



House of Commons
Environment, Food and Rural
Affairs Committee

Draft Water Bill

Sixth Report of Session 2012–13

Volume I

Volume I: Report, together with formal minutes, oral and written evidence

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The Environment, Food and Rural Affairs Committee

The Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Environment, Food and Rural Affairs (Defra) and its associated public bodies.

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Summary

We and our predecessor Committees have scrutinised subjects of water resource management and flooding over a number of years. During the course of this inquiry, the critical importance of managing water effectively was thrown into sharp relief. The country suffered first widespread drought and then several episodes of flooding during 2012. Successive Governments commissioned detailed reviews of these issues to help inform policy development—principally Sir Michael Pitt’s review of the 2007 summer floods and the Cave and Walker reviews on competition in water supply and water efficiency. Following those reports the Flood and Water Management Act, enacted in 2010, reflected the need for better management of scarce water resources and improved resilience in the face of more frequent and devastating flood events. Our views on the Draft Water Bill have been informed by our earlier work and, most recently, our scrutiny of the *Water for Life* White Paper.

The Water Bill that follows from the draft Bill is unlikely to become law before the end of 2013. It will provide a framework with much of the detail of how its provisions will work in practice left to guidance and secondary legislation. Whilst Governments argue that the limited Parliamentary time available means that it is reasonable to provide only the outline legislative framework necessary to implement a particular policy, we consider that primary legislation should provide enough detail and clarity of purpose in order to allow effective scrutiny. We consider that, as it stands, the Draft Water Bill relies too heavily on establishing the broad framework for future reforms whilst leaving the details to be set out in guidance with the likelihood that these will receive less scrutiny. We highlight parts of the draft legislation where amendment is necessary to provide greater clarity and, where appropriate, recommend that guidance be published at the same time as the Bill.

The water sector is heavily reliant on investment and this in turn has an impact on the industry’s costs and hence the charges it makes to customers. Uncertainty in the proposed legislation may have an impact on the way investors view the water industry, leading to increased financing costs. We consider that provision of greater clarity on the face of the Bill will not compromise the industry’s ability to attract investment, rather it will provide the certainty needed by those planning to invest. Nevertheless, where we have recommended amendments to the legislation, we have been conscious of the impact on investor confidence and any potential impact on the costs paid by household and business customers.

The majority of the Draft Bill’s provisions relate to increasing the opportunities for competition within the water sector which should provide improvements for customers. Business customers have been pressing for greater competition for some years and are understandably keen that the reforms maintain momentum. We welcome the Government’s commitment to opening the retail market in 2017 but the Bill must make clear that householders will be protected from cross-subsidising the business market. We carefully considered the case for introducing reform in the upstream water market but conclude that further work is needed before the Government embarks on this stage of reform. An essential precondition of upstream reform is that customers are protected from any de-averaging of prices.

We are disappointed that Defra has not brought forward for legislation the breadth of proposals that were included in *Water for Life*. In particular we considered the arguments for and against including in this Bill framework legislation to reform the abstraction regime. Whilst we are not pressing for such provisions to be on the face of the Bill, abstraction reform is an important objective and the Government must demonstrate how it will be achieved by the target date of 2022. We do not consider it appropriate for the details of abstraction reform to be left to secondary legislation and the necessary provisions should be included in the primary legislation that Defra intends to introduce in 2015. Similarly, we were disappointed that the Draft Bill does not provide provisions to improve resilience, either in relation to flood defence or tackling water stress.

Given increasing pressure on water resources we were not persuaded by Ofwat's arguments that the duty to encourage sustainable development should not be elevated to primary status. We therefore recommend that the Bill include provisions to elevate the pursuit of sustainable development to a primary duty of the Regulator.

We restate in this report our concerns about successive Governments' failure to implement several of the recommendations in the Pitt Review and certain provisions in the Flood and Water Management Act 2010, in particular provisions relating to sustainable drainage systems, reservoirs and the provision of household flood insurance. We also urge the Government to implement existing provisions relating to bad debt and those which encourage greater use of water meters since these would lower customers' water bills.

1 Introduction

1. The Draft Water Bill,¹ published in July 2012, sets out legislative provisions to take forward the Coalition Government's plans for the water sector particularly as they relate to increasing competition.² The Draft Bill builds on proposals set out in the Water White Paper, *Water for Life*, published in December 2011.³ *Water for Life* considered how water resources should be managed in the face of the twin challenges of climate change and population growth and on the previous Government's reviews of the water sector carried out by Professor Martin Cave⁴ and Anna Walker.⁵

2. The Government's intention is that the Water Bill will be introduced in the next Session, which starts in May 2013. It is therefore likely that a new Water Act will not be enacted until the Autumn at the earliest. The Draft Water Bill document comprises 207 pages, 130 of which consist of the draft legislative provisions. The remainder of the document provides an explanation of the draft clauses and schedules and sets out the Government's intentions behind the provisions. In this report we have indicated where we consider amendments to the provisions are necessary but have not set out the text of amendments.

3. In July 2012 we invited written submissions on pre-legislative scrutiny of the Draft Bill. We received 45 written submissions and held four oral evidence sessions in October and November 2012, hearing from incumbent water companies, potential new entrants, consumers, the industry regulator Ofwat, Moody's Investors Service, Blueprint for Water, and Richard Benyon MP, Parliamentary Under-Secretary of State for Natural Environment, Water, and Rural Affairs, Defra.⁶ We are grateful to all who provided written and oral evidence to our inquiry.

Previous work by the Committee

4. In the previous Parliament our predecessor Committee conducted several inquiries into flood and water management issues, including a report on the summer 2007 floods; the 2009 Ofwat price review and pre-legislative scrutiny of the draft Flood and Water Management Bill.⁷ In this Parliament we have published two reports on water policy: *Future Flood and Water Management Legislation*,⁸ and *The Water White Paper*.⁹

1 Department for Environment, food and Rural Affairs, *Draft Water Bill*, Cm 8375, July 2012

2 One specific proposal in the White Paper, a reduction in bills for customers in the South West, has already been taken forward by the Water Industry (Financial Assistance) Act 2012.

3 Department for Environment, food and Rural Affairs, *Water for Life*, Cm 8230, December 2011

4 Professor Martin Cave, Independent Review of Competition and Innovation in Water Markets; Final Report, April 2009

5 Anna Walker, The Independent Review of Charging for Household Water and Sewerage Services: Final Report, December 2009

6 A full list of those individuals and organisations who provided oral evidence to the inquiry is appended to this report.

7 Environment, Food and Rural Affairs Committee, Fifth Report of Session 2007-08, *Flooding*, HC 49-I; Environment, Food and Rural Affairs Committee, Fifth Report of Session 2008-09, *Ofwat Price Review 2009*, HC 554-I; Environment, Food and Rural Affairs Committee, Sixth Report of Session 2008-09, *The Draft Flood and Water Management Bill*, HC 555-I

8 Environment, Food and Rural Affairs Committee, First Report of Session 2010-12, *Future flood and water management legislation*, HC 522-I

5. In this report we have made a number of recommendations relating to issues that were included in the White Paper but are not covered by the Draft Bill, including: reform of the abstraction regime, water metering and water affordability. We have also raised a number of issues which have concerned us for several years. In *Flooding*, published in May 2008, our predecessor Committee urged the Government to implement the Pitt Review's recommendations in full and to bring forward the appropriate legislation. We continued to press for the action in our pre-legislative scrutiny of the draft Flood and Water Management Bill and in *Future Flood and Water Management Legislation*, published in December 2010, we highlighted the importance of the Government implementing the outstanding Pitt Review recommendations. Now, in 2013, several of those recommendations, such as those relating to risk-based standards for public sewerage systems and unifying flooding legislation in a single Act remain unimplemented.

6. Some recommendations made in the Pitt Review have not yet been fully implemented.¹⁰ For example, several of the Shoreline Management Plans, which contribute to the Environment Agency's national overview of flood risk, and local authority local flood Risk Management Strategies have not yet been signed off. We are also concerned that local government and the Environment Agency do not pay sufficient attention to dredging and maintenance of water courses, which can have a significant impact on the risk of flooding. We will explore these issues in more detail when we take evidence of flood funding later this year. Our colleagues on the Science and Technology Committee reported in February 2012 that: "It is of great concern to us that scientific advances in weather forecasting and the associated public benefits (particular in regard to severe weather warnings) are ready and waiting but are being held back by insufficient supercomputing capacity";¹¹ another Pitt recommendation that has not been fully implemented. Similarly, we have pressed the Government on its failure to commence provisions in the Flood and Water Management Act 2010. Several of those provisions are still not in force, including those related to the automatic right to connect to the public sewerage system, dam and reservoir safety and Sustainable Drainage Systems (SuDs). We discuss issues relating to reservoir safety and in SuDs later in this report. **We find it frustrating that successive Governments have lacked the tenacity and resolution to implement important recommendations outstanding from the Pitt Review and provisions in the Flood and Water Management Act 2010. That frustration is made more acute as legislative time is a scarce resource. We recommend that Defra set out in its response a full list of the outstanding issues from the Pitt Review and Flood and Water Management Act together with a clear timetable for their full implementation.**

9 Environment, Food and Rural Affairs Committee, Second Report of Session 2012–13, *The Water White Paper*, HC 374

10 See The Government's Response to Sir Michael Pitt's Review of the summer 2007 Floods: Final Progress Report, 27 January 2012; <http://www.defra.gov.uk/publications/files/2012-01-31-pb13705-pitt-review-progress.pdf> and Flood & Water Management Act 2010, Progress Report on Implementation, December 2012; <http://www.defra.gov.uk/publications/files/pb13844-fwma-progress-report201212.pdf>

11 Science and Technology Committee, Thirteenth Report of Session 2010-12, *Science in the Met Office*, HC 1538

2 Enabling legislation

7. Increased competition is a central theme of the Water White Paper and the Draft Bill. The majority of Part 1 of the Draft Bill and five of the seven Schedules, relate to establishing the overarching framework under which the competitive market would operate. Many of our witnesses considered that there was insufficient detail in the draft provisions and that they were therefore limited in the extent to which they could comment on their likely effectiveness. For example, Southern Water Services Ltd commented that “many of the key proposals around market reform set out in the Draft Bill are in the form of ‘enabling’ legislation with detail to be developed subsequently [...] Until we see that detail it is impossible for us to know whether the end result will be workable, clear or efficient”.¹² Similarly, Water UK said that it was “difficult to know at this stage whether the proposals will be workable and efficient, or whether they will have unintended consequences”.¹³

8. The detailed rules for the operation of the competitive market will be drafted by the water industry regulator, Ofwat. For example, Schedule 2 to the Draft Bill provides that Ofwat may publish rules about the charges that new entrants will pay to receive a wholesale supply of water from an incumbent. The same Schedule includes the provision that the Secretary of State and Welsh Ministers may issue guidance on the contents of those charging rules. According to our witnesses the substance of that guidance will be vital to determine with clarity and certainty the final shape of the competitive market, particularly in areas where a clear policy steer to the regulator would be required (such as the abolition of the costs principle and regional de-averaging of prices, both of which we discuss further below). At present, under Schedule 2 this guidance must be laid before both Houses of Parliament.¹⁴ The Minister referred to it as “statutory guidance”¹⁵ but as drafted, the Bill appears to provide no mechanism by which Parliament could formally accept or reject the contents of the guidance. **We recommend that the Draft Bill be amended to make clear that guidance produced by the Secretary of State and Welsh Ministers on charging rules will be laid before Parliament for scrutiny and subject to the affirmative resolution procedure. We further recommend that this guidance should be published in draft alongside the Water Bill itself to maximise transparency and to inform debate on the Bill.** In this report we have considered key issues for which witnesses considered the policy intention should be set out in the primary legislation, rather than in guidance.

12 Ev w42

13 Ev 96

14 *Draft Water Bill*, Clause 15

15 Q 278

3 Market reform

9. In *Water for Life* Defra proposed increasing competition in the water market with the intention of improving efficiency and ultimately lowering bills for customers. At present, the water sector in England and Wales consists of 21 vertically integrated, regional monopoly, water only or water and sewerage companies. With limited exceptions for very large users of water, customers are unable to switch their water supplier. The lack of competition, it is argued, hinders innovation and efficiency, and can be time-consuming and expensive for businesses with several premises across the country who have to process multiple bills from different water suppliers.

10. Clause 3 of the Draft Bill enables a Minister, by order made by statutory instrument, to remove the existing 50 megalitre threshold at which non-household users are able to switch their water supplier.¹⁶ This change would increase the size of the potential market and make it more attractive to new entrants.¹⁷ There are a number of other provisions designed to reduce the barriers to new entrants to the market, such as a reduced regulatory burden through the introduction of charging rules and market codes, and the removal of the requirement for new entrants to establish a separate ring-fenced limited company before entering the market.¹⁸

11. Provisions in Clause 1 and Schedule 1 introduce competition to the “upstream” end of the supply chain. This would enable new entrants to provide raw or treated water into an incumbent’s network without being obliged (as is currently the case) to provide retail services to customers. Schedule 1 would also remove some of the restrictions on access to water companies’ treatment and storage systems and allow new entrants to provide their own network and retail infrastructure. Clause 4 and Schedule 3 provide for a similar licensing regime to the sewerage system.

12. There was broad agreement from our witnesses about the Draft Bill’s overall approach to reforming the retail market, although concerns were raised about particular aspects of the proposals. In contrast, witnesses identified a host of difficulties with proposals for the upstream reforms, questioning both the policy intention behind them and the practicalities of their implementation.

Retail reforms

13. In 2008 the then Government commissioned Professor Martin Cave to report on competition in the water sector. His report, published in April 2009, recommended significant changes to encourage competition and allow non-household customers greater choice over their supplier.¹⁹ In Scotland there has been a competitive retail water market for non-household customers since 2008.²⁰ Scottish Procurement, the body responsible for

16 The threshold requirement would remain in Wales unless and until new licensing arrangements are fully commenced in Wales.

17 The Welsh Government’s current policy is for the existing 50 million litre a year threshold to be retained in Wales.

18 *Draft Water Bill*, p18

19 Professor Martin Cave, *Independent Review of Competition in Water Markets; Final Report*, April 2009

20 Retail competition in Scotland was introduced through the *Water Services etc. (Scotland) Act 2005*

public sector procurement in Scotland, told us that the Scottish public sector (which makes up approximately 20% of the Scottish competitive market for water),²¹ is on track to save up to £25 million over the first three years of tendering for its water supply.²² Alongside these financial benefits, Scottish Procurement also highlighted the non-monetary advantages of competition, including improved service levels and sustainability benefits.²³

14. It is clear that there is widespread support from customers for the introduction of retail competition. Network Rail told us that since the introduction of competition in Scotland they have seen a “significant improvement” in the service they receive and they looked forward to being able to choose their supplier in England as well.²⁴ The Federation of Small Businesses said that it has been campaigning for greater competition “for some time”,²⁵ and Greene King and Asda were also supportive.²⁶ Water companies were also in favour of the Government’s policy intention, with Water UK stating that it “fully supports giving choice to business customers... companies are committed to being an active partner in making this a reality”.²⁷ Nonetheless, concerns were raised about particular aspects of the proposed reforms, and we explore these below.

Abolition of the Costs Principle

15. Under the current regime, new entrants to the market wishing to purchase water for retail must apply separately to each incumbent water company from whom they wish to purchase a wholesale supply and negotiate a price using the “costs principle”. The costs principle follows a “retail minus” approach in which the discount provided to retailers is determined by calculating what portion of the incumbent company’s costs could reasonably be avoided, reduced, or recovered in some other way (known as “ARROW” costs). Any additional costs that the incumbent will incur in providing access to the retailer are set against the ARROW costs to determine the final price of the wholesale supply.

16. Introduced to ensure that household customers do not end up subsidising businesses, the costs principle has been criticised for providing little incentive to incumbent water companies to become more efficient.²⁸ The complexities involved in negotiating separately with multiple wholesalers acts as a further barrier to new entrants. Schedule 2 would replace the costs principle with a wholesale access pricing regime, with charging rules to be developed by Ofwat. Whilst generally in agreement with the decision to abolish the costs principle, the evidence we received drew attention to the potential for the new approach to bring its own problems. The Consumer Council for Water recognised that the existence of the costs principle had constrained competition, but noted that this was at least in part because of its role in protecting household customers. The Consumer Council for Water

21 Q 66

22 Q 84

23 Ev 88

24 Ev w80

25 Ev w14

26 Ev w21, w4

27 Ev 99

28 See, for example, the discussion in Professor Martin Cave’s interim report on Competition and Innovation in Water Markets, pp 78-80.

believed that “it should be possible to identify a different way of setting access prices in a way that does not [act to] the detriment of domestic customers”,²⁹ and that “it must be the regulator’s job to make sure that happens.”³⁰ The Council considered that the Bill should make clear that the abolition of the costs principle must not lead to the household sector subsidising costs in the contestable non-household market, and suggested that the Draft Bill be amended to reflect this.³¹ Ofwat told us that their existing primary duty to protect the interests of customers meant that they would “not be in the business of replacing the costs principle with something that is bad for customers... we already have that safeguard.”³² The regulator was cautious about including further protection on the face of the Bill, noting that the cost principle’s existing status in primary legislation had made it very difficult to change it when it was found to be inefficient, and that consequently “we need to be very careful what we write on the face of the Bill.”³³ Defra shared Ofwat’s view, telling us that they “did not feel that it needs to be on the face of the Bill”, but that “it would certainly be in statutory guidance”.³⁴

17. We believe that protecting householders from subsidising competition in the non-household sector is a fundamental principle that should be enshrined in primary legislation. We recommend that the Draft Bill be amended to reflect this. We are not convinced by the argument that such a course of action would be likely to present similar problems of inflexibility as have emerged in relation to the existing costs principle, as the Bill’s wording need not set out in detail the regulatory mechanism by which this aim should be achieved and could thus afford flexibility to the regulator.

Establishing a level playing field

18. If new entrants are to be encouraged to enter the market, it is essential that they have confidence that they will not receive unfavourable terms or treatment from the incumbent water companies upon which they will, at least in the first instance, rely for the wholesale supply of water. New entrants will be competing directly against the incumbent’s retail business, and as the incumbent companies will continue to control the wholesale supply of water, there is naturally a danger that they will discriminate against new entrants to protect their own interests. One way to achieve a level playing field between new entrants and incumbent companies would be to require the legal separation of incumbents’ retail arms. This was recommended by Professor Martin Cave in his Independent Review of Competition and Innovation in Water Markets, but Defra subsequently made clear in the Water White Paper that they had decided against requiring legal separation in response to concern that structural change to the industry could unsettle investor confidence.³⁵ Instead,

29 Q 69

30 Q 71

31 Q 69

32 Q 119

33 Q 119

34 Q 324

35 *Water for Life*, p70

they would rely on Ofwat to police non-discrimination via regulatory means.³⁶ The Draft Bill has not departed from this approach.

19. Business Stream, a potential new entrant to the retail market, expressed concern that the Draft Bill was not sufficiently robust in its approach to ensuring a level playing field. In particular, they highlighted the absence of any significant mention of non-discrimination and a lack of clarity over what the separation requirements would be in the absence of legal separation.³⁷ The company told us that:

The principle should be that, as a new entrant, I should be able to access exactly the same terms, pricing and service levels as their incumbent company. In terms of communication, the way people interact within that integrated water company needs to be considered. They cannot be able to access back doors and other channels that I, as a new entrant, do not have.³⁸

Business Stream argued that, if the separation requirements were not clear from the start, “we will end up with multiple claims in the competition courts or to the regulator that are lengthy, costly and burdensome, and customers will not get benefits”.³⁹ Ofwat told us that in regulating the market they would require “demonstrable Chinese walls between the retail and wholesale arms within an incumbent”.⁴⁰

20. We considered the issue of separation in our report on the Water White Paper and concluded that Defra should consider including a requirement for functional separation in the Draft Bill.⁴¹ The evidence we have received in the course of pre-legislative scrutiny has reinforced our view that, in the absence of legal separation, every effort must be made to reassure new entrants that they will compete on a level playing field. We do not doubt Ofwat’s assurances that they will seek to achieve this through regulation, but we believe that it is a principle of sufficient importance that it should be included on the face of the Bill itself. **We recommend that the Draft Bill be amended to include a requirement for the functional separation of incumbent companies’ wholesale and retail arms. We further recommend that the principle of non-discrimination be included on the face of the Bill.**

Exiting the retail market

21. A natural consequence of competition is that whilst some companies will thrive, others will be less successful. Those incumbent companies with less efficient retail arms may decide that they would be better served by exiting the retail market and focusing on their wholesale operations. At present, however, they are obliged under the terms of their licences to continue to offer a retail service.

36 *Ibid*, p72

37 Ev 74

38 Q 227

39 Q 222

40 Q 115

41 HC (2012-13) 374, para 78

22. In our report on the Water White Paper, in response to concerns raised by both the English and Scottish regulators and water companies themselves, we recommended that the Government should include a clause in the Draft Bill allowing incumbents to exit the retail market, should they wish to do so.⁴² In coming to this conclusion, we were particularly struck by Ofwat’s view that allowing such a mechanism would be an important factor in achieving a “well-functioning” and “dynamic” market. In the event, the Government rejected our recommendation and the Draft Bill is silent on establishing an exit route.

23. It became apparent in the course of this inquiry that there is little support for the Government’s position. Again, both regulators pressed for the inclusion of an exit route.⁴³ Perhaps more strikingly, incumbent companies and new entrants were united in calling for the Bill to include an exit clause.⁴⁴ We put it to the Minister that the Department appeared to be alone in its view and he told us that allowing a company to exit could be a “seismic shift” in the structure of the industry and risked unsettling investors.⁴⁵

24. Given the weight of evidence from regulators, incumbent water companies and new entrants we are not persuaded by the Minister’s arguments. In particular, we cannot accept that allowing voluntary exits would unsettle investors given that a water company would have no reason to act against its own interests by choosing to exit the retail market if this would have an adverse impact on investor confidence. **We recommend that the Bill include provisions to enable incumbent companies to voluntarily exit the retail market.**

Timescale for retail reform

25. The introduction of a competitive retail market is long overdue. The Major Energy Users Council told us that “customers... have waited many years for full-scale retail water competition”,⁴⁶ and that there was a “real appetite” amongst its members to be able to choose supplier, with poor levels of customer service giving rise to an “urgent demand for retail competition”.⁴⁷ Whilst the provisions in the Draft Bill are a start, the vast majority of the work needed to implement reform will fall to regulators and water companies. The likely timescale for the reforms will consequently depend not only on the speed with which legislation is introduced, but also on the commitment with which companies and regulators approach the task of establishing the detailed design of the market. Defra has established a High Level Group, consisting of representatives from the UK, Scottish and Welsh Governments, Ofwat, the Water Industry Commission for Scotland, customers and the water and sewerage industry, which is intended to drive the process of reform. The High Level Group will report directly to Ministers.⁴⁸

42 HC (2012-13) 374, para 80

43 Ev w83; Qq 116-118

44 See Qq 19-22 and Q 228

45 Q 326, Q328

46 Ev w29

47 Ev w25

48 *Draft Water Bill*, p10, para 26

26. We received mixed evidence on the progress of the High Level Group. At the date when we took oral evidence from the Minister it had met twice; he told us that he was satisfied with its progress and that it was “working well”.⁴⁹ Water UK and Anglian Water told us that the group had got off to a “good start”.⁵⁰ Ofwat were more equivocal about its impact, telling us that they “do not think we are going to deliver market reform through meetings; we are going to achieve it through activity, action and deliverables... the real activity has to happen in the engine rooms... We could do with a little bit more effort at that level.”⁵¹ The Water Industry Commission for Scotland were critical, saying that they were “disappointed with progress to date” and that “the lack of a clear, fully developed and agreed vision...is delaying progress”.⁵²

27. In our report on the Water White Paper, we recommended that Defra should aim to open the retail market three years after Royal Assent of a Water Act. Although obviously dependent on the timing of legislation, this would appear to be broadly in line with the likely target date of April 2017 that the Government set out in the Draft Bill,⁵³ a target that the Minister said remained “doable”.⁵⁴

28. We are pleased that the Minister remains committed to opening the retail market in 2017. Business customers have been pressing for greater competition for some years and are understandably keen that the reforms retain momentum. We were therefore concerned by the suggestion that the progress of the High Level Group set up to drive the reforms may be hindered by the lack of a clear vision. We recommend that the Government set out what steps it is taking to provide the necessary direction and oversight of the High Level Group in its response to this report.

29. We recommended earlier in this report that the Government publish statutory guidance to the regulator in draft alongside the Water Bill. We note that by doing so it would provide a greater level of certainty for market regulators and participants which would greatly assist them in the operational development of the competitive retail market.

Upstream Reforms

30. Alongside opening up the retail market to increased competition, Defra has also set out plans to encourage upstream competition (i.e. the input of raw or treated water into a water company’s network, or the removal of waste water or sewage for treatment). At present, the Water Supply Licensing regime requires licence holders that provide upstream services to also provide retail services. That requirement may discourage new entrants who could provide competitive upstream services but do not wish to deliver retail services. Clause 1 and Schedule 1 of Draft Bill will “unbundle” the existing licensing structure so that new entrants can sell raw or treated water into an incumbent’s network, or remove

49 Q 321

50 Q 36

51 Q 124

52 Ev w83

53 *Draft Water Bill*, p9, para 24

54 Q 320

and treat waste water from a network, without having to also provide retail services. New entrants will also be able to access water companies' treatment and storage systems (rather than just their mains and pipes) and to hold a new network licence which will allow them to own and operate their own infrastructure which they can connect to an incumbent's network. A similar scheme of licence authorisations will be introduced for sewerage.⁵⁵

31. Unlike the introduction of retail competition, which was largely uncontroversial in principle, we received a great deal of evidence expressing concern about the proposed introduction of upstream competition. These concerns stemmed in part from the “enabling” nature of the Draft Bill, which we have commented on earlier in this report. The lack of detail contained in the Draft Bill was felt to be of particular concern in relation to upstream reforms due to the limited experience of introducing such reforms in other jurisdictions, in contrast to retail reforms where the Scottish experience provides a clear starting point.⁵⁶ The resulting concerns can be split into two broad categories: the potential for a loss of investor confidence due a lack of clarity about the detail of the reforms and in particular the potential for the “cherry picking” of customers; and a loss of resilience in the sector leading to a less effective response to short-term interruptions to supply and longer-term pressures such as drought. We set out the evidence relating to these issues below.

Investor confidence

32. Since privatisation, the water industry has attracted over £108 billion of investment.⁵⁷ Moody's Investors Service told us that the sector is “regarded very much as a gold standard. It has attracted [...] very significant investment at very low cost”,⁵⁸ and that the industry's regulatory regime was held “in very high regard for its historic transparency, predictability and clear principles that have been consistently applied.”⁵⁹ Water companies warned that the lack of clarity surrounding the Draft Bill's existing provisions on the introduction of upstream reform could see the industry's reputation as a safe haven threatened. Thames Water argued that

Any reform of upstream markets... inevitably raises financial and regulatory risk... a lack of clarity as to the future regulatory regime could undermine incentives to invest... We would therefore encourage clarity to be provided, either on the face of the Bill or through the production of clear and binding Government guidance. If not, there is a danger that increased uncertainty will increase the risks associated with investment, pushing up the cost of finance, ultimately leading to an adverse impact on customers' bills.⁶⁰

33. Despite taking evidence on this issue from water companies, Ofwat and Moody's, we have found it difficult to quantify how far these fears are likely to be realised. Our scrutiny was not helped by the ongoing dispute between Ofwat and water companies over Ofwat's

55 *Draft Water Bill*, Clause 4 and Schedule 3

56 See Q 46

57 Department for Environment, Food and Rural Affairs, *Defra's Strategic Policy Statement for Ofwat: Draft for Consultation*, November 2012, p9

58 Q 184

59 Q 143

60 Ev w48

proposed modifications to water companies' licence conditions, an issue which is separate to the Draft Bill but has been contemporaneous with our inquiry and has itself led to concerns about investor confidence.⁶¹ We sought to establish with Moody's how far their stated concerns about a potentially "credit negative" outlook for the industry,⁶² which they issued in October 2012 could be attributed to the Draft Bill itself and how far it might be due to the licence modification proposals, but they were not able to take us any further, telling us that "investors do not make that distinction. We do not particularly make that distinction. What they are doing is looking at the broad direction of travel".⁶³ Similarly, Moody's said that one could not "disaggregate" the particular elements of upstream competition that might pose a particular risk to investor confidence.⁶⁴ They did comment, however, that "Uncertainty is credit negative... if you have certainty, that is always a more positive thing".⁶⁵

De-averaging of prices

34. Water and sewerage customers usually pay the same prices within a given company's area, even if the costs of serving those customers vary because the costs of building and maintaining the infrastructure are averaged out across the company's customer base. An individual customer's bill will depend on a variety of factors including the amount of water they use (if their supply is metered), or the rateable value of their home. Even if metered, the bill does not, however, reflect the true cost of supplying water to that individual customer. So, for example, the distance that a customer is from a treatment works, or the additional cost of the infrastructure required to provide a water supply to a remote household, is not routinely taken into account when calculating individual bills.⁶⁶

35. The potential for upstream reforms to lead to a move away from this position to a regional de-averaging of prices was raised as a concern by many of our witnesses, including water companies, the Consumer Council for Water, and the Water Industry Commission for Scotland. The potential for de-averaging would come about because of the incentive for new entrants to "cherry pick" those customers within an incumbent company's region that are the lowest cost to serve. WICS illustrated the possible impact of this with an example:

If a dairy in a rural community were to [identify an alternative source of water that would meet its needs or] reduce the strength or volume of its waste, this could lead to the partial stranding of an asset built to serve that customer. It may be the only significant business (in population equivalent terms) in the area and potentially significant costs would now have to be met by those customers that remain, including households if the asset that was constructed is to be paid for in full.⁶⁷

61 In December 2012, following the conclusion of our oral evidence sessions, Ofwat published a consultation on revised proposals for the modification of company licences which it said would reduce levels of uncertainty about the impact of the licence changes.

62 Moody's Investors Service Announcement, Continued uncertainty for UK water sector with proposed licence changes, 29 October 2012

63 Q 171

64 Q 185

65 Q 192

66 See Ev w87

67 Ev w59

36. Ofwat told us that it was a “myth” to say that upstream reforms would lead to a de-averaging of prices between rural and urban household customers.⁶⁸ However, they appeared to accept the prospect of some element of de-averaging in the non-household sector, saying that there was “clearly an argument for giving non-household customers, particularly heavy users of water and sewerage services, cost-reflective price signals, so that they make efficient decisions—for example, on where to locate.”⁶⁹ The Minister told us that he would “hold Ofwat to their duty to make sure that we are not penalising customers who live in rural areas because it is more expensive to provide water to them” and that “we think it continues to be a very clear duty on the regulator to make sure that prices are averaged in the right way.”⁷⁰

37. In order to improve certainty for all parties, including investors, we recommend that Defra make clear on the face of the Bill the key principles that will underpin the introduction of upstream reforms. This should include a clear commitment that the reforms will not lead to any further de-averaging of prices.

38. The prospect of de-averaging was considered to pose a particular risk to investor confidence. Ofwat currently determines the total revenue for each water company over a five-year period through the Price Review process. In price-setting, Ofwat takes into account the need to provide a return to investors and calculates the level of this return using the Regulatory Capital Value, or RCV, model to measure the capital invested in the business. United Utilities argued that de-averaging of prices could threaten the RCV model and therefore deter investment:

The draft Bill... proposes establishing a system whereby future remuneration of the RCV will become less plausible over time, with the number of customers contributing to it becoming fewer and the composition of RCV reflecting a larger number of underutilised assets.

The process of “cherry picking” by new entrants will undermine the economic sustainability of existing wholesale activities and continued servicing of the RCV will impose greater burdens on those customers who are unable to “opt out”; the largest proportion of these will be domestic customers. As this risk becomes self-evident to the investment community, the cost of capital will be driven higher making the long-term viability of RCV more questionable.⁷¹

39. Defra have acknowledged that upstream reforms are likely to have some impact on the cost of capital. The impact assessment which accompanied the Draft Bill (first published alongside the White Paper) assumed a 1% increase in the cost of capital, leading to an increased cost of finance of £426m.⁷² This increase would, according to Defra’s calculations, be outweighed by the savings that upstream competition would bring: the

68 Q 128

69 Ev 88

70 Q 301

71 Ev w51

72 Impact Assessment Upstream Competition p49. The impact assessment considered a range of sensitivities for the increase in the cost of capital, ranging from 0.5% (low) – 2.5% (high). Defra assumed a medium financing cost increase of 1% in arriving at the figure of £426 million.

impact assessment put the net present benefit of the reforms at £1,952 million. The impact assessment did, however, note that the impact of the reforms on financing costs was a “key uncertainty”,⁷³ and that “the final financing impacts are also closely related to Ofwat decisions about how it treats stranded assets and the ongoing protection of the RCV”.⁷⁴ United Utilities said that the impact assessment’s cost/ benefit analysis had been subject only to “limited” consultation by Defra and questioned whether the expected £2 billion benefits would materialise. They called for an independent review of the cost/benefit analysis in the impact assessment, to allow input from a wider range of stakeholders and consideration of industry assessments of costs and benefits.⁷⁵ In oral evidence Defra told us that they had not re-visited the impact assessment since its publication,⁷⁶ but that a full, updated impact assessment would be carried out before the introduction of the Bill itself.⁷⁷

Loss of resilience

40. A further concern expressed by many of our witnesses was that upstream reforms could lead to a loss of resilience in the sector. South West Water explained that:

Currently, an element of capacity is built into the network to accommodate peaks in flows or to ensure continuity of service where an aspect of the system fails. However, in a “competitive” environment, where new entrants will be competing to provide resources and assets at the most efficient cost, it is not yet clear how these critical capacity safety nets will be maintained.⁷⁸

Similarly, it was argued that a more competitive, fragmented market would make it more difficult for water companies to work together to safeguard supply. The Food and Drink Federation said that a competitive upstream model could “weaken, or even undermine, the degree of co-operation required between water companies and their customers in terms of maximising the efficient use of resources”.⁷⁹ The Local Government Association drew on its experience of the severe drought in 2012, noting that it “brought together water companies and a range of stakeholders, including the LGA, to manage the immediate stakeholder concerns and communication needs. Government should ensure that a potentially more complex water sector could still be marshalled this way”.⁸⁰ Also commenting on the 2012 drought, Wessex Water described how water companies had worked together to transfer supplies to areas of need and said that they were advised at the time that they would not have been able to co-operate in such a way in a competitive market.⁸¹

73 Impact Assessment: Upstream Competition, p33

74 *Ibid.* p49

75 Ev w51

76 Q 291

77 Q 293

78 Ev w45

79 Ev w17

80 Ev w28

81 Q 43

41. We are concerned by the levels of uncertainty in the proposals for reform of the upstream markets and we do not believe that the case for these reforms has yet been fully made out. Given the potentially serious implications of the reforms both for customer bills and for national resilience in the face of climate change and population growth, we believe that further work must be undertaken to establish how upstream reforms can be introduced in a way that will preserve investor confidence, ensure that customers do not face increased bills, and maintain resilience in the sector. We recommend that Defra revisit this issue, inviting evidence from water companies, consumer representatives and other interested parties both on the likely impact of the reforms and on the detail of their implementation. This work should be commenced immediately.

Timescale for upstream reform

42. A great deal of further work must be undertaken by Defra, in consultation with interested parties, before any steps can be taken to introduce upstream competition. Consequently, upstream reforms are unlikely to be brought in at the same time as the retail reforms; there is simply too much preparatory work to be carried out and the Minister told us that the Department had “always anticipated upstream competition being introduced in a phased manner on a slower timescale”.⁸² Nevertheless, we believe that it is important to be as clear as possible about the reforms’ expected timescales to enable water companies and investors to engage with the Government and prepare for the new market. **We recommend that the Bill set target dates for the final decision on the form and scope of upstream reforms, and the opening of the upstream market.**

Engagement with the devolved administrations

43. Water policy is a devolved issue. The Draft Bill has been developed in conjunction with the Welsh Government and will apply in both England and Wales. In written evidence the Welsh Government criticised Defra’s engagement.⁸³ The Minister told us that he had recently met with the Welsh Minister and “agreed to have further discussions in the very near future to make sure we are ironing out any difficulties that may be perceived to exist across the border”.⁸⁴

44. The legislation will enable the creation of a joint English-Scottish market. Creating such a market will require close working between the UK and Scottish Governments and the respective regulators. The Scottish regulator, the Water Industry Commission for Scotland (WICS), has expressed concern that some of the provisions in the Draft Bill for reform of the upstream market south of the border could have unintended consequences in Scotland. WICS argued that “the combination of the Competition Act and legal precedent could result in de-averaging in England spilling over into Scotland”.⁸⁵ Defra told us that they did “not fully understand the issue that WICS has raised and will be exploring this further with

82 Ev 80

83 Ev w61

84 Q 336

85 Ev w82

them. We currently believe that changing the regime in England and Wales will not make any substantive difference to the legal position in Scotland under the Competition Act”.⁸⁶

45. Given the UK-wide implications of the Draft Water Bill, it is essential that Defra takes a collaborative and consultative approach to engagement with the devolved administrations. In its response to this report we expect Defra to be able to confirm that there are no outstanding areas of dispute or concern with either the Welsh or Scottish administrations.

4 Omissions from the Draft Bill

46. The Water White Paper covered the breadth of challenges facing the Government, the industry and regulators in a future where climate change and population growth are expected to place increasing strain on the management of our water resources. By contrast, the Draft Bill has a narrower focus, leading some of our witnesses to describe it as a missed opportunity to tackle the wider issues which were highlighted in *Water for Life*. The Minister denied this, telling us that the ambitions set out in the Water White Paper “remain absolutely on track” and that he wanted to “address head on... the institutionalised view that the only way to change things is through primary legislation”.⁸⁷

Abstraction reform

47. *Water for Life* set out the Government’s intention to overhaul the abstraction regime, which governs the extraction of water from rivers and aquifers for the public water supply and for use by others such as farmers and industry. The current abstraction regime, established in the 1960s, is widely recognised as outdated and ineffective in managing our increasingly pressured water resources. The Government announced in the White Paper that it will consult on reform proposals in 2013 and the new regime will be fully implemented by the mid-to-late 2020s.⁸⁸ Although legislation will be required to reform the current regime, the Draft Bill does not contain the necessary framework, and the Government has instead said that it will introduce legislation in the next Parliament.

48. Environmental groups argued that the legislative framework for abstraction reform should be included in the Water Bill. According to WWF-UK, this would bring a range of benefits, including sending a clear signal of commitment to reform, and clarifying the timetable by which reforms will be implemented. They argued that “There is nothing that would be needed in [a later] Bill which cannot be provided for in this current Bill.”⁸⁹ In oral evidence, representatives of the Blueprint for Water coalition described the absence of action on abstraction reform as “the most glaring gap” in the Draft Bill,⁹⁰ commenting that “Water Bills do not come around very often... we should grasp this opportunity while we can. It is indicative of the overall problem we have, that memories are very short. We were facing a really significant drought in the early part of this spring”.⁹¹

49. Water companies were more circumspect. Wessex Water warned against introducing legislation at this stage, arguing that “It is fine to talk about it in principle, but you need to do a lot of work to ascertain how it will work in practice. I would caution against rushing too fast into this”.⁹² Ofwat also appeared to have reservations, noting that “without some of the detail... it appears quite difficult to write it into this piece of legislation”.⁹³ The Minister

87 Q 262

88 *Water for Life* p23-24

89 Ev w67

90 Q 235

91 Q 239

92 Q 7

93 Q 138

also resisted suggestions that the Bill could include a framework for abstraction reform and sought to stress that much could be done at this stage without requiring legislation.⁹⁴

50. In our report on the Water White Paper, we were critical of its lengthy timescales for abstraction reform and we recommended that the end date for the reforms should be brought forward to 2022. While it may be tempting to argue that the Draft Bill be used to provide the legislative foundations for future reform, we do not believe it would be appropriate for the details of these important reforms to be brought forward through secondary legislation several years after the passage of the primary legislation.

51. We remain concerned that Defra appears to lack the necessary sense of urgency to press on with these reforms. The detail of a new abstraction regime will need to be developed following consultation. Following that consultation Defra will have to produce legislative proposals and secure space in the legislative programme before a new regime can be introduced. We urge the Department to redouble its efforts and to set out in response to this report how it will meet our target date for a new abstraction regime of 2022.

Ofwat’s duty to promote sustainable development

52. Ofwat’s duties as economic regulator of the water industry are laid down in section 2 of the Water Industry Act 1991. Its main, or primary, duties are to:

- protect the interests of consumers, wherever appropriate by promoting effective competition;
- secure that the functions of each undertaker (ie water company) are properly carried out and that they are able to finance their functions, in particular by securing reasonable returns on their capital; and to
- secure that companies with water supply licences (ie those selling water to large business customers, known as licensees) properly carry out their functions.⁹⁵

53. Ofwat also has several secondary duties, including a duty to contribute to the achievement of sustainable development. In the Water White Paper the Government said that it would “carefully consider” the case for elevating this to a primary duty which would require primary legislation. The Welsh Government has already stated that this should be done: in the Draft Bill, the Government says that a final decision will be taken before the Bill is introduced.⁹⁶

54. The evidence we took on this issue was divided. Environmental groups were keen for the sustainability duty to be elevated, with Blueprint for Water pointing out the limitations of the current arrangements:

Ofwat has a duty to “contribute to the achievement of sustainable development”. However, this is a secondary duty, which means that it is ignored if the contributions

94 Q 371

95 www.ofwat.gov.uk/aboutofwat

96 *Draft Water Bill*, p 14

interfere with Ofwat’s primary duty (i.e. if there are significant financial implications for companies). The practical effect of this, as seen in the 2009 price review, is that Ofwat is forced to strike out investments that would deliver demand management in ‘over abstracted’ areas, or areas in which it would address supply deficits that exist beyond the five-year planning horizon.⁹⁷

55. They also drew attention to the approach taken to sustainable development by the energy regulator, Ofgem, which lists “the need to contribute to the achievement of sustainable development” as one of three factors which it must take account of in carrying out its principal objective. Blueprint for Water described the Energy Act 2008’s promotion of this duty as “critical in driving cultural change both within the regulator and across the energy industry”,⁹⁸ and told us that it had resulted in a “much more open dialogue about the sustainability challenges that are facing Ofgem”.⁹⁹

56. In supplementary evidence Ofwat argued that it would be undesirable to elevate its duty to contribute to the achievement of sustainable development to a primary duty. The Regulator argues that under the current arrangement it is able to balance customer, environmental and economic needs and elevating sustainable development to a primary duty could unbalance the sector, and risks increasing bills and investment. Ofwat also argue that it currently integrates sustainability into its functions and it considers it “difficult to identify a single area where it is obviously the case that Ofwat would do things differently were the sustainable development duty elevated to a primary duty.¹⁰⁰ The regulator expressed concern that such a change would broaden the scope of the regulator substantially and create a situation where it might take decisions about much broader policy issues that may be considered more properly the role of Government.¹⁰¹ In oral evidence, the Minister was clearly leaning towards preserving the status quo, suggesting that Defra’s recently published social and environmental guidance to Ofwat was sufficient to ensure that the regulator took the right approach to sustainability.¹⁰²

57. We have carefully considered the arguments for and against elevating Ofwat’s duty to contribute to the achievement of sustainable development to primary status. We are persuaded that the increasing pressures on our water resources, highlighted in the Water White Paper, justify such a change. We therefore recommend that the Draft Bill be amended to include a clause giving effect to this change.

