programme as fast as can practically be done to replace the mains. We believe that that approach conforms with the views of Professor Maccrory, who has written a report for the Government on suitable enforcement for regulatory failures, in that it is directed to remedying the problem rather than simply fining for the sake of it.

Q155 Mr Williams: Why have you been given the powers to award compensation if you do not use them?
Philip Fletcher: We do use them. They are used for failures of service by the company to the individual customer. It is an open policy and has, in some cases—

Q156 Mr Williams: So if you let enough down it does not matter, as you have addressed an individual case?
Philip Fletcher: Before our fining powers came into effect in April 2006, which was the first year we could really look at them, there were occasions the best part of a decade ago, for example in relation to Mid-Kent, when we had said as a result of using regulatory push that companies should give something back to the customers. Yorkshire did the same during the drought in the mid-90s. The regulator has informal powers that have been brought into play where the regulator has thought it appropriate. We believe that in respect of the fining power that is much more powerful and effective.

Q157 Mr Mitchell: We have some interesting figures in the supplementary briefing about the performance of water authorities in our own areas. In particular the figures make comparisons and Anglian Water,[5] which is the authority shared by the area represented by the Chairman and me, seems to be doing pretty well. Can you give us some comparative figures based on performance for each water authority—certainly for the bigger ones—and profitability? Can profitability be measured by some

[4] Ev 18

[5] Ev 19-23

common factor such as profit per gallon? We would like to be able to make comparisons between profitability and performance. Can those figures be supplied?

Q158 Chairman: Ms Finn, that concludes our hearing. This is a poor report and this has not been a good hearing for you. I am sure that our report will show that you have been lacklustre in your performance and particularly passive in your dealings with Thames Water. Customers who are paying ever larger bills will be furious at the amount of leakage. Apparently, every day the leaking pipes of water companies are wasting 3,500 million litres, which is enough water to fill more than 3,500 Olympic swimming pools every single day. I am sure that the Committee would like you, Sir John, to return to this matter in a couple of years to see what progress has been made. We would want to be reassured that Ofwat was asserting itself and putting the interests of consumers at the heart of its work. If you cannot deliver an improvement, Ms Finn, I am sure that in two years' time the Committee would want to turn to somebody who can.

Philip Fletcher: Can we just note that the report says: "Ofwat's approach to setting leakage targets is sensible and supported by 62% of consumers surveyed". If all the leakage were waste that would require zero leakage and bills would go up enormously.

Chairman: Nobody is expecting zero leakage from you. All I have said is that when consumers see that their bills are escalating and that 3,500 million litres of water is leaking away every day, they are entitled to be upset. Thank you very much.

Supplementary memorandum submitted by Ofwat

Question 146 (Mr Alan Williams): *Directors' renumeration*

The level of directors' remuneration including bonuses is a matter for each company to decide. It is the role of the independent remuneration committee (made up of independent non-executive directors) to set the policy for and level of directors' remuneration. Levels of remuneration for directors should be sufficient to attract individuals of the required quality, but should avoid paying more than is necessary.

The Water Act 2003 introduced a new requirement for all water companies to make a statement to Ofwat disclosing links between directors' pay and standards of performance. In order to ensure the links are subject to public challenge and scrutiny we require each company to provide this statement annually in its regulatory accounts. Prior to the 2003 Act we had provided companies' remuneration committees with a summary of annual performance as part of our monitoring processes.

The bonus scheme operated by Thames runs for the calendar year. The relevant extract from Thames' regulatory accounts for the period to 31 March 2006 is as follows:

Pay and Performance Arrangements. Executive Directors' Bonuses for the Period

The structure and design of the directors' bonus scheme (the Scheme) is determined by the ultimate parent company, RWE AG. The Remuneration Committee approved the application of the Scheme in November 2004. The Scheme year ran from 1 January 2005 to 31 December 2005. As explained in the Remuneration Report on page 21, the Scheme does not include non-executive directors, The Scheme has two measures:

— Financial targets, based on the financial performance for the 2005 calendar year. Split equally between Free Cash Flow 1 and Value Contribution, these represent at least 50% of the total bonus achievable. The total of the two components is reported in the table below.