97 Ev 69

98 The Energy Act 2008 promoted Ofgem’s pre-existing duty to contribute to the achievement of sustainable development to a primary duty, placing it on an equal footing with the regulator’s duty to meet reasonable demand and finance authorised activities. (www.ofgem.gov.uk/sustainability)

99 Q 245

100 Ev 102

101 *Ibid.*

102 Q 346

5 The Wider Policy Agenda

58. Where we believe that important matters have been omitted from the Draft Bill we have made specific recommendations. We do not, however, disagree in principle with the Minister's assertion that much can be achieved without legislation. Coming just a few months after our inquiry into the Water White Paper, we have taken the opportunity during pre-legislative scrutiny to return to some of the wider policy issues that we considered in our previous report and to consider whether they are being taken forward with sufficient urgency. We have taken a particular interest in those provisions of the Flood and Water Management Act 2010 (FWMA) which remain outstanding.

Sustainable Drainage and Reservoirs Guidance

59. The key provisions of the FWMA on Sustainable Drainage Systems, or SuDS remain unimplemented, including: removing the right to lay impermeable surfaces as of right on back gardens and business premises; removing the automatic right to connect surface water drainage of new developments to the sewerage system; and resolving the ownership and maintenance of SuDs. In our report on the White Paper we criticised the lack of urgency in Defra's work to improve the management of surface water and we urged the Department to ensure that implementation of the FWMA's provisions was not subject to any further unnecessary delay.¹⁰³ During the course of our pre-legislative scrutiny, parts of England and Wales were once again hit by flooding, with surface water a major contributory factor to the damage caused to homes and businesses. In their evidence to this inquiry, Severn Trent argued that pushing ahead with the implementation of these provisions should be a priority.¹⁰⁴

60. We were therefore dismayed to discover during the course of the oral evidence session with the Minister that implementation of the SuDS regulations had been put back once again, and was now not expected until April 2014.¹⁰⁵ The Minister defended this additional further delay, telling us that "we simply could not take this forward in a meaningful way any quicker",¹⁰⁶ and that "we found that the provisions in the Act are not easy to take forward. They were for a new Government to take forward, and we have done that in a way that has really tested the resources of both our Department and others who would have to implement this".¹⁰⁷

61. We are greatly concerned by the further postponement of the implementation of the Flood and Water Management Act's provisions on Sustainable Drainage Systems to April 2014. We expect the Department, in its response to this report, to set out which particular elements of the regulations have caused such difficulty to implement and to explain the steps it is taking to address those issues so that the regulations can come into force at the earliest possible opportunity.

103 HC (2012-13) 374, p13

104 Ev 93

105 Q 349

106 Q 357

107 Q 359

62. The FWMA contained provisions to give effect to Sir Michael Pitt's recommendations relating to reservoir safety, including amendments to the Reservoirs Act 1975. Defra consulted on the implementation of these provisions in 2012 and has commissioned the Institution of Civil Engineers to review two key guidance documents: *A guide to the Reservoirs Act 1975* and *Floods and Reservoirs Safety Guidance, 3rd edition*. The Environment Agency is also producing a new risk-based methodology for the classification of high-risk reservoirs. We have previously pressed the Department to work with the Institution of Civil Engineers to complete the reviews of guidance documents by December 2012; that date has now passed but the Minister told us that Defra intended to publish the *Guide to the Reservoirs Act* in 2013 and that the revised *Floods and Safety Reservoirs Guidance*, commissioned in August 2011, was working to a target timescale of two years.

63. We urge Defra to ensure that the revised *Guide to the Reservoirs Act 1975* is published no later than April 2013. We are disappointed by the two-year target timescale for the review of *Floods and Reservoirs Safety Guidance* and recommend that Defra work with the Institution of Civil Engineers to bring publication forward to April 2013.

Bad Debt

64. The FWMA contained provisions to tackle the problem of bad debt in the industry, which has been estimated to add approximately £15 to each customer's bill.¹⁰⁸ These provisions, which would place a responsibility on landlords to provide details of their tenants for billing purposes, have not been implemented, and the Government has subsequently consulted on an alternative, voluntary approach to obtaining this information. During the course of our inquiry into the Water White Paper, we heard evidence from both water companies and consumer representatives which criticised the Government's failure to implement the bad debt provisions and questioned the likely effectiveness of a voluntary approach. We recommended that the Government implement the relevant provisions without further delay, noting the injustice of increasing bills for hard-pressed customers to subsidise those who simply refused to pay.¹⁰⁹

65. Again, we were disappointed to find that little or no progress had been made since our report was published. In oral evidence the Minister reiterated his concern that regulation could place a disproportionate burden on landlords;¹¹⁰ Water UK argued that "It really is a very small administrative burden for something which would avoid customers, who are facing difficulty paying their bills, paying more because of bad debt".¹¹¹ **We remain of the view that it is unacceptable for honest customers to be forced to subsidise those who refuse to pay their water bills. We reiterate our previous recommendation that Defra should implement the provisions of the Flood and Water Management Act 2010 on bad debt without further delay.**

¹⁰⁸ *Water for Life*, p66

¹⁰⁹ HC (2012-13) 374, p20

¹¹⁰ Q 349

¹¹¹ Q 2

Flood Insurance

66. Another area in which there has been a notable and deeply worrying lack of progress since our last report is on the issue of flood insurance. The current Statement of Principles agreed between the Association of British Insurers (ABI) and the Government is due to expire at the end of June 2013 and, although discussions have been ongoing throughout the course of our pre-legislative scrutiny, no agreement has yet been reached on the provision of insurance cover for at-risk homes and businesses beyond this date. The Draft Bill does not include any specific clauses relating to flood insurance, but the introductory section on “Taking the Draft Bill forward” notes that “the UK and Welsh Governments may also need to consider legislation to help manage the financial risk of flooding”.¹¹²

67. The Minister was reluctant to discuss the progress of negotiations in any detail when he appeared before us, but said that the Department was “working really hard to achieve” affordable and freely available cover.¹¹³ On the specific issue of whether legislation would be needed, officials told us that “The structure that might emerge is not clear, but if it involved either financial or regulatory structures or a combination that would probably require further legislation”.¹¹⁴ In addition, the Government has not yet fully implemented ‘insurance with rent schemes’ that were recommended in the Pitt Review. We will explore these issues with the insurance industry when we take evidence from them shortly.

68. Whilst we understand the Minister’s reluctance to provide a running commentary on negotiations with the Association for British Insurers and the possible solutions that are being considered, we are conscious that the current Statement of Principles will expire in less than six months, well before Royal Assent to a Water Act can reasonably be expected. We therefore wish to establish more details of the legislative solution(s) that are being considered should it prove necessary to go down that route; and in particular what consideration has been given to the basis on which flood insurance would be provided during the period between the expiry of the Statement of Principles and Royal Assent to a Water Act. We expect the Department to provide these details in its response to this report.

Water efficiency

69. We face a future in which water resources are likely to come under increasing pressure. It is therefore ever more important to encourage the efficient use of water. There are a number of steps that householders can take to reduce their water use, for example, through rainwater harvesting. The UK Rainwater Harvesting Association argued that water companies should “be encouraged to work in closer partnership with the rainwater harvesting industry in addressing the future sustainability of water supplies”.¹¹⁵ We endorse this call.

70. One key tool that has been shown to reduce demand for water is the more widespread use of metering. We have previously expressed our disappointment that the Water White

¹¹² *Draft Water Bill*, p15

¹¹³ Q 361

¹¹⁴ Q 364

¹¹⁵ Ev w50

Paper did not take a more ambitious approach to metering.¹¹⁶ Some of the evidence we received in connection with this inquiry argued that the Draft Bill was also a missed opportunity to increase metering levels. Environmental groups argued that the Draft Bill should have taken steps to remove existing barriers to metering, whilst Wessex Water felt that metering should be the default position on change of occupancy, pointing out the benefits of using this opportunity to introduce a meter:

Households have been shown to be willing to accept metering at the point of moving into a property. Households tend to incorporate their new water charges as one part of much wider changes to their budget. And as most water use behaviour is driven by habit the new house gives them a good opportunity to change those habits and become more water efficient.¹¹⁷

71. We remain disappointed that the Government has not acted on our recommendation that it set a clear and ambitious target to increase levels of metering. We believe that more should be done to educate the public about the value of water and to increase take up levels of metering. **We recommend that Defra work with water companies to explore methods to encourage the installation of water meters upon change of occupancy, including through providing financial incentives.**

116 HC (2012-13) 374, para 41

117 Ev 99

Conclusion

72. We welcome the Draft Bill as the next step to introducing much needed reform to the water industry and we urge the Government to maintain momentum and ensure the timely introduction of the Bill itself. We have set out in this report where amendments will be required before the Bill is introduced if it is to successfully bring about the required change to the industry whilst also protecting the interests of all customers. We expect the Government to carefully consider the recommendations we make in this report before introducing a Water Bill to Parliament.

73. We have also noted those issues that are not addressed in the draft Bill, and in the wider policy field, where the Government still has work to do to implement recommendations made in the Pitt Review and commence provisions in the Flood and Water Management Act 2010. Flooding is becoming an increasingly common—the Government must ensure that it makes use of all the tools at its disposal to reduce the impact of flooding on households and businesses.

Conclusions and recommendations

1. We find it frustrating that successive Governments have lacked the tenacity and resolution to implement important recommendations outstanding from the Pitt Review and provisions in the Flood and Water Management Act 2010. That frustration is made more acute as legislative time is a scarce resource. We recommend that Defra set out in its response a full list of the outstanding issues from the Pitt Review and Flood and Water Management Act together with a clear timetable for their full implementation. (Paragraph 6)

Enabling legislation

2. We recommend that the Draft Bill be amended to make clear that guidance produced by the Secretary of State and Welsh Ministers on charging rules will be laid before Parliament for scrutiny and subject to the affirmative resolution procedure. We further recommend that this guidance should be published in draft alongside the Water Bill itself to maximise transparency and to inform debate on the Bill. (Paragraph 8)

Market reforms

3. We believe that protecting householders from subsidising competition in the non-household sector is a fundamental principle that should be enshrined in primary legislation. We recommend that the Draft Bill be amended to reflect this. (Paragraph 17)
4. We recommend that the Draft Bill be amended to include a requirement for the functional separation of incumbent companies' wholesale and retail arms. We further recommend that the principle of non-discrimination be included on the face of the Bill. (Paragraph 20)
5. We recommend that the Bill include provisions to enable incumbent companies to voluntarily exit the retail market. (Paragraph 24)
6. We are pleased that the Minister remains committed to opening the retail market in 2017. Business customers have been pressing for greater competition for some years and are understandably keen that the reforms retain momentum. We were therefore concerned by the suggestion that the progress of the High Level Group set up to drive the reforms may be hindered by the lack of a clear vision. We recommend that the Government set out what steps it is taking to provide the necessary direction and oversight of the High Level Group in its response to this report. (Paragraph 28)
7. We recommended earlier in this report that the Government publish statutory guidance to the regulator in draft alongside the Water Bill. We note that by doing so it would provide a greater level of certainty for market regulators and participants which would greatly assist them in the operational development of the competitive retail market. (Paragraph 29)

8. In order to improve certainty for all parties, including investors, we recommend that Defra make clear on the face of the Bill the key principles that will underpin the introduction of upstream reforms. This should include a clear commitment that the reforms will not lead to any further de-averaging of prices. (Paragraph 37)
9. We are concerned by the levels of uncertainty in the proposals for reform of the upstream markets and we do not believe that the case for these reforms has yet been fully made out. Given the potentially serious implications of the reforms both for customer bills and for national resilience in the face of climate change and population growth, we believe that further work must be undertaken to establish how upstream reforms can be introduced in a way that will preserve investor confidence, ensure that customers do not face increased bills, and maintain resilience in the sector. We recommend that Defra revisit this issue, inviting evidence from water companies, consumer representatives and other interested parties both on the likely impact of the reforms and on the detail of their implementation. This work should be commenced immediately. (Paragraph 41)
10. We recommend that the Bill set target dates for the final decision on the form and scope of upstream reforms, and the opening of the upstream market. (Paragraph 42)
11. Given the UK-wide implications of the Draft Water Bill, it is essential that Defra takes a collaborative and consultative approach to engagement with the devolved administrations. In its response to this report we expect Defra to be able to confirm that there are no outstanding areas of dispute or concern with either the Welsh or Scottish administrations. (Paragraph 45)

Omissions from the Draft Bill

12. We remain concerned that Defra appears to lack the necessary sense of urgency to press on with these reforms. The detail of a new abstraction regime will need to be developed following consultation. Following that consultation Defra will have to produce legislative proposals and secure space in the legislative programme before a new regime can be introduced. We urge the Department to redouble its efforts and to set out in response to this report how it will meet our target date for a new abstraction regime of 2022. (Paragraph 51)
13. We have carefully considered the arguments for and against elevating Ofwat's duty to contribute to the achievement of sustainable development to primary status. We are persuaded that the increasing pressures on our water resources, highlighted in the Water White Paper, justify such a change. We therefore recommend that the Draft Bill be amended to include a clause giving effect to this change. (Paragraph 57)

The Wider Policy Agenda

14. We are greatly concerned by the further postponement of the implementation of the Flood and Water Management Act's provisions on Sustainable Drainage Systems to April 2014. We expect the Department, in its response to this report, to set out which particular elements of the regulations have caused such difficulty to implement and to explain the steps it is taking to address those issues so that the regulations can come into force at the earliest possible opportunity. (Paragraph 61)
15. We urge Defra to ensure that the revised Guide to the Reservoirs Act 1975 is published no later than April 2013. We are disappointed by the two-year target timescale for the review of Floods and Reservoirs Safety Guidance and recommend that Defra work with the Institution of Civil Engineers to bring publication forward to April 2013. (Paragraph 63)
16. We remain of the view that it is unacceptable for honest customers to be forced to subsidise those who refuse to pay their water bills. We reiterate our previous recommendation that Defra should implement the provisions of the Flood and Water Management Act 2010 on bad debt without further delay. (Paragraph 65)
17. Whilst we understand the Minister's reluctance to provide a running commentary on negotiations with the Association for British Insurers and the possible solutions that are being considered, we are conscious that the current Statement of Principles will expire in less than six months, well before Royal Assent to a Water Act can reasonably be expected. We therefore wish to establish more details of the legislative solution(s) that are being considered should it prove necessary to go down that route; and in particular what consideration has been given to the basis on which flood insurance would be provided during the period between the expiry of the Statement of Principles and Royal Assent to a Water Act. We expect the Department to provide these details in its response to this report. (Paragraph 68)

Formal Minutes

Wednesday 23 January 2013

Members present:

Miss Anne McIntosh, in the Chair

Thomas Docherty

Richard Drax

George Eustice

Barry Gardiner

Mrs Mary Glendon

Neil Parish

Dan Rogerson

Draft Report (Draft Water Bill), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 73 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Sixth Report of the Committee to the House.

Ordered, That the Chair 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 till Tuesday 29 January at 2.15 pm]

Witnesses

Tuesday 23 October 2012

page

Rob Wesley, Water UK, **Colin Skellett**, Wessex Water, **Tony Ballance**, Severn Trent Water and **Jean Spencer**, Anglian Water

Ev 1

Tuesday 30 October 2012

Yve Buckland and **Tony Smith**, Consumer Council for Water, **Robert Leask**, Scottish Procurement, Scottish Government

Ev 14

Regina Finn, Ofwat

Ev 21

Tuesday 20 November 2012

Neil Griffiths-Lambeth, Moody's Investors Service

Ev 31

Mark Powles, Business Stream and **Nathan Sanders**, SSE Water

Ev 38

Rob Cunningham and **Nicci Russell**, Blueprint for Water

Ev 42

Wednesday 21 November 2012

Richard Benyon MP, Parliamentary Under-Secretary of State for the Natural Environment and Fisheries, **Sonia Phippard** and **Gabrielle Edwards**, Defra

Ev 48

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Blueprint for Water	Ev 68
Business Stream	Ev 70
Consumer Council for Water	Ev 75; Ev 77; Ev 79
Department for Environment, Food and Rural Affairs	Ev 79
Ofwat	Ev 82; Ev 87, Ev 102
Scottish Government, Procurement Division	Ev 88
Severn Trent Water	Ev 89
SSE plc	Ev 94
Water UK	Ev 95; Ev 97
Wessex Water	Ev 99

List of additional written evidence

(published in Volume II on the Committee's website www.parliament.uk/efracom)

Action for the River Kennet	Ev w1
Arqiva	Ev w1
ASDA Stores Ltd	Ev w4
British Hydropower Association	Ev w7
Chartered Institution of Water and Environmental Management	Ev w9
Dee Valley Water plc	Ev w10
Dŵr Cymru—Welsh Water	Ev w11
Environment Agency	Ev w12
Federation of Small Businesses	Ev w14
Food and Drink Federation	Ev w17
Professor Colin Green	Ev w19
Greene King plc	Ev w21
Home Builders Federation	Ev w22
Institution of Civil Engineers	Ev w25
Local Government Association	Ev w27
Major Energy Users' Council	Ev w28
Network Rail	Ev w30
NFU	Ev w31
Northumbrian Water Ltd	Ev w34
RSPB	Ev w35
Royal Town Planning Institute	Ev w37
Salmon and Trout Association	Ev w38
Scottish Water	Ev w41
Southern Water Services Ltd	Ev w42
South West Water	Ev w43
Thamesbank	Ev w46
Thames Water	Ev w47
UK Rainwater Harvesting Association	Ev w49
United Utilities Group plc	Ev w50
Waterwise	Ev w53
Water Industry Commission for Scotland	Ev w55; Ev w59, Ev w81
Welsh Government	Ev w60
Wessex Water	Ev w63
West Midlands Branch of the Emergency Planning Society	Ev w66
World Wildlife Fund UK	Ev w67
Yorkshire Water Services Ltd	Ev w79

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2012–13

First Report	Greening the Common Agricultural Policy	HC 170 (HC 654)
Second Report	The Water White Paper	HC 374 (HC 602)
Third Report	Pre-appointment hearing: Chair of the Water Services Regulation Authority (Ofwat)	HC 471-I & -II
Fourth Report	Natural Environment White Paper	HC 492 (HC 653)
Fifth Report	Desinewed Meat	HC 120 (Cm 8462)

Session 2010–12

First Report	Future Flood and Water Management Legislation	HC 522 (HC 922)
Second Report	The Marine Policy Statement	HC 635
Third Report	Farming in the Uplands	HC 556 (HC 953)
Fourth Report	The draft National Policy statement (NPS) on Waste Water	HC 736
Fifth Report	The Common Agricultural Policy after 2013	HC 671 (HC 1356)
Sixth Report	Implementation of the Common Fisheries Policy: Domestic Fisheries Management	HC 858 (HC 1485)
Seventh Report	Pre-appointment hearing: Chair of Gangmasters Licensing Authority	HC 1400-I & -II
Eighth Report	EU proposals for the dairy sector and the future of the dairy industry	HC 952 (HC 1548)
Ninth Report	The Welfare of Laying Hens Directive—Implications for the egg industry	HC 830 (HC 1664)
Tenth Report	The outcome of the independent Farming Regulation Task Force	HC 1266 (HC 1669)
Eleventh Report	The draft National Policy Statement for Hazardous Waste	HC 1465 (HC (Session 2012–13) 540)
Twelfth Report	EU proposals for reform of the Common Fisheries Policy	HC 1563-I & -II (HC (Session 2012–13) 108)
First Special Report	The National Forest: Government response to the Committee's Fourth Report of Session 2009–10	HC 400
Second Special Report	Dairy Farmers of Britain: Government response to the Committee's Fifth Report of Session 2009–10	HC 401

Oral evidence

Taken before the Environment, Food and Rural Affairs Committee on Tuesday 23 October 2012

Members present:

Miss Anne McIntosh (Chair)

Richard Drax
George Eustice
Barry Gardiner

Mrs Mary Glendon
Neil Parish
Ms Margaret Ritchie

Examination of Witness

Witnesses: **Rob Wesley**, Head of Policy, Water UK, **Colin Skellett**, Executive Chairman, Wessex Water, **Tony Ballance**, Director of Strategy and Regulation, Severn Trent Water and **Jean Spencer**, Director of Regulation, Anglian Water, gave evidence.

Q1 Chair: Good afternoon and welcome. Thank you for joining us for our first evidence session on the Draft Water Bill inquiry. I will just say at the outset that we are not expecting a vote; if there is a vote, we will adjourn for the shortest possible period. That would normally be between 10 and 15 minutes, if you could bear with us. We are very grateful for your being here with us today. For the record, could I ask you to say who you are and which company you are with, starting with Mr Skellett?

Colin Skellett: Thank you, Chair. I am Colin Skellett, Executive Chairman of Wessex Water. I started in the water industry in 1961, so I have been around for a while.

Rob Wesley: I am Rob Wesley, Head of Policy at Water UK, representing water and sewerage companies throughout the United Kingdom.

Jean Spencer: I am Jean Spencer, Regulation Director at Anglian Water.

Tony Ballance: I am Tony Ballance, Director of Strategy and Regulation at Severn Trent Water.

Q2 Chair: I will just ask an opening question or two, if I may. Were you surprised by the direction of the Draft Water Bill? Do you believe that the Draft Water Bill entirely mirrors the direction of travel of the Water White Paper?

Colin Skellett: If I could start, if you look at the key challenges facing the water industry, there are three: there is climate change and its consequences, which takes you into the area of supply and resilience; for some customers there are issues of affordability; and there is retail competition for business customers.

The White Paper was wider than the Bill. The White Paper focused a lot on sustainability, resilience and these other issues. The Bill seems to be largely focused on the retail competition issue. The other big issue for the industry is maintaining the cost of financing. This industry has been successful because we have managed to maintain access to low-cost finance. Running across all these challenges and the way that we deal with them has to be the ability to maintain the low-cost financing of the industry. I think the Bill is in danger of being a lost opportunity to tackle the bigger issues. Unlike customers, we do not get water bills very often; they only come along very

occasionally. It would be really good to use this Water Bill to deal with the bigger issues. Perhaps we can enlarge on that a little.

Jean Spencer: For us, the White Paper was very welcome because it put the focus very much on water resilience and the security of water supplies for our customers. For us, that clarity is missing in the Water Bill. Now, it may be that the issues around that do not require legislation, but nevertheless it seems to have been somewhat lost. Clearly, companies are ultimately responsible for security of supply and for resilience of their assets, but I think that having clear Government policy and Government direction around that, which regulators as well as companies would have to take notice of, would be very helpful.

We think that, clearly, the Government, along with all our regulators—Ofwat and the environmental regulators—and the water companies, played a key role in the recent drought. The work of the National Drought Group was extremely helpful. We think it would be really useful to build on that going forward through something like a new national water resource resilience group that can keep the focus that was there in the White Paper.

Rob Wesley: Another area that could be covered in more detail would be the linked areas of bad debt and affordability, which were referred to in the White Paper extensively but are essentially absent from the Draft Water Bill. On debt, the Bill does not address the growing burden of bad debt: £15 on every customer's bill, and that is growing year on year. From an industry point of view, there is a frustration that there is a measure on the statute book already that is waiting to be implemented, which would require a flow of information from landlords to companies, so that companies can effectively bill customers living in rented properties where it is difficult to know who is the right customer to bill.

From the industry's perspective, we are already taking measures to provide an easy route for landlords to provide information by implementing a national website. That will be a very easy route for landlords to provide information. It really is a very small administrative burden for something which would avoid customers, who are facing difficulty paying their bills, paying more because of bad debt.

Q3 Chair: I am sorry to interrupt, but can I just ask whether they need primary legislation to do that?

Rob Wesley: There is no need for primary legislation because the primary legislation was covered in the Flood and Water Management Act. It is purely a matter of implementing the already passed measures from the last Government. It really would be a quick win that could be implemented straight away.

On affordability, one measure that would make a real difference would be allowing companies to have access to benefits information; they would be able to better target affordability measures such as social tariffs. There is now guidance on implementing social tariffs, which is welcome, but access to benefits information would really be a key step towards being able to take things forward effectively and efficiently. I know this is a matter that the Committee has raised previously. We have had some preliminary discussions with the DWP, but that is at an early stage and we would welcome greater support from DWP to make allowing access to benefits information a reality.

Tony Ballance: It is clear—as my colleagues have articulated—that competition forms a large part of the Bill. It is probably worth reflecting that to some extent the Bill recognises that the water supply licensing regime probably has not delivered much in the way of meaningful competition in the sector. It is right, therefore, that a large focus is around getting appropriate competition for business retail customers, which is a space that a number of us are trying to enter into.

One of the areas where I specifically think the Bill could be strengthened is in relation to giving companies a genuine choice as to whether they wish to participate in the retail market by allowing companies to have a separate licence. Given that you have 20 or so companies, having 20 or so retailers will not allow for the economies of scale that are inevitably there in the retail sector. Thames Water, the largest company, would have the most customers, but even they are not really at the scale of the energy companies in terms of the economies of scale they would have.

We would be in favour of enabling companies to grow properly into that retail space and allowing companies to exit. Without that, it is extremely complicated for companies to have retail arrangements that allow one to compete out of their area but, obviously, maintain their business service offering in their area. It is very complicated, in terms of the arrangements that are required to do that.

Q4 Chair: We will come to that. I would just like to follow up on something Jean Spencer said about resilience. This is a personal wish list. In terms of resilience, reducing water stress and, perhaps, putting responsibility on developers when there are major new housing developments taking place, would it be appropriate to ask developers to contribute to some sort of fund so that, going forward, maintenance, looking at the adequacy of supply levels and any potential flood defence measures could be funded out of such a fund? Is that something that you think would sit comfortably with such a national water source resilience group?

Jean Spencer: That is not something I have thought about previously, so it is something we would need to think about. My first reaction, though, is that developers already have to make significant contributions to local infrastructure—both on-site infrastructure and also infrastructure to support individual sites. That already gives rise to some issues around affordable housing. I would question how that fits with affordable housing. Also, growth is more widely based; it is not just attributable to individual developers. The best answer is probably that this is something we can perhaps think about and come back to, rather than making more off-the-cuff remarks.

Colin Skellett: I think we need to be careful that we do not hit developers again. Developers have enough to deal with in the way of contributions. I think that part of the solution to the problem of unlocking development is to release some of those burdens. We do already have infrastructure charges; if the level of these was set correctly, then you could reflect this problem in those infrastructure charges that are levied. I think there is a case for revisiting the infrastructure charges.

The other thing I would say regarding resilience generally is that it needs to be a combination of encouraging people to reduce demand and encouraging interconnection between companies—the creation of grids and interconnection within companies. Those sorts of things will make a real difference to resilience, and development is part of that.

The other thing that we need, which could be included in the Bill, is to look more holistically at how we deal with flooding issues. Despite the Flood and Water Management Act, there is still a bit of a mismatch as to who holds those responsibilities for flooding. The Bill has the opportunity to bring some of these items together. We really need to encourage proper sustainable urban drainage, and the proper management of urban drainage.

Q5 Chair: Would you say this was a missed opportunity?

Colin Skellett: Generally, I think the Bill runs the risk of being a missed opportunity.

Q6 Chair: That is very helpful. Environmental groups have said that the Water Bill should have set out a legislative framework for abstraction reforms. Do you think there is any reason why the Bill should not have included such a framework?

Tony Ballance: If I may, Chair, I think we all recognise that abstraction licence reform could provide real benefits—not only to this sector, but to other water sectors. Notwithstanding that, we also recognise that it is a complex issue that does not just involve this sector; it also involves the energy sector and farming communities. We welcome the Government undertaking to do work in this area and to consult on it, but I think it is important to try and get this right, because what would not be satisfactory is to rush legislation in this space and get it wrong, because it does provide a great opportunity going forward.

23 October Rob Wesley, Colin Skellett, Tony Ballance and Jean Spencer

It is also encouraging that our regulators have grasped the nettle on this; Ofwat are talking about including incentives around abstraction in the next price review period, to reduce abstraction in the most damaging areas. The Environment Agency have introduced new guidance on the trading of licences, whereby they will not automatically reduce abstraction licences when people wish to trade them. These are welcome steps that we should be getting on with. We obviously look forward to seeing the Government's consultation in due course. I do not know whether Jean wants to add to that.

Jean Spencer: I also just wanted to add—the Chair may be aware of this—that Anglian Water is sponsoring a project through the Cambridge Programme for Sustainability Leadership on testing and building a trading platform to inform policy around trading. We are doing that by working with agriculture—the NFU and the Royal Agricultural Society of England—as well as regulators to test out and better understand some of the implications of introducing trading. Hopefully, when legislation does come forward it can be informed by that process.

Q7 Chair: Would this not have been a good opportunity, though, to pass the primary legislation and then have the secondary legislation at a later date?

Colin Skellett: That is a difficult area, I have to say. The last people who talked about water trading in that way were Enron—we happened to be owned by Enron for four and a half years—and they were keen to pursue water trading in the US. They were going to make a fortune out of it; unfortunately, rather like some of their other things, they did not. I think this is a really difficult area. It is fine to talk about it in principle, but you need to do a lot of work in order to ascertain how it will work in practice. I would caution against rushing too fast into this.

Q8 Chair: To sum up what you have said so far, the Draft Water Bill is potentially a missed opportunity, and there is definitely unfinished business in terms of SUDS, ancillary flooding issues, bad debts and social tariffs.

Colin Skellett: Yes. We also need to set the direction on things like metering, for example. There is no mention of metering in there. We must keep moving towards metering—at the very least, metering on change of occupancy; that is when people make decisions. All the evidence is that if you install a meter on change of occupancy people's consumption reduces by about 20%. It is an opportunity; at the very least the Bill should set that direction, recognising that there are different needs in different parts of the country. It should set the direction of policy.

Q9 Neil Parish: You have started to answer my question for me, really. Where water companies have put in meters, they have found that there has been a 15–20% saving when consumers actually work out whether they have leaking taps and are conscious of the amount of water they are using. Would you support the inclusion of a provision in the Bill that would allow water companies to roll out universal

metering, not just those in areas of serious water stress?

Colin Skellett: I would not be in favour of compulsory metering. This is an industry that needs to take its customers with it. Compulsory metering will alienate customers. What we need to do is encourage the roll-out of metering as appropriate, which is why a lot of progress has been made with voluntary metering and why metering on change of occupancy and similar measures to that would move us significantly forward. However, I would not be in favour of saying, "Everyone must have a meter".

Q10 Neil Parish: Are you saying that it should be compulsory when there is a change in occupancy?

Colin Skellett: Yes. If the occupancy of the houses changes, it should be compulsory.

Q11 Neil Parish: If a single lady is living in that house at one stage and then a large family comes in, it will not be to their benefit, necessarily, to have a meter, will it? This is just playing devil's advocate.

Colin Skellett: If you know that is going to happen, you make a choice when you move. If you came down from space and looked at this industry, you would see we are charging a lot of customers on the basis of the rateable value set in 1976, or whenever it was; it is madness.

Jean Spencer: Different companies have taken different approaches. Rather than compulsorily charging on the basis of a meter, what we have done over the last five years or so in the east of England—because it is a water-stressed area—is have a rolling programme of fitting meters. We then give customer alternative bills, so we let them know what their bill would be on the basis of the meter, and the customers then have the choice of switching to meters; it is their choice. We do also make them active on change of occupier, but we also accompany that with a water-efficiency programme, which includes doing retrofitting in the home to ensure water efficiency there. It also gives us information about those customers who have not opted to be charged on the basis of a meter. Some of those customers would end up paying more, but it allows us to understand the effects of compulsory metering better and to think about affordability tariffs when we come to those in the future.

Tony Ballance: Certainly, as a company with one of the lower meter penetration rates—ours is something like 34%, compared to the average of 40% in the sector—we have been less advanced in terms of what we do with metering. What we have certainly found is that metering is not always the most economical way of balancing supply and demand. Certainly, as Jean alludes to, we have been very successful in getting water consumption down by water efficiency; we have one of the lowest per-capita consumption rates in the country as a result of that.

We are increasingly finding that meters are expensive to put in, and we are getting more bang for our buck by doing water efficiency and other measures to ensure that supply and demand are balanced going forward. We are not against metering, but we are less in that space of wanting to make metering compulsory

on change of occupancy. We are trialling it at the moment in certain areas, but by no means would we want to do it across the piece.

Rob Wesley: Across the industry, each company is currently in the process of engaging with its customers and stakeholders on what would be the most appropriate arrangement in its own area. There are different circumstances in different areas, so moves towards metering on change of occupier would be more appropriate in some areas than other areas. There is a widespread agreement that metering is the direction of travel. The question is really as much about what the appropriate pace is for different areas.

Q12 Neil Parish: In the South West Water area—where you have very high sewerage charges in particular, linked to the amount of water that you use—I think something like 80% of people are on meters. Therefore, where they are paying high charges, people are very keen to go on meters. I am not suggesting that everybody should pay high charges, but it does have a reflection. Surely, given the resource and environment—and using that resource effectively—it is right to go on to a more vigorous metering regime.

Colin Skellett: At Wessex Water, we have just completed the largest meter trial since the Isle of Wight trials. That has shown clearly that if you put a meter in, people save 15% on average. The advantage of a meter, as well, is that it then enables you to move on to tariffs and different sorts of tariffs to control demand, and, also, the social tariffs that you need to deal with some of the affordability issues.

Q13 Mrs Glendon: Just following on from that discussion and answering the question about metering, in their written evidence Wessex Water made it clear what they feel about metering, but could I ask the other three of you—following on from what you have said—whether you agree with Wessex Water that the Bill should introduce a default position? Wessex Water have said that meters should be installed on change of occupier. Do you think there should be that sort of default?

Tony Ballance: We would see that as a matter of choice for individual companies. We understand Wessex's position; in some senses, that is a part of the country which might require that. As I say, in Severn Trent's case, we do meter on change of occupancy, on a trial basis. That will be something that we will look at in the future, but it would probably not be a step we would want to take now.

Jean Spencer: We aim to have 80% of our customers on meters by 2015. I do not think that we will continue to roll meters out to the remainder. We would rather do it with a phased approach rather than going all over the rest of the region and fitting meters on an ad hoc basis. For us, it is about getting that efficient roll-out of meters. As I said previously, we already have good coverage, so when customers with a meter fitted move house, then we will charge the new customer on the basis of a meter in any case, because the meter, by and large, will already have been fitted. We would not do it on an ad hoc basis.

Rob Wesley: Picking up on responses from Jean and Tony, there are different management views as to the most appropriate pace and style to progress towards greater metering across the industry. There are already some companies that do meter on change of occupier quite successfully. That may not be the appropriate solution for all companies, but it is definitely one of the tools available and potentially could be used more in the future. There is broad agreement that metering is the preferred direction of charging in the medium term. Really, the question is just about what the most appropriate way is of reaching that goal in each particular region of the country. This is probably an area where it is natural for it not to be a one-size-fits-all approach.

Q14 Chair: Would you like to add anything, Mr Skellett?

Colin Skellett: No, not at all. As you can see, this is not a monolithic industry with one opinion. I would make the point that, although in theory it is open to companies to do this, in practice Ofwat must agree to fund it. We tried to introduce it at the last price review and Ofwat refused to fund it. It is about setting a tone that says, "This is where we ought to be going", while recognising that there will be different needs in different places.

Q15 George Eustice: May I ask you a question about the proposed changes to the special merger regime, which I think has been welcomed by both Ofwat and the industry generally? What are the main benefits of the changes that have been proposed, to have this two-tier referral system?

Jean Spencer: Ofwat's response to the two-tier proposal seems to make a lot of sense, actually. Colleagues agree with that. Rather than have it as a set limit, having criteria around the impact on Ofwat's ability to make comparisons and also the impact on markets seems to be a sensible way forward. Companies can then investigate opportunities and have sensible discussions with the OFT and Ofwat. It seems a sensible approach to us.

Tony Ballance: To build on that, certainly the current regime is extremely burdensome. As Colin alluded to, if you came down from space and asked how we go about merging in this sector, when we articulated how we do that, you might think that it is very odd that it is easy to take over a company if you are a foreign owner. For companies in the sector to have the opportunity to at least demonstrate that it would represent good value to conduct a merger is something that, obviously, the Bill seeks to address. We are very supportive of the two-tier system that is being proposed. It is a step in right direction to allow sensible merger activity in the sector going forward.

Q16 George Eustice: Are there any disadvantages, though? Obviously, these provisions were put there for a very good reason in the first place, which is to avoid geographic monopolies of sorts. There was a view that you did not want to consolidate. The purpose of the Bill is to increase competition.

Colin Skellett: They were put there originally by Nicholas Ridley at the time of privatisation, because

23 October Rob Wesley, Colin Skellett, Tony Ballance and Jean Spencer

he was concerned about the French coming in and buying up the UK water industry. He put the provisions in for the mandatory reference. At the time Wessex Water was trying to buy South West Water, Sir Ian Byatt invented comparators and the values of comparators. What this does is it rationalises; it rationalises in a sensible way that says, “We need to look at this properly.” We need to encourage some merger activity and some coming together. Again, if you started with a clean sheet of paper, you would not draw a water industry with 22 individual companies, 10 of which are water and sewerage companies and 12 of which are water-only companies. You would have a different view of it. Some sensible coming together with appropriate safeguards should be encouraged.

Q17 George Eustice: There is an argument about the comparative data and the inability to do benchmarking properly. Are you saying that was a presentational ruse at the time?

Colin Skellett: I would not say it was a presentational ruse.

Q18 George Eustice: But was that not the reason for doing it?

Colin Skellett: There is clearly a benefit to being able to make comparators. Actually, the quality of comparators between the range of companies—because of the differences in sizes of companies—is less than you might think, but allowing some merger activity would be a good thing. What is being proposed is a sensible, balanced way of evolving the merger requirements.

Tony Ballance: If you go back through history, there was certainly a need to have rigorous, comparative competition in the early days using econometrics, the cost base and all the things that Ofwat used to do. The regulatory regime has evolved substantially, particularly over the last two or three years, and one might argue that comparative competition still remains important, but the need for 20 or so comparators is probably less important now than it was in 1994 or whenever. Therefore, this is a sensible step that does not automatically allow companies to merge but, where it is sensible, allows you to demonstrate that a case can be made.

Q19 George Eustice: Mr Ballance, you touched on this earlier, but the other question I had was about allowing companies to exit the retail sector. When we last looked at this—we looked at the White Paper initially—this was very much the view that was put to us by Ofwat. We bought in to that argument and concluded the same. The Government’s counter-argument was that you had to bear in mind that there are still household retail customers that have to be served and they wanted to be very sure that greater customer focus from water companies would also benefit households. They were not confident that allowing people to exit the retail market was the right thing to do at this time. What do you say to that?

Tony Ballance: The reasons for having more competition in the non-household sector are pretty clear, because what we have are companies in sectors

whose demands on water companies are quite different to the demands from households. You have multiple-site companies who want aggregate billing and more specialist services in terms of water efficiency on site. They are looking for a different bundle of services. That lends itself to a competitive space where new-entrant companies can get the right scales in that sector to service those companies properly. That is something that Severn Trent have stepped into with our joint venture with Costain. Yesterday, we announced the first switch of a major customer across the company to do that. Other companies in the sector are also trying to do that.

I think the issues facing households should not be conflated with the business-customer issues. Of course, customer service is paramount for our domestic customers, but things like the Service Incentive Mechanism that Ofwat are using to regulate the sector are having a very powerful impact on the way in which we look at our customers in that space. I still stick by the argument that allowing companies to have a separate licence to allow them to compete properly in that space is a good thing. We should not conflate the issue of domestic customers into that space, because that leads to a situation where you are not really allowing proper competition to take place in that business-customer space, which is of paramount importance, as the Bill recognises.

Q20 Chair: Would you like to comment?

Colin Skellett: I agree entirely. If we finish with 22 companies pursuing business customers, there will not be 22 companies in 10 years; there should not be 22. We have had a separate billing company, a joint company with Bristol Water, for 10 or 12 years. It works well; it is a separate company, and there is no reason why those companies should not be brought together, or why companies should not be allowed to exit. This is a natural progression of creating a competitive marketplace for business customers.

Q21 George Eustice: Do you see a situation, then, where there are very much two markets? You might have a statutory obligation on one water company to provide the domestic supply, but then you might have totally separate companies that specialise in business water.

Colin Skellett: Indeed you might.

Rob Wesley: To build on that, I think the key in this area will be for this to be a genuine choice for the management of water companies as to what the best arrangements are for serving the customers in their area, rather than this being in any sense a mandated or a guided choice, either by Government or by regulators. This should really be a genuine matter for the management of companies.

Q22 George Eustice: Finally, how likely is it that a company—say, Wessex Water—would want to exit the business market in its own patch? That is, effectively, what you are saying they should be allowed to do.

Colin Skellett: That depends on how successful they were. We have the lowest cost of billing in the country at the moment, so we hope to be very successful and

take on others. We are keener for others to exit so that we can buy their companies. However, it could be a business decision that a company says, "It is not working and we will allow consolidation to take place." I think if you do not do that, you create a terribly artificial business market.

Tony Ballance: If it is going to work well, some companies will be good at it and some will not be. The natural progression is to allow those who are better at it to take over those who are less good at it. We need to get the right economies of scale in that sector.

Q23 Barry Gardiner: You said it made sense to have competition in the business sector because businesses have multiple and complex needs, and that it would be good to have competition in there. Of course, the householder is very simple: they want to have gas and they want to have water in their taps. Why is this so dramatically different from gas? How is it that competition in the gas market is deemed to work? Why is water so special that competition could not work for households?

Chair: I dare say that water companies would like to increase their prices by as much as the gas companies.

Tony Ballance: The simple answer is that the case for competition in the gas sector was largely predicated on having successful upstream competition in combination with retail competition. You have much larger gas bills than you have water bills and you have much more ability to have large-scale upstream competition with multiple-supply entry into that market, which allows customers genuine choice as to their gas provider. While Severn Trent is a supporter of market reform and more competition in the sector, we do not see—certainly immediately, but even in the medium term—that the water market going to be anything like gas market is. It is just a different commodity in the way that it is supplied.

Q24 Barry Gardiner: Are you in favour of upstream competition?

Tony Ballance: We are in favour of some upstream competition, yes.

Q25 Ms Ritchie: If I could move on to the issue of degrees of separation—I think Mr Skellett already referred to some of that. I suppose my question is about the encouragement of new entrants into the market. If we could elaborate on that, would you agree that those companies that voluntarily choose to legally separate their retail and wholesale arms should face a lighter-touch regulatory regime?

Tony Ballance: If I may, I think this is quite a tricky question to answer. There are a number of components to it. Certainly, we are supportive of the direction of travel in terms of lighter-touch or risk-based regulations. I have already alluded to the fact that Ofwat are moving that direction; that is a good thing. I have also alluded to the fact that, if companies are not allowed to separate their retail activities, it is a quite complicated activity to have a monopoly supplier and a competitive element.

Therein lies part of the answer to this question: if you stay in that state, it will require quite a lot of

regulatory activity on those boundaries between the competitive and non-competitive elements. So in principle, yes, but I think the behaviour of the participants in the regulatory framework is equally as critical in all of these questions about regulation. Before jumping up and saying, "Yes, that is certainly the answer," I think it is critical that the companies and the regulator act appropriately and in the right way in that framework. We are supportive of lighter-touch regulation, but it has to be right for the participants.

Q26 Ms Ritchie: Could I move on? Particularly, I would like to move on to Wessex Water and Mr Skellett. Why did you set up Bristol Wessex Billing Services Ltd? What effect did that have on your business?

Colin Skellett: We set it up because one of the anomalies of history is that we have common territory. Bristol Water has about 500,000 accounts in common with us, where we provide sewerage services and they provide the potable water supply. It seemed crazy to us that we were sending two bills to customers. It confused them and added to cost. We initially set it up as a cost-reduction vehicle to drive costs down between the two companies. The only way we could agree to do that was to set up a separate legal entity that was owned by the parents of the two companies. It has worked extremely well, because it has created a business that is totally focused on billing and customer service. It has enabled us to achieve the lowest unit-cost for billing in the industry and very high levels of customer service. One of the things that came out of this is that focus is really important. The experience from Scotland of separation is that the focus that comes with it provides a better service. It has worked well; it has driven down costs. It is legally separated and has not caused us any problems at all. We very much welcome lighter-touch regulation on it.

Q27 Ms Ritchie: As we move on into the whole area of separation and new entrants, how can the new entrants have confidence that there will be a level playing field, given that the Draft Bill does not specifically require any degree of functional separation between incumbents' wholesale and retail arms?

Tony Ballance: Undoubtedly a large part of companies' service provision is—and may well continue into the future to be—a natural monopoly. It is absolutely important that new entrants have some confidence in the rules that apply to the sector to allow them fair entry into it. I think the Bill lays down sufficient powers to Ofwat in terms of the way that it sets access codes and prices to afford quite a lot of protection, hopefully, to new entrants into the sector. There are also the Competition Act powers; obviously, if those powers are not seen to be effective, there is a fallback for new entrants into the sector. To some extent, the proof of the pudding will be in the eating once the new Bill is hopefully enacted, in terms of how well it will allow new entrants into sector, in terms of whether there will be entry on fair terms.

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Q28 Richard Drax: Do you believe that the Draft Bill strikes the right balance between legislation and guidance, in particular in relation to the introduction of charging rules and market codes? Mr Skellett, would you like to kick off? You are nodding your head.

Colin Skellett: No, I was shaking my head. It is surprising how much latitude has given to Ofwat within the Bill. I am surprised that Ministers do not want to take more control over this. Due to the way we develop these access codes—this is the replacement for the current cost principle—if we are not careful there is a danger that this will put additional burdens on other customers. This is an industry that is full of cross-subsidies. Once you start to unwind cross-subsidies, somebody else has to pay. It needs to be done very carefully and with a good degree of thought and control. Within Scotland, there is a duty on the Scottish regulator not to allow changes in one place to affect other customers adversely. That is something that the Committee might want to think about in relation to the proposed changes here. In general, however, I think too much discretion is given to Ofwat under the current proposals.

Rob Wesley: Building on that, one thing that is striking to us is the sheer number of codes, guidance, and regulations in the Bill. It does make it genuinely quite hard to assess what the full impact of the Bill will be. This copy of the Bill is marked up with all of the examples of where there are codes, guidance or regulations referred to in the Bill; it tells its own story. The question of whether regional averaging of charging could be undermined is something that is causing concern, as that has been a principle of the industry for many, many years. If the Government wish to depart from that, then we think that should be a point explicitly made in the Bill. We see no reason to depart from that, and see the benefit from regional averaging being maintained. That should be a matter for the Government rather than one deferred to the regulator.

Perhaps one broader point is that the Bill does confer a lot of discretion to the regulator but does not, to our mind, provide an appropriate appeals process or the correct degree of scrutiny of decisions made by the regulator to balance that discretion granted to the regulator. That might also be an area that the Committee might like to explore further.

Jean Spencer: I really just want to reiterate the comments that Colin and Rob have already made around the potential for de-averaging. One of the consequences of upstream competition is the likelihood of a move towards de-averaged charging. If that is not the intention, then that should be explicit. We have done some work previously to look at the effect of de-averaging in unwinding some of the cross-subsidies; we looked particularly on sewerage side. From the analysis that we did, the impact on rural customers in particular would be bills of about two to three times that of those being paid currently.

Chair: We will be coming on to de-averaging; if we could just stick to market codes for the moment.

Jean Spencer: Otherwise, I think the appeal rights point is important. There should be a route for challenging Ofwat's decisions.

Tony Ballance: I will not repeat what my colleagues have said. What is important is to get the balance right. As I say, a large part of what we do is a natural monopoly. We have to earn the right to that position, and to some extent it is only right and fair that competition, where it can be made to work, is a good thing. If somebody can provide cheaper water in our area than we can, that should be allowed to happen. I will not repeat the de-averaging point, but it would be good to avoid a situation where we are compelled to de-average our tariffs in order to have a fair and level playing field. Notwithstanding that, some competition in our activities is a good thing.

Q29 Richard Drax: Does the Draft Bill give Ofwat too much discretion? I think one of you touched on this already. In your view, what are the possible consequences of that?

Tony Ballance: I think we have already touched on that point. It is a difficult one, because the Government's intention is to have less on the face of statute and give more guidance. As I said earlier, the proof of the pudding is in the eating, in terms of what those codes and the guidance for pricing will look like. If Ofwat get that right then we will have sensible competition. I think the key point that others have made is about having sensible appeals mechanisms when that is seen not to work. One particular example is that Ofwat will be given new powers under the Bill to go back five years in terms of fining, but we know the appeals mechanism in relation to fines is not a particularly good or robust one to challenge. That is a good example where the Bill could be strengthened.

Jean Spencer: I do not think I have anything to add.

Rob Wesley: One area where the Bill would give Ofwat greater powers and discretion is in relation to changes to companies' licence conditions. As market reforms are implemented, some changes to companies' licences will be required to implement those reforms. We would just flag that as an area where caution is required, because companies' licences are an important part of the confidence that investors have in the sector. They have enabled the sector to raise a very large amount of finance to invest £100 billion over the last 20 years and raise that finance at very low rates, due to the stability and predictability that those licences and the regulatory regime give at present.

Colin Skellett: I would only repeat that if you look at the Bill at the moment it looks more like enabling legislation than a Bill that is actually going to be legislated on. The Bill ought to be explicit. Do you want to protect the subsidies? Are you going to allow one set of customers to pay for benefits that go to another set of customers? There are some fundamental public policy issues that are effectively being left to the regulator to deal with at a later date.

Q30 Chair: If we could leave that, you touched, Mr Wesley, on the amount of secondary legislation that is flagged up. Would you not normally expect the Secretary of State to be the person setting out the guidance? Parliament would then also have the opportunity to give a view. Is this the first time the

regulator has been given the level of discretion that is set out here?

Rob Wesley: It is noticeable that a different approach has been taken in this legislation from the previous legislation, the Water Act 2003, where there was significantly more detail on the face of Bill and through the Secretary of State, rather than delegating to the regulator. We do wonder whether greater Parliamentary oversight may be appropriate on such crucial areas public policy such as the charging regime.

Q31 Chair: Am I right in thinking that the level of fines will also increase substantially—within the discretion of the regulator—and would go over an average of five years?

Tony Ballance: Yes.

Jean Spencer: Yes.

Colin Skellett: Yes.

Rob Wesley: It would allow fines to be over a longer period. The concern there is the one Tony alluded to: whether there is an appropriate appeals mechanism to ensure there is an appeals route that provides a safeguard to ensure that those greater powers will be used proportionately and appropriately by the regulator.

Tony Ballance: The current appeals mechanism, as I understand it, in that space is akin to a judicial review. It is not quite the same, but it is quite an onerous task. It is not that the appeal will go the Competition Appeals Tribunal as under the Competition Act. It is quite an onerous appeals mechanism.

Q32 Chair: Just to conclude that point, would you prefer the Draft Bill to define more tightly the circumstances in which Ofwat can modify company licences? Do you all agree?

Tony Ballance: Yes.

Jean Spencer: Yes.

Colin Skellett: Yes.

Rob Wesley: There is no dispute that as the reforms are implemented there will need to be changes to the licences, but rather than making any changes that the regulator might feel are expedient, there is an argument for making perhaps only those changes that are proportionate and necessary, with an appropriate appeals route, for example to the Competition Commission.

Q33 Chair: Just so the Committee is absolutely clear, is the appeals route that you normally would have now, to the Competition Commission, being taken out of picture?

Rob Wesley: Indeed, yes.

Q34 Chair: One is nodding his head and the others are shaking theirs. If we could just get on the record what the situation is.

Jean Spencer: I think it depends on which powers Ofwat is using. For example, currently if Ofwat wishes to amend companies' licences, then companies either have to agree or, if not, the matter is referred to the Competition Commission. Discussions are actually ongoing with Ofwat at the moment around that. If Ofwat uses its Competition Act powers—so

carries out a competition investigation—the appeal route for that is the Competition Appeals Tribunal. If Ofwat levies fines for things like misreporting, then there is no straightforward appeal mechanism for that, other than to say—this is my understanding—that Ofwat has been so outrageous that there is a case for judicial review.

Tony Ballance: Yes, it is akin to that.

Jean Spencer: That is not quite the technical term.

Colin Skellett: The reason why this is so important is this fundamental point about the cost of financing this industry. The reason why people lend us money at knock-down rates is that we are seen as safe and secure, and we have a regulatory system that is safe and secure. The more that is undermined and the more it is open to a lot of discretion, the more difficult it will be. A 1% increase in the cost of capital puts 5% on bills.

Q35 Richard Drax: Will the continued operation of the inset regime for existing appointees lead to inconsistencies between their treatment and that of new entrants under the reformed water supply licensing regime?

Jean Spencer: I do not have a deep knowledge of this part of what is in the inset regime. I think it depends on how it is implemented. It is another example of where we do not know the full impact of the Bill, the substance of which will be in the codes and the guidance. I think we do not yet know the extent to which they will be treated differently. It depends on what comes through in the guidance and the codes in due course. I understand that Scottish Water and SSE made representations around this; I have not studied those in great detail. The answer is that it probably depends on how it is implemented.

Tony Ballance: It is just one of those complicated areas. You are splicing together different parts of the regime; it will depend how it works in practice. It should not be a problem, but it could be if it is not brought together properly and appropriately, with the use of guidance and so forth.

Colin Skellett: I bow to my colleagues' greater knowledge; this is one that we do not really understand yet. In general, though, regarding inset appointments, I am not sure it is in customers' interests to have these micro-monopolies for housing estates spreading across the country. I think it would be far better to focus on the bigger issues of retail competition, rather than the micro-inset appointments. That is a slightly different issue from the one you raised.

Rob Wesley: I have little to add to my colleagues' responses, other than perhaps the observation that the Draft Bill sets out an ambitious reform programme, and there is a lot of detail to be worked through to ensure that all elements of that are practical and deliverable.

Q36 Neil Parish: Regarding the Anglo-Scottish market, the Committee has looked at this. We are a little bit worried that, if we have Ofwat and WICS issuing licences between the Scottish and the English market, this will create a bureaucracy. Are you satisfied with the progress of the high-level group,

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particularly in relation to the establishment of a joint Anglo-Scottish market? It may not be particularly interesting to Wessex Water; I do not know. It is a long way from Scotland.

Colin Skellett: We participate in the Scottish market at the moment.

Jean Spencer: I think it is a good start. The establishment of the high-level group is very helpful in providing direction. Anglian Water's Chief Executive, Peter Simpson, sits on the high-level group, so we have been involved in driving that. In terms of looking at bringing together the Scottish and English markets, Anglian Water Group, through one of its subsidiaries, Osprey Water, is the biggest entrant in Scotland, so we have a number of customers up there.

I do not think we see any particular issue, at this stage, with bringing together the Scottish and English markets. As ever, though, the devil will be in the detail. One of the particular issues that will need to be addressed is the central market mechanism and the models around that. Again, I do not think it is necessarily an issue; it will just take time to implement. Also, I think we can learn a lot from the experience in Scotland, particularly regarding things like data quality. Peter Simpson is heading that work-stream, because we have some direct experience of that in Scotland and can bring that into England.

Rob Wesley: Chair, if I may add to that, I agree there has been a good start so far from the high-level group, and we are pleased that Defra has established an inclusive group, bringing all of the key parties together. That is a very positive development. Within the industry, we are very keen to make progress in delivering the choice to business customers that they have been asking for.

Looking forward, the high-level group plays a key role in providing strategic direction, but we would see benefits in that being complemented by a broader implementation group to get further stuck into the detail and the nitty-gritty, to ensure we keep momentum going, that we manage to hit deadlines and that progress does not slow. We would support a broader implementation group to drive progress forward; the industry would be very happy to play a positive, constructive role in that.

Tony Ballance: I do not think I have much to add to colleagues' points. It absolutely is an important area to get right; it needs focus and energy and that is being brought to bear at the moment. Obviously, there is still a lot of work to do.

Q37 Neil Parish: Could it be argued that there might well be greater competition available for business customers in the Anglo-Scottish market on the borders of Scotland than there is in the rest of England?

Colin Skellett: I do not think so. We are talking about retail competition. It is the provision of billing, customer services and advice to customers. The evidence from the Scottish market is that people are not switching because of price; they are switching because of the quality of the service they are getting. Putting the two together makes an enormous amount of sense; learning from and building on the Scottish experience makes sense. We do not need to reinvent

the wheel for ourselves. They have done a lot of work and they have something that operates. We should build on that and create a single market. I think the competition will be as vigorous in Cornwall as it will in Northumbria.

Neil Parish: I hope you are right.

Q38 Chair: Does it not surprise you that the high-level group has only met once and has no plans, immediately, to meet again?

Jean Spencer: It has met once.

Chair: And only once.

Jean Spencer: It does have plans to meet again; I do not have the date.

Q39 Chair: Do you not expect a little bit more? I think, Mr Wesley, you said you would like to see some momentum. Does this smack of momentum to you?

Rob Wesley: Perhaps if I could expand on that. As well as the meeting of the full high-level group, there has also been a working-level group meeting. In setting off this process, it is very important that there is a coherent vision for establishing the new market and that this vision has broad support from all of the stakeholders and participants. There is a lot of work to be done establishing the appropriate order and the appropriate tasks to be carried out; that is a crucial first step. Building that consensus is a key part of the process. The high-level group, by its nature, is small focus group providing strategic direction. I think we would see a strong case for there being a broader and perhaps more detailed, working-level implementation group to be able to take the practical step of delving down into detail to meet that high-level vision.

Q40 Barry Gardiner: Reading the submissions that you have given to us, it would seem that sizable chunks of the industry have real problems with the upstream reforms. If I try and characterise them for the sake of expediency, they would be: the possibility of increased household bills, which would be if there were competition in one part of your business, the business unit supplying to other businesses, then you would look to recover that from household bills; declining investor confidence because of cherry-picking; loss of economies scale and a risk of stranded assets; and reduced resilience through a lack of clarity over the need to build capacity by new entrants into the market.

Those are really sizable objections that the industry is putting forward. Mr Ballance, you were good enough to say earlier that you are in favour of the upstream reforms. Can you explain to me why you disagree with some of your colleagues over the nature of the upstream reforms and the risks associated with them?

Tony Ballance: It is probably worth starting by breaking down the areas of upstream competition that are being promoted. We have discussed the issue of business-retail separation. I think the industry has largely reached a consensus around that being a sensible step to take and the extent to which that should happen. I think there are two components to upstream competition. The Bill effectively seeks to allow entry into the supply chain with new entrants coming in who can supply goods and services cheaper

or more efficiently than the incumbent water undertakers. Secondly, there is scope to increase water trading through bulk suppliers and the Bill strengthens Ofwat's powers in that regard.

Dealing with the bulk supply issue first and water trading, Severn Trent makes no secret of being advocates of that; we have, indeed, published work in the recent past on the economic benefits that would accrue to customers through encouraging more water trading between companies, where it makes economic sense. That is where one water company can develop water resources cheaper than their neighbour, and supply it across the border inclusive of the costs of transportation. Indeed, Jean and I were talking earlier in the summer when it was hot and dry—before it started chucking it down with rain—about a potential trade between Severn Trent and Anglian Water.

Q41 Barry Gardiner: Was it 50 billion litres? It was extraordinary. You never drew down on it, though, did you?

Tony Ballance: No, we did not need to, because effectively that water would have come from Birmingham, from pumping water out of the ground, into the Trent and down into Anglian's region. It started raining. The Trent was full of water for the remainder of the summer period, so Anglian did not need the water. We make no secret of that.

Our view would be that it is possible to implement a water-trading regime without destabilising investor confidence in the sector because, to some extent, it leaves the companies' funding mechanisms entirely intact.

If I then turn to the provisions relating to allowing new entrants to supply into the value chain, others have expressed the view that there is a risk there in terms of the impact that can have on de-averaging of charges, because we have large cross-subsidies in the way that we charge, and, if that competition was going to be extreme, then that might force us down that route.

Q42 Barry Gardiner: Sorry; could you be explicit about what that route is? That route is loading household bills to make up for it. Is that right?

Tony Ballance: That could be one consequence. It could be loading certain household bills, for example, or charging more in rural areas, because it is more expensive to supply, and cheaper tariffs for urban areas, in order to protect your customers from, effectively, new entrants being able to supply them at cheaper prices.

Jean Spencer: It might not necessarily be households.

Q43 Barry Gardiner: Is it protecting your customers or is it protecting you, as a company?

Tony Ballance: Getting the balance right in this space is important because it is entirely right, as I said earlier, that there should be some form of competition if it is on a level playing field. For years and years we have had the situation where breweries, or whoever, can drill boreholes into the ground and take water from underneath their factories if it is cheaper to do so than get water through the network, or companies can pre-treat their effluent waste before sending it

down the sewerage network to Severn Trent or whoever else.

We have always faced some form of contestability in the supply chain; it is a question of getting that balance right. It is sensible to have some competition, but if, to some extent, it is not on a level playing field, in terms of the way in which the price mechanisms work, that is where the concern comes, because you may end up with stranded assets or you may end up loading the bills of some domestic customers higher. Obviously, that is the concern that has been expressed in some quarters in relation to the provisions in the Bill.

Jean Spencer: I would say that it is not just about rebalancing on to domestic customers necessarily; it is rebalancing on to other business customers, particularly thinking about SMEs and especially those in rural areas. It is not necessarily the case that the unwinding of the subsidies would be from businesses to households. It would potentially be within businesses as well. Sorry to interrupt, Tony.

Colin Skellett: I think Mr Gardiner did an excellent job of describing why this is a good way of shooting yourself in foot. I think we are starting at the wrong end. We should not start from the notion of, "Competition is the answer; what is the question?" We should start from the question of, "How do we create resilience in system? How do we create additional capacity within the system?" It is perfectly possible to do this by requiring companies to continue to work on their grids, to work on their regional grids, to interconnect their regional grids and to work together. All the evidence says that once you create a regional grid—we have done it at Wessex Water—you actually create additional capacity, because you are able to move water around and meet demands in different ways. We need to focus on how we achieve that resilience.

I do not see how upstream competition will do anything to help with that. I think it will add to uncertainty; I think it will add to the cost of the industry; and it will lead to a horrendous unwinding of cross-subsidies. To me, this should start from another place, which is this: how do we achieve the resilience we need within the system? We can do that by setting the right incentives in place. Ofwat can do that by putting the incentives in place for companies to work together and trade. An additional point is that I would have thought that if we got into the national emergency situation of a serious, prolonged drought—and we are going to get more and more droughts—we would want to be able to have a more command-and-control approach to this, rather than saying that the market will sort it out.

We had a fascinating meeting of the chief executives of the water companies when we were looking at the drought and how we worked together to do the things that we described, moving water from one place to another. We were told very clearly by our lawyers at the time that, of course, if we were in a competitive market we would not have been able to do that.

Q44 Barry Gardiner: I go back to the Martian that you referred to at the beginning. You do not think that the size and shape of the water industry is the correct

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one any more than the Committee does, but what strikes the Committee—or certainly strikes me—as odd is that, for a private-sector business, you are remarkably resistant to a private-sector, market-led approach to sorting it out. Somebody might come along and says, “You know what, guys, we should use the market. We should use competition to drive efficiency into this industry. We should use competition as a way of rationalising it,” so that the Martian can come down and have a look at it and say, “Actually, that makes sense,” instead of, “Hey, this is a mess”. You guys from the private sector would push back on that and say, “Hey, no. We do not want the market to do this.”

If it is not going to be the market that will drive that competitive improvement and rationalisation of the industry, what will?

Colin Skellett: Can I be clear? We are absolutely in favour of competition in the right place. Competition on business customers makes an enormous amount of sense; it is what business customers want. There is a competitive market for providing the capital solutions in the way the industry operates now, but what you do not want to do is to create an artificial competitive market that simply increases the cost to the industry. That is not sensible way of doing this. Opening up the market and allowing more mergers and takeovers would continue to drive efficiencies in this business.

Q45 Barry Gardiner: Mr Skellett, with respect, you are telling me motherhood and apple pie. You are saying, “We do not want to introduce bad competition. We do not want to introduce competition that is going to drive up costs. Of course we do not.” Come on, then. How will we change the shape of this industry, so that, instead of 22 companies, you might end up with five; you might go back to the Regional Water Authorities; and you might have a catchment-based system that makes sense, and all of those other things? How will you do that? How do you need to change this Draft Bill in order to get back to a sensible system for your Martian?

Tony Ballance: One of the things we talked about earlier was abstraction licence reform, and we made the point that we largely would be in favour of that. That, I think, would be a catalyst to helping stimulate the movement of water in a different way because it would realise the economic value of that. Once there is a value associated with it, that would allow that. I wanted to go back the water-trading piece, because I think the Bill does push forward in that direction, strengthening Ofwat’s powers in relation to water trading. I see that as sensible upstream competition, which does not destabilise investor confidence in the sector, which is intrinsic to having a regulatory cap on the value of some forms of vertical integration.

Using the Martian example, if somebody in 1989 came back to the industry now and said, “Could you tell me how much water trading has happened since 1989?” and we said, “Very little, other than what was put in by the Victorians”, I think they would be pretty surprised with that. What is lacking is incentives in that space. I think Ofwat recognise that; I think the Bill recognises that by strengthening the powers in relation to that. If we can get water trading working,

which may require companies to work sensibly together, that will give us a form of competition. What it will mean is that some companies will be building resources in their own traditional area. Colin’s absolutely right that individual companies need to strengthen their grids for resilience purposes. We need resilience across boundaries and I think that will come from more water trading between companies, which is a real form of competition that does not spook the markets.

Colin Skellett: Can I answer the question in another way? This industry is not broke. It actually works and it works remarkably well. It has driven up standards for customers; it has driven up efficiency; it has kept bills much lower than they would have been without the changes that took place. What we are not trying to do is to recreate the industry. We are trying to sensibly evolve the industry. I agree entirely with what has just been said: we should put the incentives in place to encourage water trading and water movement. What we do not need is a complicated trading mechanism to do it. We need the right incentives put in place.

Q46 Neil Parish: Carrying on with Mr Gardiner’s question, is this not a case of, “Lord, make me good, but not just yet”? Is it not the case that you want to actually have competition and not be fearful of it? It could be argued that we handed a public monopoly over to a private monopoly; I am playing devil’s advocate here. Surely, what we need is a great deal more competition. That would actually drive prices down, ultimately, and not drive them up.

Rob Wesley: It is absolutely right that competition is right for business customers. We fully support that, and are working actively to make that happen on the ground. We are very conscious of the great benefit to customers of the ability of the industry to raise finance at extremely low rates. We touched earlier on affordability. There could be some significant consequences if that confidence for investors was lost. That is not to say that evolution cannot happen over time, but the confidence of investors has been hard-won and could be easily lost.

Obviously, we are conscious, being industry representatives, that you may take anything we say with a degree of scepticism. However, these are points that are being made by range of commentators on the industry, such as Dieter Helm, for example. There are some serious questions out there to be answered, and we would take the view that it is right that there should be a cautious approach. For retail competition, there is a model. There is an example which is working well north of the border, in Scotland. For the upstream reforms that have been proposed, there really is no model. These are untried and untested, so a cautious approach, of carefully working through how they could add value while maintaining investor confidence, has to be the right approach.

Q47 Chair: Is there anywhere in the world which has upstream competition in the private market?

Rob Wesley: There are no substantial examples of this. There are some areas on the margins with some degree of water trading.

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Jean Spencer: There is some in Australia. We actually published a report last year, as a precursor to the work we are doing on the trading platform, called *A Right To Water*. That does set out some of the international experience. There has been some in Australia, but in Australia it is very much on a catchment basis, so it is not across even the whole of a region. It is very catchment focused. That is very much around trading, which, as Tony says and which we very much agree with, is important and should be the focus going forward, rather than some of the other reforms that are being suggested.

I would add to Rob's point that whatever we say would be treated with some scepticism. It is important to look at other commentators; Rob mentioned Dieter Helm. I think it is also worth looking back at the National Infrastructure Plan that was published in December. I cannot remember which year that was. That sets out the respective cost of financing with different models. The cost of financing regulated infrastructure is significantly lower than financing competitive, market-based infrastructural investment. I think you have to look at those other external commentators and not just at what water companies are saying.

Q48 George Eustice: You are right; we do treat it with a bit of scepticism. The arguments you are using do sound like arguments used down the ages by vested interests trying to protect their position. It is the type of thing people now use against opening new schools or decentralising the NHS.

I wanted to push you on a different point. I take your point that you do not want completely rival systems that would then increase the cost, but are there any elements that you would accept? For instance, if you want to encourage water companies to be able to leave areas where they are not efficient, could a water company, for instance, say, "Well, we were good at maintaining the pipework, but our reservoirs are not done very well. We are going to sell that bit of the business off to a new provider who can come up with the capital to invest in it more cheaply than we can. It is in our interests to do that." Or they might say, "We are not very good at sewage treatment works; we are losing money. We are not as efficient as we should be, so we should sell that element of it."

Are you being unrealistic in saying there will be 10 different systems of water pipes? Is the case that, in reality, you will be able to pick and choose which bits of the infrastructure you would maintain?

Colin Skellett: That is an interesting argument. There is already competition in the construction of the assets. That is absolutely clear. There is also competition in the operation of the assets, to the extent that all of us put those assets out for competition, in terms of maintaining them. In some places they are maintained by other companies; in some places they are maintained by us. What we have not thought about is the idea of selling off those assets to others.

I suspect that you have come back to the problem that you have created a regulatory asset base, against which people have lent money, and the overwhelming need to keep down the cost of that borrowing means that you want to keep that asset base intact. Now, you

can look at it with a different approach for new assets, and that is happening in different places. However, I think selling off the existing assets on a piecemeal basis would present you with a lot of financing problems and would probably result in most companies breaching their various debt covenants.

Tony Ballance: There has been some interesting work done on what economists call the "economies of scope" in the water sector. We run complex networks comprising water treatment, distribution and resources; it is an integrated system that we run, rather than a separate system. I do not think there are many companies that have a separate water-supply division from a water-distribution division, because you tend to run those things as integrated systems.

There are good economic reasons why you want to maintain integration in significant parts of the value chain. The point is that to some extent you are then trying to defend the fact that we want to keep significant elements of a natural monopoly, which is where the competition debate comes in, and people ask about how competition can work around something that is effectively a private monopoly. To some extent, we have to accept that, for a significant period of time, large parts of what we do will be a private monopoly. We need to have competition in the right space within that framework.

Q49 Barry Gardiner: The unbundling should provide the opportunity to anybody who wishes to challenge, rather than you saying that it is the one side of it that is unfair or will cause problems. Briefly, to wrap up, I wanted to ask a question. Given that upstream reform is likely to go through—it is in the Draft Bill—and given that what the Committee is partially about is to make sure we get the best Bill we can, rather than just start off in a new place, what changes could be made to the Bill so that the upstream reforms that we have been talking about do not have those perverse effects on investment confidence, on reduced resilience, on stranded assets and so on? What are the key changes that you would wish to see made to the Bill to avoid those deleterious consequences?

Jean Spencer: I think it is important that the Bill is clear on the intentions for upstream reforms. We have already heard that Ofwat say that it sees the Bill giving it the green light to look at separating companies' functions or activities—for example, potentially taking water resources and treatment, and subjecting it to a different form of regulation, which means it might not be a RCV-based or return-based form of regulation. I think the Bill needs to be clear on what its intention is. It is absolutely fine if the Bill's intention is that Ofwat takes those next steps—that is a matter for Government policy—but it needs to be clear on what the policy is. That will be an important part of Bill.

Another key part is the point around averaging and the potential risk of de-averaging as a consequence of the Bill. That will be a consequence, unless it made clear that it needs to be addressed through the approach to setting prices. That can be dealt with; it can be dealt with through all participants in the market taking account of rural communities, for example, and paying their share of those additional costs. It is not

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an insurmountable challenge, but it needs to be clear what the Government's policy is around that. Then it is also about continuing to maintain investor confidence.

Colin Skellett: I agree entirely with that point, but I have one additional practical thing: there needs to be clarity on where criminal liability will sit for supplying unwholesome water, because you are introducing different filters.

Q50 Chair: Could I just ask about cost-effectiveness? Bearing in mind that water is a lot heavier to transport than gas or electricity, is trading generally deemed to be a cost-effective way to meet the increased demand that Defra hopes will come out of upstream reforms and water trading?

Tony Ballance: If I may respond to that, because I and Severn Trent have made the case for water trading. Water trading is not the only solution to balancing supply and demand going forward. It is one of a number of things, which would include things such as water efficiency, metering, leakage control, new resources and so forth. Certainly, the work that we have done suggests that trading more water across boundaries makes economic sense, but, as I say, it will not be the only solution to the country's supply-demand balance going forward.

Q51 Mrs Glendon: My question is to Mr Wesley and Mr Ballance. Do you believe it is feasible for an incumbent water company to adhere to different market regimes on either side of the Anglo-Welsh border?

Rob Wesley: Everything is possible, but would that be desirable? Clearly, it would be an odd situation to be

in, and we would really see this as a question that does need to be resolved between the Welsh Government and the UK Government. The simplest approach would be for only one approach to apply to one company, so that there is clarity and simplicity.

It is perhaps worth mentioning that Welsh Water is in a somewhat different position to other water companies, in that it is owned by Glas Cymru, which is a not-for-profit company limited by guarantee and which exists solely to deliver better value to the customers of Welsh Water. Welsh Water has been doing equally so to its customers in Herefordshire and Deeside and to its customers in Wales. My understanding is that Welsh Water has not been asked at this stage—and neither has Dee Valley Water—to consider whether it could operate effectively within a different regime applying in England to that which applies in Wales. Clearly, that would be much more administratively complex. The obvious solution would be for one regime to apply to one company, as is the case at the moment.

Tony Ballance: Obviously, Severn Trent Water serves customers in mid-Wales and is indeed proud to serve those customers. We do not envisage any issues, from our perspective, because we fall under the auspices of Defra and therefore, to some extent, the regime is clear for how those customers are treated, so we do not foresee any issues from our customers' particular perspective.

Chair: On behalf of the Committee, can I thank you very warmly for being so generous with your time and contributing to our evidence session? Thank you.

Tuesday 30 October 2012

Members present:

Miss Anne McIntosh (Chair)

Thomas Docherty
Barry Gardiner

Mrs Mary Glendon
Dan Rogerson

Examination of Witnesses

Witnesses: **Yve Buckland**, Chair, Consumer Council for Water, **Tony Smith**, Chief Executive, Consumer Council for Water, and **Robert Leask**, Senior Portfolio Manager, Scottish Procurement, gave evidence.

Q52 Chair: Good afternoon and welcome. Thank you very much indeed for joining us this afternoon for our second evidence session of the Draft Water Bill inquiry. You are all extremely welcome. In advance, we are expecting at least one vote, so I will adjourn for that. Do bear with us; we will come back as quickly as we possibly can. Could I just ask you to introduce yourselves for the purposes of the record, perhaps starting with Mr Leask, on the left?

Robert Leask: My name is Robert Leask. I am from Scottish Procurement, in the Scottish Government.

Yve Buckland: Hello. My name is Yve Buckland. I am Chair of the Consumer Council for Water.

Tony Smith: I am Tony Smith, the Chief Executive of the Consumer Council for Water.

Q53 Chair: Thank you very much indeed. Can I put the opening question to the Consumer Council for Water, and Yve Buckland? Is there anything that you at the Consumer Council for Water believe has been omitted from the Draft Bill that you would like to see included?

Yve Buckland: Firstly, we welcome the Bill and lots that is in it, and I am sure we will come on to talk about that today. We welcome its pragmatic and practical style. In terms of the Bill, there is a broad welcome. There are probably two areas where we would have liked the Bill to have gone further. The first issue is the issue of affordability. I am sure it will not surprise you that that is an issue that we feel is a very important one. You will all be aware of current economic problems, and the current debt that is carried by every customer because of those who cannot or will not pay their bills. I know many Members of this Committee are from the south-west, where 20% of customers are living in water poverty. There is a real issue there.

We are supportive of the approach to social tariffs set out in the Bill, and customer-funded social tariffs. Indeed, the Consumer Council for Water is very actively involved with each water company at the moment, talking to customers about social tariffs and cross-subsidies, and testing their appetite to fund social tariffs. But—and I suppose this is the issue—we know from our research there is a limited appetite out there from customers for more than £1 to £2 going towards funding the bills of other customers. We also know, from evidence that is available nationally, that we probably need £400 million to £500 million if we are going to start to address the problem of affordability and ensure that we can bring people's bills down, below that 3% water affordability cap. So

it needs more money, and customers say to us time and time again that they do not believe that is their job; they think that should come from somewhere else, be it the benefit system or whatever.

What can be done about it? What we are doing is still working very actively with the companies out there locally to look at what can be done in terms of immediate social tariffs. But what we would want to represent here is our fears about the fact that there is not enough money in the system, and customers are looking for that to come either from the Government or from companies. Our research shows that customers have a greater appetite to contribute to customer-funded social tariffs if they feel it is part of a game where the Government is giving some too, through the benefit system; they also feel increasingly that water companies themselves ought to be looking at this in terms of their profits and returns to shareholders and investors. That is an omission.

The other omission that we would raise here is the area in the Bill that is about complaints and the need to better streamline the complaints systems that are around at the moment. This may end up in the final Bill, but we believe that the complaints that are currently handled by Ofwat could be better streamed if they came to the Consumer Council for Water. This is a point that David Gray also made in his review; he felt there ought to be better streamlining and suggested that there could be powers given to the Consumer Council for Water to help with this. We offer the Consumer Council for Water in this respect because obviously customers know where to come to and we can deliver high levels of customer satisfaction with our service—about 75%—which compares very well with other sector-like ombudsmen. We have a lot of experience in dealing with complaints. We are grounded; we have arrangements at individual-company level. Last year we resolved more than 93% of our complaints within a two-month period, which again benchmarks well. That would be the second area that we would draw to your attention. As I say, potentially that may end up in the final Bill, and we would like to support that here.

Q54 Chair: What benefits do you expect the Draft Bill's proposals will bring directly to consumers?

Tony Smith: There are three major benefits that we can see. Firstly, in the market reform area, it will hopefully give business customers a choice that they have long wanted. A very large percentage of business customers, whether they are large or small, are very keen on having that choice. There are two crucial

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things: one is to make sure that a competition regime works in the way those business customers expect it to, and that it gets implemented in a way that does not cause problems in terms of switching in the future. We just need to make sure that the system works. The second thing is, very importantly, that market reform does not happen in a way that causes detriment to ineligible customers—domestic customers and small business customers—because those customers are far less positive about the idea of competition at all. The second area of benefit of the Bill is the changes to the merger regime. We think that more mergers in the sector could be beneficial to customers. It is very important, though, that the emphasis is placed on Ofwat to make sure the benefits of mergers are shared with customers, rather than being kept exclusively for shareholders.

The third area, for a very specific group of customers, is the issue of connection charges. David Gray pointed out that the current water regime does not work very well for developers and companies that want to lay their own pipes or sewers. I think developers should welcome the greater clarity that will hopefully come out of Ofwat being more specific about rules and the way that connections are charged in the future. That is a big area for those very important customer groups.

Q55 Chair: Could I just ask you one thing about the previous consultation in December on proposed changes to licence modification under Section 13, which Ofwat have now revised and brought forward again? The water companies are concerned that this may affect their credit under Moody's forecast. They are saying that this cost could only be met by increased customer bills. Does the Consumer Council for Water have a view about whether that is possibly a risk?

Tony Smith: It is very important that the system works for customers. There is a sanction if the companies really do believe that; they can go to the Competition Commission and argue their case. We would look to the Competition Commission to make sure they are looking very hard at it and making sure that customers are not disadvantaged.

There is a broader point here, as well, which is the issue that David Gray raised, about where the distinction is between regulatory discretion and government policy. We would take the view that it is important that the regulator remains independent of Government, because that is beneficial to all customers, but, on the other hand, if the regulator does something that destabilises the sector, that is a major concern to all customers, because it could increase the cost of capital, and therefore the extent of their bills. We would therefore be very concerned if Ofwat was not taking that very seriously now.

Q56 Chair: Are you concerned?

Tony Smith: We hear the messages back from water companies, so we would be concerned if anything caused the cost of capital to rise. You only need a 1% increase in the cost of capital to add £20 to the customer's bill, on average. We will be looking very closely at that consultation. On the one hand, it gives Ofwat, at least in theory, the discretion they need to

implement some of these market reforms, but the question is whether they are going beyond that and trying to keep open a more open-ended discretion, which would be a big concern to us.

Q57 Chair: Would you say that the appeals procedure, after the Draft Water Bill, remains as robust as it is currently, in terms of companies appealing?

Tony Smith: It depends what the issue is. If it is about licence conditions, they can go to the Competition Commission.

Q58 Chair: Now?

Tony Smith: Yes. They will be able to afterwards, as well, as far as I understand.

Q59 Chair: So they do not have to revert to a judicial review.

Tony Smith: There are different rules. If Ofwat try to fine a company, they have a legal redress there. As far as these issues about licence conditions or price setting, they can go to the Competition Commission.

Q60 Chair: Just to conclude on that point, you believe that this discretion, if exercised responsibly, could be a good thing, but if Ofwat oversteps the mark, it could potentially be destabilising.

Tony Smith: It could be very destabilising. We have faith that the regime, in the form of the Competition Commission, will address that. We would expect to be giving evidence to the Competition Commission along those lines, if it goes to the Competition Commission.

Q61 Chair: Who regulates the regulator?

Tony Smith: That is a very good question. That is what I was referring to earlier. I think it is very important. We do need to emphasise the importance of the independence of an economic regulator, because if the Government gets too closely involved it can be problematic for customers, as well as investors. There is an issue about how far water policy is to do with Government, and at what point, then, the regulator's discretion arrives. David Gray highlighted that issue, and that is an issue for all the regulated sectors, as far as I can see.

Yve Buckland: Indeed, one of the issues that we have made very clear in our discussions with Ofwat and more broadly in the industry is that we think regulators need to be accountable to customers, just as they need to be accountable in terms of the broader sector. It does not always go down too well, but we believe that it is terribly important, not to customer representatives, but that we make sure that customers are as satisfied with the regulation of the system as the outcomes of regulation, and are engaged in those discussions.

Chair: We stand adjourned.

*Sitting suspended for a Division in the House.
On resuming—*

Q62 Dan Rogerson: Good afternoon. I wanted to pick up on your earlier comments about social tariffs, in particular, and your disappointment over that area. I am interested in whether you had examined or

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thought very much about the in-region versus national social tariffs. Regarding the consultation you have had with customers about their potential support for a tariff, is that an issue that you have looked at?

Tony Smith: Yes, we did. We researched a whole raft of things about what customers would think was the priority in terms of helping customers. That work tended to suggest that they want to support customers on affordability issues first, but they also, slightly separately, recognise the issue of unfairness, rather than affordability, which is to do with the very large difference in bills, particularly in the south-west. Customers, even in other regions, are prepared to help with that fairness issue as well as with the social tariff issue.