— A personal performance element, representing up to 50% of the bonus achievable.

Performance against these targets are provisionally assessed by the Managing Director and the Human Resources Director and then noted or approved by the Remuneration Committee. It is intended that in 2006 the Scheme will be amended to include operational targets.

	Financial performance as % of base salary	*Personal performance as % of base salary*	*Percentage of base pay*	*Bonus awarded*
R Aylard	15.60%	19.80%	35.4%	£16,35
W U Bottcher	26.63%	12.18%	38.8%	£93,843
S J Buck	15.60%	18.00%	33.6%	£47,880
J M England	15.60%	15.00%	30.6%	£49,572
S C Walker	15.60%	20.00%	35.6%	£18,583

Questions 27 (Mr Sadiq Khan), 109 (Annette Brooke) and 157 (Mr Austin Mitchell): *Water companies' profits*

Background

Ofwat has a duty to secure that efficient companies are able to finance the proper carrying out of their functions as licensed undertakers.

Since privatisation the water companies have been required to invest heavily to maintain current services and meet new obligations which have significantly improved the quality of the water and the environment. The main reason for the increase in price limits determined for the five years 2005–10 was the need for a very large investment programme (an estimated £16.8 billion)—on top of the £50 billion or so invested since 1990. In order to finance this investment the water companies are required to attract and reward investors who have a choice as to where they are prepared to provide capital. The return on capital in price limits is our assessment of the level of return that investors will accept for providing capital to the water sector.

The profit figure most often quoted in companies' results and also shown in Ofwat's "Financial Performance and Expenditure" reports is current cost operating profit. This is the level of profit available for companies to meet tax charges and make payments (both interest and dividends) to the providers of capital. The industry reported current cost operating profit in 2005–06 was £2.577 billion an increase of £382 million compared to the figure of £2,195 billion reported in 2004–05. (See also Table 1 below).

In absolute terms the level of current cost operating profit will increase year on year where companies' regulatory capital values are growing due to investment requirements, provided a company has been efficient in its operations. This is because the company is required to pay a return on the larger absolute amount of capital provided. The regulatory capital value for the sector is expected to increase from £39.1 billion at 2005–06 to £43.5 billion by 2009–10. There are other factors affecting the level of profit in 2005–06 compared to 2004–05.

The profits reported in 2005–06 were for the first year of the five-year price limits set in December 2004. The new price limits reflect a step change in certain unavoidable costs such as wholesale energy prices which had increased markedly from the assumptions made in 1999 when previous price limits were set. Taken in isolation, this will lead to a step change in profits relative to those reported when the increased costs were being borne by the companies. Other factors will also affect actual reported profits in a particular year including the companies' outturn revenues and depreciation charges.

In addition the price limits allowed for the impact of higher levels of tax in the water sector arising from changes made by Her Majesty's Revenue and Customs (HMRC) to the treatment of certain types of expenditure for tax purposes. This is a very significant factor affecting the level of operating profit (which is a pre tax measure) in 2005–06 compared to 2004–05. We expand on this point below.

Profits and Returns Reported in 2005–06

Table 1

FINANCIAL PROJECTIONS 2004–05 AND 2005–06

	Current cost profit and loss account (£ billion)			
2005–06 prices	*2004–05 Expected 1999 review*	*2004–05 Actual*	*2005–06 Expected 2004 review*	*2005–06 Actual*
Turnover	7.314	7.520	8.162	8.228
Operating expenditure	2.904	3.056	3.227	3.196
Current cost depreciation	1.526	1.839	1.846	1.830
Infrastructure renewals charge	0.445	0.486	0.615	0.643
Current cost operating profit	2.454	2.195	2.487	2.577
Regulatory capital value (average)	37.386	37.256	39.147	39.147
Return on capital (pre-tax)	6.5%	5.9%	6.4%	6.6%

As Table 1 above shows, under the new price limits an increase in current cost operating profits was always expected in 2005–06 compared to reported levels in 2004–05. Companies actual reported profits were marginally higher at £2.577 billion compared to the expectation when price limits were set of £2.487 billion (£90 million or 3.6% higher than expected). Actual current cost operating profits for 2005–06 for each company are set out in Table 2 below.