Q63 Dan Rogerson: So there was some support for a national social tariff, as opposed to it being parcelled up into the regions?

Tony Smith: Yes.

Q64 Dan Rogerson: That is interesting. Secondly, briefly on the regulation issues you were talking about there, in my opinion, you do an excellent job of articulating customers' concerns. We now have people from the industry saying that they have concerns about the regulator being given further powers, as well. Is there a communications problem here with the regulator? You would expect either the companies or the customers to be happy with what the regulator was doing; if neither are particularly keen on what the regulator is doing, have they got a problem?

Yve Buckland: In some ways, it is the nature of the beast. There is something in this system that is about balancing a whole series of different views. From a customer's perspective, we want to see more and more that customers' views are taken into account formally and on the record, not just through good working relationships. Wherever possible, we have been advocating—we can see some of it in this Bill—that customers and their representatives ought to be formal consultees. As I said, earlier we have been advocating, in other debates outside of this Bill, that the whole industry needs to hold itself into account in terms of general levels of customer satisfaction. That is so important, and that would include the regulator. Good working relationships help with all of that, but you cannot just rely on personality; you have to have systems in place.

Q65 Dan Rogerson: I want to move on to a couple of things about the introduction of competition, which was the second area you moved on to discuss. Are you confident that the introduction of competition for non-household customers will eventually see household customers also benefit from increased efficiency savings?

Yve Buckland: We believe that there should be benefits for domestic customers. There should be benefits in terms of greater efficiency and more service innovation; we are hoping those benefits would be apparent through trickle-down. It is important that companies would also have a better understanding of their costs; that could also have benefit.

There will also, absolutely, be potential risks for household customers, particularly if there is less focus on domestic customers, if there are things like stranded assets, if the non-contestable element of the Bill bears costs, or if there is uncertainty over the cost of capital. Ofwat needs to make it clear to household customers and business customers what the benefits are, and assure those that will not experience competition that they will not see higher bills or worsening service as a result of it. In particular, customers will need strong protection—penalties and incentives—and strong representation. It is very important to learn the lessons of competition in energy. There is a legitimacy issue about taking customers with you through all of this. There is often a credibility gap, among domestic customers, as to whether competition in energy has really delivered them a lot, in terms of lower bills or a more reliable service. We can see that without a strong customer voice, all sorts of parties are now getting engaged in that debate. We need to learn from those lessons and not repeat them in water.

Q66 Dan Rogerson: If I can turn to Mr Leask in particular now, I would like to talk about how the Scottish public sector benefited from the introduction of retail competition in Scotland, in terms of financial benefits but also improved service.

Robert Leask: To put things into context, the public sector in Scotland spends £73 million per year on water and water-associated services. That accounts for somewhere in the region of 20% of the competitive retail market. We tendered that requirement as a single entity and, certainly in terms of savings, we exceeded the top-level savings targets that we had put in place. Just to give the Committee an idea of what those were, prior to tendering the requirement, the public sector as a whole was receiving savings somewhere in the region of £1.4 million per year for its entire water bill. In the first year, the tendered requirement delivered just under £5.2 million, and in the current financial year we are targeting £7.7 million. In the final year of the contract we believe that we will achieve £9.4 million of savings. In addition, the appointed licence provider has helped the public sector to identify other efficiency savings, in terms of both financial and water savings. Those savings amount to an additional £4.6 million over the duration of the contract, and, in terms of looking at water savings by the end of the contract, we believe we could be in a position to have saved 2 billion litres of water in the public sector.

Looking at the service elements, what we found during the tender process was that the dominant incumbent in Scotland was forced to up its game in terms of customer service, and we saw a step-change in terms of performance. That step-change was matched by other competitive elements in the market, and when the contract was eventually awarded, it did come down to price. It was only the incumbent dropping its price at the last minute that ensured that it won the competition.

Moving forward, we are seeing a significant increase in customer satisfaction levels reported—in excess of 90%. When we have surveyed our customers, the

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satisfaction levels have been consistently high. Indeed, we are seeing the provider innovate in terms of customer service, for instance installing a new customer portal—a customer relationship management suite of software. That is facilitating the ability for the public sector, in terms of its billing, its consumption, its water usage, managing its site portfolio and data, and there will indeed be a trickle effect, as other elements not in the public sector will benefit from those, too.

Q67 Chair: You may not have the figures at your fingertips. I wonder if you could possibly write to us about the benefits for public sector institutions like the NHS, because I would imagine they will have benefited.

Robert Leask: Yes, the NHS has benefited. Prior to the contract being introduced, the net benefit they were getting was about £240,000. In year one it was just over £1 million. This year it is £1.5 million, and next year it will be just over £1.9 million.

Q68 Dan Rogerson: Just briefly on that, Mr Smith, on the issue of national versus regional in terms of the social tariff, is that something we have already had in terms of written evidence, or could you give us some data on that?

Tony Smith: I think we have given it to you previously.

Dan Rogerson: Yes, but not for this inquiry. If you could share that with us again, that would be helpful.

Q69 Barry Gardiner: The abolition of the cost principle that is proposed, and its replacement with these market codes that you will be instrumental and involved in preparing, seems to have given rise to a dispute between the water companies, on the one hand, who are saying that the abolition of the principle could see bills for householders rise if revenue from the non-contestable household market is used to offset lower bills in the non-household sector, and, on the other hand, Ofwat, who are saying that because you are proposing to separate retail price controls—one for household and one for non-household—it would not be possible to make that compensation between sectors.

From a consumer point of view, I am sure that you would be concerned that there is this apparent confusion in the first place, and if you can do anything to clear it up, that would be very helpful. I would also ask whether you believe it should be clear on the face of the Bill that that sort of arbitrage between the two sectors should not be permitted.

Yve Buckland: In answer to the last point, yes, it should. I will defer to Mr Smith to explain why.

Tony Smith: The cost principle was a problem in the past because it constrained competition, because there was insufficient margin for business customers and new entrants. However, part of the reason for that is it does protect ineligible customers; that is the big attraction of the cost principle. It should be possible to identify a different way of setting access prices in a way that does not cause costs to go into the non-contestable market to the detriment of domestic customers; that should be possible. However, I think

that such would be the pressure for costs to do that in the future, it would be highly beneficial that it is made very clear that that is not the intention. Arguably, it would be useful for that to be on the face of the Bill.

Q70 Barry Gardiner: I am just trying to get clarity here; I do not have an agenda that I am trying to advance. I just want clarity. At the moment, regarding the sort of compensation that is going on, the water companies are saying there is some sort of offsetting going on here, which is beneficial to householders. Is that correct?

Tony Smith: It is not beneficial to householders. What the cost principle does is start with the price that the business customer pays, and then when they lose a business customer they have to take off the costs that directly relate to that customer. That means that any cost, therefore, that the company avoids as a result of that potentially gets passed to the new entrants or to the customer that switched. That, by itself, protects domestic customers. The danger with a new way of setting access prices is it could mean some costs, which it cannot allocate very clearly between different customer groups, may, because it would be in the company's interest, be pushed into the non-contestable market, because all customers would have to pay for it. That is the risk, and I think it is a very real risk.

Q71 Barry Gardiner: So the ARROW costs, as they are known—the avoidable, reduced and recoverable costs—are taken off under the current system, but what you are saying is that under the new system there will still be a residual costs that will remain, albeit that under Ofwat's proposals they will not be able to be compensated for by raising household bills. Who will bear them, and how do we ensure that is the fair allocation?

Tony Smith: The answer to that is that it has to be the regulator's job. It must be the regulator's job to make sure that happens. The principle for legislators is to make it clear what you expect to happen: that it should not disadvantage ineligible customers. That is the crucial thing. To some extent, it already happens when there are insets, or new appointments and variations, where it can benefit customers who are subject to the competitive regime, but may not be beneficial to the remaining customers in a company's area. There is already that concern there, and that is why we think it should be for the legislators. It goes back to that point about making the policy clear, so that the regulator has to deal with that policy. It is not beyond the regulator's job to be able to identify a new access pricing regime that does what you want, but it is very important that the nature of that regime is very clear to all companies, as well as to all new entrants.

Q72 Barry Gardiner: Is this why the companies are complaining that there will be costs that they are left with, such as overhead costs and capacity costs? I am sure you read the transcript from last time. Is this where these costs, which they are concerned they will be lumbered with under the new upstream competition, come from? Is that how they arrive?

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Tony Smith: That will be part of the problem: the question about who ends up paying for the costs that are very difficult to allocate. Are they allocated appropriately between customers who can have competition and customers who cannot? It is a problem in all regulated and competitive sectors; it will be a problem in water. The rules have got to be made very clear, particularly in the case of water because in other regulated sectors all customers, including domestic customers, have the benefit of competition—in energy, in telecoms. For the foreseeable future, there will be no competition for domestic customers, so it is extremely important, in this particular industry, that those domestic customers are protected.

Q73 Dan Rogerson: One of the other issues that water companies have expressed concern about is this issue of the regional de-averaging of prices. It sounds like I am special pleading again here, but we could look at an area like mine, where there is some distance involved between the conventional items of kit that are there and some consumers, as opposed to others. Should the Bill make clear, on the face of the legislation, that regional de-averaging of prices needs to be avoided?

Tony Smith: We would say that the answer to that is “yes”. We can see that upstream competition can help all customers if it causes water to be allocated more efficiently than it is at the moment. That is beneficial. The problem will be—and this is probably inevitable—if there is pressure for local pricing, because if there is local pricing, that could cause the bills of some customers, who are in low-cost areas to serve, to go up, but the opposite would be true in areas where the costs are higher. Again, in other sectors you do see pressure for de-averaging as a result of competition. The same thing applies: with domestic customers not having the direct benefits of competition, it is really important that they are protected from this sort of thing. Therefore, we again think we can see the benefits of upstream competition for everybody—domestic and business—but if you were to make it clear that there should not be de-averaging, that would be helpful.

Q74 Dan Rogerson: Following on from that, there are issues around regional versus local. Should it be done across a regional water authority area? Should that be a thing, or should there be some element within that of a sub-regional thing, or should it be on the system? Again, looking at an area like mine, you effectively have a number of separate water and sewer systems that do not necessarily connect to each other. What should be the basis for ensuring that there is some kind of levelling across an area?

Tony Smith: Generally speaking, the unit of consideration for most of the industry at the moment is company region, though there are some companies that actually have sub-pricing within their regions already. That is the obvious thing to do at the moment, on the grounds that that is the way that companies decide what their water resource management plans look like, and that is what decides what their bills are and what the billing impact is on different customers.

There will, I imagine, be quite a lot of pressure from new entrants, and possibly from competition authorities, to go much more local than that. That is the point at which you do need legislation to help, to say, “No. The unit of consideration here is probably the company’s area.”

Q75 Dan Rogerson: Do you have some ideas about how that might look in terms of an amendment?

Tony Smith: I think we would have to think about that.

Q76 Dan Rogerson: And could you share that with the Committee?

Tony Smith: Yes.

Q77 Barry Gardiner: I want to turn now to investor confidence. You will recall that earlier this year, in the summer, Moody’s said that they believed that the reforms planned by the Government and Ofwat “create a degree of uncertainty and somewhat increase the credit risk for UK water and sewerage companies”. Mr Smith, you said to the Committee earlier this afternoon that every 1% rise in capital cost was a £20 rise in domestic bills. That was the figure you quoted to us. Therefore, you would be very concerned and very troubled to see Moody’s latest issue on 29 October, where they talked of “continuing uncertainty for [the] UK water sector with proposed licence changes”. In particular, there are two paragraphs there that I would welcome your comments on and your thoughts about, around the issue of investor confidence. They said, “It appears that the biggest area of dispute between the companies and the regulator is around future flexibility. Ofwat considers it important that the services and activities covered by the proposed wholesale controls can be adjusted over time, so that it can create the right incentives and adjust the framework as appropriate. To provide this flexibility, the regulator has proposed that in any price control it would be able to move activities accounting for up to 20% of total revenue outside of the wholesale price control. There would also, it is proposed, be a further cumulative cap on activities moved outside of the wholesale business set at 40% of total revenue. The degree of flexibility that Ofwat is seeking is surprising given its estimate that about 90% of companies’ assets (on a current cost basis) would remain as part of wholesale activities. We also note that the credit profile of a company where 40% of revenue is subject to as yet undefined price controls and/or competition will be different to that of the rated water companies today.”

Given what you have said about the effect of a rising cost of capital on domestic bills, can you analyse for us what you believe Moody’s are saying in terms of rising bill prices?

Tony Smith: I think Moody’s, in the past, have made it clear that they are not too concerned about retail business competition, because actually the impact on companies of customers switching in the numbers you might expect is not huge. I think their concerns are about the way Ofwat is going to regulate the non-contestable retail market and indeed the

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wholesale market, which is what you are referring to there.

The key question for us is about the extent to which Ofwat needs to make these changes in order to enact what the Government is choosing to do, or whether it is going beyond what it needs to do immediately. We are going to be exploring that over the next few weeks, because Ofwat have just put out their final consultation on that particular issue. The concern is that Moody's are correct and that the benefits of competition, which are significant but not huge, could be wiped out by the cost-of-capital effect, and we, as customer representatives, would share that concern if that were to be true. Because of the leveraging effect of the cost of capital, you could see how that could be true.

Q78 Barry Gardiner: I do not want to interrupt you, but do you think that there is a certain irony, in that the Draft Bill did not go down the route that Martin Cave proposed about separation, because of a concern with investor confidence, and yet now, the way in which the implementation of the upstream reforms and the introduction of competition there is taking place, we precisely have a problem of investor confidence?

Tony Smith: Yes, and I think the issue relates very much to the licence condition consultation, rather than the market reform regime. The market reform regime can, particularly on the upstream stuff, create uncertainty for investors. Again we would be concerned about that, because a customer's number one priority is a safe, reliable, long-term water supply, so anything that jeopardises that—in terms of investment in reservoirs, if that is needed, or the cost of capital—would be a concern. This is more an issue around the licence condition changes than it is about the underlying competition regime that is proposed here.

Q79 Chair: If you are looking at this and you reach a view within, say, three or four weeks, could you possibly share it with us?

Tony Smith: Yes. We only received the final document from Ofwat on Friday, and obviously we are going to be looking at that very closely.

Chair: It is linked to the question I asked earlier about the cost of capital potentially impacting on customers' bills.

Tony Smith: We will be happy to give you that.

Chair: That would be very helpful indeed.

Q80 Thomas Docherty: If I have understood correctly, what you have said is that it is the licensing conditions or the conditions of the licence that are causing you some concern. Very quickly, what would you look for, on the licensing, to avoid that concern?

Tony Smith: Ofwat need to give us very clear reasons as to why they need to go further than just the ability to set separate prices for wholesale and retail, because that is all the regime needs at the moment, as I understand it. Ofwat would need the facility to do that, but that is very narrow, and somewhat narrower than what Moody's were concerned about. That is the thing we will be exploring with Ofwat—why they need to

go beyond that very narrow definition of change, because the concern tends to be about the broader discretion that Ofwat will have. Ofwat may have good reasons for that, but we need to explore that over the next few weeks and give a view.

Q81 Chair: Just before we move on, do you think that possibly Ofwat might have overstepped the mark?

Tony Smith: I do not know. It is too early for us to say, until we have had that conversation.

Thomas Docherty: It is a shame that she has not chosen to come in.

Chair: I did ask her if she wanted to.

Q82 Thomas Docherty: I think that is disappointing. Mr Leask, how have you sought to exploit the competitive market in Scotland, to ensure that the public sector gets the best value for money?

Robert Leask: In terms of how we went about exploiting the market in Scotland, the public sector set out some clear objectives at the start of our procurement. One of those was to tender the requirement, to ensure that the supplies of water and waste-water services were compliant in terms of the procurement rules. We sought to maximise competition by creating a level playing field for all the licence providers operating in the market, and, arising from that, we sought to engage effectively with the market and the market structures. We did the latter primarily through workshops held by the Water Industry Commission for Scotland. At those workshops, we initially saw wholesalers and licence providers having a debate about what customers really wanted from the market and engaging in fairly technical discussions about how the market operated. It was very clear that, at that point, they were really lacking a strong customer input, and we engaged, over a period of 10 or 12 months, on some key issues that the regulator was looking at.

What we saw, over that period of time, was that the market developed very rapidly, mainly in areas about trade effluent connections and disconnections, and metering, in terms of AMR metering. Prior to tendering the requirement, we met with all the licence providers, explaining what our requirements were and where we were going, and gave them an indication of what the tender was likely going to look like. We were very pleased at that point that some of the licence providers said that, if that was going to be the form of the tender, we would have delivered as much as they could have asked for in terms of a level playing field.

We then went through the tender exercise. In effect, we structured the tender across two different lots; they were about equal size in terms of value, but with very different customer requirements in those lots. We delivered competition across both of those lots, and, as I previously pointed out, the incumbent won both of those lots, but was pushed very hard in terms of customer service and customer delivery. The final assessment really did come down to price. The key aspect of how we delivered that was that the public sector behaved as one entity and one requirement, and we spent a lot of time—about 12 months—consulting with the public sector, through various workshops and

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independent visits, really understanding the requirements of the public sector and pulling those together. We can say that 99% of the Scottish public sector are benefiting from the contract.

Q83 Chair: Is that higher than you expected?

Robert Leask: At the start, we had anticipated about 85%. That was because there was one sector-specific deal already in place in the public sector. Prior to us going to market, there was a belief that, because of the requirement for the dominant provider to publish its prices and its discounts as part of its licence conditions, we were not really going to deliver much more in terms of competition. By pooling and amalgamating the demand, we clearly set a new benchmark in terms of discounts and discount structures moving forward. When we looked at the deal that was in place, that was delivering about 5% benefit. The average that we have delivered is over 10%, so it doubled the best requirement that was in the public sector before.

Q84 Thomas Docherty: What is your best guess of the value of that 10% saving, either on an annual basis or over the first 10 years?

Robert Leask: Over the duration of the contract—it is a scale basis, because the discounts escalated—the maximum discount in year one was 8%; in year two it is 11%; and in year three it is 13%. Those discounts are based on a combination of factors, including paying annually in advance for water, paying by direct debit, taking consolidated billing, and so on. Public bodies take a measure of discounts, and we estimated at the start that we would deliver somewhere between £18 million and £25 million of benefit to the public sector over the three-year contract duration. We are very much on track to deliver at the top end of that.

Q85 Thomas Docherty: And that £18 million to £25 million is over the three years.

Robert Leask: Over the three-year period, yes.

Q86 Thomas Docherty: As an MP, my maths is not fantastic. Over the first decade, would it be as simple as saying that it is three times that, or would the numbers drop significantly, or would they grow?

Robert Leask: It is difficult to know, because we will be going into a new pricing review in around 2015. The price controls set at that point may have a bearing on it. Certainly for the remainder of this price control period, it would deliver, on average, 10%.

Q87 Thomas Docherty: Are there any aspects of the Scottish system that you think act, inadvertently or deliberately, as barriers to more effective competition?

Robert Leask: There were a couple of unusual aspects, in terms of the Scottish market, which we saw at the start. There was the requirement for licence providers to pre-pay for water, prior to delivery and usage by, in our case, public bodies. We realised that the financing of that pre-payment was quite a significant cost, in terms of the market, and so when we engaged with the licence providers in the market, we sought for the market to come up with a solution for that pre-payment that was in effect cost-neutral,

i.e. to minimise the cost both for the licence providers and for the public sector. In our tender documentation we did not dictate how that should be done, but we made clear it very clear to the licence providers that we were looking for the market to provide a solution to that.

Q88 Thomas Docherty: Again, I am not the brightest boy in the world; is the reason why that is an inhibitor because if you are not a large utility with the money to stump up funds, it is a challenge to raise the money in the first place? Am I right in thinking that?

Robert Leask: It is a cost of capital. We did some assessments several years ago, and we reckoned that just financing that would cost the public sector somewhere in the region of £1.5 million a year in pre-payment, and we thought that was a big enough number to attack in terms of the tender process, and that is what we duly did.

Q89 Thomas Docherty: Obviously you have now had a number of years of experience. Looking back—hindsight is always wonderful—are there any aspects of the introduction of competition that you think, on reflection, could have been handled better? If there are, have you had the opportunity to pass that advice on to Defra?

Robert Leask: The key element that we saw was customer engagement: really engaging as the market develops, and really putting customers' views forward, in terms of looking at the various issues. I noted earlier today that connections and disconnections popped up; that still rumbles on, in terms of the Scottish markets and difficulties around connections and disconnections, and how that is handled. So there are a number of areas in which there are issues as the market develops. Importantly, I think customers still should continue to engage on those issues and put forward what their experiences are on those issues, and really drive for the market to come up with a solution.

Q90 Thomas Docherty: My last question: you have obviously had a number of years. You have highlighted the savings but also the challenges. After your experiences, do you think that opening up the market has been of benefit, on balance, to the public sector in terms of reducing costs?

Robert Leask: I think it has been very beneficial in terms of costs. The clear desire that came forward from the public sector was that what customers really wanted was an accurate bill, detailing usage and cost. Up until competition, they were struggling to get that. Now, through competition and enhanced customer service, we are beginning to get accurate bills.

Q91 Mrs Glendon: I would like to direct my question to the Consumer Council for Water members. Are you satisfied that the Draft Bill makes sufficient provision for the interests of consumers to be represented, both as the reforms are implemented and once the competitive market is up and running?

Yve Buckland: We welcome that consumer representatives are being consulted, but actually we

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think it should go further. There needs to be sufficient provision to make sure that there is customer representation in a number of really key areas that we have touched on today—on charges, on the regulation of price setting, and on the way the market reforms are designed and implemented. Clearly, there are lots of issues for both domestic and business customers in these reforms, both as they are implemented—we must make sure that their voice is heard, and that there is clarity about how their voice will be heard and how the regime extends to sewerage services—and once the market is up and running. We must make sure that customers do not lose out on mergers. It is about making sure that there is not customer detriment by engaging customers, making sure that we avoid the risk of customers experiencing problems when their bills arrive, giving domestic customers strong representation during the changes in the industry, and also speaking up for small businesses. We were pleased with, and would obviously endorse, the point that the Federation of Small Businesses

made, saying that they feel there is a very strong role for the Consumer Council for Water and for strong cross-customer representation, to help them for three years after the market has opened. We are not trying to make a pitch here for the Consumer Council for Water, but we feel the consumer voice has to have knowledge of the sector, must be able to represent business as well as domestic customers, and must be grounded in the reality of day-to-day service provision, having the capacity to engage with individual companies, not just high-level or just dealing with small sectors. So the big issues for customers: yes, there needs to be stability, and I refer back to the point that we should learn from some of the issues there have been around energy and make sure that they are not repeated, by taking customers with the reforms and alongside the reforms.

Chair: Thank you for your patience during the interruption, and for being with us and sharing the evidence with us in our inquiry? We are very grateful indeed.

Examination of Witness

Witness: **Regina Finn**, Chief Executive, Ofwat, gave evidence.

Q92 Chair: Good afternoon and welcome. Thank you very much for being here this afternoon. I apologise for having over-run because of the earlier vote. We are delighted that you are here with us to help in our inquiry on the Draft Water Bill. Just for the record, could I invite you to give your name and position?

Regina Finn: Regina Finn, Chief Executive of Ofwat, the water regulator.

Q93 Chair: I am going to start on the Draft Water Bill in a moment. Since we last met formally, Ofwat has very recently published revised proposals for licence modifications; I think it was last week. You will have seen that Moody's have warned that continued uncertainty will be credit-negative for the sector. How do you react to that response to your revised notification?

Regina Finn: The reason that Ofwat published a clear proposal, with a time scale for companies to consider and respond, is precisely because of that: because it is time for decisions to be made and for the sector to move on. We do note that Moody's says, in particular, that those companies who might find it difficult to adapt to a changing environment may find this difficult. That is the entire challenge ahead of this sector. The proposals that we have put in place, which we have been consulting on with the industry for an extensive period, are designed simply to allow the changes that we know are necessary to give effect to the Water White Paper, the Draft Bill, and the more general objectives, which I know we have discussed at this Committee before, of delivering a sustainable sector. Regrettably, because of the way the sector is set up, every individual company has to agree to licence changes. All of the 20-plus companies were unable to reach a common agreement, so the way of dealing with this uncertainty is for a clear proposal to

be put there, and each individual company is now in a position to be able to make its decision about that. There is, through the Competition Commission, a clear and very transparent route of appeal if companies decide that they do not want to do that. We agree it is necessary to conclude this process, and that is why we have published our proposals at this stage.

Q94 Chair: There has been a 10-month interval since the proposals were proposed in their original form. There has been 10 months in which an agreement could have been sought, so it would be helpful to have an indication as to why you think possibly there is resistance from the water companies. Also, what is your reaction to the expression that Moody's used in their statement, where they say, "The degree of flexibility that Ofwat is seeking is surprising"? In particular they say that "90% of companies' assets (on a current cost basis) would remain as part of wholesale activities". Moody's note that "the credit profile of a company where 40% of revenue is subject to as yet undefined price controls and/or competition will be different to that of the rated water companies today". Are you confident that you are acting under your existing powers, and that Ofwat is not seeking to act under powers that are in the Draft Water Bill but obviously are not yet in legal effect?

Regina Finn: Absolutely. I can confidently say that. Perhaps I can just start with your process question, Chair. Yes, there has been a considerable period of time, because we published initial proposals that would have modified companies' licences to make them quite similar to those in other utility sectors like the energy sector, which raise capital on very similar terms and at similar cost to the water companies. However, we heard from companies and some investors that they had concerns about this because it represented a change. Therefore, we paused our

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process. We engaged in extensive consultation, including face-to-face meetings with every company at Chair and Chief Executive level. There was extensive investor engagement. We established a forum to work with companies whereby we were seeking to see if they could come to agreement. As I said, unlike other sectors that have a majority mechanism, whereby licence modifications can be made, in our sector every individual company must agree. We worked with the companies, in a working group, to see if they could agree, and all companies could not agree. Quite a number of the companies, at that stage, were urging us to make a proposal, because it was necessary for this to be moved forward.

We have made a proposal, which is significantly different from the proposal made 10 or 11 months ago. 10 or 11 months ago we were proposing to allow a range of flexibility to allow us to change the way we regulate and target our incentives on companies' management, in particular, because what they do is different in different parts of the value chain. Having listened to the concerns, we picked out the big concerns and we changed our proposals to address those. For example, there was a concern that our modification took away the link to RPI on the face of the licence. We currently regulate using a linkage to RPI. We have committed to putting that in on the face of the licence; that is a change that we have made. We did not intend to change that, but there was a perception that we would change it, so we put it back in.

Similarly, we have given assurances that we would continue to use the RCV mechanism, linked to the RPI, to regulate the wholesale asset-intensive part of the business. Let me be clear: the RCV is not in the licence. It never has been in the licence, but investors are very confident in investing on the basis of it, because we have a track record of regulating using it, and we have given very clear written statements and commitments that we will continue to do that. Then what we have done is we have limited to a very significant degree the ability to which we may evolve price limits. What we have not changed, and could not change even if we wanted to, is the safeguards that companies and investors can be assured are in place. We have a two-fold primary duty: to protect customers, and to ensure that efficient companies can finance their functions. We cannot operate ultra vires those primary duties. Any change we make to any part of our regulation is subject to those duties, and companies can be assured about that. However, we have gone further and given them quite significant assurances insofar as we have said that in the limited areas where, over two price control periods—about 10 years—we may consider change, if we are considering changes we will consult on them, and if we do make changes they will be fully appealable; any company can appeal the changes on their merits to the Competition Commission. If they are outside of our powers, the Competition Commission is there to safeguard the company's rights. But any changes we do make will be limited to those parts of the business that are not at all asset intensive, but where we may need change to deliver on the vision of the Water White Paper, and the ambitions of the Draft Bill. In

particular, the Water White Paper and the Bill both talk about the need to get more efficient use of water: allocate water better; use it more effectively; move it around. It may be that, in order to do that, we need to target our incentives on companies around resource management. That might mean we need to have a different set of incentives for that part of the business, but that part of the business is not asset intensive. As you say, at minimum 90% of the assets based on net book value are in the wholesale price control, which we have committed to continue using RCV for, and index linking to RPI.

Q95 Chair: To be clear, apparently the companies are saying that they would be agreeable to make changes immediately for retail market reforms; that separate price controls for retail and wholesale services and wider changes to companies' licences do not need to be made now; that they could be considered in the future, presumably when the draft Water Bill has gone through. Is that the nub of the disagreement?

Regina Finn: Companies have put forward a range of proposals. Their proposal to us was that we actually go much further than that, and embed things in the licence that are not currently in it.

Q96 Chair: Are you trying to embed in the licence issues that are before us, the Committee, in the legislation that has not yet gone through?

Regina Finn: No, we are not going outside our powers, and we are not seeking to do anything beyond what need to do to regulate the sector effectively. I think it is very important to recognise that. We have been consulting for some considerable time on how we can improve our regulation, target our incentives and deliver better outcomes. The changes we are proposing are, in the first instance, to allow us to do that. In the second instance, one of the things we are doing, by setting separate retail price limits, is clearly in anticipation of the proposals in the Bill, as well as because we wish to target incentives on companies to deliver better outcomes for consumers. I really can assure you, we are not going outside our statutory powers, and we are not going ahead of proposals in the Bill and doing things that are still subject to pre-legislative scrutiny. That is absolutely not the case.

What we are doing is creating a regulatory framework. This has nothing to do with provisions in the Bill or with market opening in the first instance. It is to do with targeting our incentives and our regulation on the different parts of the value chain, depending on what they do.

Q97 Chair: It might be semantics, but we will proceed. Martin Cave said that legal separation should be compulsory except where there were "unavoidable and unacceptably large bill increases". Yet the Bill before us does not require legal separation of companies' retail operations. The Bill relies on Ofwat using its powers "smartly" to prevent incumbents discriminating against new entrants. Do you believe those companies that voluntarily choose to legally

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separate their retail and wholesale arms should face a lighter-touch regulatory regime?

Regina Finn: We recognise Government decided not to require that separation. The reasoning that Martin gave for requiring that was because, if the separation is there, it is transparent and easier to police and regulate. We acknowledge the Government has said that is not going to happen. Therefore, we will need to police and regulate that interface between the retail and wholesale businesses more intrusively than we otherwise would have to have done.

This is something the Committee, through its report on the Water White Paper, really helpfully highlighted. I think the debate on this has moved forward significantly; it just shows the value of the sort of scrutiny the Committee brings. Since the Committee's report on the Water White Paper, the issue of the potential for companies to voluntarily separate has come back on the agenda. I think that is a very useful debate. We do see about half of the water and sewerage companies now saying it would be helpful to have the ability to do that, but not to be forced to. Clearly, in a case where the company did have the ability to do that and did implement that separation, it would be much more transparent in terms of the non-discrimination requirements that would be on it. That would mean, yes, we would need to be less intrusive in how we regulated in that instance, because, quite simply, the confidence of other market players would be assured by the fact that they could see a legally separate company interacting with the wholesale company. We would have to police using Water Industry Act powers for non-discrimination, and using Competition Act powers because of the lack of transparency and separation, so there would definitely be a difference in how we would regulate.

Q98 Chair: If that is the case, would it not be better that a requirement was on the face of the Bill, with guidance produced by the Secretary of State? Would that not be preferable to leaving it to your discretion?

Regina Finn: The requirement to regulate differently if a company is separated?

Chair: Having lighter-touch regulation in the event that they voluntarily choose to legally separate.

Regina Finn: I do not think it is necessary to have it on the face of the Bill, because it is effectively already a duty on us. We are subject to the Better Regulation Principles. We operate on the basis of applying proportionate and targeted regulation. We have a duty to ensure that we do not regulate onerously where we do not need to, which applies not just in this instance but to all our regulation. That is, then, already inherently part of our duties. I think repeating it in this one instance on the face of a Bill might complicate matters, because frankly it is something that should apply to all of our regulation.

Q99 Chair: Earlier, we did establish that there is unease among water companies about the discretion being given to Ofwat under the Bill. What are the advantages of the Draft Bill's delegation of responsibility to Ofwat for developing the detailed market reforms?

Regina Finn: This has been an interesting debate, and we have been trying to unpick where the stakeholders' concerns are, because they seem to be around a small number of issues. The first issue seems to be around the ability to make consequential amendments to licences to give effect to the Bill. I find it quite surprising that companies are concerned about that discretion, because it is exactly the same discretion that Ofwat was given in the 2003 Act. It is bounded, because these can only be changes to give effect to the Bill; we cannot go beyond that, or else we are subject to appeal. So I find that one strange.

Q100 Chair: With the greatest of respect, that might be the case, but the potential for opening up the market to competition is the exciting feature of this Draft Water Bill, so it is actually going much further than the 2003 Act. That might explain the unease among investors and the water companies.

Regina Finn: The provision for making consequential amendments is a very standard one, and is bounded. If the concern is that the Bill itself is making changes that companies are uncomfortable with, frankly, vested interests will have discomfort with things, and will want to say they do not want them; I understand that.

Q101 Chair: I do not think that Moody's are a vested interest.

Regina Finn: We have been trying to tease this out because there are a number of things happening here; it is not just one thing. One issue is about the consequential amendments. I do not think there should be concern about that, but I can understand why companies will generally not want to see discretion and change. The second issue is the licence modification proposal that I talked to you about a while ago. That is the one I think you, Chair, were referring to. Frankly, the issue there is: where we do need to make some changes, they need to be evolutionary. However, it is understandable that the sector, the same vested interests, may not want to see that change. We can understand that people want to protect their positions. It is important for us to give appropriate reassurances that, while the change can happen, investors will continue to be protected, which they will, and companies will be able to continue to finance their functions, which they will.

There are a couple of other areas where companies have raised the question of whether the Bill gives too much discretion around things like setting up market codes, governance and managing the market development. Again, I do not think the Bill offers too much discretion, but if there are concerns about how we might use that discretion, that points to a need for engagement, communication and understanding. We would be open to that debate with companies.

Q102 Chair: Reassure us. What are the appeals procedures going to be under the licensing modification proposal and the market codes and access pricing regime, if the Bill passes in its current form?

Regina Finn: There are a variety of mechanisms of appeal for water companies, so I apologise if this

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seems long, but I do want to reassure you that the appeal mechanisms are there and are quite extensive.

Q103 Chair: They are there now. The Committee wants to be reassured that the appeals are not being removed or downgraded, leading to a judicial review rather than a reference to the Competition Commission.

Regina Finn: They are not being removed or downgraded; I can assure the Committee of that. There are some areas where our decisions are subject to judicial review, where we make a decision that a company might think is unreasonable or ultra vires, and that continues. Companies are quite comfortable using judicial reviews. I have had a number of judicial reviews in this business. Most recently, I have had two, from Thames Water and Welsh Water, against decisions about issuing licences to new entrants. Both companies used the judicial review to appeal whether we were within our powers. In both those cases, the courts said we were, but I am quite comfortable that companies should be able to appeal those things, and that remains.

In terms of all our price determination decisions, any price control decision, any revenue affecting decision for any company at any stage, is fully appealable on the merits to the Competition Commission; that does not change. Companies' full rights of appeal remain intact on any decision we make that affects their revenues. I can assure the Committee that that is not changing. Finally, there are appeals to our decisions under the Competition Act to the Competition Appeal Tribunal; so there are appeal mechanisms there for companies.

When the companies were discussing appeal mechanisms, there was perhaps confusion, with different types of decisions having different appeal mechanisms. We are happy to provide you with a briefing note on the detail of that, if it would be helpful. But I can assure you that Ofwat works within very, very clear statutory boundaries. We understand our duties; we understand the importance of our track record; and we understand the importance of the safeguards of the appeal mechanisms, which are not in any way being undermined.

Q104 Chair: You will act with discretion, but entirely proportionately?

Regina Finn: Yes, absolutely. We have an absolute duty to do that in a proportionate and reasonable way. If we do not, companies have a right of appeal.

Q105 Chair: It would be helpful to see that in writing. What opportunities will Parliament and we as a Committee have to scrutinise the detail of the market codes and access pricing regime before the reforms are introduced?

Regina Finn: In terms of accountability, there is the legislation in the first instance, then there is specific guidance.

Q106 Chair: The point is that the legislation gives enormous discretionary powers to Ofwat.

Regina Finn: I would say that the legislation gives discretionary powers that are on a par with other

sectors and are bounded by our primary duty. If any access pricing rules that we set were ultra vires—for example, if they meant an efficient company could not finance its functions—then a company could appeal that; that is fully appealable. But there is another accountability: the Bill provides for the Secretary of State to issue guidance to Ofwat, which will set out what we have to take regard of when setting those access pricing rules; I think that is helpful, too. In addition, there are strategic policy statements, and social and environmental guidance that we need to have regard to. Finally—and I genuinely mean this—Ofwat is always open and willing to come before this Committee, because its scrutiny, in terms of providing transparency and openness around these different points of view, is very helpful. Ofwat would never refuse to come here and explain those developments. I think there is more that we can do. In particular, this is where, as I say, we are happy to engage with companies. Our preferred model for market governance would involve a significant amount of industry ownership. We would like to see industry codes owned by industry, with Ofwat granting approval of changes only where there are disputes. That is an example whereby we would seek industry involvement in this, and therefore some accountability with the industry as well as Ofwat. These are things have been done in other sectors, and can be done in a way that is effective, with communication and engagement, and we do understand that.

Q107 Barry Gardiner: We are bringing the big guns out against you, aren't we? It is good to see you fighting back. They do not like clause 23 of the Draft Bill much, do they, because it gives you what you consider to be necessary and expedient powers to amend their licence conditions for two years? Of course, the change there is from previously just "necessary" to "necessary and expedient". I guess they think that your view of what is expedient and their view might not be the same. Is that right?

Regina Finn: I hear the feedback that companies consider this too wide a discretion. I admit to being surprised by it, because it implies Ofwat might make a consequential change—because it does have to be consequential—that was somehow not intended to deliver on the intent of Parliament in passing the Bill.

Q108 Barry Gardiner: But it has to be, in order to implement the Bill's provisions, so they cannot maintain that.

Regina Finn: I agree.

Q109 Barry Gardiner: So it is not the "necessary", because "necessary" you already have. It is "expedient". So it gives you an element of discretion, as the regulator, which they are afraid of, aren't they? Why?

Regina Finn: The point about the enabling modification is it has to be necessary, but it still has to be expedient to deliver what is in the Bill; it cannot be expedient just because we would like it. We are very conscious of that. We are also bounded by our primary duties. If we made a change that we considered expedient, but which was contradictory to

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our primary duties—I can assure you we would not do that because we are a creature of statute, and are bound by those duties—companies have an absolute protection, because that would be unreasonable and ultra vires and could be appealed.

When the companies are nervous, we are trying to reassure them that their rights are protected, and that, furthermore, the stability of the regime, which is underpinned by those primary duties, is also protected. However, it is understandable that those companies that do not want change, those who consider that change would be difficult for them, those who are in the camp that Moody's said might find it difficult to adapt to a changing environment, would prefer not to see that there. Companies that are beginning to see they are less efficient than others, and feel they are coming under pressure, might find it difficult. I can understand, in their own particular positioning, companies will have to take a view on that and tell you what it is.

However, we are here, remember, to balance the interests of the customers with the interests of these big monopoly companies. Our duty is to get that right, and we must comply with those primary duties in exercising this discretion.

Q110 Barry Gardiner: For those reasons that you have very clearly and ably set out to the Committee, you do not believe, I take it, that a more effective appeal mechanism is required.

Regina Finn: It seems to me the appeal mechanism is comprehensive and companies' rights are protected. If the Committee or anybody gives to me or to Government a clear case that there is a gap in that appeal mechanism—which they have not—it would absolutely have to be considered. I cannot see gaps in these appeal mechanisms right now.

Q111 Barry Gardiner: So why are they afraid? Is it simply because they see their monopoly base being eroded? Or is there a genuine fear that the costs of capital could rise, which, as we heard from the previous witnesses earlier this afternoon, could have a very damaging effect on the consumers' bills? For every 1% rise in cost of capital, we heard there was a potential increase of £20 on a consumer bill. Is there a genuine fear there, or is that something you can absolutely scotch to this Committee now?

Regina Finn: I would bring you back to the starting point here: we have a duty. Our primary duty is to protect the interests of consumers and to ensure that efficient companies can finance their functions. We have been very clear. We have come before the Committee, and we have welcomed the White Paper and the Bill, because what it is doing is giving us the tools to do just that in a long-term, sustainable way. What we need to do is ensure that the cost of financing remains as efficient as possible; that is one of our goals. Also, we need to ensure that the finance raised at that low cost of capital goes into the right investments for the long-term future of this sector. That is important: you could have a very low cost of capital and invest a lot of money in assets you do not need, and customers' bills would be higher than they otherwise would have been. We do not want that. On

the contrary, you could have fewer assets and a dreadfully high cost of capital, which could drive up customers' bills. We do not want that either.

We want a balance here. We want to maintain the most efficient cost of financing, consistent with sustainable investment in the assets customers know will be delivering now and for the long term—for their children, for their children's children, and for the environment. I am not saying it is not a balancing act; it is. But with regard to the reforms in the Bill, the impact assessments the Government did included sensitivity analysis around potential impact on cost of capital up to 250 basis points. That still came out with £2 billion pounds of net present value for this economy and for customers. So these changes, evolutionary and gradual as they are, can and will be done in a way that is in the interests of consumers.

Q112 Chair: What about potential stranded assets?

Regina Finn: One of the things we have said quite clearly as part of our reassurance to investors is that we continue to use the RCV; the RCV is allocated to wholesale control; we will continue to use RPI indexation for as long as appropriate, noting some of the changes to the broader environment that are outside of our remit; and, finally, efficiently incurred investment up to the end of the current price review period will be reflected in whatever controls we use. The point here is about reforms going forward. It is about reforms to send signals to companies to invest in the right assets in the future at the best possible cost. It is about avoiding assets that might need to be stranded in the future; that is a key driver of making sure that companies have the right incentives. I know I have shared this example with the Committee before; under the current arrangements, we have talked about the potential bias towards capex and a focus on particular types of assets: companies might seek to develop new resources or build desalination plants in their own areas. We want to incentivise them to build different assets where they are more efficient, perhaps with interconnection between companies to allow for more resilience and to allow for water trading. It is about changing the incentives to drive those behaviours for the future.

Q113 Thomas Docherty: On the issue of Moody's and the City, can you remind me what percentage has been knocked off the share price of utilities in the last year as a result—5%, 10%?

Regina Finn: Nothing; it has been going up. And companies have been changing hands at very significant premiums. People do not buy a company if they are not sure they will get a long-term return. We have seen companies sold at premiums between 25% and 30% of RAB, which is a pretty significant premium.

Q114 Thomas Docherty: So it does not actually look like there is any—

Regina Finn: We have not seen any impact on share prices; we have not seen any impacts on dividends and return to shareholders of any negative kind.

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Q115 Thomas Docherty: It is probably fair to say that separation is an issue where you and your Scottish counterpart are at one. The new entrants think there should be separation. There is a mixed view among existing water companies. Will some degree of separation be required in order to give a level playing field for new entrants coming in to compete against existing water companies?

Regina Finn: The answer is the minimum we will do is price control separation; that will be essential. That is one of the reasons we are proposing separate retail price control. So there will be a minimum need for price control separation. Beyond that, we will need to require—this is where the regulatory burden increases—demonstrable Chinese walls between the retail and wholesale arms within an incumbent. We will need very transparent transfer accounting, charging and cost allocation between the two. That is what happened in the telecom sector. There was no separate retail arm. New entrants came in; they had to compete with the incumbent, who owned both the retailer and the wholesaler. There, what you do get is quite a lot of necessary oversight and regulation to ensure non-discrimination. New entrants ask quite a lot of questions, which means you have to force quite a lot of transparency through regulation.

That is the minimum that will be necessary. The Committee's report on the White Paper really helpfully brought this into focus. Since then, the power of the Committee's report has come through. A number of companies, which together represent about half of the value of the industry by customers, are now thinking that the voluntary ability to separate might help them do that in a more efficient way. So I think that has been a really useful debate to have on the table. But at minimum, there will be price control separation and regulatory oversight of the interface.

Q116 Thomas Docherty: Are there different perspectives about where that requirement for separation will be placed? I think I am right that one option is on the face of the Bill; another option would be in guidance produced by the Secretary of State; and the third option is to leave it to your discretion as the regulator. Where do you think that requirement should be set?

Regina Finn: The final option is, rather than there being a requirement, that there be enabling of companies to separate fully if they want. In terms of the minimum level of separation, price control separation and policing of non-discrimination do not need to be on the face of the Bill because it is already a requirement on us, given our existing tools, the existing obligations on companies and competition law. There are obligations to police for undue discrimination and unfair behaviours already in legislation. I do not think it is necessary to say it again, because those requirements are there. It would be helpful if the legislation simply allowed the further evolution of your list there, which is that there be an ability for the market to evolve, and companies to make commercial choices that in the end should benefit customers.

Q117 Thomas Docherty: Everyone but the Minister appears to support the establishment of an exit route. If, however, the Minister does not listen to everyone else, could we have effective competition in England without an exit clause? Could you explain briefly why?

Regina Finn: We will put in place all the provisions we can to ensure effective competition with that constraint. Yes, we can have competition with that constraint. There will be an impact without the ability for retail exit. Frankly, retailers who are inefficient will be required to stay in business and will be unable to allow more efficient retailers to take over their business and thus provide a better service at lower cost to customers. So the effect would be that prices will be higher, and services less good to customers. In the absence of an exit route to deliver those benefits, we will want to regulate in a way that maximises the level playing field and allows the maximum benefit to customers within that limit. But there is a limit; it will definitely cause a limit. It seems to us that, if we get to a stage where those benefits are not realisable for customers, we may well end up having to use more of Parliament's precious time to revisit this. In terms of what is in the Bill, it is not that we think there should be requirement for the change, but if there is a barrier to the market evolving, and the only way to move that barrier in future will be primary legislation, that will have to be the route we come back to, to change it, if it is considered appropriate.

Q118 Thomas Docherty: A scenario has been suggested to me whereby, if the existing companies cannot sell, or indeed merge, and there are half a dozen new entrants over a decade, you could end up approaching, on paper, 30 retailers. However, a number of them would have one person sitting in an office with a brass plate, not having any customers, not doing any activity. Could that scenario exist?

Regina Finn: It is potentially inefficient. In the scenario you are describing, the way things sit at the moment, if I am operating an incumbent water company and I have a retail business, I have the licence obligation to provide that retail service. If, however, I am not very good at it, where in a normal market I would sell that, realising gains for my investors—and the new retailer would be giving a better service—if I cannot do that, I will try to do all sort of other things, such as potentially to outsource it and cut my costs. But at the end of the day, I retain the licensed obligation, so if something goes wrong with that retail business, Ofwat, the regulator, will come after me for that licence enforcement. So I will need to retain some overheads. That might be your one person in a room with no customers; that might be what is behind that scenario. I am not sure how this would pan out, but there are potential inefficiencies built into this approach.

Q119 Dan Rogerson: You have made it clear you do not think the abolition of the costs principle will necessarily result in increased bills for householders at all. Given the level of concern that has been

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expressed about it, do you think that determination to avoid it should be on face of the Bill?

Regina Finn: We need to come back to the fact that protecting consumers and ensuring efficient companies can finance their functions will always be our overriding duty, within the frame of guidance. One of the things we have collectively learned from the fact that the costs principle is in primary legislation, rather than in secondary or guidance, is that writing something on the face of the Bill, which is very difficult to change when you might find out it is necessary to change it, is not very efficient. So we have delayed customers getting the benefit of competition by more than 10 years by writing that on the face of the Bill last time round. We need to be very careful what we write on the face of the Bill.

In terms of removing the costs principle, the Bill provides for guidance to Ofwat about the pricing and access rules that should replace it, so that will help ensure the point you are making can be made in that guidance. It is still secondary to the fact that our primary duties require us to protect customers anyway, so we will not be in the business of replacing the costs principle with something that is bad for customers. If we did, frankly, we should be appealed on it, because that would be an incorrect regulatory decision. So we already have that safeguard, and it is probably not necessary to put it in twice.

Q120 Dan Rogerson: Colleagues in other debates and elsewhere have explored the concern about the very complicated structures of companies in the sector; that there is tier after tier of company, in some areas more than others. Is this something you think you should have a view on, or that the legislative framework should look at as well? Or do you think it has just been a very efficient market, it has been fine and has encouraged investment, and therefore it is okay? There is a suspicion that costs go one way, and any profits go another, and that, while they meet the strictures you place upon them, some of these structures allow them to pass the risks on and to take the profits.

Regina Finn: If you think investors are concerned about uncertainty with Ofwat, if you opened that up you would find a huge amount of concern. To be fair, we have to recognise that one of the things the UK regime does very well is to regulate a regulated business to protect the customers of that regulated business, and to allow a huge amount of discretion, if I can use that word, to company owners in terms of how they structure the ownership of the business. There is a clear view that the commercial sector is best placed to manage those risks and put in place the most efficient financing structure. That has delivered a lot of benefits to the sector; it has delivered a low cost of capital; it has delivered a huge amount of investment.

I recognise the point you are making: people are concerned about the structure of companies, and whether that structure somehow or other is transferring risk to customers and away from owners. That is the concern. From our point of view, there are safeguards in the regime to protect customers, and they are incredibly important. We have provisions in

licences; we have managed to put in licence changes over many, many years. These include the regulatory ring-fence: if a regulated company looks as though it is getting into trouble in any way that might jeopardise service to customers—whether because of its structures or not—we engage that licence condition, and there is a cash lockup provision; the cash remains in the business and it cannot be taken out of it to any of those broader structures. It must remain in the business to service the business. If the company goes even further and ends up in serious difficulty, there are provisions for special administration; the company can be sold on.

Those provisions do work; we saw them work when Enron, which was the owner of Wessex, got into trouble. It was at that higher level of complex structures that the problem happened, but the customers of the water company were protected through these regulatory provisions and it was sold.

Q121 Dan Rogerson: You have picked up on a view of the relationship between an acceptable level of profit and what is regarded as the cost to the consumer. Are you as a regulator confident that none of that is obscured from these relationships, and when you are saying, “This is an acceptable price increase,” or whatever, that is very much based on the total reality of where the money is going in that nest of companies, rather than there being anything hidden there?

Regina Finn: We do regulate the RegCos, the regulated companies, not the HoldCos, the holding companies—I am going into jargon now. It is a fair point. One of the reasons we have heard it raised is because a lot of these companies are now privately owned, because they are so attractive in terms of long-term returns and the stability of the regime, and that sometimes leads to a slight lack of transparency about what is happening. It is an interesting question as to whether greater transparency might be appropriate. That is something we are happy to look at, but transparency is different from direction or oversight, and we are very firmly, within our powers and duties, focused on regulating the regulated company. But customers are entitled to see what is happening with their money; that is a fair point.

Dan Rogerson: “Interesting question” is good; we can come back to interesting questions another time.

Q122 Thomas Docherty: You, I think, personally are a member of the High Level Group; is that correct?

Regina Finn: The High Level Group for market reform? My Director of Markets and Economics sits on it. Ofwat is, yes.

Q123 Thomas Docherty: How many times has it met since it was set up?

Regina Finn: The High Level Group has met once.

Q124 Thomas Docherty: Is there a date in the diary for the next meeting, yet?

Regina Finn: There are dates in the diary for a number of meetings. The important thing about the High Level Group is that it is a “high level group” for a reason. I do not think we are going to deliver market

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reform through meetings; we are going to deliver it through activity, action and deliverables. While the High Level Group is set up to agree certain high-level principles, I think the real activity has to happen in the engine rooms. I am very keen to see the industry step up its role here, because there is an opportunity to shape the market. We are certainly looking to increase that work, and will be publishing some consultations around governance to get it going more quickly. We could do with a little bit more effort at that level.

Q125 Thomas Docherty: Can I press you to give an assessment of the progress of the High Level Group, particularly on the Anglo-Scottish market? As a group itself, what is your assessment of its progress?

Regina Finn: The High Level Group's initial meetings—

Thomas Docherty: Meeting.

Regina Finn: There were discussions beforehand and around meetings. I beg your pardon.

The High Level Group has taken the initial road map away, kick the tyres and come back and see if it will work. I think that is perfectly reasonable. What is important is not that we have loads of High Level Group meetings, but the work the High Level Group needs to have done in order to give its guidance and overview as to how things are going needs to get going; that is where the real pressure needs to come.

Q126 Thomas Docherty: You have heard the call in the previous session from the water industry lobbyists for an implementation group to sit below the High Level Group to provide more focus on the detail. What is your view on that?

Regina Finn: The High Level Group has already identified three key workstreams. For me, what is more important than another group meeting is that those three workstreams get their work plans together and get a programme of work that will deliver. That is the focus that I would like to see happening.

Q127 Thomas Docherty: Do you share a concern that the reason the water industry lobbyists want more meetings is that they do not really want to make great progress?

Regina Finn: I am not sure. I was recently looking at a TED lecture that I am very fond of, and which I had seen some time ago, by Jason Fried. It was about why work does not get done at work, and he was saying it is essentially because you spend most of your time doing meetings. I have a little bit of sympathy with that. You do need meetings, but you really need work plans, deliverables and output to get things done.

Thomas Docherty: I will take that as a yes, then.

Q128 Barry Gardiner: One of the potential unintended consequences of upstream competition has been identified by the companies as a de-averaging of bills, with those customers who are located closer to treatment works able to bypass the existing infrastructure and therefore get lower bills. Are you confident upstream reforms can be introduced without that regional de-averaging, to some extent?

Regina Finn: There seems to be a conflation of more than one issue here, which seems to be confusing the thing. In terms of retail pricing to households, these companies will continue to have a monopoly on that service; those prices will continue to be regulated. Clearly, that can ensure there is no undue de-averaging that would be seen as inappropriate or unhelpful to customers. For example, I see absolutely no reason why prices to those customers would need to be de-averaged between rural and urban customers. That is a myth; it does not have to happen. That is one thing that has been thrown in there as a potential impact of upstream competition. It is not true.

The second issue is—

Q129 Barry Gardiner: I don't want to stop your flow, but I do want to make sure we are clear on this. Are you saying the incumbent company does not need to introduce de-averaging of prices in order to ward off competition, or that they will not be allowed to introduce that?

Regina Finn: I would say they do not need to. They certainly do not need to on household customers, because there is no competition allowed for those customers, so there will not be an issue there. It isn't going to happen.

The second point I was going to come on to was: where there is choice, where we are looking to develop upstream competition over time, we are looking to send the right price signals to people as to where to locate, for example, water-intensive industries. So, if the UK started to attract new water-intensive industries, we would want them to go into a place where it was most cost effective to deliver that water service to them. In that instance, it would be very important for the company to understand the relative costs of developing and supplying that product to the end user.

You could call that de-averaging, but it happens already anyway. It happens in some cases where, for example, a developer will move what he is going to develop closer to a treatment works; he gets a better price because he has to pay less costs. That happens, and it is sensible. It should happen in a way that is transparent as upstream markets develop. That is a good thing; that is positive. What has been confusing is the concern that, somehow or other, household customers would see this rural/urban divide come in. I see no logic in that concern. Nothing is changing around that aspect. Companies have not been able to explain to me why they are saying that; I cannot answer the detail of their argument because I do not know it.

Q130 Barry Gardiner: Might I put a gloss on it? Of course, I do not want to put words into your mouth, but might that simply be seen as scaremongering, given that upstream competition does not apply to the domestic sector?

Regina Finn: It seems to be a confusion, I would say.

Q131 Mrs Glendon: In your written evidence, you acknowledge the importance of investor confidence in the sector, but water companies argue that the Draft Bill's proposals, particularly on upstream reforms, are

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likely to increase the cost of capital. Are you confident that such sweeping reforms can be introduced without denting the confidence of the investors?

Regina Finn: This comes back to, from my point of view, the overarching duty of the economic regulatory regime to balance protecting customers with ensuring efficient companies can finance their functions. The work that has been done in developing the proposals in this Bill has taken place very much in the context of that debate. When I talked to the Committee last time about the Water White Paper, in the context of investor confidence, I spoke of managing the scale and pace of change carefully. That would help manage investor confidence, as would adequate protection for investors both in primary legislation and in their licences, the track record, the appeals mechanisms. So would ensuring clear understanding and communications as we develop the proposals.

Coming back to the Government impact assessment of the changes in the Bill, that did do a scenario analysis of what if the cost of capital did rise to a degree. It still came out with a net present value benefit of the overall reforms. It is important that you combine what you invest in and how much you invest, with the cost to invest in it. Against that backdrop, and with our duty to ensure efficient companies can finance their functions, it is very important that we bring investors with us, so they understand that these changes are positive for them as well. I think we can do that and preserve investor confidence.

I know water companies are saying that reforms may impact here, and we are listening very carefully to investors who are saying that this causes concerns. It is important that we disentangle the true investor concerns from other drivers of concern. Investors want reassurance around the stability, transparency and predictability of the regime. We want to ensure they get that, while understanding that the changes are necessary to ensure their investment is sustainable in the long term. We mentioned earlier stranded assets; the worst case scenario for investors would be, because we do not regulate effectively and we do not allocate water efficiently, they invest in something that turns out to have been terribly inefficient, and we will be questioning that. That would cause a lack of confidence. We do not want to get there; we want them to continue to invest in sustainable long-term assets.

The Chair talked about Moody's comments, and various other comments. The concern is around "companies that are unable to adapt to a changing environment", which says to me companies that can adapt and deliver for their investors and customers are actually going to be quite confident in this environment.

Q132 Mrs Glendon: Could the upstream reforms be introduced in such a way as to protect the resilience of the industry in terms of continuity of supply?

Regina Finn: Yes, it absolutely can be done in a way that protects resilience and continuity of supply. Indeed, reforms can help contribute to resilience and security of supply. The key area it can do that in is the upstream reforms we have been talking about, because what they are designed to do is not just get water

companies developing water resources in their own geographic area, but allow other people with water resources to sell water to water companies. At the moment, water companies take about half of the available water out of the environment for public supply in a time when they might need more water, for example a drought. In this new world where these provisions are in place, somebody who has a right to water could sell that water to a company, therefore making their provision of service more resilient, so they could have access to a wider source of supplies. It will help with resilience if water companies begin to source water from elsewhere, like that.

Another way it will help with resilience is that our reforms, which are complementary, encourage them to trade water between themselves. We should also see them building more interconnection between their networks, and that clearly is important for resilience as well, if one bit of the network goes down and you want to be able to move water from somewhere else. So I think these reforms will help deliver a resilient long-term system.

Q133 Mrs Glendon: Would it lead to more fragmentation?

Regina Finn: I do not see that it will lead to fragmentation that will damage resilience. As we have said, these companies are going to remain monopoly network operators; there is a natural monopoly in this business, so we will not see any effect on that. We do want to see the incentives on those companies to build more resilient networks, to find the best places to build those networks and the best and most efficient way to use them. Frankly, a third of our catchments are already over-abstracted. We cannot just keep taking water out where it is convenient. We need to be smarter about how we use it and move it around. I think that is what these reforms go to.

Q134 Chair: Are you surprised there is not more emphasis on resilience measures, flood protection measures and moving water around in the Draft Bill compared with what was in the White Paper?

Regina Finn: I can see the evolution from the White Paper's ambition, which is what we want to achieve, to the Bill, which is how we will achieve it. Of necessity, how we will achieve it involves amending issues around the upstream market and putting in place the tools that will enable the evolution to deliver the vision of the White Paper. That is the difference between a piece of legislation and a White Paper, which can be much more ambitious. The Draft Bill takes really significant steps towards delivering on that vision. Let's be honest, it does not do absolutely everything. Frankly, to do everything, we would need the perfect piece of legislation. I am not sure we could ever get that, but it takes significant steps in the right direction.

Q135 Dan Rogerson: Would you support the inclusion in the Bill of a provision that would allow a water company to seek the rollout of universal metering, not just those in areas of serious water stress?

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Regina Finn: That is very much a Government policy issue. We appreciate and work within the framework of the Government policy. As an economic regulator, we support metering; we think it is the fairest way to charge. We accept that Government does not believe that compulsory rollout of metering is the way to go, so we will work within the framework. The fact of the matter is by about 2015 we do expect that half of household customers will be metered. Some companies are rolling out compulsory metering schemes because of water stress. Beyond that, I think we are seeing a rising understanding, by the companies, of the wider beneficial reasons for rolling out metering. There is a natural progression of metering that will happen, and we will work to make sure that happens within existing policies. This is one where it is definitely an issue of Government policy, and we, as the economic regulator, will implement that.

Q136 Dan Rogerson: I understand the distinction, and there are some other regulators who maybe do not quite understand that structure yet.

To follow up on the issues you have discussed of investment and the confidence on the part of companies to invest, do you think the Bill or the thrust of Government policy generally does enough to incentivise non-capital-intensive things, such as dealing with waste water? That does not show up on the balance sheet, but might be an issue in the future. Do you think the regime is flexible enough for that, or could the Bill go further in that respect?

Regina Finn: There has been quite a lot of work looking at whether there is a bias among water companies towards capital expenditure, and, if there is, how we can deal with it. There have been a range of barriers identified. We have not needed the Bill to start to address quite a few of those. For example, one of the potential issues was the water resource management planning guidelines, which could be strengthened around this. And they have been; we have worked with the Environment Agency to do that. Frankly, it is one of the reasons we are changing our regulation. One of the reasons underpinning our licence modification, which companies are concerned about, is that we need to be able to incentivise them to move away from that capex bias, to make them indifferent, or make them choose the best solution, even where the solution may not be capex. One of the reasons we needed that modification is we want to move from treating capex and opex separately—sorry, jargon again: capital expenditure and operating expenditure—to treating them together as total expenditure. Doing that requires us to change some of the way we regulate, and we need to ensure we have the flexibility to do that. That is the kind of flexibility that we as the regulator need to deliver on the White Paper ambition: to drive more sustainable solutions where they are potentially opex rather than capex. So I think the barriers identified were not ones that needed primary legislation, but needed us to change our regulation, and needed the Environment Agency to

change some things that it is doing. We expect our Social and Environmental Guidance and Strategy and Policy Statement from Defra to reiterate this. We want sustainable solutions, and will be working hard to make the changes we need to. I do not think it needed primary legislation.

Q137 Dan Rogerson: Bearing in mind, then, what you said about Bills not coming along that often and opportunities being missed in previous Bills, we are not missing an opportunity here on that; we are okay.

Regina Finn: I do not think we need primary legislation. We are doing an awful lot without it.

Q138 Chair: There is a huge amount in the White Paper about abstraction and reform of the abstraction regime. Are you surprised there is not a great deal in the Draft Bill on abstraction, particularly setting out a timetable and progress to reaching it? Do you think that is because there needs to be further consultation on secondary legislation? Can you think of any reason why it has not been included in more robust form in the Draft Bill?

Regina Finn: My understanding, in the debates we had on the White Paper and the useful debate we had here with the Committee, was that Government considers that there is—and no doubt there is—a considerable amount of work to be done to develop a sustainable solution for a form of the abstraction regime. There is a very clear acknowledgement that there needs to be reform, which is positive. It is excellent that it is in the White Paper. I accept, similarly to what we have been discussing recently, that without some of the detail of how we are going to do that, it appears quite difficult to write it into this piece of legislation. We acknowledge that.

There are two things happening. One is that Government will be working, and definitely needing to consult on what further changes would be needed to reform that regime across the board. We will be doing everything we can in the meantime to try to drive more efficient use of water resources through our regulatory regime and working with the Environment Agency, because we firmly believe that is the first set of steps towards a more sustainable abstraction regime. That is why the upstream reforms in the Bill are particularly important; they are a first step towards that. They are the first step towards at least trading water, and using the raw water more efficiently. We will probably be able to learn some lessons from that that will help inform how we might use the abstraction licences more efficiently. We are very happy to do a lot of work on the economics of that to support Government's consultations.

Chair: Thank you. You have been very helpful, and it has been a marathon session. Apologies again for the delay at the start. On behalf of the whole Committee, thank you for being so fulsome in your evidence and for contributing to our inquiry. We are very grateful indeed.

Tuesday 20 November 2012

Members present:

Miss Anne McIntosh (Chair)

Thomas Docherty
Barry Gardiner
Ms Margaret Ritchie

Sheryll Murray
Neil Parish

Examination of Witness

Witness: **Neil Griffiths-Lambeth**, Senior Vice President, Infrastructure Finance, Moody's Investors Service, gave evidence.

Q139 Chair: Good afternoon and welcome. Thank you very much, Mr Griffiths-Lambeth, for joining us in our inquiry into the Draft Water Bill. I wonder if you could just introduce yourself and give your position, purely for the record.

Neil Griffiths-Lambeth: I am Neil Griffiths-Lambeth. I am the senior analyst at Moody's covering the UK water sector.

Q140 Chair: We are aware of your work, and it is a wonderful opportunity for you to elaborate on that. Just before we turn to the Draft Water Bill, I wonder if you could just update the Committee: following the publication by Ofwat of proposals to modify water company licences in December, and again its revised proposals in this regard on 26 October, have you seen any movement in the credit ratings or the share price relating to water companies?

Neil Griffiths-Lambeth: In terms of credit ratings, no. We have not changed ratings over that period. In terms of share prices, I am not an equity analyst and do not religiously follow share price movements. Nevertheless, you may be aware that there has been a decline in the price of the three publicly listed companies. In the case of United Utilities, I believe that is of the order of around 10%, and for Severn Trent, I think it is around 8%; Pennon is a little larger, but there have been other factors at play there. As you will be aware, asset prices are a function of a variety of factors, so one cannot necessarily lay blame entirely at the feet of Ofwat.

Q141 Chair: Could we just ask you to consider whether the risk posed by changes to the licences can be separated from the risks potentially associated with the provisions of the Draft Bill? Could I possibly add a rider? Do you consider that Ofwat are assuming the powers that are to be granted under the Draft Water Bill before they have been passed through this place?

Neil Griffiths-Lambeth: It is very hard, going back to my previous answer, to distinguish between particular factors that may be driving share price movements. In addition, I wonder, to be honest, about the extent to which investors would differentiate between the Draft Water Bill and the other changes that are being suggested by Ofwat. To your second question, which I think is effectively about whether Ofwat are perhaps going ahead of policy, I do not have a view, to be frank. I think perhaps those on the other side of this table have a better feeling.

Q142 Chair: Like who, for example?

Neil Griffiths-Lambeth: My role in life is very simple. I am a credit analyst; I look at the credit impact of actual or potential changes. I look at the changes that government has set out and that Ofwat is talking about. I do not form a view as to whether Ofwat might be getting ahead of government.

Q143 Chair: You will have a view, though, as to the potential credit risk associated with the introduction of competition. Do you believe that there will inevitably be some sort of credit risk with the introduction of competition?

Neil Griffiths-Lambeth: If one looks at the UK water sector today, you have vertically integrated companies who are monopoly suppliers of an essential commodity. They operate within the context of a regulatory regime, which we hold in very high regard for its historic transparency, predictability and clear principles that have been consistently applied. That is a very different business model to one which is subject to competition. Therefore if you move towards competition the business risk profile will inevitably increase. It will increase from a very low base, and of course the extent of that increase will be related to the extent of the competition that is brought about.

Q144 Chair: But if you look at pension funds and other assets, would you not say that investment in the water industry has been deemed to be both transparent and, in an ever-changing economic climate, ultra-safe, for the simple fact that within a five-year price review period there has been an element of certainty. Therefore the share prices have remained fairly stable, the level of investment has been fairly consistent, and the returns have been fairly reliable. Looking ahead, is that something that concerns you—that this now might be at risk, through both the introduction of competition, but also the behaviour of the regulator?

Neil Griffiths-Lambeth: You are absolutely right. The sector has been very highly regarded historically by investors, and its appeal has recently been heightened by the turbulence that we have seen elsewhere, in particular that associated with the continuing euro-area crisis. Companies have benefited from that to a meaningful extent over the last 12 to 18 months, a point we made in our industry outlook we published in October. On your point looking forward, our view is that the credit risk of the sector will deteriorate, or rather the credit risk will increase over the medium to long term. That is our view as credit analysts. Clearly

our view is only a single factor that investors will take into account going forwards. People can legitimately disagree with our view. Nevertheless, people may perceive it as being less attractive in the future than they have done in the past. That may equally be the case as the situation improves elsewhere and other asset classes in other geographies perhaps become more attractive.

Q145 Chair: So how would you compare your assessment of the risk in relation to water companies with assessments of other utilities which have introduced competition at this time?

Neil Griffiths-Lambeth: It is very difficult to do a like-for-like comparison, and one cannot compare the UK water sector very easily with water businesses elsewhere in the world, because they tend to have a different model. As you will know, the sector tends to be in public ownership so much elsewhere. One cannot do a simple comparison and say, "The sector in this particular region used to look very much like the UK; now they have competition and as a result of that our rating has changed as follows." So it is very difficult for me to predict the future in terms of what the rating impact might be.

Q146 Chair: Can I just take you back to what you said about the drop in the share price? Did this surprise and concern you? Would you accept that within the price review period there should normally be an expectation of stability and certainty, and that that was shattered?

Neil Griffiths-Lambeth: That is a very interesting question. One sees quite a lot of volatility in share prices during regulatory periods. As I say, this is not my area of expertise, but share prices have been boosted quite significantly during the course of this year by potential M and A activity and the possibility that companies were going to be bid for. I think when the second licence amendment proposals came out there was an element of re-rating. Perhaps people decided that M and A activity was not imminent and perhaps there was greater focus on the perceived risks around the sector.

Q147 Chair: That is very helpful to hear that. Can I ask you to do something that you would not normally do? I think Moody's would normally look to a three-year time frame, which is quite a short time frame in terms of making a forecast.

Neil Griffiths-Lambeth: Our typical rating horizon is three to five years.

Q148 Chair: So if you were to look at the longer extreme of your forecasts, are you concerned at the impact of any regulatory movement, or any increase in competition, as to the impact on the share price, the impact therefore on the stock market and any potential credit movement—one hesitates to say downgrade—that there might be as a result of that?

Neil Griffiths-Lambeth: Let me focus, please, on credit. As I say, I am not an equity analyst, and that is beyond my area of expertise. In terms of credit, our view, as I have said, is that there will be deterioration in the credit standing of the sector over the medium

to long term. Why do I say medium to long term? As you know, Ofwat has described a number of possible changes to the sector. However, it seems that many of those changes will not take effect particularly quickly. There seems to be a consensus that we will not have retail competition before 2017, and changes in terms of upstream may not occur until the latter part of this decade. So to the extent that negative credit pressure develops, we expect it to develop over that medium to long-term horizon. Having said that, as you will also be aware, we have said that the licence change proposals put forward by the regulator have introduced uncertainty, and that is also credit negative.

Q149 Chair: Let me put that question in a slightly different way. If there was a negative credit risk arising from the changes, specifically in regulation, would that risk possibly be more significant if the economy itself became stronger, yet water companies were to lose the benefit that they have hitherto enjoyed of being perceived as something of a safe haven in uncertain economic times?

Neil Griffiths-Lambeth: That is a possibility, yes. The demand for capital is only likely to grow over time as the UK, together with other economies, seeks to fund the infrastructure investments the Government want to make. So, yes, there is a risk that capital is going to be drawn in other directions.

Q150 Chair: Could you just repeat that? There is a risk—

Neil Griffiths-Lambeth: That capital may be drawn in other directions.

Q151 Chair: That would impact negatively potentially on the future investment in water companies?

Neil Griffiths-Lambeth: Yes, both in terms of companies' ability to access capital and the cost of capital.

Q152 Chair: Have you considered what impact that might have on customer bills if that was the case?

Neil Griffiths-Lambeth: If there was an increase in cost of capital, it has been discussed in this forum that that would potentially impact customer bills. That is a consideration for us because, as you will be aware, we have a methodology that we follow in assigning ratings. That covers a number of factors. It particularly focuses on the regulatory framework and the financial metrics for the companies, but we also look at a broad range of factors including sustainability of the sector in the broadest sense. Affordability is clearly part of that.

Q153 Thomas Docherty: What percentage of the loss of share price firstly for UU do you attribute to the regulator's recent remarks?

Neil Griffiths-Lambeth: I cannot say.

Q154 Thomas Docherty: We can happily get the quote read back to you if it helps, Mr Griffiths-Lambeth, but you were quite clear earlier on that you felt some of the blame should be laid at the feet of Ms Finn. I think that was the phrase you used. So you

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must have a figure in mind. You would not just be spit-balling.

Neil Griffiths-Lambeth: No, as I said, asset prices are driven by a variety of factors. One observed a decline in the share price from 26 October at a time when the FTSE was remaining more or less static, so it seemed that there were some water-specific factors at play. One cannot isolate the impact of any one of those factors. Going back to my earlier point, I am a credit analyst; I am not an equity professional. It is not my role.

Q155 Thomas Docherty: Just so there is no confusion, you are not actually suggesting that the comments from a couple of weeks ago from the regulator are the direct cause of a point—

Neil Griffiths-Lambeth: No, the two events were merely associated. I cannot say there was any causality.

Thomas Docherty: That is helpful.

Q156 Chair: Would you say that they were not?

Neil Griffiths-Lambeth: I could not say one way or the other.

Q157 Chair: So in fact what you are saying is completely neutral?

Neil Griffiths-Lambeth: Yes.

Q158 Thomas Docherty: So there is absolutely no evidence either way?

Neil Griffiths-Lambeth: I cannot provide you with any evidence.

Q159 Thomas Docherty: That is perfect, thank you; that is very clear. Would you regard water companies as now being a bad risk, or if there was retail competition would you then advise your clients that they are a bad risk?

Neil Griffiths-Lambeth: Water companies that we rate in the UK have very solid ratings, typically at Baa1 or A3. I know you may not be familiar with our scale, but those are strong investment-grade ratings. They are considered by us as still being very creditworthy. Our view looking forward is we expect the credit risk profile of the sector to deteriorate over the medium to long term, and it may therefore be that they are less highly rated in the future than they are today.

Q160 Thomas Docherty: But you would not say they have become a bad risk?

Neil Griffiths-Lambeth: No, they are not a bad risk today.

Q161 Thomas Docherty: If there is retail reform going forward, would you then see them as a bad risk?

Neil Griffiths-Lambeth: It depends on the extent of the reforms that are introduced and the way in which they are implemented. We published research in February of this year, which showed that in isolation, the effect of customers switching between companies could be very limited. We have said previously that retail competition could be implemented in a way that was credit neutral. So you could have retail

competition in the future without, it seems, adversely affecting the credit standing of these companies.

Thomas Docherty: That is helpful.

Q162 Chair: Can I just ask: were your remarks about credit risk deteriorating in regard to the regulatory activities or potential competition? Could you clarify?

Neil Griffiths-Lambeth: We, as I say, assign ratings following a methodology. If competition is implemented it could adversely affect two of the factors within that methodology. The first of which is around our view of the regulatory regime, which we have historically regarded as being very strong. The second factor is around revenue risk. Inevitably if you have companies where a significant majority of their revenue is exposed to competition, there is likely to be greater volatility in that revenue, and all else being equal, deterioration in their credit profile.

Q163 Thomas Docherty: But deterioration from—

Neil Griffiths-Lambeth: A very high level.

Q164 Thomas Docherty: Yes. I think it might be helpful just to clarify the Chairman's earlier question about comparing with other utilities. Certainly the frame I had in mind—I cannot speak for the Chairman—was within the United Kingdom, so, for example, energy companies or telecommunications.

Neil Griffiths-Lambeth: If you look elsewhere in the UK there are other utility companies that are highly rated. Centrica is one which springs to mind. I believe it is rated A3, so it is comparable with some of the more strongly rated water companies, but it does not have the same level of debt. As you will be aware, some of the water companies have debt equivalent to as much as 80%, or thereabouts, of their regulatory capital value. They are very highly geared, and they still have high ratings because that high gearing is offset by our view of the regulatory regime as being very strong, and by the monopolistic and non-competitive nature of their businesses.

Q165 Thomas Docherty: So would you recommend to clients not to invest in energy companies?

Neil Griffiths-Lambeth: Just to be clear, we do not make recommendations to invest or not to invest. We simply publish credit ratings and opinions about the relative creditworthiness of particular companies. It is for investors to then take a view, based on those ratings and other information and their own views, as to whether they wish to invest or not.

Q166 Thomas Docherty: One final question: have you spent much time talking to, say, Mark Powles from Business Stream, because obviously we do have a market in Scotland.

Neil Griffiths-Lambeth: Yes.

Q167 Thomas Docherty: How many occasions have you met Business Stream representatives to look at how Scotland works? Have you met Alan Sutherland to discuss the Scottish perspective?

Neil Griffiths-Lambeth: I have met Alan Sutherland a number of times. One of his former staff members at WICS works for us at Moody's, so we certainly

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have a degree of familiarity with what is happening north of the border, although to be clear, we do not rate Business Stream.

Q168 Thomas Docherty: No, of course, but am I right in thinking, therefore, it is because of Business Stream's model that you are considering downgrading the English companies?

Neil Griffiths-Lambeth: No, we have not said that we are considering downgrading the English companies. As I said earlier, we believe that negative credit pressure will develop over the medium to long term. That may or may not translate into rating action; I cannot say over what timescale that may occur.

Q169 Barry Gardiner: Are you a student of Shakespeare at all?

Neil Griffiths-Lambeth: No. Do you think I should be?

Q170 Barry Gardiner: No, I just wondered if you remembered the impersonation that Tom Snout did in Act V, Scene 1, of *A Midsummer Night's Dream*.

Neil Griffiths-Lambeth: You may have to help me, sir.

Q171 Barry Gardiner: He did an expert impersonation of a stone wall, and it strikes me that that is what you have done to perfection before this Committee this afternoon. Look, you have told us about the methodology, and that there are a number of factors. What you have not given us is any information, which is what you know we are seeking. So can I just ask you: your job presumably is not just to apply the methodology; it is to disaggregate the various factors. We are asking you to disaggregate the factors between those elements of the Draft Bill, perhaps upstream competition, and such things as the change to the licence condition, as to what are the negative credit pressures on this industry? Can you please do that?

Neil Griffiths-Lambeth: I will do my best. If we look at the medium to long term, as I have said, over that period we anticipate negative credit pressure developing; that anticipation is driven by the changes proposed by Ofwat, and I believe supported by the Draft Bill. If one looks at the nearer term and now, there is a degree of uncertainty associated with those planned changes and also with the licence amendments, which Ofwat, as you know very well, published at the end of October.

Going back to what I was saying earlier, and trying to differentiate between Ofwat's proposals and the Draft Bill, investors do not make that distinction. We do not particularly make that distinction. What they are doing is looking at the broad direction of travel.

Q172 Barry Gardiner: Yes, but you weight those different elements; otherwise you could not claim to be providing a systematic assessment of the credit worthiness of this organisation going forward. It is not as if you do not have a weighting somewhere in the annals of Moody's; you do. It may just be that for commercial reasons you are not prepared to impart what it is to this Committee, but it is there, is it not?

Neil Griffiths-Lambeth: We do not assign weights between, if you like, the regulatory regime and the legal framework in which it operates. We look at those things as one.

Q173 Barry Gardiner: You are simply telling us it is a case of "suck it and see". You are undermining the value of your own job and your own profession because you are saying, "We look at it and come up with a result". Nonsense. You actually try and quantify this quite clearly as to the effect it is going to have on the market. Now you may not be prepared to tell us what you actually have done in this instance, but at least have the decency to say that that is what goes on.

Neil Griffiths-Lambeth: If I may, we look at the regime as a whole, and in terms of the particular factors we look at in rating a water company, as I have said, there are four set out in the methodology, and the regulatory framework is one of those. Clearly we form a view on that, and associated with that is our view on the broader legal regime in which the regulator is operating. So there is no attempt on my part to be disingenuous and to not reveal the weightings we might give to regulatory changes as opposed to legal changes. As I say, we look at these things together.

Q174 Chair: In the specific planned changes on the horizon, how would you weight two separate issues: the regulatory regime in Ofwat's proposed modifications to company licences on the one hand—this is the lawyer speaking—and on the other hand, the introduction of competition, particularly the upstream competition that we do not see in Business Stream, but which we do see in the English model in the Draft Bill? How would you differentiate or quantify those in your methodology and financial metrics?

Neil Griffiths-Lambeth: If we look at the methodology factors within the first one, the regulatory environment and asset ownership model, we have a factor for revenue risk. As I have said, in the future if you have meaningful competition it seems there is potentially going to be greater volatility in companies' revenues, and perhaps therefore we would mark that score down. In terms of financial metrics, which accounts for as much weight within the methodology as the regulatory environment and asset ownership model, to the extent there is deterioration in those metrics, obviously that will result in downward credit rating pressure.

It comes back to the point that really the devil is in the detail, and it is a question of how these changes are to be implemented and what impact they then are going to have on companies' standing. I was saying earlier that one could envisage perhaps retail competition being introduced without adversely affecting companies. Perhaps the same is true of upstream, but as of today we do not really have the detail to be able to say. So one can say if you are moving towards a world in which there is meaningful competition, then the credit standing of companies is probably going to be lower than it is today, but I cannot say how different it is going to be without that

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additional information of exactly how these changes might be implemented.

Q175 Chair: If I was to ask a question I asked earlier in a slightly different way, you just said your rating would depend on how the changes were to be implemented. Would it make more sense for the regulatory changes to be implemented as part of the Draft Water Bill, rather than separate licensing changes year on year?

Neil Griffiths-Lambeth: Certainly if one had clarity today on the full extent of the changes then we would be able to form a view as to what the full impact was going to be on companies. If you have a more gradual step-by-step process, we cannot say today where those companies are going to end up, and hence what our view of their credit standing might be at that time.

Q176 Chair: Before we move on to de-averaging of prices, can I just ask: in the water sector, is there an average, above-average or below-average level of inward investment from foreign investment, such as Australia?

Neil Griffiths-Lambeth: As you are perhaps aware, we have seen significant investment into the sector from overseas over recent years. We have seen the acquisition of Northumbrian Water by foreign investors, and Chinese investors take a stake in Thames Water. This sector has undoubtedly been seen as very attractive to both equity and debt investors.

Q177 Chair: And might that be jeopardised?

Neil Griffiths-Lambeth: It may be that it will be seen as less attractive in the future for the reasons we have discussed. Firstly, because of the introduction of competition, and perhaps also because of other asset classes becoming more attractive than they are today.

Q178 Thomas Docherty: Very quickly, Mr Griffiths-Lambeth, would it be helpful, from your perspective, if we moved at two speeds? So we did the retail competition first and then did the upstream changes to competition at a later date? Would that be something you would support?

Neil Griffiths-Lambeth: It is perhaps important to say that we would not view any changes as being either good or bad. We do not view any particular pace of change as being either good or bad. Our role is simply that of commentator, to offer a view on what it is that we see.

Q179 Chair: Can we look at it in a slightly different way? How will it impact on your rating if we were to proceed with retail first and upstream later?

Neil Griffiths-Lambeth: There are two parts to that answer.

Chair: Excellent.

Neil Griffiths-Lambeth: The first is about transparency and predictability of the regime. A slower pace of change tends to be associated with a higher degree of predictability. It also depends on exactly what it is that you do. So if you move slowly but nevertheless make very major changes, then perhaps there will still be a substantial impact on the credit standing of the sector. If you move very slowly

and do almost nothing then there will probably be almost no impact.

Q180 Barry Gardiner: Mr Griffiths-Lambeth, the Government has estimated that the introduction of competition is likely to increase the cost of capital to companies by between 1% and 2.5%. I am determined to get a figure out of you.

Neil Griffiths-Lambeth: Out of me?

Q181 Barry Gardiner: Yes. Do you agree with the Government assessment? If not, what figure would you put on it?

Neil Griffiths-Lambeth: I think those numbers actually originally appeared in the Cave Review, and I believe the range there was 1% to 4%. I believe, in the impact assessment published by Government, the higher end of that range was ruled out, leaving a range of 1% to 2.5%. It is actually very difficult to estimate these things. There could be scenarios in the future where the cost of capital changes by those amounts, but I cannot say today because I do not know what the changes are going to be. I cannot tell you the impact of something when I do not know what that something is. I know the broad direction of travel, but I do not know what that is going to involve. Ultimately, as I was saying, our role is to publish credit ratings. That is one of the factors that investors will take into account in pricing risk, but it is not Moody's that prices risk.