Table 2

CURRENT COST OPERATING PROFIT BY COMPANY 2005–06

	£m
Water and sewerage companies	
Anglian	257.6
Dwr Cymru	169.3
Northumbrian	171.5
Severn Trent	358.5
South West	97.7
Southern	163.0
Thames	386.1[1]
United Utilities	412.1
Wessex	133.8
Yorkshire	234.1
Total WaSCs	2,383.6
Water only companies	
Bournemouth & W Hampshire	9.0
Bristol	17.8
Cambridge	3.9
Dee Valley	3.3
Folkestone & Dover	5.2
Mid Kent	13.6
Portsmouth	5.7
South East	42.6
South Staffordshire	16.4
Sutton & East Surrey	9.8
Tendring Hundred	5.8
Three Valleys	60.3
Total WoCs	193.4
Total Industry	2,577.0

The industry total reported current cost operating profit for 2005–06 at £2.577 billion is £382 million higher than reported in 2004–05 (£2.195 billion). A very significant part (around 60%) of this increase arises from higher current taxation charges in 2005–06. Current taxation increased by £233 million from £64 million to £297 million in 2005–06. The increase was mainly caused by changes in the industry's current agreements with HMRC, which Ofwat reflected in price limits as a legitimate business cost. Current cost operating profit after current tax in 2005–06 at £2.280 billion is £149 million higher than reported in 2004–05 at £2.131 billion.

The most normal way of comparing profits to scale is to show profits as a percentage of capital employed. In the water sector capital employed is represented by companies' regulatory capital values. To show profits per gallon could mislead because it does not relate companies' profits to the underlying investment requirements—the very reason that Ofwat needs to allow for profits in companies' revenue requirement. However, for completeness sake we provide this information in table 3 below.

Table 3 shows the element of operating profit relating to the water service and the equivalent profit per litre of water supplied. Water supplied includes both potable and non-potable water but is net of distribution losses and leakage.

Table 3

CURRENT COST OPERATING PROFIT FOR WATER ONLY AND PROFIT PER LITRE OF WATER DELIVERED

	Water operating profit (£m)	*Water delivered (megalitres per annum)*	*Operating profit per litre of water delivered (pence)*
Water and sewerage companies			
Anglian	119.3	424,681	0.028
Dwr Cymru	55.3	316,094	0.017

[1] Mr Khan made reference to a profit figure of £347 million for Thames Water. This is the 2005–06 figure reported for Thames Water Utilities Limited (including non appointed business) for historic cost profit before taxation. As well as reporting historic costs rather than current costs this measure of profit is after interest charges.

	Water operating profit (£m)	Water delivered (megalitres per annum)	Operating profit per litre of water delivered (pence)
Northumbrian	86.9	434,197	0.020
Severn Trent	153.2	710,421	0.022
South West	31.2	164,195	0.019
Southern	18.8	212,299	0.009
Thames	167.8	1,022,223	0.016
United Utilities	186.9	707991	0.026
Wessex	36	135,295	0.027
Yorkshire	104.7	472,514	0.022
Total WaSCs	960.1	4,599,909	0.021
Water only companies			
Bournemouth & W Hampshire	9	57,674	0.016
Bristol	17.8	105,215	0.017
Cambridge	3.9	27,419	0.014
Dee Valley	3.3	25,181	0.013
Folkestone & Dover	5.2	16,403	0.032
Mid Kent	13.6	59,243	0.023
Portsmouth	5.7	65,284	0.009
South East	42.6	140,547	0.030
South Staffordshire	16.4	120,311	0.014
Sutton and East Surrey	9.8	58,141	0.017
Tendring Hundred	5.8	11,045	0.053
Three Valleys	60.3	318,539	0.019
Total WoCs	193.4	1,005,002	0.019
Industry	1,153.5	5,604,911	0.021

We compare companies' returns in our annual Financial Performance and Expenditure report. These are reproduced for 2005–06 in Table 4 overleaf.