Q182 Barry Gardiner: I started off being cross. I am moving to admiration for your capacity to maintain this wall. We live in a world of imperfect knowledge, right? But Moody's operates in that world, and it makes judgments and assessments within that world. It will have a figure in mind about what the likely increased cost of capital is from upstream competition, and it will be operating on that basis when it makes this suck-it-and-see assessment that you have advised us of. What I am asking you is whether Moody's assessment of the increased cost of capital roughly equates to the Government's estimate, or do you have a vastly different estimate?

Neil Griffiths-Lambeth: But if I may, we do not assess cost of capital; we assess credit risk. If we do not know what changes are going to be introduced over what timescale, how could we assess the potential impact on the cost of capital? The range of numbers that have been cited by Government is perhaps sensible. I cannot say, "It will be less than that for the following reasons", and I cannot say, "It is going to be more than that for the following reasons", because I do not know what change ultimately will be introduced, or over what timescale, or the degree of investor confidence that might be associated with those changes.

To be very dull and to go back to my key point, ultimately we are assessing credit risk. We are not assessing cost of capital, or offering views on actual or appropriate costs of capital.

Q183 Barry Gardiner: But the one, as you have just pointed out, is influenced by the other.

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Neil Griffiths-Lambeth: That is right, but when we are assigning ratings today we are observing companies' ability to access capital in the market, and the cost of that capital. I cannot make predictions as to what that cost of capital might be in the future. I cannot predict how the water sector is going to evolve. Clearly I can try and form a view, but also I cannot particularly predict how investors are going to react to that. I can offer the view that I see credit risk increasing over time, but exactly how that credit risk will be priced, I do not know.

Q184 Chair: Is it going to invite more investment, or will it risk that investment? What is it actually going to do to investor confidence?

Neil Griffiths-Lambeth: The UK's water sector, as I said, is currently regarded very much as a gold standard. It has attracted, as you know very well, very significant investment at very low cost. In a sense one might say it has only got one way to go, which is down. Nevertheless, government is very keen to maintain investor confidence, as was the regulator, and that may be the case.

Q185 Barry Gardiner: Which particular elements of upstream competition do you consider pose the greatest threat to investor confidence?

Neil Griffiths-Lambeth: I do not think one can disaggregate them. If you are moving towards a model in which you have competition, that has a very different business risk profile to the current vertically integrated monopolistic companies. Perhaps it does not really matter which aspect you might change. If you do things that mean that in future there is going to be significant volatility around companies' revenues, that is likely to adversely affect their credit standing, and hence their cost of capital. It really does depend on what you do. Going back to what I was saying earlier, the analysis we published in late February showed that actually the impact of retail competition could be very modest, could have little impact on companies' revenues and hence could have little impact on their credit standing. The same may be true in terms of upstream competition, depending on what is done.

Q186 Barry Gardiner: Yes, but you have disaggregated there to a certain extent, haven't you? You said it does depend on what is done. We know some of the elements of what is being proposed, and one of the fears put out there is that there will be cherry-picking in the upstream sector, which may lead to de-averaging of prices. So my question, rephrased to you, is: is this a particular aspect of upstream competition that might reasonably, in your view, give rise to lower investor confidence?

Neil Griffiths-Lambeth: It could do.

Q187 Barry Gardiner: I will be grateful for small mercies. Thank you very much.

Q188 Thomas Docherty: Is the reason why it has such a high confidence, to paraphrase what you said before, because it is easy money, because there is no competition, customers are getting screwed over by

the water companies regularly and it is basically a licence to print money? Is that the reason why any opening up of competition will make it less attractive?

Neil Griffiths-Lambeth: You may view it as easy money, but we have had more than 20-plus years of economic regulation of the sector of continual downward pressure on their operating costs. The allowed returns for these companies are, in my view, commensurate with the risks that they assume, and I believe that is the view of the regulator. That is the basis on which they set prices.

Q189 Thomas Docherty: Yes, we all know that water companies are such a martyr case at the moment. But turning to the Draft Water Bill, it delegates responsibility to Ofwat to determine the market codes and the new access pricing regime. To what extent is it uncertainty created by leaving Ofwat to determine these and other measures, rather than the retail competition, or upstream competition, to be fair, which is the cause of increased credit risk concerns?

Neil Griffiths-Lambeth: The Bill does potentially give Ofwat very significant discretion, and of course in the licence change amendments that were put forward, the regulator is also seeking quite significant additional discretion. The uncertainty arises because of a lack of clarity as to how that discretion is going to be exercised. As we know, Ofwat will be publishing its draft methodology towards the end of this year. That will provide greater clarity, as will the final methodology next year. It may be that those things reduce uncertainty by creating greater knowledge about the direction in which the regulator is heading, but there is a general sense that there is a desire to introduce greater competition into the sector. From our perspective, competition is naturally a credit negative.

Q190 Thomas Docherty: So from your point of view competition is a bad thing?

Neil Griffiths-Lambeth: I am not saying that competition is bad.

Q191 Thomas Docherty: Okay; it is not as good as no competition?

Neil Griffiths-Lambeth: It is credit negative rather than credit positive for a sector that to date has experienced very little competition.

Q192 Thomas Docherty: I think we are getting somewhere. I do not know if that is a good thing or a bad thing. Am I right, therefore, in thinking that it is the uncertainty over the direction, rather than the direction itself, that carries a high proportion of risk?

Neil Griffiths-Lambeth: I think it is both things. Uncertainty is credit negative, because if you have certainty, that is always a more positive thing. But moving towards a world in which you have more meaningful competition is also credit negative, simply because, all else being equal, activities that are contestable, and environments that are competitive, where there are winners and losers, tend to have a weaker business risk profile than the current monopolistic water sector.

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Q193 Thomas Docherty: I promise that, hopefully, this is my final question. Would you prefer, therefore, to see more detail placed on the face of the Bill, so to speak, rather than left to regulators to go away and come up with?

Neil Griffiths-Lambeth: If there was more detail, then perhaps we would be able to form a firmer view than we have today. Ultimately it is a matter for government and for the regulator as to how they wish to prescribe this industry, if I might put it that way.

Q194 Thomas Docherty: You tempt me to a supplementary. Which do you think should do it? Should it be the government or the regulator?

Neil Griffiths-Lambeth: I think that is a question of policy, is it not? It is for the government to decide.

Q195 Thomas Docherty: Forgive me, sir, but you are sitting in front of the Select Committee, having volunteered to give written evidence and then oral evidence, so I do not think it is unreasonable to ask your opinion. In your professional capacity, which would provide less credit risk damage—if I have not just made up a new phrase—and which would be preferable from your point of view: the government, on the face of the Bill, or left to the regulators?

Neil Griffiths-Lambeth: More information is always positive and it allows us to advance our views, but I have no preference as to whether that information comes from the government or from the regulator.

Thomas Docherty: Okay. Thank you, I think.

Q196 Ms Ritchie: Moving on to the area of other regulatory and legal frameworks, how likely is it that changes in the regulatory framework will lead to a greater divergence in the credit ratings of companies, rather than a reduction in the industry's credit ratings overall?

Neil Griffiths-Lambeth: We could see both things; we could see a migration downwards in the overall rating for the sector associated with the introduction of competition, but we could also see divergence between the ratings for companies within the sector. As I was saying earlier, if you have competition you have winners and losers. You have companies that do better and companies that do not do so well. Perhaps in the future we will see a greater divergence in the ratings of the top and bottom of that band.

Q197 Ms Ritchie: Do you agree with Ofwat that it is those companies which are unable to adapt to a changing environment that will be most threatened by competition?

Neil Griffiths-Lambeth: I think that is probably right, is it not?

Q198 Ms Ritchie: You have described the degree of flexibility that Ofwat is seeking to change the level of services and activities covered by the wholesale price controls as “surprising”. Do you think that licence changes would be more acceptable if Ofwat reduces the level that it can change the activities covered by defined priced controls, for example, from 40% to 20%?

Neil Griffiths-Lambeth: I think that would certainly reduce the uncertainty. It may not entirely eliminate it, but yes, it is a small number.

Q199 Ms Ritchie: And can you put an estimate around that number?

Neil Griffiths-Lambeth: Sorry, an estimate in terms of whether it should be 20% or 25% or 15%?

Ms Ritchie: Yes.

Neil Griffiths-Lambeth: No, I cannot. As I was saying earlier, our view is simply to comment on what we see, so I cannot say that the numbers should be X or that the number should be Y.

Q200 Ms Ritchie: You are not prepared at this stage to say?

Neil Griffiths-Lambeth: It is not a question of being not prepared. Our job is not to structure companies, to structure sectors, or to advise people. It is simply a question of looking at what we see and offering a credit perspective.

Q201 Ms Ritchie: Could it be argued that water companies are contributing to levels of uncertainty in their business and their negative credit ratings by choosing not to accept Ofwat's proposed changes to the licence, leaving the Competition Commission to decide the matter?

Neil Griffiths-Lambeth: It is clear that Ofwat and the companies have failed to agree on this matter, or most of them have failed to agree. We were not party to that process. I cannot allocate blame either to the regulator or to the companies for that failure to agree. Clearly had the companies accepted, then there might have been a perception of less risk, because externally investors would say, “Okay, companies and the regulator have managed to agree. The companies are clearly comfortable that this does not expose them to risks that they cannot manage, and on that basis I am comfortable.” However, we have a situation where the regulator and the companies cannot agree, and perhaps that elevates the level of perceived risk.

Q202 Chair: Is the water sector unique in that regard?

Neil Griffiths-Lambeth: I do not recall a similar situation in the history of regulated utilities within the UK, but I cannot rule it out. I certainly do not recall one.

Q203 Chair: Does that have an impact on the way that you view the credit rating, going forward?

Neil Griffiths-Lambeth: We hold the regulatory regimes in the UK in very high regard. We regard the Competition Commission as being part of the overall framework, so a failure on the part of a company and the regulator to agree is not credit negative, and ordinarily a referral to the Competition Commission is not credit negative. It is just part and parcel of the normal mechanism. We have said, however, that it sustains this uncertainty associated with the licence changes, and were it to happen it would draw additional attention to the matter, and perhaps that is not helpful for the sector in terms of continuing to raise capital.

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Q204 Chair: Just taking you back to 29 October and Moody's announcement, in which it said that continued uncertainty around licence conditions was credit negative for the sector, what do you believe the impact of that statement has been for the market, potential investors and the consumer in terms of potential future water bills?

Neil Griffiths-Lambeth: It is very hard to point to evidence, and we have talked earlier about share prices, which have clearly moved. There has been, as far as one can see, no reaction in the bond market. Bond prices have not fallen. Nevertheless, as we say, it has created additional uncertainty. That uncertainty may persist. It is something that investors may remember, and it may play a part in their decisions in the future as to whether to invest in this sector. Certainly amongst investors there are some very strong feelings at the moment on the UK water sector and its continued attractiveness. Others, no doubt, perhaps think this is rather a storm in a teacup and are happy to continue to lend their money.

Q205 Chair: Just to take you back to what you said earlier, if there was a resistance to future investment, there would be implications for future water customer bills?

Neil Griffiths-Lambeth: Yes, if the cost of capital for the sector goes up, then customers have to pay more, and/or returns to shareholders will suffer, which will impair companies' abilities to attract additional equity to support future investment.

Q206 Chair: Being a simple soul, what concerns me is that water companies are going to be left in a certain no-man's land, potentially, where there might be a resistance to invest and where there might be a need to pick up the lack of investment through increased customer bills, but the regulator will prevent that from happening.

Neil Griffiths-Lambeth: Yes, certainly water companies could, in the future, find themselves squeezed, as you say, between the regulator, on one hand, and investors, on the other.

Q207 Thomas Docherty: But you cannot point to evidence that that is what is going to happen?

Neil Griffiths-Lambeth: No, I cannot. As I said earlier, all I can do is offer my view. I cannot provide you with evidence that that is going to happen. It may not happen. That is my view; others may legitimately disagree with that view.

Q208 Chair: Mr Griffiths-Lambert, thank you for being so generous with your time. We have had quite an education in the role of Moody's, but we are very grateful to you for being with us this afternoon. It has been enormously helpful.

Neil Griffiths-Lambeth: Thank you very much indeed.

Examination of Witnesses

Witnesses: **Mark Powles**, Chief Executive, Business Stream, and **Nathan Sanders**, Managing Director, Utility Solutions, SSE and Director of SSE Water, gave evidence.

Q209 Chair: Gentlemen, good afternoon. Can I welcome you and thank you very much indeed for participating in our inquiry on the Draft Water Bill? For the record, could just give your positions?

Nathan Sanders: My name is Nathan Sanders, MD of SSE Utility Solutions, and I have responsibility for SSE Water, of which I am a Director.

Mark Powles: I am Mark Powles. I am the Chief Executive of Business Stream. We are the largest incumbent water retailer in the Scottish competitive retail market.

Q210 Chair: Just to set the scene, what impact has the introduction of competition in Scotland had on introducing new entrants to the sector?

Mark Powles: The characteristics of the Scottish market were very much that, as an incumbent, the regulator made sure that there was a level playing field for competition in terms of moderating our behaviour, physical separation, the way we were funded and the way we interacted with Scottish Water. We could get no unfair advantage over a new entrant. I think that gave confidence to new entrants. Allied to that was the creation of a central market data set, so the data that new entrants could use to potentially price and switch customers was exactly the same data that I or the central market had. So visibility, transparency and

protection for new entrants against incumbent behaviour played a fundamental part in the creation of the Scottish market.

Chair: Mr Sanders?

Nathan Sanders: We really stick to the English market, not the Scottish market. We are looking at putting assets in the ground, so it was not a market that we went towards.

Q211 Chair: Could I ask you, Mr Powles, bearing in mind what we just heard from the first witness, whether you believe that the regulator is equally setting a level playing field at this stage?

Mark Powles: I think the Draft Bill has many other—

Chair: No, that was not my question.

Mark Powles: If you do not mind, I was just going to move on to that. I think it creates most of the component parts that are needed to create a retail market, but it does give a lot of latitude and freedom to how Ofwat interpret things. The Bill would benefit from more clarity around regulated access versus negotiated access. In England, the access pricing regime has played a major part in stopping a retail market functioning. The Draft Bill talks a lot about bilateral agreements, and I would like to see more clarity on regulated access, i.e. creating wholesale prices that all entrants can enter into.

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The level-playing-field argument is one that we would like more clarity on. I am an incumbent in Scotland but will be a new entrant in England; in the absence of separation, how can I be assured that I will get the same treatment from a wholesaler as their incumbent retailer?

Q212 Chair: Would the regulator in Scotland be able to act in such a way as Ofwat has, by modifying company licences?

Mark Powles: It is not my area of expertise, if I am honest with you, Madam Chair, so I would be wrong to comment on that.

Q213 Chair: Are you both confident that the Draft Bill will be successful in encouraging new entrants to this sector? Does it go far enough? Are there any amendments that you would like to see to promote further competition?

Nathan Sanders: If you look at SSE Water, we entered this market because we wanted to install and look after assets, and we have been able to do that as a new entrant. It has allowed us to have touch points with the customers, and it has also given what the customer wants. A developer who was around in 2007 mentioned to us, "I wish you guys could do the same as you do in electrical and gas". That is one of the main reasons we have come in.

The market has not been difficult to break into when we came in, back in 2007. We do not think the Bill would make that any harder, but it has been very difficult to grow within that market because of the time it takes to get an inset appointment and the size of developments that we are able to go after, mainly due to the competitiveness of the wholesale prices. We do welcome the way the Bill is, but think it is long overdue.

With regard to amendments, it is really around the level playing field. We would like to be sure that it is a level playing field. For example, at the moment with connection charges, occupiers of properties can be charged differently from the way an inset appointee may be charged, and potentially it is the same with the water licences. We also have some concerns about how the current inset regime will work with the new regime. How will that transition work? Effectively, if we can introduce these market codes or understand what these market codes looked like earlier, we can get some comfort that this Draft Bill will provide a platform for new market entrants.

Chair: Mr Powles?

Mark Powles: We have got to start by thinking about how we can deliver better outcomes for customers. In Scotland what drives me is whether I can give customers better value, better service and more innovation. The model that we create in England should build on some of the component parts in Scotland. Where are my concerns? Again, I go back to this level playing field and some of the other things. Also harmonisation of price and service tariff structures will mean that if you are serving a multi-site customer you can provide one bill very easily, but you do not have to have 25 backing sheets with different service standards. So we should try and avoid the complexity that will be built in to having

different structures in each region. I think harmonisation of those sorts of service standards is really important.

We also need to create a model that makes it easy for a customer that intends to go to a new entrant, so they do not have to go through four months of waiting for that process to take place. In Scotland, a customer, from making that decision, can switch within 20 days. It is instant and they can start to deliver the benefits of that. In terms of creating common codes, common structures and common contracts, enabling that to work in a cost-effective, efficient and timely way will mean that we give customers confidence and deliver maximum benefit to them. I would also say that we do need an efficient, well-funded and stable set of wholesalers because ultimately a large chunk of what we do as a retailer depends on the network businesses performing those services. We do not want instability because that will, in the end, impact on customers.

Q214 Chair: This seems to be a new term that you are using, that was not raised in the evidence we took on the Water White Paper, about a level playing field. What is in the Draft Water Bill that is alarming you that was not in the White Paper?

Mark Powles: The lack of separation. In Scotland, Business Stream had to legally separate from its parent company to give new entrants confidence that we were not getting an unfair advantage. Clearly separation has not come through in that form, so it is incumbent on the regulator to put in place a governance regime that creates that level playing field. It may just be terminology, Madam Chairman, but again, I want confidence, and I think all new entrants will want confidence that they are getting the same treatment as a water company's retail arm.

Q215 Chair: Could I just ask you, Mr Powles, why the Scottish model did not look at upstream competition?

Mark Powles: I think the regulator and the government are the best people to answer that question, but at the time there was a focus on delivering customer benefits and bringing market forces into play. It was felt that the retail end was the right place to start with that, to see where that took it. In previous evidence sessions, Alan Sutherland, the regulator, has talked about there being an initial definition of retail that focused on those customer-facing points. There has been iteration since then, where retailers are now being encouraged to go further into the value chain to try to give better value and deliver more efficiency. That incremental approach was the way that the Scottish market decided to go. The regulator also had a responsibility to do nothing that was to the detriment of the core business as a mandate, so that perhaps influenced it as well.

Q216 Chair: Has there been a problem with stranded assets in the way that the Scottish competition has been led?

Mark Powles: No, but there is a clause within the reform in Scotland, called 29E. The best way of describing it is that if I, as a retailer, can do something

with a customer that would reduce Scottish Water, the wholesaler's, cost base, then that can be shared between customer, wholesaler and retailer. For instance, if part of the network is capacity-constrained, and if I, with the customer, built a 72-hour storage tank that enabled them to reduce that pressure on the network that in turn meant Scottish Water did not have to upgrade and invest in that asset, then that money can be shared between all parties. That is the only way, and I do not believe there have been any issues on stranded assets to date.

Q217 Sheryll Murray: I want to specifically ask Mr Sanders a little bit more about the inset appointments regime at the moment. You currently use this. Could you tell me why you have chosen to use this route so far, rather than the existing water supply licensing regime?

Nathan Sanders: We listened to our customers back in 2007, and it was apparent that they were looking to bundle up utilities. They wanted to go to one provider who could provide them electrical, gas and water. So this is now using our expertise to add value to this marketplace, and that value is getting pipes and water pipes in the ground, which means owning the asset. We wanted to own the asset and look at the long-term revenue, so we are in this market for a long period of time. We could not do that under the water supply licence regime. However, looking at the Draft Bill, we have asked for such reforms as the national licence. We have asked for the market codes; whilst there is more development on the market codes, hopefully when we get some details around those, it will give us the opportunity to see where the best place to set our future growth lies.

Q218 Sheryll Murray: And do you think you will be likely to reconsider your approach if the draft Bill is enacted?

Nathan Sanders: I think we would. We would look at all options. It is around the transition—how we transit from one to the other.

Q219 Sheryll Murray: I just want to ask both of you about Ofwat, and whether the Draft Bill strikes the right balance between legislation, guidance and regulation. We have had different people with different views, and it would be interesting to know what you both think about that.

Nathan Sanders: Yes, fundamentally it does. The key, fundamentally, is flexibility in the market codes and how they develop; that is the real fundamental there—setting out market rules such as cost principles. Legislation is probably too inflexible. Ofwat, therefore, would be the best people to be the policemen, to oversee the rules and the governance of that. We have seen Ofwat use their powers in the past, and they have changed the way things are done. They worked with us to revise the inset process. Hopefully we will see some benefit of that going forward, but I suggest that with all reforms the devil will be in the detail, and when we see the detail we can act accordingly.

Sheryll Murray: And Mr Powles?

Mark Powles: In the main, yes. I am always nervous of having too much in legislation that can create unintended consequences in the future. I think perhaps the access pricing regime is an example of that. The Bill would benefit from some more guidance to give some clarity of the principles that we are trying to create, and also some principles from Ofwat of how it intends to interpret the relevant pieces of legislation. I know there are consultations coming out later, but things like the clear definition of what retail and what wholesale is; some clearer definition of how they intend to manage the governance of incumbent behaviours; and regulated access versus negotiated access. All of those things would give clarity to incumbents and new entrants as to how we want to access that market.

Q220 Neil Parish: Good afternoon. In Scotland, the company had to split the wholesale business from the retail business. The government here has decided against mandating the legal separation of incumbent companies' retail operations. What impact do you expect this decision to have on competition? Mr Sanders, perhaps, to start with?

Nathan Sanders: I think we believe that this is really for the politicians and the regulators to decide. We find dealing with incumbents a fairly mixed bag; some are good and some are bad. Separation, therefore, is not very high on our agenda when we are looking as a competitor to this market. It is more important to us that the market codes are done very well and that they themselves introduce the competition.

Q221 Neil Parish: At the moment, then, do you buy water and supply just to businesses, or to households?

Nathan Sanders: To households as well, but ours is an asset business. We look to put the water pipe in the ground, take the water and deliver to the end consumer.

Q222 Neil Parish: I see. Because what I cannot quite understand is if a company owns both wholesale and retail, surely they can control their prices to make sure that you cannot price against them?

Mark Powles: That refers back to what I was saying earlier, about if it is regulated access. In Scotland there is a clear wholesale price. That is the same price that is paid by me as an incumbent, and it is also paid by new entrants, so there is complete transparency. There are also a default set of service standards, so if my customer wants Scottish Water to respond within five days to a particular fault find or whatever, that is exactly the same service as a new entrant will get from customers they are serving. A lot of that is picked up within the market and the operations codes. We would like to see that regulated rather than negotiated.

The other point on separation—you are preaching to the converted, because I have had to go through it, and we are now in a physically separate business. We have separated all our IT systems. My people cannot speak to Scottish Water in the same way as they did when they were colleagues; we have to go through defined channels. The regulator audits me on that. To new entrants that means they have certainty that we are not getting an unfair advantage. The Bill is silent

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on how that will be applied in detail, but my worry is that if we do not get that right at the start we will end up with multiple claims in the competition courts or to the regulator that are lengthy, costly and burdensome, and customers will not get benefits.

I would really like to see some clarity on how they would apply a governance regime in the absence of separation.

Q223 Neil Parish: How do you see competition working where you have got two different wholesale water companies, because you only have one in Scotland? For example, Wessex Water and South West Water have significantly different charges, partly because of sewerage disposal and cleaning of beaches. How would that work?

Mark Powles: In terms of the price per litre, if that is what we are talking about, we accept that there are going to be different prices in different regions because of the cost profiles and the investment that has happened over the years. We accept that, and it would be our job, if we were serving a customer with sites in different regions, to aggregate that and put a deal to the customer that made sense and was fair. However, we would like to see more harmonisation of price structures, because that is where complexity can get out of control—if you cannot demonstrate to a customer the value they are getting from contracting with you. If that is broken down 21 times, it starts to get difficult.

Q224 Neil Parish: What I cannot get to the bottom of is why Wessex Water or South West Water would sell their water to another company for a cheaper price than that for which the customer could buy it from them?

Mark Powles: They should not be able to.

Q225 Neil Parish: Right, okay. It does not create much in the way of competition, as far as I can see. I will move on to the next question. What particular forms of potential discrimination must be addressed if a well-functioning market is to be established? I am not convinced it is a well-functioning market yet.

Nathan Sanders: There are two that we would probably see. One is around the inset process as a whole. Currently the process takes a considerable amount of time, and that time is too long for the developers and it deters them. The process currently allows incumbents to slow down the mechanism for the transfer of information, such as the reporter's report, which is to prove that any site is not served, and also agreeing the bulk service terms. We would like to see that discrimination taken away and for the market code to really define that, or even go further around those terms within the Bill.

The second one is calculating the cost of connections, which we talked about earlier. There is a requirement to be applied under the Act to take into account discounts on future revenues. Some of the incumbents apply that to us, as a new entrant; some do not. Some use the Act itself, because there is a technicality in the Act that says that that discount should only apply for occupiers of the premises, rather than the people that go under the inset regime. Those issues can be

addressed in the market codes, but we would like to see a stronger steer in the Bill for the charges for connections to make sure that they are for any person on a non-discriminatory basis, and therefore that they will apply consistently across the industry.

Q226 Neil Parish: Who will police all this? Would it be Ofwat?

Nathan Sanders: I would see it being Ofwat.

Q227 Ms Ritchie: This is a question for both of you. Are you confident that Ofwat will be able to effectively police non-discrimination through regulatory means?

Mark Powles: It is certainly easier in a physically separated market. The regulator audits me, as the incumbent in Scotland, and we have signed up to certain licence conditions that mean we need to behave in a certain way. As I say, it is easier in a legally separated context. It is difficult to answer your question until we see the substance of the regime that Ofwat intend to put in place. The principle should be that, as a new entrant, I should be able to access exactly the same terms, pricing and service levels as their incumbent company.

In terms of communication, the way people interact within that integrated water company needs to be considered. They cannot be able to access back doors and other channels that I, as a new entrant, do not have. There needs to be a thought about transfer pricing: how do they price elements of service contracts between their wholesale and retail business? We need to see more detail before we can comment on it. For a market to function effectively and fairly, there needs to be a very robust system in place that is open to scrutiny.

Chair: Mr Sanders, did you want to comment?

Nathan Sanders: I just think time will tell. They have the powers. They just need to use them better than they may have been using them in the past.

Q228 Barry Gardiner: One of the other things that you said in your written evidence about a well-functioning, fair market was that it should provide for less efficient incumbents to exit that market. You were backed up in that by Ofwat, and you backed Ofwat up in that. What do you think of the government's decision, then, to not allow that, and what impact will that have?

Mark Powles: Retailing is an economies-of-scale business. If we do not allow an exit, we could have anything between 20 and 30 retailers all vying for 1 million customers. I do not think that is the way of maximising both the value and the efficiency to the customer. Whether you are a small company or a large company, if the competencies that you have are more network-based, you could be a bad retailer, and ultimately bad retailers give bad service to customers. The only way a customer will benefit is to switch, and I just think it would be healthy to create a scenario where those that do not have and do not want the competencies can get out.

Q229 Barry Gardiner: Do you actually foresee a possibility of a high level of competition with a very

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poor level of service, and a very high charge as a result of this?

Mark Powles: No, I think the charges will be regulated, I hope, so you are assured of no problems there. If a bad retailer has to stay in the market, and it withers on the vine, because they are not very good at it, that is potentially going to damage their wholesale business in terms of things like the revenue streams.

Q230 Barry Gardiner: Will that not put prices up?

Mark Powles: Potentially in the longer term. I just think it would be healthy to have a mature conversation. Regarding Scottish Water and the discussions they had before the market opened, they had to bring in a whole new set of skills to run the retail business. I was one of them, but I have also brought other people in. It is a very different skill-set from running a customer service department at a billing service in an integrated water company. Just to pick up on Mr Parish's point, competition is not just about price benefits. It is about service benefits and beyond-the-meter solutions to reduce consumption for customers. That is a very different skill-set to what

was there when it started, and we should be mature about that, because not everybody will want to play in that game.

Q231 Barry Gardiner: What do you think could persuade the government to change its mind on this one?

Mark Powles: I am not sure I have an answer.

Q232 Barry Gardiner: Apart from experience.

Mark Powles: Looking at that, you have to recognise that retail is an economies-of-scale business. To do it you do need to have volume. There are niche players in every business, and maybe it is just looking at some more impact assessments of what 30 retailers fighting for a million customers might actually look like.

Q233 Chair: Mr Powles and Mr Sanders, thank you both very much indeed for contributing to our inquiry and being so generous with your time. We really are very grateful.

Mark Powles: Thank you.

Nathan Sanders: Thank you.

Examination of Witnesses

Witnesses: **Rob Cunningham** and **Nicci Russell**, Blueprint for Water, gave evidence.

Q234 Chair: I welcome you both very warmly, and thank you for being here to contribute to our inquiry into the Draft Water Bill. If you could just introduce yourselves for the record, and give your position, that would be great.

Nicci Russell: I am Nicci Russell, Policy Director at Waterwise, and I am here as part of the Blueprint for Water NGO coalition.

Rob Cunningham: I am Rob Cunningham, I head up the water policy team at the RSPB, and I am also here as part of the Blueprint for Water coalition.

Q235 Chair: If you agree with each other and do not need to add anything, then that is fine. If you do wish to supplement what the other has said, that is equally fine. Can I just ask, in your view, are there any obvious omissions or gaps in the Draft Water Bill, either in and of itself or having looked at the White Paper that preceded it?

Rob Cunningham: I think probably the most glaring gap is any action on abstraction or significant action on water resources reform. I cannot help but conclude that if we had not had the wettest summer on record we would have probably had a very different Bill in front of us. The Blueprint for Water coalition is very clear that there should be some action on abstraction reform. There are a few other things that could be wrapped up in the Bill, such as removing legislation that restricts compulsory metering to areas of water stress, to try to encourage that to move forward in places where it is cost-effective and supported by customers; another issue is about removing statutory limits on fines. We do not get a Water Bill very often, so we would like to see a much broader base of reforms brought forward in a Bill.

Q236 Chair: We are going to come on to abstraction in a moment. On water efficiency and resilience, would you have expected to see something perhaps more in the Draft Bill?

Nicci Russell: Yes, we would have liked to see something on water efficiency in homes. We are grateful that when Ministers launched the Draft Bill they stated clearly that they hoped that the competition proposals would lead to greater water efficiency for non-domestic customers, but we would have liked to have seen something for domestic customers. We think something along the lines of an enabling duty, subject to a future ministerial target on water efficiency, would have reflected the ambitions set out in the Water White Paper, and given a clear steer that the government wants to see a shift in the balance between supply and demand-side measures towards more demand management.

Q237 Chair: And of the 10 steps that you have set out towards sustainable water in your Blueprint, how many of those steps relies on legislative change—either primary change or secondary legislation?

Rob Cunningham: There is surprisingly little on primary legislation, perhaps, and I have touched on a few of those. There is a backlog of things that require secondary legislation. That is one of the reasons we are so concerned about this being a missed opportunity, because the government already has powers under the 2003 Act, for example, to take action on damage. Abstraction is causing significant damage, and we have had a consultation on that. It is lumbering towards a conclusion, but we are not entirely sure what that will be, so there is that kind of thing.

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Under the 2010 Act we were very keen to see widespread use of sustainable urban drainage, but that is being held up by a lack of secondary legislation and statutory guidance. There is a backlog of work, so promising future reforms in a future Bill, when we have still got so much unfinished business, feels a bit—

Q238 Chair: You have certainly pressed the right button with me by referring to SUDS. Have you assessed the government's progress towards achieving environmental measures, which were set out in the White Paper, that fall outside the remit of the Draft Water Bill?

Nicci Russell: Yes, we have. Earlier this month we published a scorecard on the 10 steps, which we set out a couple of years ago for the government. The Minister asked us to come back and test him on them. Overall we gave the government a D. We gave fewer Bs and fewer Es than we did in 2008, but overall we gave a rating of "Must try harder". Perhaps I can pick out a couple of quick examples.

On water efficiency, we welcome the scale of ambition set out in the White Paper, and the narrative, but we are lacking a lot of the policy action to deliver that. We welcome the link with energy efficiency and Green Deal, but there was nothing on retro-fitting the vast bulk of homes for water efficiency, and nothing on new homes. We are in danger of losing the existing water efficiency measures that we have in building regulations, so we gave overall a C on water efficiency.

On metering we gave a D, largely because the government explicitly ruled out anything that looked like universal metering coming as a steer from the government in favour of local solutions led by the companies.

The only E we gave was on the step relating to stopping pollutants contaminating water, where there has not been enough progress, if any, on pesticides, and we gave a D on keeping sewage out of homes, rivers and beaches. So overall "Must try harder" was our assessment, but we very much believe that the Government is on the same side as us in terms of the narrative. It is about the delivery now.

Q239 Sheryll Murray: If I could turn to abstraction, the water companies and Ofwat were not convinced by your suggestion that the Draft Bill should include enabling legislation for abstraction reform. Given that the details of the reforms will not be settled for some time, why do you think it is so important?

Rob Cunningham: The fundamental point here is that Water Bills do not come around very often and we should grasp this opportunity while we can. It is indicative of the overall problem we have, that memories are very short. We were facing a really significant drought in the early part of this spring. We were saved by unseasonably wet weather.

Q240 Sheryll Murray: If I could just come in there. I have heard you say twice now that Water Bills do not come around very often. Do you have any specific evidence to back that up?

Rob Cunningham: In terms of specific evidence, the 2003 Act was probably the last time that abstraction reform was looked at in a really significant way. Two of the key parts to that were, first, the serious damage test, regarding which we are waiting for the secondary legislation so we can revoke licences causing serious damage, and the other is removing exempt abstractions for navigation and other large abstractions, which are locally very significant. The action on that has been delayed again. I think we were promised something late next year.

So there are missed opportunities. The Water White Paper set out a very compelling narrative about the problems with the current system, and we really look to this Bill to establish commitment to act. We are not asking for secondary legislation powers that are not going to be subject to scrutiny and public consultation and all the rest of it. We just think that if the Government is really serious about this it should signal its intention in this Draft Bill or in the Bill that comes forward.

There are also a couple of other issues around abstraction. One is the consequence of upstream competition. In the discussion of unbundling water supply licences, the narrative talks about farmers or others being able to utilise abstraction licences that they are not using and put them into water supply networks for onward sale. Anyone who is working on the water resource reforms knows that a significant number of catchments are over-licensed. Something like a third of our catchments are over-licensed or over-abstracted. This Bill, as it stands, could actually reactivate a number of dormant licences causing damage, so if the Government is going to go forward with these upstream competition proposals there is a very clear need to tackle that.

There is also the issue that, even if we were to follow the glacially slow reform process for abstraction reform, that is all predicated on dealing with today's damaging abstractions under something called the Restoring Sustainable Abstraction regime. Everyone recognises that that is moving very, very slowly. The Government, in its White Paper and its statements, has said that it would like to see, for the water industry, those Restoring Sustainable Abstraction schemes funded under the periodic review process. We think this Bill could be a way of forcing that issue, because at the moment the only people we can see opposing that is Ofwat. We really think it is time to break that impasse, so we think that there are reforms that could be made in the Bill to actually force that issue, to get those Restoring Sustainable Abstraction schemes put through the periodic review process, and actually get that system moving. If we miss this next periodic review process it will not be 2025 on the Government's timetable; it will be 2030 or beyond. Therefore, it is really critical that we break that.

Q241 Sheryll Murray: Did you want to add anything?

Nicci Russell: The only other I would add is that we have identified that the move to environmental permitting in the Bill would be a good opportunity to do this. It would not be a brand new clause; it would

be a linking in with a new measure that was already being brought in.

Q242 Barry Gardiner: Can I turn to the issue of Ofwat declaring that it is a secondary duty to have sustainability, rather than a primary duty? Your written evidence to us on that suggests that it should be a primary duty. There have been concerns raised that if it were a primary duty it could have an adverse impact on investment in the industry and actually drive out investment from the industry and have a negative effect in that way. Firstly, can you respond to that criticism, and then we will go from there.

Rob Cunningham: Regarding that criticism specifically, on investor confidence, I have heard that before. It was interesting that we heard from Moody's earlier that actually taking a long-term view and having long-term certainty in terms of investment is really critical. That is the kind of thing that sustainable development duty would drive you more towards, because you are taking the long-term view, thinking about inter-generational issues and not putting off difficult decisions in the short term because of the long term sustainability issues. I do not particularly buy it. I do not see it as a significant issue given the scale of uncertainty that Ofwat itself is willing to introduce into the regulatory system, as we heard earlier.

Q243 Barry Gardiner: Can you give us any examples in which the fact that it is currently a secondary duty, rather than a primary duty, has had an adverse effect?

Nicci Russell: We have had a chat about this and came up with lots of examples. One is that water companies currently spend 0.08% of their capex spend on water efficiency measures. Given the narrative—and everybody agrees that we will need to shift towards more demand management, which is set out clearly in the water resource management plan guidance—that is not sustainable. We would not be there if, when the industry was privatised 20-odd years ago, a sustainability duty had been in place. I think the discussion about water efficiency and leakage would be different. It is possible that we would not have needed a desalination plant on the Thames.

There are also some more specific issues. It is only quite recently that water companies have been allowed to look beyond the five years for their investment plans. Clearly, if you are putting in place a demand management measure to offset the need for future supply 20 years down the line, it is really important that the regulatory framework can reflect that. The other I would add is that I also heard the evidence from Moody's, and he said that the industry is considered a gold standard industry. I am no economist, and I am not an investor, but it strikes me that the industry is not particularly resilient to climate change, and it is at the forefront of climate change. We have had two dry winters, we are in danger of having a third—although we have had the recharge this summer—and I think the investment community should be looking at that resilience to climate change and not just uncertainty in regulation itself.

Q244 Barry Gardiner: Yes, I suspect Moody's are more proficient at looking at the capital base rather than the natural capital base.

Nicci Russell: Yes.

Q245 Barry Gardiner: Finally, you cited Ofgem as a regulator that does have a primary duty for sustainability. It is almost the flipside of the last question: can you give an example of where it being a primary duty has substantially made a difference to the regulation of the energy industry in a positive way?

Rob Cunningham: We did a bit of thinking about this before we submitted our evidence. The first thing we would acknowledge is that a sustainability duty in itself is not a silver bullet. You do not give somebody a sustainability duty and expect things to change overnight. But what we have seen in Ofgem is that they have restructured themselves, so it has put sustainability higher on their agenda. Talking to NGO colleagues who have been working in the energy sector, they feel that it resulted in a much more open dialogue about the sustainability challenges that are facing Ofgem. The way it was phrased to me was that there is a definite sense of willingness to engage and discuss, but four years on since they were given that duty, there is still a strong cultural issue around the skill-sets of the staff and the way in which the organisation operates, but it is the beginning of a process. That is how I would see where we would go with Ofwat as well.

Q246 Neil Parish: I think Harold Wilson said, "A week is a long time in politics". I think six months in water supply is a very long time. We were talking six months ago about being in a drought situation and now we have had the wettest summer on record. As you have been saying, that does not really alter the fact that we might well need to bring in more metering. Are you aware of any specific instances where water company customers would support compulsory metering but the company is prevented from carrying it out because it is not in an area of serious water stress, because that is very much in the Government proposals.

Nicci Russell: The barrier in terms of only being able to compulsorily meter in water-stressed areas is not just regulatory barrier or a hard barrier, but it is also a barrier in terms of customer perception. I do not have a specific example of a water company whose customers were desperate for metering but were unable to do so because it was not defined as water-stressed. It is a bit more three-dimensional than that, although I know that is not what you were suggesting.

Thames Water, who are in an area of high water stress, were not awarded their metering programme at the last price review, despite being in an area of water stress. We feel that it complicates the issue, and, in line with the Government's red tape review, it would be worth, as we propose, just getting rid of that distinction entirely, and just allowing companies, where their customers are happy for that to happen, to meter compulsorily wherever, as necessary. The Environment Agency's new definition of water stress

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will actually put a lot more companies into the high water stress category.

Q247 Neil Parish: So give the companies the freedom to go ahead with metering if their customers wanted it; is that what you are saying?

Nicci Russell: Yes. It strikes us as a regulatory barrier that does not need to be there.

Q248 Neil Parish: And does Mr Cunningham want to add anything?

Rob Cunningham: The problem is that it is difficult to come up with examples; why would a water company go through the pain of putting it in its water resource management plan and trying to win the argument when it knows that the legislation is against it? We think the water companies should be given greater latitude in coming up with a sustainable solution, and, if it is supported by the customers, that going forward.

Q249 Neil Parish: My next question is very much linked really, because I want to talk about how we designate water as stressed. Various parts of the country will change where the water stress is over a period of time. Perhaps the eastern side is usually drier and the western wetter, but it does not always work that way. The Environment Agency is currently consulting on changes to its methodology for designation of water stress. Do you expect the new methodology to have a positive impact on levels of metering?

Nicci Russell: Yes, we do. We are very supportive of that process. It will move more companies, including companies in the centre of England, into a classification of serious water stress. We think that will make a difference. However, although I am not quite sure how regularly it would be made, that classification certainly would not be made every six months. Your six-months analogy is relevant, because everything can change in six months. Even under the new classification, a company that is not classified as highly water-stressed or seriously water-stressed might still need to be taking urgent measures. .

Q250 Neil Parish: I see from my notes here that Bristol Water, Severn Trent Water, South Staffordshire Water and Wessex Water could well having serious shortages of water.

Nicci Russell: Yes.

Q251 Neil Parish: So you would support the idea that they then could bring in more metering?

Nicci Russell: Yes, and that reflects more our view of the world. The previous classification did not include climate change impacts, for example, or catchment management approaches and the CAMS process, for example. So we are very supportive of that, but it is a halfway house for us. We would like to see the regulation gone entirely.

Q252 Chair: Just before we leave metering, in the South West Water area, they have probably metered to the maximum that they are going to, and it seems to have a perverse consequence that those that are not

metered because they are on particularly low incomes are actually being disadvantaged. Do you share that view?

Nicci Russell: This one of the reasons why we were keen for the Government to take a strategic role in the move to full metering. We feel very strongly that there is a tipping point, which might be different for each company, where you do start to get those cross-subsidies and inequalities that people are concerned about with the move to full metering actually starting to happen during the transition. That is an issue. It comes at a certain stage as you move to full metering, but you can manage that through tariffs and water efficiency measures as a package with metering, not metering alone. .

Q253 Neil Parish: The trouble is low-income families who use a lot of water do not want to go onto the meter. Would it actually be better that all people were metered, and then help was given to those families that are having difficulty paying the bill? I do think it is ultimately fairer that all people are metered, not only from an environmental point of view, but on the fact of the resource that they are using.

Nicci Russell: Yes, we absolutely share that view, and it enables you to address the affordability aspect far more strategically. It is fairer in the long run, and I certainly agree with you that it is fairer for everybody if they pay according to how much they use, with those safeguards in place.

Rob Cunningham: Waterwise, RSPB and a range of other organisations are members of a coalition called Fairness on Tap, which explore these issues, and we would be happy to send you a copy of our coalition document that sets out the case for metering. But the point you make is perfectly valid.

Chair: That would be very helpful.

Q254 Sheryll Murray: I have just a couple of very quick supplementary questions. Firstly, some water companies, such as South West Water, have a scheme where you can try a water meter for 12 months and revert back to the normal billing if it does not prove to suit your needs. Do you think that is publicised enough? Secondly, how would you deal with multi-occupancy properties if you had compulsory billing for every household?

Nicci Russell: On the first issue, I certainly think it is a good idea to meter in a consensual way and to give customers information to help them drive a change in their behaviour, otherwise putting the meter in has less of an impact. Southern Water are metering all of their homes and doing the same—giving both bills for a year so you can see the difference and try and drive your use down—so I very much agree with that.

In terms of publicising it, that is obviously a really important part of the package. I think working with other partners helps in that measure. We are always happy, as NGOs, to work with water companies as they go out to customers and say, “We would like to meter you, and this is why”, and that might help with the trust issue.

Sorry, what was the other question?

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Q255 Sheryll Murray: It was on multi-occupancy homes. There are some properties that physically cannot have a meter. How would you deal with those?

Nicci Russell: I agree with you that some homes cannot be metered. Universal metering gets up to about 80% or 85%, and they would probably still have to be billed on the basis of rateable value, but that could be updated because it is currently 25 years old.

Q256 Sheryll Murray: How much do you think that would cost if you were going out to rerate properties? Have you got any assessment on that?

Nicci Russell: No, we have not. I think at the last election there was a big political debate about this, and a decision was taken that it was far too politically sensitive. That ratering of properties was beyond water.

Q257 Ms Ritchie: I have another question around Ofwat. Do you accept that if Ofwat had a primary sustainability duty this would be likely to lead to increases in customers' bills?

Nicci Russell: I do not accept that. Affordability is an issue in the water sector that will always be there, and we need a far better system to deal with it. The issue of sustainability leading to higher bills is not a fair representation of the situation because Ofwat are committed to protecting the interests of current and future customers. Sometimes it feels as if there is a skew towards current customers, but if we are investing on the basis of sustainability, then that might mean that future customers do not need to invest or pay bills for another desalination plant, for example. Therefore, I do not think there is necessarily a tension; it is just a question of spending the money differently. It does not necessarily mean that bills would need to go up.

Q258 Ms Ritchie: How would you envisage the equal duties to promote sustainability and financeability could be balanced by the regulator when there is a conflict between them? I suppose it is a question of balance.

Rob Cunningham: One of the issues here is the definition of sustainability, which is mercurial and has been debated by academics for years. Defra and the Government have a very clear view about what sustainability is. We are not here talking about sustainability being purely the environment. Sustainability, as defined by the Government, includes aspects of social and economic consideration, so I do not think it is something that necessarily we should view as being intention. It is just broadening the assessment criteria of how you make your decisions. It was described, by the Sustainable Development Commission, as the difference between making a cheap system more sustainable or making a sustainable system most cheaply. I think that is essentially what we have to be aiming for.

Q259 Chair: Looking at the implications for water customers, I know you are very keen to see the Water Framework Directive implemented, and probably also the Urban Waste Water Directive implemented. Are

you in a position to cost what the implications for future and present water customers' bills will be?

Rob Cunningham: That is something that has been keeping people occupied for a while. No, but I think the interesting thing about the Water Framework Directive is that as its core it has the disproportionate costs test, and that is that marks it out as being unusual, unlike the Urban Waste Water Treatment Directive. So the Environment Agency, Defra and Ofwat will come to a view, or government will come to a view, as to what is disproportionately costly.

There are a couple of wrinkles in this that are relevant to the current water policy debate. The first is, of course, we have heard from various people that upstream competition could increase the cost of capital, and that could have a knock-on in terms of the cost to water customers. So the Water Framework Directive is a bit of a moveable feast. From our point of view, in terms of the disproportionate costs test, we need schemes delivered at the least possible cost. There is a really big question as to whether opening the water industry to upstream competition is going to do that, so you could see a tension between competition, driving up water customers' bills and driving down environmental ambition. That is a very real risk we are concerned about.

The other thing that is exercising a lot of people is the fact that we have in the Bill this realignment of drought planning, which is an industry in itself, but compared to the overall periodic review and the Water Framework Directive, it is a small component. However, in the current planning cycle we are facing Ofwat coming to a final determination on water company investment two or three months before the Government officially announces the outcome of the river basin management planning process. That timing mismatch is going to cause an awful lot of headaches and a lot of uncertainty for customers, in terms of the decisions about whether the water companies will suddenly be facing another set of investment priorities that were not accounted for in the price review, and how they are going to deal with that. That is something that the Bill could deal with, or government policy could deal with, because it is going to be an issue of one or two months this time round; it will be 13 months the next time round, and I think that is a big problem.

Q260 Chair: That is very helpful. On climate change, Ms Russell, you said that it should be a core function of water companies. In North Yorkshire, we saw temperatures of minus 19 and minus 17 for four days in a row. That obviously was over and above any leakage policy that they had. You mentioned earlier that if the leakage work had been done, perhaps we would not have needed the desalination plant. It would be very helpful if you could perhaps share, in writing, with the Committee the background that you actually reached that calculation on. And going forward, perhaps in writing you could share with the Committee what role you would expect water companies to play. Clearly any extreme weather conditions like burst pipes because of cold weather is over and above what any water company is expected

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to do, so if you had anything like that you could share with us, that would be most helpful.

Nicci Russell: Yes. I am not sure we have a huge amount on that, but certainly what we have we would be happy to share with you. One of the things that we are pushing for as the Blueprint for Water coalition in the price review is a water supply target, so that would

cover water efficiency, leakage and metering, and would take up a bigger slice of the pie, and would potentially be a more strategic approach to leakage.

Chair: Thank you both, Ms Russell and Mr Cunningham, for being with us and being so generous with your time, and participating in our inquiry. We are very grateful to you, and we stand adjourned.

Wednesday 21 November 2012

Members present:

Miss Anne McIntosh (Chair)

Thomas Docherty
Neil Parish
Sheryll Murray
Richard Drax

Barry Gardiner
George Eustice
Mrs Mary Glendon
Dan Rogerson

Examination of Witnesses

Witnesses: **Richard Benyon MP**, Parliamentary Under-Secretary of State for the Natural Environment and Fisheries, **Sonia Phippard**, Director, Water and Flood Risk Management, Defra, and **Gabrielle Edwards**, Deputy Director, Water Legislation, Competition and Charging, Defra, gave evidence.

Q261 Chair: Good afternoon, Minister, and welcome to you and your team. I commence by apologising for the private business on other issues that ran over. We are extremely sorry to have kept you and your team waiting. We are delighted that you are joining us today for our concluding evidence session on the Draft Water Bill Inquiry. Minister, could you introduce yourself and your team, purely for the record?

Richard Benyon: Thank you, Madam Chair. I am Richard Benyon, the Minister responsible for water matters at Defra. On my left is Sonia Phippard, who is the Director of Water and Flood Risk Management. On my right is Gabrielle Edwards, who is the Deputy Director in the Water Availability and Quality programme.

Q262 Chair: Thank you. There seem to be differences in emphasis and nuance between the Water White Paper and the draft Bill. Was this intentional, and was it the same team that drafted them?

Richard Benyon: Pretty much, yes, it was. Our ambitions in the Water White Paper, which were pretty universally welcomed across the piece, remain absolutely on track. The Water Bill is just part of our ambition in delivering that reform agenda. I think it is important to perhaps address head on some of the perceptions in some quarters about this Bill. I know not in this Committee but in some areas there is an institutionalised view that the only way to change things is through primary legislation, which I hope we might tease out in the course of our conversation this afternoon.

Q263 Chair: Like SUDS, but we do not seem to be going anywhere on SUDS.

Richard Benyon: I thought that might come up.

Q264 Chair: We are coming on to SUDS.

Richard Benyon: I had a premonition, Chairman, that that would come up. With respect, that is to do with the Flood and Water Management Act and the implementation of that. I am very happy to talk about that. But there is a view in some quarters that we have to legislate. I hope to prove to you this afternoon that there is a lot that we are doing now and that we can do outside primary legislation, and that we are developing here a piece of enabling legislation that will see certain parts of the Water White Paper ambitions taken forward.

Q265 Chair: I would just like to start off with something that is not actually in the Bill but is deemed to be a precursor to the Bill. The Prime Minister, the Chancellor of the Exchequer and others have said that water companies represent the gold standard for investment in utilities in this country, and they want that to continue. Are you concerned by the events following the modifications to the licences that were proposed initially in December last year by Ofwat as economic regulator and the revised changes that were republished in November?

Richard Benyon: Of course I am concerned when I hear some of the things being said by some of the water companies and some of their investors, and I hope that those concerns can be addressed. Today is Wednesday and the consultation process on this will be closed by Friday. I hope that accommodation can be reached and we can have a way forward that addresses the concerns that water companies and investors have, but also recognises that the current licence system needs some modification. It is important to get that balance right.

We have an independent economic regulator, and Government has to be really careful about how it intervenes here. If that independent regulator starts driving policy, that upsets investors, and it certainly upsets investors if Government starts driving an independent regulator. I have been very careful, along with the Secretary of State and right to the top of this Government. We want to be absolutely certain that we can ensure that we have a continued high level of investment. What the Prime Minister said about the sector is absolutely right, of course, and we want to make sure that we do have a system of regulation going forward that is fit for purpose. We are extremely engaged on this, but we hope we will see this matter resolved in the coming days.

Q266 Chair: Do you think it is possible that Ofwat is pre-empting what is in the Bill in these licence modifications?

Richard Benyon: I would be very keen to separate these two issues. We are very clear about what we want in terms of upstream reform. There are plenty of siren voices telling us that we should be reforming the water industry root and branch, going for full separation and seeing absolutely fundamental change. We did not share that view because we think it is a model that works, but we do think there needs to be

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some changes to make it fit for the future. I am really keen to separate these two issues out, and I hope we can prove that the upstream reform that we are talking about in the Bill is a very different issue to the concerns being raised about licence modifications.

Q267 Chair: It has been put to the Committee that the actions of Ofwat as the independent economic regulator are actually taking away the public interest test and the power of any parliamentary scrutiny. Yet in Defra's strategic policy statement to Ofwat recently, the Department re-emphasised the importance of a transparent and predictable regulatory regime and maintaining investor confidence. We get the impression on the Committee that there seems to be a misunderstanding between Ofwat and the water companies, which is highly regrettable. Is there a way that you can steer a path between the two?

Richard Benyon: The relationship between an economic regulator and a monopoly industry is always going to be abrasive, and rightly so. If it was too cosy, we would all be very worried. In this circumstance there is a very clear divergence of opinion. In some cases it is misplaced and misunderstood. In other respects work needs to be done to make sure this gulf no longer exists. I am loth to predict where we are before the consultation period has ended. I look at this in the context of other industries and the way they are regulated. We must make sure that water is no different and we have a stable framework.

You will have received lots of information not just from the water industry but from investors and ratings agencies as well. I am not sure I am in a position to really satisfy you with a clear, succinct answer on this, because it is a very complex techy issue that needs to be gone through with the independent regulator feeling accountable for what they are trying to achieve, clearly steered by Government through our strategic policy statement, which I am really glad that you mentioned, with as much clarity as possible about the need to see continued investment. I am dominating here; there are people who are much more involved in this.

Q268 Chair: I think this is the heart of the matter, though. The Department says, and we do not disagree at all, that the role of the regulator is to act as an independent, economic regulator. You say in your statement, it "should not anticipate or pre-empt policy decisions that are properly for Government to take". On 29 October, Moody's announced that "continued uncertainty around licence conditions was credit negative for the sector", so obviously that does set alarm bells ringing about potential future investment.

Richard Benyon: I want the future investment profile of this industry to be at least as successful as it has been, if not more. There is a new Chairman of Ofwat who has been working extremely hard in trying to explain what he is doing and what Ofwat are trying to achieve. I hope that over the next 48 hours assurances can be given, and that water companies, as some undoubtedly will, accept the changes, and there can be a degree of understanding on what we are talking about. We want sovereign wealth funds and the international investor community to continue to see

this sector as attractive for its secure, modest yielding but long-term investments, where they know that they are going to get a particular return. They need to be sure that it will not be knocked off course by an overbearing regulatory regime, or a regime that could see Government interfering too much. The investor community might think, "However benign this Government might be, one day in the future there might be a Government that will want to interfere with this." That is not a political point; it is just how the investor community looks at it. We need to get that balance absolutely right. I hope over the next few days that balance on this particular issue will emerge, but I really want to separate that out from what is in the Bill. There has been a lot of talk that the two are absolutely related, and I very strongly believe that the licence modification issue is separate to what we are trying to achieve in this Bill.

Q269 Thomas Docherty: I do not know whether the transcript of the evidence we took from Moody's yesterday has been given to you or your civil servants yet, but despite the squeals from the Water UK lobbyists and others, they were unable to point to any actual investment that was not going to happen because of the action of the regulator. Have you been made aware of any investment that is not now going to go ahead because of this dispute or divergence of opinion?

Richard Benyon: Over the last nine months, which is effectively how long this issue has been ebbing and fro, I have heard a lot of apocalyptic warnings, some modest warnings, and other people saying it will not make the slightest bit of difference.

I take this really seriously; it is so important that we get this right. You and I live in a world where perceptions are reality. If this Government or its regulator are perceived to be interfering in a way that will be damaging to future investment, that does not just sit at my lowly level of Government; that rings alarm bells right through it.

We are trying to get this right, and we have great confidence in our new Chair at Ofwat, and in Ofwat as an organisation. We want it to remain clearly as the independent regulator that it is by statute, and I hope that we can ease any fears in the investor community. Your particular question was whether I had heard of any bricks and mortar projects that are not going ahead because of this. I have not, but of course investment decisions being taken over the last nine months are really for the next price review period and beyond. The message we want to give out from Government is that this is a stable area for investment that will continue in the way it has for the last 22 years into the future.

Q270 Thomas Docherty: We had evidence yesterday from our astonishingly interesting witness—

Richard Benyon: Sorry, who was this yesterday?

Thomas Docherty: From Moody's. He was unable to point to, for example, the change in the share price of UU, which I think dropped by 9%. When he was pressed, he had to admit that there was no way of identifying if even one percentage point was because of the potential reforms or the dispute. He said it was

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as likely to be because it had been over-priced six months ago. You obviously are in the know, Minister. Other than the squeals from Water UK's lobbyists and the siren warnings, so to speak, have you any actual evidence or example that you can point to that makes you genuinely worried?

Richard Benyon: When organisations like Moody's talk like that, I think it does have an effect. It starts people asking questions. My boss, the Secretary of State, was in China and Hong Kong last week, and was asked this very question. I hope that the answers we give can allay those fears. Maybe a water company can say that they were going to have a degree of investment in a project but it is now questionable, but no one has actually passed that on to me. I cannot say I have any evidence.

Q271 Neil Parish: Minister, I take it we are a Government that is in favour of competition. We are in favour of competition in the energy industry, and we have very strong energy companies. We do not shy away from getting them to compete with one another. I am just rather worried that this Bill is a bit timid if there is no competition in there. Surely competition could actually strengthen the businesses as much as weaken them. I have heard these arguments for years, in the old nationalised industry, so can we not actually be a bit more competitive?

Richard Benyon: The last Government pushed the process into gear by getting Professor Cave to write his report. We are proposing some competition into the non-domestic market for precisely those reasons. We think it is healthy for the industry, not just the private sector but the public sector as well. For example, in Scotland schools can now buy their water from one retailer, and so can the health service. There are huge savings to be made in that.

Q272 Neil Parish: So will that happen in England?

Richard Benyon: It will, yes, with our reforms. It is quite modest, and rightly so. If we were as radical as some people have been pressuring us to be, I think it would start to test what is the successful model we want to keep.

Competition can help in innovation, which is something that is absolutely key to this White Paper. We want to see companies thinking about things that they did not have to think about 22 years ago, such as climate change and the pressures on their businesses. For example, where a food producer is using an enormous amount of water, they might want to develop a recycling system, which would require some legislative support, because they have to tap in or out of the water company's pipeline. You have to change the law to make that possible, not in a way that damages the monopoly supplier's source or sewage outflow management and that investment model, but that allows innovation or, for example, the building of a new reservoir. This is where competition can come in and be a great advantage for the customer as well as society.

Q273 Sheryll Murray: If another company is tapping into a company's pipeline, and I noticed that is what the Bill intends to happen, who is responsible

for the maintenance of that pipeline? Will they have to pay for the privilege?

Richard Benyon: The asset, whether it is a pipeline or whatever is providing that water or sewage function, is the responsibility of the water company that built it or owns it. It is their long-term asset, and that is the rock-solid basis on which investment has been so successful. We want to keep that, but we do want to allow new entrants to be able to access the process at some point in order to deliver innovative projects that reduce costs for companies and will be better for the customer and the environment. This is a market mechanism, to answer Mr Parish's point as well, that can achieve that in a modest way. I do not pretend that we are going for a revolutionary change.

Q274 Chair: Could I just look at the draft Bill and competition? You have given little or no detail on how the competitive market that you talk about will operate in practice. Water companies and consumer representatives have told us that a clearer policy steer on issues such as the potential for de-averaging prices and the impact of competition on household customers should be included on the face of the Bill. Is it your intention to put this on the face of the actual final Bill?

Richard Benyon: This is a framework piece of legislation, but we fully intend to issue charging guidance well in advance of the introduction of market reforms. Primary legislation, I put to you, Madam Chair, is not the right place to set this out. We want to consult carefully with all concerned as we develop this guidance. In developing it we really need to strike the right balance. Water companies must be able to generate a return on their existing infrastructure and finance future investment, but we must not constrain innovation and reduce the benefits of this reform package. It is very complex, and it is important to get it right. If we try to write it in on the face of the Bill, that would be too inflexible, but I do give you the absolute assurance that we want to move this forward as we introduce market reforms, not at a later stage.

Q275 Chair: You are going to publish guidance. Will this be published in a form that we and Parliament can scrutinise, consistent with your draft strategic policy statement saying that decisions on the fundamental structure of the industry, and presumably competition as well, will continue to rest with Ministers and Parliament? Because we take our responsibilities very seriously, and that goes to the heart of the Bill.

Richard Benyon: I will ask my colleagues to give you the exact way in which we wish to proceed on this.

Sonia Phippard: It would certainly be our intention to consult on that guidance.

Q276 Chair: No, no, that is not good enough. We have given pre-legislative scrutiny to this Bill, and we want to know that we will have the opportunity to give pre-legislative scrutiny to the guidance that is going to be enshrined for the water companies to follow. That goes to the heart of what you are trying to do.

Sonia Phippard: Just to be clear: this is guidance to Ofwat, not to companies.

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Q277 Chair: On competition, de-averaging of prices, on the whole thing. Perhaps Gabrielle Edwards could assist.

Thomas Docherty: Have you thought about it before today?

Chair: This is standard procedure. We are not going to give you a blank cheque to go away and write guidance that we are not going to be consulted on.

Gabrielle Edwards: The guidance will be produced under the legislation, so the final version of the guidance would follow from Royal Assent and would not be available at the time it went through the House. I would need to just double-check whether it is statutory guidance or not.

Q278 Chair: We would like to know before we put this report to bed. I have to say, going through the Draft Water Bill, that there is huge discretion for Ofwat and you to draft this guidance. The Committee is slightly uneasy about concluding our inquiry into something as substantial as you are trying to do, which for whatever reason has never been tried before in this country or anywhere else, if we are not going to have the chance to scrutinise the implementing regulations.

Richard Benyon: I understand. It is statutory guidance; therefore, it has to be laid before Parliament and you will have every opportunity to look at it and question us on it.

Q279 Chair: And the guidance that Ofwat will be issuing?

Richard Benyon: Will that be statutory guidance?

Q280 Chair: I am slightly concerned that Ofwat has quite a lot of discretion in this regard. You have issued the statement that I referred to earlier. I am sorry, I do not have the Hansard reference, but it is the recent statement that you issued to Ofwat to say that there will continue to be this public interest test, and presumably this will be exercised by Parliament on behalf of the public.

Richard Benyon: Ofwat's guidance has to be in compliance with our statutory authority.

Q281 Chair: Sorry, you are not answering the point. It has to be compliant, but are we going to have opportunity to comment? Does it pass the public interest test that you have said they must not wave away?

Gabrielle Edwards: The first draft does not set out a procedure like that: for Ofwat to consult Parliament on its guidance.

Q282 Chair: So you are asking us to take on trust quite a lot of discretion that will pass from the Secretary of State to Ofwat, where some of the interpretation could essentially be political in nature? We can come on to that and discuss it under the various heads of the draft Bill.

Richard Benyon: I think that you understand our statutory position: that it would be for Parliament to scrutinise this. As far as Ofwat's guidance is concerned, we need to write to you with a very clear understanding of where the legal parameters are to

make sure that we are getting the advice to the Committee absolutely right. I am pretty sure in my mind, but I do not want to say it in case I am wrong. I cannot believe that it could be done to the exclusion of consulting at this level.

Chair: We just want confirmation that the public interest test will still be there and there will be the opportunity for parliamentary scrutiny. We will come on to discuss specifics as to whether it is political or economic in nature.

Q283 Richard Drax: I would like to touch on something you said a moment ago. You said access "at some point", Minister, so far as competitors are concerned. Can you just expand on what you meant by that? Are you talking at a pipeline or a certain juncture? How and where?

Richard Benyon: I gave an example in reply to Mr Parish and Ms Murray's question. Say a company that uses a lot of water was looking at introducing an innovative scheme that meant they would use less, therefore pay less, and perhaps recycle it. Currently they do not have the statutory right to access the water company's network. We want to give them that right because we want to see that kind of innovation introduced, but not in way that diminishes the ability of that water company to continue to maintain its asset in the way it is invested in at the moment. Perhaps a better example would be a new reservoir. We would like to see a system that would allow a new entrant to find a new source of water, and for that water to access the water company's network in an agreed way with a clear mechanism whereby that water company might purchase that water. That is the kind of innovation with a new entrant that we want to try to encourage.

Q284 Richard Drax: I would like to ask you about how this is going to be costed, and how any new entrant could possibly afford to provide water at a cheaper rate than that already being provided by the original supplier, but perhaps that is not a question I will ask you. Can I move on now to the appeals? Water companies have expressed some concerns about the extent of Ofwat's discretion under the draft Bill. Will you include a more effective appeals mechanism against the regulator's decisions?

Richard Benyon: Do you mean their appeals against an Ofwat decision on pricing?

Q285 Richard Drax: Appeals against the regulator's decisions, whatever they are. The question is hinting at the appeals procedure per se. It says here water companies are concerned about the extent of Ofwat's discretion.

Gabrielle Edwards: There have been a range of concerns that water companies have raised with you and us about the extent of Ofwat's discretion in this Bill. That is the value of the pre-legislative scrutiny process, because we can look very hard at those concerns and decide whether or not we need to reflect them in the final Bill. I cannot give you a precise answer about the appeals point, but we are very aware of the concerns that have been raised about the level of Ofwat's discretion.

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Q286 Chair: And what are you doing about the concerns?

Gabrielle Edwards: We are considering how we would respond to them in the final Bill.

Richard Benyon: We are open to any recommendations you make on this. We want to make sure that we get that balance I was talking about earlier right.

Q287 Chair: Minister, we would all like to see more reservoirs. What is happening about the reservoir guidance that was promised so long ago I cannot remember when, to be agreed by Defra and the Institution of Civil Engineers?

Richard Benyon: This is the Reservoir Act. I should have come prepared because I thought you might raise this.

Chair: Indeed, I am very predictable, I am told.

Richard Benyon: I think we are pretty near to hearing from them.

Q288 Chair: I think you said that the last time. Do you think Christmas? Spring? New Year? Summer? Which year?

Richard Benyon: We will write to you, Chair. To be perfectly honest, I am not sure, and I want to make sure. I mean I know that this is holding up a very important flood project, although there are some innovative ideas that may possibly be there to solve the problem without this. But I do think it is very over-precautionary, and that is why we asked the Institution of Civil Engineers to look into this.

Q289 Barry Gardiner: Minister, originally you said it would provide a benefit of £2 billion from upstream competition to the industry, but your impact assessment on the White Paper showed that there would be a £426 million downside if there were a 1% increase over the base case with no upstream competition. Since the White Paper last year, have you revisited the cost-benefit analysis of the impact of upstream reforms, particularly in relation to the projected increase in the cost of capital?

Richard Benyon: We have talked already about rating agencies. The rating agencies have said that our reforms should not have any significant effect on the cost of capital, which is worth noting.

Q290 Chair: As regards upstream?

Richard Benyon: Yes, upstream reforms.

Q291 Barry Gardiner: When you issued the impact assessment alongside the White Paper, you said that the net present benefit calculated took into account an increase in the cost of water and capital for water companies of £426 million. That is your assessment. I did not raise the issue of the rating agencies; you did, Minister. I am asking you only of your own Department's assessment here.

Gabrielle Edwards: No, we have not re-visited the impact assessment since we published it just under a year ago. That impact assessment was a very substantial piece of work, which included sensitivity analysis around the increases in the cost of capital. On balance, we would say it took some fairly

conservative assumptions throughout because we wanted to be cautious and clear that we were not taking risks. As you say, we factored in the assumption that there would potentially be some increase in the cost of capital, and it still delivered a relatively substantial benefit. We have not seen anything to suggest that it is wrong at the moment.

Q292 Barry Gardiner: So you still hold to the figures of £426 million potential downside from the upstream competition, against a £2 billion potential benefit?

Gabrielle Edwards: If that is what is in the impact assessment, those are still the best figures we have.

Sonia Phippard: There is obviously a range of figures in the impact assessment, and those are the central case. In the interim there has been some other work by Ofwat and the Water Resources in the South East Group, which again came up with net benefits of a similar order.

Q293 Barry Gardiner: What further analysis of the effects of upstream competition do you propose to carry out before the introduction of the Bill, if any?

Richard Benyon: We will have to have a full, updated impact assessment, not only to satisfy people like you but also the Better Regulation Executive in Government. I think it is worth noting that what we are talking about with the benefits is more about service than price. We have seen an example of one customer receiving over 4,000 paper bills a year, whereas a single national supplier could save that customer between £80,000 and £200,000 a year in administration. It is trying to factor that in across a very divergent, wide range of customers, and making sure that the figures we are presenting as the cost-benefit analysis are robust.

Q294 Barry Gardiner: When will Ofwat publish their economic impact assessment?

Sonia Phippard: Sorry, their assessment of what?

Barry Gardiner: The upstream reform.

Chair: The cost and benefit analysis.

Richard Benyon: I am not sure.

Q295 Barry Gardiner: You do not think they will?

Sonia Phippard: In terms of developing firm proposals for the implementation of upstream reform, there will be a lot more work to be done by Ofwat with the water companies and Government, similar to the work that will need to be done in developing the detail of precisely how the retail arrangement is going to work. Upstream is obviously in that sense more complicated than retail because it contains different types of access. There is trading between companies and the ability for new players to come in, so there will undoubtedly be more detailed work to be done, but I cannot give a detailed timescale.

Q296 Barry Gardiner: You have no date for that then. The draft strategic policy statement for Ofwat says that the regulator will be expected to provide a thorough assessment of the impact of their regulatory proposals on both consumers and investors, including evidence of the costs and benefits. How would you

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expect that requirement to be fulfilled in relation to the introduction of upstream competition?

Richard Benyon: I would expect them to provide it through the price review process. We would need to have a very accurate figure about what we are talking about here, and this will become apparent as the Bill becomes as an Act.

Q297 Chair: I am slightly confused, because the strategic policy statement that Defra published to Ofwat emphasised the importance of thorough impact assessments, including evidence of costs and benefits, for substantive changes to the regulatory framework, which Ofwat's proposals clearly are. There is concern in the market and amongst water companies that no impact assessment has yet been placed on the table, and you are clearly calling for it in your statement.

Sonia Phippard: We need to separate out history and future a little. We have only just published this strategic policy statement in draft, and it does place some new requirements on Ofwat. The licence modification process, which is where the water companies' issues arise, is something that has been in train for the best part of a year. When it comes to the further work on retail and upstream reform, we will need to work with Ofwat and water companies to produce that sort of impact assessment as the proposals become more concrete and Ofwat's regulatory regime to deliver and enable one becomes clearer. We are clearly not there yet, because at the moment we only have the primary legislative framework very much in draft.

Q298 Chair: On this assessment that you are asking for, are you saying that there is a real risk that the costs would outweigh the benefits that you think might be brought in by the introduction of upstream competition? Is that a real possibility—that the impact assessment may show that the costs outweigh any potential benefits?

Richard Benyon: We have our best assessment of the benefits and the costs of this, and we will review them, but you have the figures before you.

Q299 Barry Gardiner: You are sticking by £1.5 billion benefit to the industry?

Richard Benyon: That was what we produced as part of the Water White Paper, and it is open for challenge; we challenge ourselves on it. It has been produced by economists working within the sectors.

Q300 George Eustice: I just want to ask whether there are any particular elements of upstream competition that you think competitors might take up. It seems to me that all the concerns we have expressed about upstream competition are the concerns that monopolies down the generations have expressed about competition: that you are going to duplicate everything and spend capital on things twice when you do not really need to. Actually, there might be certain things such as sewage works or particular elements of upstream supply that an individual company might come in and supply more effectively. Have you thought about which elements of the

upstream are more likely to be involved with competition?

Richard Benyon: I hope you will believe that we have not done this in a bubble. This has been the product of a lot of extensive work done by Professor Cave and others who have been advising us. We think there is a real benefit for this, and we have seen it happening in other countries, and we think this is an important way of delivering the kind of innovation we were talking about in the White Paper. Maybe my colleagues can come in with some concrete examples of the kind of innovation that we could see coming out of these reforms that might help.

Sonia Phippard: It is actually quite a range. Most of the intervention is relatively modest. It is indeed industrial supplies being available to the public supply. It may well be co-operation with farmers who have abstraction rights. It may be people who want to provide a more extensive service for new developments than that which can currently be provided by inset companies. So there are a variety of ideas and propositions that currently are not practicable under the current regime.

Q301 Mrs Glendon: In their evidence, witnesses have suggested that the draft Bill's current provisions in relation to upstream reforms would lead to the regional de-averaging of prices. Does the Government believe this is desirable?

Richard Benyon: We very much hold Ofwat to their duty to make sure that we are not penalising customers who live in rural areas because it is more expensive to provide water to them. We think it continues to be a very clear duty on the regulator to make sure that prices are averaged in the right way.

Q302 Mrs Glendon: Would you consider that this is really an issue of public policy and should be legislated in Parliament rather than left to the regulator to decide?

Richard Benyon: With respect, we are not leaving it to the regulator, because we have said very clearly in our duties to the regulator that they have to be mindful of this.

Gabrielle Edwards: Also we will be producing the statutory charging guidance that we were discussing earlier, so we can set out very clearly what our expectations of Ofwat are. They will then have to follow that in the rules that they set for charging.

Q303 Barry Gardiner: Minister, if I come in as a new entrant into the upstream market and I cherry-pick off those areas that are closer to the eventual remediation facilities, then I am coming in and providing competitive advantage because I do not have to deal with much other stuff out there. I am offering a very good price to the people that I am going to be supplying. Are you telling me now that Ofwat will come in and stop me, effectively, providing that competition?

Richard Benyon: No. If a company, Gardiner Inc, has a particularly innovative product or means of financing a cheaper source of water that would be of benefit to the customer, I want it to be able to access the system, which it currently cannot. Therefore, we

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have to set out in the legislative framework and in the charging guidance a fair means for you to access the system. That is all we are doing here. All the indications are that this will not be a seismic change. We are not going to see a huge disruption of services that water companies provide, mostly very successfully, now. But it does just provide the chance of innovation to come in backed by a legal framework.

Q304 Barry Gardiner: The whole issue about de-averaging, surely, is that if I come in here and I can bypass the existing treatment infrastructure, I can provide this service cheaper. You seemed to be saying in response to Mrs Glindon that Ofwat was going to regulate this, and it would not be possible for them to have de-averaging of prices in a given area in that way. I am just trying to get clarity here on quite what it will take for Ofwat to come in, in the way you have suggested, and ensure that this de-averaging does not take place. If I, Gardiner Inc, am going to provide this service, I want to know that I will not have the regulator saying, "Well, you actually can't charge that lower price."

Richard Benyon: That will be in the charging guidance, and we have to be absolutely clear that we are not going to do anything that would disrupt the investment model, but still provide fair access.

Gabrielle Edwards: The two questions taken together show why this is so difficult and why we were very careful, firstly, not to rush into this, and secondly, not to try to put something very inflexible on the face of the Bill. There were lots of concerns that going down this road might lead to de-averaging. At the same time, how are we going to be sure that we do manage to get some benefits through innovative approaches by enabling competitors to come into the market and deliver something new and gain some benefit from it? Trying to balance those two concerns is quite difficult; therefore, this charging guidance is important, and we need to make sure we take the time to get it right, and talk to people as we do that.

Q305 Barry Gardiner: Can I give you an example that was provided in evidence to the Committee by WICS? They tried to give an illustration of the potential for de-averaging. They said, "If a dairy in a rural community were to reduce the strength or volume of its waste, this could lead to the partial stranding of an asset built to serve that customer. It may be the only significant business in population-equivalent terms in the area, and potentially significant costs would now have to be met by those customers that remained, including households, if the asset that was constructed is to be paid for in full. The same would apply if the dairy were to identify an alternative source of water," such as Gardiner Inc—they do not say that—"that would meet its needs." How do you respond to that, given what you have said about Ofwat coming in here and in effect imposing a price control?

Gabrielle Edwards: There are ways in which Ofwat can choose to regulate. You either deal with the stranded assets point by saying that the company takes a loss, and that is the competitive market, or it is

reflected in the charging, or there are ways in which Ofwat can regulate to ensure that if a company has sunk investment in a considered way, they are to some extent at least protected.

Q306 Barry Gardiner: So they are allowed to put the costs of that on the remaining householders or customers' bills.

Gabrielle Edwards: Potentially.

Barry Gardiner: So you are raising the bills in the incumbent area. Look, as Gardiner Inc, I feel very reluctant now to come into this market because it seems to me that three people sitting before the Select Committee are not really sure about what my investment risk is going to be. And if they are not sure, I am not sure either.

Q307 Thomas Docherty: Minister, you have talked about the regulator. The reality is there are two regulators.

Richard Benyon: Three.

Thomas Docherty: There are WICS and Ofwat.

Richard Benyon: Economic regulators, yes.

Thomas Docherty: As I am sure you are aware, competition law trumps devolution, and this would apply to Scotland. This is not only a problem for my English colleagues. If you do not sort the de-averaging, and I have heard nothing that tells me that you have, this could lead to a de-harmonising of prices in Scotland.

Q308 Sheryll Murray: Basically I just wanted to raise the issue of the south-west. I know there is legislation already in place to help South West Water customers, and I would like to say thank you very much for that. But South West Water is worried that the knock on effect on rural customers to cherry-picking of commercial customers in urban areas—upstreaming—could have an impact on household customers again. They estimate, particularly with bad debts of an extra £10 per household, that would eat into that financial assistance that they have already been given. What guarantees could you give to me that this is not likely to happen?

Richard Benyon: This fits very much into the accusation that somehow our modest proposals for greater competition, which would be of massive benefit to a lot of non-household customers, are going to increase the cost of capital. It is not our intention to do anything that increases the cost of capital, and indeed the reforms we have suggested have been given the green light by the rating agencies to say that they will not have that effect. If you follow down a what-if route on a whole lot of examples, you see the sheer complexity of what we are talking about—22,000 abstraction licences, and I am sure we will talk about those at some point. We are talking about a highly complex delivery network that is underpinned by a monopoly industry with a clear regulatory framework. We are just tweaking that slightly to allow the kind of innovation that I think you universally welcomed in the Water White Paper, in a way that we believe will not cause the kinds of problems that you and South West Water raise.

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I am not sure I have answered Mr Docherty's point. Can you just clarify?

Q309 Thomas Docherty: Because competition law trumps the devolved settlement, this would have to apply to Scotland. If it goes down the Anglo-Scottish market, Scotland would have to apply the same rules. As Alan Sutherland said in his evidence, and given that Scotland has a large amount of rural areas, you would get de-harmonising and de-averaging of prices. Veolia or someone will come in and, as Mrs Murray has already said, cherry-pick out an area and say that they will serve that or build a new plant and serve it, which is why the Scottish Government is threatening to pull out of this deal. My supplementary question is that when a free marketer like me and Alan Sutherland are on the same side as Water UK and the existing companies, why are alarm bells not going off in Defra because everybody, apart from Ms Finn, thinks there is a problem, particularly as Alan Sutherland is actually proposing a straightforward solution to this issue?

Richard Benyon: Which would result in—

Q310 Thomas Docherty: Which would compel the new entrant to use the cheapest source, i.e. the existing upstream source. Barry Gardiner Inc cannot come along and build a cheaper one to cherry-pick a bit of supply. Why is Defra resisting when everybody else is on the same side?

Chair: It is basically the stranded assets question. You said you do not wish to increase the cost of raising capital, but Gabrielle Edwards said that one possibility is putting it onto the customer. It is the fear, I understand, of both Alan Sutherland and the water companies that it is going to end up putting the cost of the customers' bills up, which as a rural MP obviously sets alarm bells going for me.

Richard Benyon: Give them the rationale that you were getting at.

Gabrielle Edwards: I was not entirely saying that we would be putting this onto customers. I said there are different ways this could be regulated. No one exactly knows at the moment what that approach would be because this is just a framework piece of legislation. To go back to the Scottish point, clearly there is no intention that by legislating to change the system in England we would change the system in Scotland. This is a framework piece of legislation. There is a huge amount of work to be done as we go through all the implementation. This is not going to be implemented in a short time period, and we really are at the very early stage of working through these practical details of implementation. That is why we have set up a process with the industry and the regulators, including the Scottish regulator and the Scottish Government and the Scottish companies that are active in this field, to make sure that if there are any unintended consequences, we absolutely work those through, because that is not the intention.

Richard Benyon: If you can come up with a form of words so that we could put those safeguards on the face of the Bill, or at least much more clearly in the guidance, I would be happy to do that. But throughout this process I have been very careful not to tie

ourselves down with too much detail on the face of the Bill. I am a rural MP myself and I know that causes concerns because it creates a very open situation. If through the pre-legislative scrutiny, and as we develop our thinking, working with WICS and others, we can develop a form of words that satisfies those concerns, then we very much will.

Q311 Chair: Can I just come back to the question that Mary Glendon actually asked? Do you recognise that this is a political decision? We have already heard from Thomas Docherty that competition policy trumps all. Albeit it is statutory guidance, but depending on which procedure you bring forward, we would be excluded from actually having a view at that time. I think you need to go away and do a bit more work on this.

Richard Benyon: This is a process that I am very happy to share with you right the way through. You understand better than most in this House the complexity of the system and the care that needs to be taken when you are reforming something successful. We hear lots of voices that were very concerned about Cave, Gray and the review of Ofwat. They were very concerned as we took forward Water for Life, the White Paper, and now they are equally concerned in terms of the legislative framework. Some people are saying that we are not going nearly far enough; some people are saying we are going too far. We are concerned about getting this right. You publishing your report on the draft legislation is just one part in the process. I can absolutely assure you that I am happy to involve you in the production of the charging guidance and anything else.

Q312 Barry Gardiner: I do not think anybody in this Committee questions your willingness to be transparent and open on this with us. Absolutely not. But both you and Ms Edwards have highlighted to the Committee how complex this area is, how this is simply framework legislation and that it is not going into the detail; the regulation and so on will have to come later. Yet you are able to calculate that the net present benefit calculated does take into account an increase in the cost of capital for water companies of £426 million. You stuck by your own estimate of £1.5 billion, and yet you do not know what this legislation is going to contain at the end of the day. How can it simply on the one hand be a framework Bill on which no detail has been provided, and yet you have come up with very, very specific estimates of the amount of money or the benefit the introduction of this legislation will bring? As somebody who might look at investing in this, I do not understand the regulations I would be subject to and what sort of environment I will have to be making my money in.

Richard Benyon: As we go through the process, we carry out impact assessments, and they are not just fingers-in-the-air grasps at figures. These are detailed pieces of work that involve economists working with the industry and the regulators.

Q313 Barry Gardiner: But they can only do that if they know what these regulations ultimately are going to be.

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Richard Benyon: Exactly, and that is why this is an ongoing process. In these circumstances, people throw a whole range of different examples, and we have talked about some today. But as for trying to predict precisely what will happen and what the impact will be, as with all detailed economic factors, there is a range of possibilities. We want to land this in a positive place for investment and impact on customers—and we do not mention customers enough in this. We think we are setting in train something that will take forward modest reform proposals in an effective way.

Chair: Thank you. I am sure we will return to this.

Q314 Neil Parish: I made the same point yesterday; we have had both drought and flood in the last six months. This concerns the drought and flooding features on the national register. What consideration have you given to how a more fragmented industry will be able to provide resilience in the face of these threats, especially with new entrants coming in? Are they going to be held accountable by the national register?