Table 4

2005–06 RETURN ON CAPITAL MEASURED BY REGULATORY CAPITAL VALUE BY COMPANY

Company	*Profit before tax (£m)*	*Average regulatory capital value (£m)*	*Return on capital employed (%)*
Water and sewerage companies			
Anglian	257.6	4,452.2	5.8
Dwr Cymru	169.3	2,947.2	5.7
Northumbrian	171.5	2,550.2	6.7
Severn Trent	358.5	5,177.5	6.9
South West	97.7	2,026.9	4.8
Southern	163.0	2,435.6	6.7
Thames	386.1	5,694.5	6.8
Utilities	412.1	6,217.3	6.6
Wessex	133.8	1,782.1	7.5
Yorkshire	234.1	3,560.4	6.6
Total WaSCs	2383.6	36,843.8	6.5
Water only companies			
Bournemouth &W Hampshire	9.0	123.0	7.3
Bristol	17.8	230.1	7.7
Cambridge	3.9	49.3	7.9
Dee Valley	3.3	52.1	6.3
Folkestone & Dover	5.2	56.2	9.2
Mid Kent	13.6	202.9	6.7
Portsmouth	5.7	95.1	5.9
South East	42.6	494.0	8.6
South Staffordshire	16.4	178.8	9.2
Sutton & East Surrey	9.8	139.0	7.1
Tendring Hundred	5.8	52.3	11.2

Company	Profit before tax (£m)	Average regulatory capital value (£m)	Return on capital employed (%)
Three Valleys	60.3	630.2	9.6
Total WoCs	193.4	2,303.0	8.4
Industry	2,577.0	39,146.8	6.6

For 2005–06 the pre tax return on capital for the industry in 2005–06 was 6.6% compared to 6.4% assumed in price limits in 2005–06.

It is too early to conclude whether this reflects genuine outperformance—some companies face a stiff challenge to deliver the outputs expected of them. If water companies do continue to outperform Ofwat's assumptions this will be taken into account when we set price limits in 2009 through the rolling incentive mechanism. It will produce new more demanding efficiency benchmarks and thereby result in customers paying less, because it will enable Ofwat to justify lower price limits than otherwise could have been set.

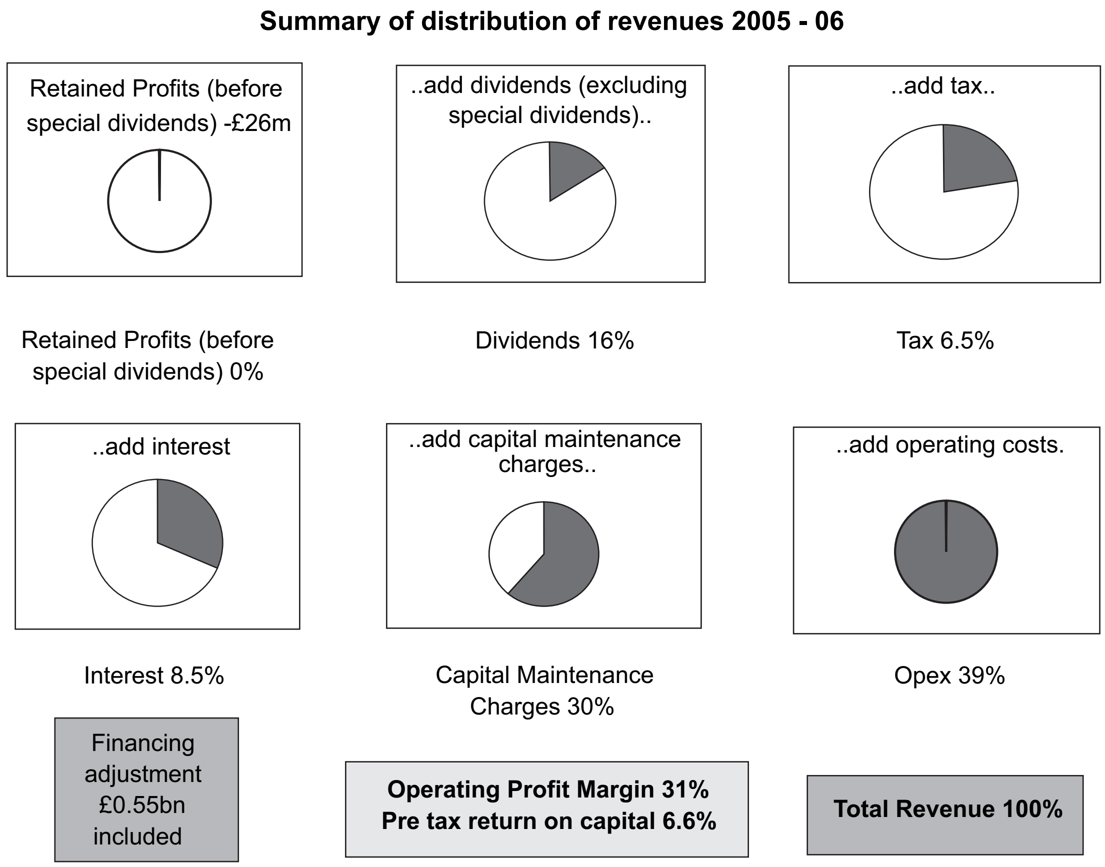
Where Do Profits Go—2005–06 Example

In 2005–06 companies had earnings before interest, tax, depreciation and amortisation (EBITDA) of £5.032 billion. £2.473 billion of this is accounted for by capital charges (depreciation and the infrastructure renewals charge). After very small adjustments (+ £0.018 million) for operating income and working capital this gives the £2.577 billion current cost operating profit for the industry shown in Tables 1 and 2 above. Companies used £1.289 billion to pay interest charges and had other income of £0.011 billion leaving £1.299 billion.

A financing adjustment of +£0.554 billion leaves profit before tax of £1.853 billion (ie profit attributable to shareholders). The financing adjustment reflects the impact of general inflation on the value of net finance. Of this profit attributable to shareholders, £0.550 billion was used to meet tax charges, (made up of £0.297 billion current taxation and £0.253 billion deferred taxation). A further £1.329 billion was used to pay dividends (excluding £0.313 billion special dividends) to shareholders as a return for investing capital in the company. It is therefore comparable to paying interest to banks that are lending money to water companies. The balance of −£0.026 billion will impact very marginally on reserves.

This is illustrated in the pie charts below.

Annex 1



PROFITS AND PERFORMANCE—WITH EXAMPLES FROM 2006–07

It is a fundamental principle underpinning incentive based regulation that companies are not guaranteed a return equal to the allowed cost of capital nor prohibited from making a higher return; ie profits and the companies' return on capital will be linked to performance. For example, a poorly managed water company might earn a return lower than the cost of capital either because it underperformed our assumptions on efficiency savings or because it had to undertake additional capital investment that had not been funded in price limits.

Companies' profits will also be affected if the company has to bear additional unavoidable costs not allowed for in price limits that may not be linked to poor performance, for example higher energy prices—as described earlier.

For 2006–07 the interim results show that for some companies operational and performance issues have had a significant impact on half year results. The full year results and in particular the regulatory accounts for the full year 2006–07 due to be submitted to Ofwat in July 2007 will be more informative on this.

The 2006–07 interim results show that whilst operating profits have increased for most companies (by 9.2% on average) to allow companies to finance growth in their regulated capital values, some companies have reported lower operating profits compared to the same period for 2005–06.

Thus, Thames Water Utilities Limited reported a fall in operating profit of 16.9% in its interim results (for the six month period ending 30 September 2006) to £201.7 million (from £242.6 million) due principally to higher operating costs. The increase in operating costs reported is attributable to drought management, fuel costs and an increased provision for renewal of infrastructure assets in the coming five year period. Some of this increased provision may be the result of the additional capital investment that Thames is committed to undertake, at shareholders expense, to address leakage and security of supply issues.

For Severn Trent Water operating profits reported in its interim results are 6.1% lower than in the previous comparable period—down from £240.2 million to £225.6 million. Like Thames some of this lower profit is the result of higher energy costs that are impacting on the sector as a whole. For Severn Trent other factors giving rise to the lower profit include rebates to customers following Ofwat's interim report on allegations of false reporting (March 2006) and management's decision to invest in leakage reduction and customer service levels to remedy poor performance in these areas.

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