Richard Benyon: I think the drought last year proved the benefit of water companies working together with neighbouring water companies and also with agencies. The drought group showed the value of this. The Water White Paper said the best way to deliver resilience, particularly in areas of the south and east of England where water is scarce, is by connecting to areas further west that have more water. That is not, as is sometimes rather easily and glibly suggested, through the construction of a water grid, which would be massively expensive unaffordable, but through better interconnectivity between water companies.

That needs to be firstly progressed through a system that welcomes and encourages innovation, and backed up by a system that encourages bulk water trading. I have been really impressed over the last years with how water companies were taking that kind of thinking forward, and I can mention Severn Trent Water as a particular example. As far as this is concerned, we want to make sure that the construction of more interconnectors is incentivised in the traditional way: that water companies build assets and it goes onto their RCV and they are rewarded, and investors from all over the world like that. But also, where there are other innovative resilience ideas, such as new reservoirs or new water-saving techniques, they can come into the system. That is not fragmenting; it is just adding to the resilience of areas to deal with issues such as drought.

Q315 Neil Parish: You just said water saving techniques. One of the traditional water-saving techniques is meters, and the national register will decide whether companies should go into metering across the whole of their piece. Do you not think it would be better if companies who wanted to move into metering could? That is one way of saving water.

Richard Benyon: They can.

Q316 Neil Parish: They have that flexibility?

Richard Benyon: There are two water companies that are carrying out universal metering now, and we are

watching that very closely. We encourage water companies, through their long-term water resources management plans, to look ahead and say, “This is the demand. What demand measures can we introduce to reduce the amount of water people use?” One of them may well be metering. We do not think a Government edict from on high saying that everyone must have meters is the right way forward, because in certain areas it would just be an impossible cost on those on low incomes, and we have to be careful about that. In your area and Mrs Murray’s area, about 80% of people have got meters, and we all know the reason why. I am not saying that we should encourage price increases to drive that.

Q317 Neil Parish: I agree with you that in some places it is very difficult, but are you actually going to stop companies from going for metering if they want to?

Richard Benyon: No.

Q318 Neil Parish: If they are not on the national risk register, from the evidence we were taking yesterday, it sounded as though companies would not necessarily be able to go for metering if they wanted to.

Sonia Phippard: They need to be able to make a case to Ofwat for the expenditure. The approach that Ofwat has taken to the next price review encourages extensive consultation with customers, so customer buy-in is pretty important. With the Environment Agency and Ofwat, we are looking at the guidance and the decision framework for Ofwat to see whether there is anything that is stopping companies that do have a good case from going ahead and either completing or driving through universal metering.

Q319 Neil Parish: In principle, with energy supply, people pay for electricity. You cannot say, “We use an awful lot of electricity, so we are not going to bill you on the amount of electricity.” We always bill people on the amount they use, so why should it be different for water? If people have got difficulty in paying those bills, we can help them in other ways, but if we are keen to save water, then surely metering must be one of the major components.

Richard Benyon: Metering on average saves between 10% and 15% of water usage. There are measures that can be introduced to mitigate the impact: taper relief and various other things. But those areas that are water stressed—and we all know where they are—need to have the full range of measures they can introduce that will result in the kinds of reductions that we want. In certain cases we will see many more properties metered, but we want that to be taken into account through their long-term planning, which they are required to do, through pricing measures that are overseen by an independent regulator, and driven by Government through our strategic policy statement and other measures that indicate a direction of travel. That is going to see an increase in metering: not fast enough for some, at a cost to some, but of benefit, we hope, ultimately to us all.

Q320 Sheryll Murray: Could I move on to the market opening? You have said that you are looking

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at April 2017. Does that remain a realistic target for opening the market? I have just a couple of supplementary questions: is this when you expect both retail and upstream competition to commence, and are you satisfied with the progress of the higher level group?

Richard Benyon: We do not have a timetable for upstream, but the target of 2017 for the retail market was taken on the advice of not least WICS and others. We think it is doable, but there is a lot of work to be done. What was your last question?

Q321 Sheryll Murray: Are you satisfied with the progress of the higher level group that has been set up?

Richard Benyon: Yes. It is working well, and I hope that the 2017 target will be achievable and that we will be able to come forward with a date on the remainder reasonably soon, as a result of that group's working.

Q322 Thomas Docherty: It was also the Select Committee's recommendation, based on three years from royal assent. Are you still confident of having a Bill in the next session?

Richard Benyon: Yes, I am confident. It is not necessarily in my gift, but I know it is a real priority for the Government.

Q323 Thomas Docherty: One thing that does not appear in the draft Bill is the issue of cost principles, which as you know was about stopping subsidies of non-domestic customers by domestic customers. That principle seems to have been lost in the draft Bill based on the evidence from some of the water companies. Would you include a provision in the Bill to make clear that despite the abolition of the cost principle, it should still be an underlying objective for the regulators?

Gabrielle Edwards: I think it is primarily for the regulator to ensure that there is no cross-subsidy between households and non-households. Ofwat have been very clear that that is what they would do. Again, that is something that we would want to emphasise to them in charging guidance that we give.

Q324 Thomas Docherty: I am going to take that as a no.

Gabrielle Edwards: That we are not planning to put it on the face of the Bill? We do not feel that it needs to be on the face of the Bill.

Sonia Phippard: But it would certainly be in statutory guidance.

Chair: The list of statutory guidance seems to be growing ever longer.

Q325 Thomas Docherty: Turning to the issue of an exit route, this is something that you and I, Minister, have discussed on more than one occasion—statist that you are and free marketeer that I am. As I say, it stuns me that I am on the same side as Water UK on this, but all the water companies, both regulators and the Select Committee all think there should be an exit clause. The only people who do not think there should be one are Defra. Why?

Richard Benyon: I will tell you why, Mr Docherty. If we allow exits, we are effectively saying we will allow separation, and I think that is something for Ministers and Parliament to be accountable for. That would be a major policy change. There is nothing to stop a water company outsourcing its functions. That happens now; Bristol Water outsources some of their billing function to Wessex very successfully, and that is perfectly permitted. But if you are allowing a water company to exit from a key part of what they currently do, that is effectively the delivery of separation, which we considered very hard and came down against. I think that is a decision that Ministers should take, because that would be a major change. I know you disagree.

Q326 Thomas Docherty: Everyone else disagrees. If you could point me to someone who does not think there should be exit clause, I would be genuinely interested, because as far as I can see, both regulators, the new entrants and the existing water companies all think there needs to be the option. Let me give you an example: a small, made-up water company, Cheltenham Water, has lost the majority of its customers to the wonderful Celts, who have come over the border, or a new entrant such as Southern Scottish, for our example, and makes a decision that it is actually just not viable to the business. Under the current rules, even if it has no customers at all, somebody has to sit in an office with a brass plate on the door, saying that they are the retail arm of this water company, which drives up the cost to that water company and drives up the bureaucracy to the regulators because they still have to regularly inspect their operations and so on, even though they have no customers at all. Is that not lunacy?

Richard Benyon: They have the ability to outsource and they can do that. If those circumstances arose, I think it would be legitimate for a future Minister to look at it. What you are asking me to do is progress a change that could see a very seismic shift in how we structure this industry, because companies would be able to separate their functions, and we think they should continue to be responsible—not necessarily carry out the function themselves—for the delivery of water right through the process, and the removal of sewage at the end.

Q327 Thomas Docherty: I am always fascinated when a Labour MP has to give a Conservative Minister a lecture on free market economics, but the bottom line is if you create a market, the better companies will thrive, new entrants will come in and poorer companies will inevitably fail. Everyone on this side of the table thinks that is how a natural free market should work, even with regulation. So why does Defra not recognise that? There are inevitably going to be existing water companies that will fail because customers will get a better deal, but you are actually stopping them from getting out of the business and delivering better value to the customers that they want to serve, i.e. their household customers.

Richard Benyon: Okay, let me just try to nail this one. There are risks from enabling voluntary exits, by splitting licences into separate wholesale and retail

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licences. The current debate about licence modifications shows the risks around making changes to licences, and we do not want to unsettle the market. When separate licences have been introduced, there has been evidence of discriminatory behaviour, and that is not a risk that we are prepared to take given our policy position on separation.

The people that we always forget in these debates, on a highly sort of technical issue, are customers, and we need to think about household customers as well. They will not be able to choose their supplier, but they can benefit when water companies develop retail businesses and become much more customer focussed. It is not as simple a question, I would respectfully suggest, as you put. I think that there are very real risks from allowing separation in the kind of market that you are talking about.

Q328 Thomas Docherty: The whole point of this debate is that the customers want it, through the regulators, and the companies want to do it. This is not a debate about separation. The companies themselves are saying they would like an exit clause, and the regulator says they think we need one, so whose interest are you protecting when everyone else says they want this?

Richard Benyon: I maintain that I am protecting the customers and the integrity of a business that people want to invest in. If we start creating loopholes through legislation that allow a different structure for our water sector, you take a very severe risk with spooking the investor.

Q329 Thomas Docherty: I do not think so. The investors do not think that. I could understand if this was one of those arguments about "It's me versus Water UK", but everyone is on the same page. The very people that you are worried will not get investment are saying they want the ability to exit the market if it does not work for them. That is why I am struggling to understand this, because you have got the regulators, on behalf of customers, and the businesses themselves saying they want this, because they are having to carry a cost.

Sonia Phippard: The water companies' views are divided. Some of them certainly have suggested that voluntary exit would be important. But the Government have said that integrated water companies with oversight and responsibility for the full range of activities are vitally important. Water companies themselves argued quite strongly for that, and the Government was persuaded. Ensuring that water companies retain responsibility for ensuring that the retail non-domestic part of their business is provided well, alongside household retail and the whole business, is an important principle.

Q330 Barry Gardiner: Martin Cave concluded that a single regime for entry and competition into the sector would be more practical in relation to inset appointments. You have said in the draft Bill that once the market reforms are in place, you will stop new inset appointments. Why don't you go further and bring the existing inset appointments under the

reformed licensing regime to simplify the market in that way?

Richard Benyon: These are the cross-border issues, you mean?

Barry Gardiner: No, it is the new appointments and variations regime.

Gabrielle Edwards: We consulted on draft provisions for changing this legislation during the last Government, and there was an appetite generally to continue with insets the way they are. The draft Bill suggests that we maintain that market and, as you say, no new appointees come in. There is also a wrinkle around Wales, where the retail reforms will not be introduced. The Welsh Government have no plans to at the moment, and so you do need to retain an inset regime for Wales.

Q331 Barry Gardiner: It is not that there is not going to be a regime. You have already said that you will stop new inset appointments. Wessex Water said they are not sure it is in the customers' interests to have these micro monopolies for housing estates spreading across the country. I think it would be far better to focus on the bigger issues of retail competition rather than micro inset appointments. It is a fairly simple question: why are you saying you will stop new insets but not actually rationalise the whole area and bring the existing ones under the new licensing regime? What is to stop you doing that, and why would simplification of the market in that way not be in the customers' interest rather than maintaining those micro monopolies?

Gabrielle Edwards: We clearly could, but there was support last time we consulted on this for maintaining the market as it was. Let's see what the comments are when we come back this time.

Q332 Barry Gardiner: Sorry, I am asking for reasons. You say there was support. Well, of course, those people who would be affected by it will lose their micro monopoly. They will say things should be left exactly as they are. That is not a reason, with respect. I am asking you for the distillation of your thinking on this as to why it is a good idea or a bad idea in terms of what you have proposed.

Gabrielle Edwards: It is a regime that at the moment is working effectively.

Q333 Barry Gardiner: But at the moment it does not have alongside it your new licensing regime. My point to you is once you put that new licensing regime in place, you are then left with your new licensing regime and those micro monopolies under the inset scheme, okay? And Martin Cave's point, not mine, was would it not be more rational to simplify the whole market and say that you will take the inset companies that have grown up and now make them subject to the new licensing regime that you are implementing? It is a simple model; it means everybody is working on the same basis. What is wrong with that?

Gabrielle Edwards: In principle clearly there is nothing wrong with it.

Barry Gardiner: Good. Does that mean we can do it?

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Gabrielle Edwards: But the question is over what sort of timescale you can introduce that change. At the moment we are proposing that you do not move to a single model straight away.

Q334 Barry Gardiner: No, sorry, I am not proposing that you do not move to it straight away. You are proposing that you do not move to it. Let's be absolutely clear. What you are proposing at the moment is that once the market reforms are in place, you will stop new inset appointments, but you are not going to change that regime or make them subject to the new licensing conditions. So let's not pretend that saying one thing is actually doing another, or saying that you might do it later. It is not.

Gabrielle Edwards: There really is an issue around Wales, and there are lots of complications here about having a regime that operates on both sides of the border. We cannot remove a regime that is going to continue to be needed in Wales.

Chair: We will move on to Wales.

Q335 Dan Rogerson: Scotland and Wales, perhaps. What progress have you made in discussions with the Scottish and Welsh Governments since the publication of the draft Bill?

Richard Benyon: We have had a lot of discussions, not just with the Scottish Government but also with the regulators. The Cave review, which informed most of the policy in the draft Bill, took account of the benefits that were delivered in Scotland and lessons learnt in other sectors. The inset regime, which was just being referred to, needs to be retained for Wales where the retail reforms may not be introduced. Consultation was carried out by the previous Government, and demonstrated that there was an appetite to continue with insets, so we have decided to allow existing water companies and inset appointees to continue to operate and invest in this market. This is going to require continued dialogue as we progress the details that exist outside the face of the Bill.

Q336 Dan Rogerson: The Welsh Government has told us that they are not really happy with the level of engagement over issues around the geographical split of functions. What steps have you taken to improve the engagement over that? Obviously as a Cornishman, I understand the sensitivities around borders; we are very tetchy about these things.

Richard Benyon: I met with the Welsh Minister last week, Mr Griffiths, as part of our regular co-ordination meetings across the devolved Ministers. We agreed to have further discussions in the very near future to make sure that we are ironing out any difficulties that may be perceived to exist across the border on this, so it is a matter we are dealing with.

Q337 Dan Rogerson: Mr Docherty raised the issue of de-averaging being a problem in the Scottish context. Do you think there is any truth to rumours that he raised earlier on—that there might be an unwillingness to continue with an Anglo-Scottish market unless that question is resolved?

Richard Benyon: It is a matter that can be resolved, and I hope that we can do this to the satisfaction of all concerned. I feel very strongly about this. It is about protecting consumers in some remote parts of the country, not just in England, but in Scotland and Wales as well. We want to make sure that we are not going to adversely affect those in rural areas.

Q338 Chair: Just before we leave this area, it was put to us by two witnesses yesterday, SSE and Business Stream, that they have a very real concern, which I think has been demonstrated by the line of questioning this afternoon, that there is not a level playing field for new entrants as between Scotland, England and Wales. What reassurance can you give the Committee and the panel this afternoon that there will be a level playing field for new entrants coming into the market under the provisions of the Bill?

Richard Benyon: May I ask what particular examples they gave?

Q339 Chair: They feel that the market data is not clear. They believe there is insufficient clarity on the face of the Bill and—I am sure colleagues will correct me—they feel confident they understand how it works in Scotland, and they are looking at it obviously with a view to either moving into England or English companies moving there. It is something you could either respond to this afternoon or come back to us perhaps in writing, but it was a very real concern as regards the regulatory framework and a level playing field.

Thomas Docherty: One example using the Scottish model is that Business Stream is required to be transparent on all its codes and all its pricing. As I understand it, and correct me if I am wrong, Minister, you are not currently requiring the same level of transparency for the incumbent water companies, so the concern that the new entrants have is that in effect they will have a different playing field than they would have in Scotland. I do not wish to open up the separation debate again, but because in their view there is not robust separation of functions, not separation, because of that transparency they are disadvantaged. Have I been coherent?

Chair: If you keep the same framework and we do not have legal separation, will this data be available to new entrants?

Sonia Phippard: That is precisely the type of issue that the two regulators, the water companies and the two Governments are working through in the high-level group.

Q340 Chair: But the high-level group has only met once. When is its next meeting?

Sonia Phippard: It has met twice. It met at the end of last week. But also, more importantly, it is sponsoring a series of work streams that are led by the industry and are working on a cross-border basis to work through things like the market codes and the data requirements, just as Ofwat, on the English side of the border, needs to look at the regulatory requirements that will provide a level playing field with the rather different structures we have in Scotland.

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Richard Benyon: At its meetings it has set up processes that are going to iron out these very difficulties, and there is a real commitment to do that.

Chair: That is very good to know, because that is not the message we are necessarily uniformly receiving from those interested parties.

Q341 Dan Rogerson: On another area of potential change, David Gray's Review in 2011 talked about Ofwat's role in terms of handling complaints and his confidence that that work would be picked up elsewhere, particularly if very specific complaints on behalf of customers were not to be handled by Ofwat. The obvious potential place for that to go is the Consumer Council. They seem quite happy to take that on if a suitable arrangement can be put in place. Have you, as Minister or a Department, reached a decision on whether that would be something that would come through with the draft Bill?

Richard Benyon: Firstly, we are very keen to give customers improving redress in the water sector, addressing the recommendations of David Gray's Review. We are assessing the case for giving Ofwat greater flexibility in dispute resolution, as used in other utility sectors. As far as transferring this function to other organisations, and CC Water have been suggested, we are still assessing this. It would need to go on the face of the Bill, because it would be for the Secretary of State to appoint an arbitrator to take on these cases.

We might review customer representation to identify the most appropriate arbitrator, but at this stage we have an open mind. As I say, it would require a change on the face of the Bill if we were going to do that.

Q342 Dan Rogerson: So this is something that was up for decision, and at this stage you still have not reached a decision.

Richard Benyon: Through the pre-legislative scrutiny process, we are assessing this and listening to people, and we very clearly got David Gray's message on this.

Q343 George Eustice: Earlier on in the Parliament there was some consideration as to whether the Consumer Council for Water would be on the quango cull, for want of a better term. Is it definitely staying now? I know there are still reviews going on in some of these organisations.

Richard Benyon: We decided to keep CCW. It is a matter that will continue to be under review. I think it does good work, but it has to be looked at in the framework of customer organisations across Government, and we want to make sure that we are fitting in with the Government policy on this. I have the highest regard for CCW; I think it is well led, and I think it does a good function.

Q344 George Eustice: And you do not think it duplicates the work of Ofwat?

Richard Benyon: That takes me back to Mr Rogerson's question. I think that there may be an increased role for CCW on this or we may feel we can enhance Ofwat's position to give redress to customers.

Q345 Chair: Would it not be a little difficult to disband the Consumer Council for Water before all the statutory guidance has been agreed? You are asking Ofwat to approve its own statutory guidance without the voice of the consumer through the Consumer Council for Water. Would it not be a good idea to keep it in place until all the regulations have been agreed, at the very least?

Sonia Phippard: The Government's current commitment is definitely to ensure that the Consumer Council for Water sees through the price review. You are absolutely right to imply, however, that the development of the framework for market reform will go on for longer, and I think ensuring that there is a consumer voice in that process is essential. Of the various options that have come up at different times, we canvassed the Consumer Council for Water. The role would continue, but we would need to consider whether the disruption of it maybe joining a larger organisation might be too much, given what else is going on.

Q346 Richard Drax: Can I just move on to Ofwat's duties on promoting sustainable development? The Government is "carefully considering" this rather tricky situation in that at the moment it is a secondary duty to promote sustainable development. The question really is what factors will you take into account when deciding whether Ofwat's duty to promote sustainable development should be elevated to primary status? Further, Ofwat says that its duty is to balance customers' bills, service equality, etc, to acceptable standards. It says itself that one of the major risks it sees, if it is given this task as a primary task, is to put off developers, who push in £4 billion every year. So what factors will you take into account?

Richard Benyon: There are those who say that this is just words. I think it is more important than that, and undoubtedly we will be tested on this through the Bill whether or not we change its duty from secondary to primary. I want to be absolutely clear where we stand. I think that in his review of Ofwat, David Gray looked at this very carefully, and he came down to the conclusion that a secondary duty was adequate. Ultimately that is a political judgment for Parliament to make through this Bill.

We are certainly open to considering the benefits of giving this equal evidence with other primary duties, but as you rightly say, could that be interpreted by a regulator in a way that could cause concern to investors? I think the definition of sustainable development requires environmental, social and economic factors to be considered, and I have got no fear that we can create a climate where water companies are fulfilling that. The Government's strategic policy statement has sustainable development at its focus, in which we clarify that this duty should inform Ofwat's regulatory strategy. As things currently are today, I think that is adequate, but through the processes of this Bill it is something we will continue to look at.

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Q347 Richard Drax: So at the moment it is likely to remain as a secondary duty; is that what you are saying?

Richard Benyon: Yes.

Q348 Richard Drax: Based on that, and as Ofgem has a primary duty to promote sustainable development, and with water resources coming under pressure, and climate change and all the things that we all know, what justification is there to keep it as a secondary duty?

Richard Benyon: I suppose I approached this as an agnostic, but I want all our measures to be restoring our environment to where it should be. At the moment some water companies are sucking aquifers dry to provide water for households and businesses that this economy needs, so we have got some difficult decisions to take forward.

We commissioned a very eminent person who really understands regulation in David Gray, and he knows the Government's environmental agenda and my Department's real concern that, through the next price review and over the next two decades in which we are trying to reform the water sector to cope with issues of climate change and overpopulation, we are able to address that. Would we do that by changing this function one way or another? I prefer to be judged on other outcomes and what we are doing both within this piece of legislation and without it. As things stand at the moment, I am happy to go along with David Gray's recommendation. But if someone can put to me an absolutely sure-fire killer point that would mean that primary duty would make a difference, we would consider it. I am sure we will be tested as part of the whole process.

Q349 Mrs Glendon: Some of the provisions of the Flood and Water Management Act 2010 that this Committee was particularly keen to see carried forward quickly, including those on sustainable drainage systems and bad debt, have not yet been fully implemented. Will these outstanding issues be addressed before the new Water Bill is introduced?

Richard Benyon: The issue on sustainable drainage systems is that in August we finished a consultation on the measures that we were going to require principally local authorities to address. We have analysed those responses, and I can tell you that we got a very clear message that this is not a simple new burden that we can apply lightly. So we are not going to be implementing these in April 2013, but we will be implementing them in April 2014.

On bad debt provision, we consulted on a requirement by landlords to inform on the status of tenants when they move. That is quite a big burden. It is easier for a large landlord, an RSL or suchlike to do, and we are working closely with housing organisations to try to achieve that. But a large percentage, and it is particularly large in certain rural areas, of rented property is owned by people who own one or relatively few properties, and that would be quite a regulatory burden. We want to go down the voluntary route before we legislate, but there is also a lot we can do on reducing that £15 burden on our constituents that is the result of bad debt. There are

some interesting innovations coming through water companies and the billing systems they use, win-wins and others, which we think can reduce that element quite considerably.

Q350 Mrs Glendon: On that one particularly, Minister, the Committee were particularly concerned by the fact that it was unfair on poor customers, and we wanted to see something done urgently. The other issue was the water companies' solutions to unsustainable abstraction in the next price review. We wanted something done on that as a matter of urgency; you have not referred to that either. What was said was the Department has made good progress, including water company solutions to unsustainable abstraction in the next price review, and that would be in terms of 2014 perhaps. Is that on track for the price review?

Richard Benyon: We are working with the Environment Agency and Ofwat to develop better means of giving incentives to help water companies manage their abstractions sustainably. We are moving funding water company solutions for restoring sustainable abstractions into the price review process, so that is going ahead.

Q351 Mrs Glendon: And what about the poorer customers bearing the burden of bad debt.

Richard Benyon: I entirely agree with you. The burden does fall on the poorest. If people are having problems paying their water bill, the chances are that they are having problems paying their utility bills across the piece, so we must not see this in isolation. I do think there are other measures on which water companies should be pushed as hard as they can in trying to reduce this figure. We looked very hard at trying to find the data of those, for example, on benefits, and providing that to water companies, but came across the Data Protection Act in a fairly major way.

Q352 Chair: If the customer agrees to lift the Data Protection Act, which is quite within their gift to do so if it was in their interest, why could you not share that information? This was our recommendation in our Flood and Water Management Bill Report.

Richard Benyon: Ofwat evidence shows that 60% of households at risk of water affordability problems do not receive means-tested benefits.

Gabrielle Edwards: I think the question is how to get to the position where the customer agrees, because you need to know that there is an issue there for the customer to be able to agree. So what is the process? Identifying the customers is the issue, and that is why water companies would like to have access to that data.

Q353 Chair: We did make a specific recommendation on this point. Obviously it would mean going to the DWP, identifying the customers, asking the customers who were in receipt to agree, and then letting the water company know so that they can benefit from the charitable funds that already exist.

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Richard Benyon: Passing the information from the benefits agency to the water company is an illegal act, but the individual furnishing their own information would be legal. How can you do that in a cost-effective way without increasing the burden on the welfare budget? Obviously that is a cross-Government issue, and I am happy to continue that if you have got a clear suggestion as to how we might be able to do that.

Q354 Barry Gardiner: If they applied, could they not sign an authority form that the water company could present to the DWP, which would allow all future benefits information to be shared?

Chair: They could tick a box on their water bill. That would cost nothing. Just add a box on the water bill: "If you are in this category, you agree to release this information." There is another thing that I really do not understand; could you just repeat what you said, Minister, about when the sustainable drainage systems regulations now are expected to enter into force? I thought I had gone deaf.

Richard Benyon: April 2014.

Q355 Chair: That is four years after the passing of the implementing Act, and you are asking the Committee this afternoon to approve authorisation on trust for a whole plethora of implementing regulations when you cannot even pass two sets. Bad debt was one recommendation, and SUDS was another.

Richard Benyon: I would ask the Committee to look very carefully at the sustainable drainage provisions in the Flood and Water Management Act, because they are very complex. We can be accused of over-consulting sometimes, but I think we were right to consult very clearly on this. We got a pretty collective raspberry from a lot of people who will actually have to be taking this forward. This was a Bill, you will be aware, that was taken forward at the final stages in the wash up of the last Parliament, and it is a provision in the Bill that frankly this Government has had to implement, and we find it extremely difficult. We do not want to create unwarranted burdens, particularly on local government and business, at a time when we want to reduce their burdens.

We do want to get this right, and if we were to implement this in haste—

Q356 Chair: I do not think four years is haste.

Richard Benyon: Well with due respect, actually the processes of taking this forward have tested the resources of this Department and others who we have been consulting with quite considerably, and I would really urge the Committee to look very closely at the provisions in the Bill to see how we could have taken this forward in a way that does not cause a completely unwarranted burden on those we are expecting to take this forward.

Q357 Chair: Again, we did make recommendations in this regard, and the Committee will have heard what you say and will be extremely disappointed that these have not been implemented.

Richard Benyon: I can only say with absolute vehemence, Chair, we simply could not take this

forward in a meaningful way any quicker. To take forward the provisions that were in the Flood and Water Management Act in anything but the way we are would have been very, very difficult, particularly for local government, and that is not something that we were prepared to do.

Q358 Chair: I just think you are reinforcing the point that a number of members of the Committee have made earlier. We are not at all comfortable that the detail is not on the face of the Bill. You are asking us to take on trust that you will be passing this statutory guidance when it has taken you four years to pass one set, and not a prayer of another.

Richard Benyon: The sustainable drainage provisions are nothing to do with this piece of legislation. They came in a previous piece of legislation.

Q359 Chair: But you are making the point for me.

Richard Benyon: We want legislation to be taken forward in a highly effective and speedy fashion, and we found that the provisions in the Act are not easy to take forward. They were for a new Government to take forward, and we have done that in a way that has really tested the resources of both our Department and others who would have to implement this.

Q360 Chair: We shall reach our own conclusions on this.

Richard Benyon: I am sure you will.

Q361 Dan Rogerson: An easy, straightforward one for you now: how close are you to reaching an agreement with the insurance industry on a replacement to the statement of principles on flood insurance?

Richard Benyon: I am sure you understand that I cannot give you chapter and verse of our negotiations. It is extremely complicated, but I hope that we will get a solution that is both sustainable, i.e. for the long term, and better than the current statement of principles. I want it to provide insurance that is freely available, which the current system is not, and affordable. That is what we are working really hard to achieve.

Q362 Dan Rogerson: One specific thing that was raised with me as one of the many rural MPs, and which has come up repeatedly during discussions, is where there are relatively isolated settlements with a few dwellings, and residents themselves accept that some sort of hard engineering solution to protecting their properties is not the obvious way forward; they accept that flooding will happen. It may be a problem that has occurred more recently than when they bought the property, but they are there now and they have to deal with it. They have taken every possible step to raise plug sockets, block off places where water can enter the property, do all the sorts of things that they can to their own property, but the insurance companies will not take that into account. They look at a postcode and they say, "Sorry". Is this one of the areas that you are negotiating closely? You cannot give us details, but people out there would like to know that the postcode issue is something that is

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being taken into account, looking at individual properties, and what steps are being taken.

Richard Benyon: It is deeply frustrating. The insurance companies will say that a lot of those provisions are not dependent on the householder being there, but quite a lot of them are. Putting the plug sockets higher is one thing, but you really need the kind of system where doors can be removed, furniture can be moved, but also airbricks can be covered and door secure systems are put in. Insurance companies say, "What happens if the person is at work or on holiday and this happens?" I have some sympathy with that, but only so far. When a householder has gone to the expense, usually driven by the force of experience, they should be rewarded through the premiums they pay or the excess charge that is made to limit that effect.

We strongly believe that there should be more clarity by the insurers as to how they can offer this. One of the most frustrating things we get as MPs is when people say, although they live in the same postcode as somebody who is flooded, it is a completely different circumstance to that particular group of houses. We are getting much better at providing information. The work done since the Flood and Water Management Act, implementing Pitt, has been hugely beneficial in terms of local knowledge and data, overlaying maps with what could happen and a better understanding of surface water management. We have got to get this reflected in insurance.

Q363 Dan Rogerson: Yes, quite. You need to reassure people that you are trying to persuade insurers they need to look at a case. It needs examples. We are not talking about the huge majority of people who are looking for insurance; it is those where there is an identified problem that some process could be agreed where a discussion could go on around amelioration.

Richard Benyon: Yes, I can understand that. There is also more assurance that small communities can get flood defences now more easily than they could in the past because of our partnership funding scheme. In the past it was very often the smaller communities that missed out because of the cost-benefit; other schemes came in above them. Now at least they know precisely where they are. Also, the partnership funding scheme is weighted in favour of those on lower incomes because very often they do not have the capacity, not in just cash but also knowing how to progress a scheme. Weighting it in favour of those on lower incomes has been a great advantage, particularly to some isolated rural communities.

Q364 Dan Rogerson: Finally, the draft Bill says that legislation may be required to help manage the financial risk of flooding. What is your most recent assessment of whether or not that might be necessary and what form it might take?

Sonia Phippard: I am afraid that comes back to the Minister's first answer, given that the discussions are quite intense.

Dan Rogerson: We are not there yet, okay.

Sonia Phippard: The structure that might emerge is not clear, but if it involved either financial or

regulatory structures or a combination that would probably require further legislation.

Q365 Dan Rogerson: So presumably those with whom the Department are negotiating are well aware that the clock is ticking in terms of the need for the legislative side, then.

Sonia Phippard: Yes.

Q366 Chair: Written evidence we received indicated there was quite a heavy shift in emphasis from resilience in the original Water White Paper, both in resilience against water stress and ensuring water supplies, but more especially, water companies increasing flood protection. Is it noteworthy that the draft Bill places less emphasis on resilience in those two areas than the actual Water White Paper?

Richard Benyon: Madam Chairman, this comes back to my opening remarks to your first question. We are implementing the Water White Paper. All our ambitions remain absolutely as they were in the Water White Paper. What the Bill looks at is certain aspects of that, but there is much that we can and should be doing now.

I can give you some examples. We are continuing to work with licence holders to reduce abstractions through the Environment Agency's Restoring Sustainable Abstraction programme, which is seeing water of the quantity that is used by a city the size of Leeds returned to the environment.

Q367 Chair: We are coming on to that in a moment. I am talking about specific reservoir provision and ecosystem payments that water companies are required to do.

Richard Benyon: Right. Those ambitions are very much top priority as well.

Q368 Chair: But they are not here.

Richard Benyon: They do not need legislation to bring in more catchment approaches and upstream management. That is done through Ofwat encouraging the process through the price review. The building of more reservoirs is part of this Bill in that it encourages innovation and new entrants, but it will also be a duty of water companies to look at future provision in their long-term management planning, which they are now required to do. Legislation is not needed to see that kind of incentive.

Q369 Neil Parish: Just before I move on to abstraction, I will make one final point on the insurance. I think affordability is the one thing that really matters. I have got constituents that come in who have insurance companies wanting two or three times the amount to insure them. Regarding postcodes, you have got hamlets and villages that are half a mile between one end and the other. Very often they can be a lot higher at one end than the other, and the whole thing is completely wrong. Are you going to be able to deal with that or not?

Richard Benyon: The Environment Agency uploads its data on a quarterly basis. Some insurance companies pull that data immediately; others do not. Sometimes you are dealing with somebody who

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understands this very clearly; sometimes you are not. I always encourage people to shop around. It is a particular issue for your constituents with what has been going on today and is forecast over the weekend. I know it is a real concern.

Through the localised resilience planning there is an extraordinary ability for lead local flood authorities to predict what will happen with different weather patterns. The amount of datum points they can put around a community to actually forecast this now is really amazing. We want to make sure that the insurance companies have it, because it can be reflected in people's premiums.

Q370 Neil Parish: I welcome that, and the Environment Agency has done a lot of good work on that. But you have talked about affordability; will it be in the agreement? People can get insurance, but if it is three, four or five times as much as they were paying before, it is not really an agreement, is it?

Richard Benyon: We have stated quite clearly throughout that we want this to make sure insurance is freely available, and that affordability is at the heart of what we come up with. That remains our ambition.

Q371 Neil Parish: Okay, I hope you will achieve that. On the abstraction, the current abstraction scheme was introduced in the 1960s and was not designed to protect the environment or manage competing demands for water. Licences were issued on a first come, first served basis. So why have you not included a legislative framework for abstraction reform in the draft Bill?

Richard Benyon: I put this to some people who say it is quite simple to reform abstraction, and we can easily write provisions into a Bill tomorrow. I told them there were 22,000 abstractions in England, most of them providing necessary water for communities and businesses. Some of them are damaging the environment. What is there in legislative terms that we could bring forward quickly tomorrow that would make a difference?

Most of them, particularly those involved in our abstraction group, called the Abstraction Reform Advisory Group, are starting to understand the complications of this, but there is a lot that we can do now outside the Bill. We have talked about the Environment Agency's Restoring Sustainable Abstraction programme, which is already tackling some unsustainable abstractions. We are able to vary or revoke abstraction licences now without paying compensation. This is a very powerful tool that has just been introduced. This was something that came from the 2003 Act, which we consulted on this year and have now implemented. We are developing a modified charging scheme that will allow a techie thing, which I am sure you understand, but others outside probably will not. The Environmental Improvement Unit Charge can be used to fund changes to rivers to improve them. Defra is working with the Environment Agency and Ofwat on incentives for water companies to manage their own abstractions more sustainably, and I mentioned that earlier. That is being done through the price review process. Ofwat are also implementing their abstraction

incentive mechanism, which is something that was in the Water White Paper.

Q372 Chair: Could we have a pithy answer?

Richard Benyon: I am trying to give the clear view that there is much we can do now. We do not need a Bill to do it.

Q373 Neil Parish: Just one final question on this: is there enough guidance for water companies in drought times to be encouraged more to recycle water? That water could be used for crops. There are nutrients in it as well. This is one of my pet subjects. Are we doing enough to make that happen in this Bill?

Richard Benyon: With the innovation that will come through new entrants, I hope, we will see some new ideas on water recycling. Through the reform of the Reservoir Act and other measures, we are trying to encourage on-farm water storage in winter so it can be used in the growing season. We are also introducing a new system to manage things currently not managed through the abstraction regime, such as trickle irrigation.

Q374 George Eustice: When we took evidence on this, the environmental groups were quite clear in saying that when the 2003 Act went through the same arguments were coming from the industry: "Oh, you shouldn't rush this; it takes time. Give us 10 years and we might then be in a position to do it." Here we are on the brink of 2013. The White Paper concedes that the regime needs reform, but maybe not for another 10 to 15 years. Do you not think it would be beneficial, even if the Bill recognised the complications and the timescale it might take, to at least embark on the journey to do that?

Richard Benyon: I think we have embarked on the journey. We are talking to abstractors, environmental groups and industry to make sure that everybody understands what we are trying to do. We do have a long-stop date that sounds a long way away, but there is nothing to stop us making the changes that we are talking about now, implementing new legislative changes in the next Parliament, which will see the abstraction regime being reformed, and progressing as quickly as possible. I share the frustration of those who see important environments and rivers that we know and value being damaged by over-abstraction. We can get on with it. I really encourage people to look at some of the measures that we had in the White Paper that we are able to implement without legislation.

Q375 Barry Gardiner: In the Government's response to this Committee's report on the White Paper when we said this should be implemented as a matter of urgency, you said that the companies' solutions for restoring sustainable abstraction were making good progress. So can you assure us that they will be incorporated into the next price review in 2014?

Richard Benyon: We are moving funding of water company solutions for restoring sustainable abstraction into the price review process, yes.

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Q376 Chair: Minister, you and your team have been very generous with your time. I think we have to conclude that if this was an end of term teacher's report, progress towards resolving bad debt, sustainable drainage, even more efficient use of water has been very disappointing indeed. I just have to say four years is unbelievable for SUDS, but that is my pet subject so I will park that to one side. What reassurance can you give us that the deadline that you have set, the indication by 2017 for upstream competition reforms, will be anything other than an aspiration?

Richard Benyon: We have talked about dates that have been clearly tested and on which we have received advice in terms of upstream reform, and we think we can deliver that. On the other point, you were in opposition at the time, Madam Chair, and I know that sustainable drainage systems were a strong issue

for you then. I urge you to consider what we were left with to implement; it is just not where I would have started. I can assure you that we are working as fast as we can to deliver this with the resources we have. There are certain times when you have to say in Government, particularly in the straitened circumstances that we find, that this is going to take longer than we would all wish. Nobody wants to see a regime for management of sustainable drainage quicker than me, but we have to make sure that it is something that future generations will not curse us for rushing and getting wrong.

Chair: We shall reflect on what you have said and draw our conclusions, and hopefully make some recommendations that will strike home. But we are grateful to you and the team for being so generous with your time and contributing to our inquiry. Thank you very much indeed.

Written evidence

Written evidence submitted by Anglian Water Services Ltd

1. *Are the powers contained in the draft Bill sufficient to achieve the policy aims set out in the Water White Paper?*

1.1. We welcome the introduction of retail competition in the non-household market, and believe this will bring benefits for customers across the UK. Introducing wholesale competition in both water and wastewater services on this scale is uncharted territory, and there is much work to do to get it right. We are keen for a clear governance framework to be put in place that facilitates a market that delivers for customers and service providers.

1.2 We fully support the ambition of the Water White Paper for a “resilient, affordable and sustainable water supply”. However achieving this will require a step-change in collaborative working that goes much further than the provisions in the draft Water Bill. To meet this challenge will require strong leadership from Government, and a clear understanding of the roles and responsibilities of the regulators, water companies and water users.

2. *Are the draft Bill’s proposals necessary, workable, efficient and clear?*

Increased Complexity

2.1 Whilst we support the overall direction of Government policy, we are concerned that the complexity of the resulting legislative framework will lead to uncertainty amongst new entrants, as well as existing incumbents and licensees. We would therefore urge Government to consolidate the Water Industry Act, simplifying the regulations for all market participants, thereby facilitating competition.

The role and powers of Ofwat

2.2 To ensure accountability, Government must retain sufficient powers aside from the regulator to ensure the desired policy direction is followed. The draft Water Bill sets out a number of new powers for Ofwat to issue binding rules and codes, which would give the regulator a greater role in setting policy. However this general shift in responsibility is not accompanied by effective measures to ensure Ofwat can be held accountable for its decisions and actions. It is essential that the new market arrangements are developed within a proper and effective framework of accountability in order to build confidence in the resulting arrangements.

We would suggest there is a need for a clear mechanism to allow market participants to obtain recourse consistent with this overall framework.

2.3 There is a potential for Ofwat’s activities to encroach upon key areas of government policy. For example Ofwat’s price setting rules could bring about the end of average pricing for non-household customers. Currently prices are based on the average cost of providing water services across a water company’s region. While some areas would benefit from lower bills through de-averaging, others would see an increase—particularly those operating in drier regions of the country, where there are greater costs associated with securing a water supply. To avoid this, Government should make a statutory commitment to averaging wholesale prices.

2.4 In terms of investment, the detailed legal and regulatory framework within which undertakers operate helps to maintain a low cost of capital. Since privatisation £8.6 billion has been invested in water and wastewater services in the Anglian Water region. There is a risk that the wholesale delegation of important functions from Government to the regulator, in ways that minimise accountability, may pose a threat to investor confidence. This could worsen the terms on which companies can raise money to finance environmental and quality improvements, and must therefore be avoided.

2.5 We support the removal of the requirement for charges schemes to be approved by Ofwat before they take effect. However, this is replaced by a power for Ofwat to set charging rules. At present companies are deterred from investing in potential new tariff initiatives because of the prospect they will be turned down by Ofwat. The deterrent is potentially stronger under the proposed new regime because companies face the prospect of having to reverse the implementation of new initiatives, at a greater cost to the company and at greater damage to its relationship with customers.

2.6 Part of Ofwat’s role is to adjudicate where there are disagreements between two parties, and issue a determination. This process needs to be improved, as it can be excessively long, thereby resulting in uncertainty and unnecessary costs. As a minimum, Ofwat should issue a timetable for resolution, to reduce the level of unpredictability.

Consistent regulation

2.7 Care must be taken to ensure new entrants to the market are subject to the same legal requirements as current undertakers. This is not currently the case in the draft Bill. For example for licensees, although “retail infrastructure” and “network infrastructure” are defined in the draft Bill, neither of the terms has any legal status. This means that any pipes built would remain private. As private distribution networks, licensees would

therefore not be subject to the provisions under the Water Industry Act, such as the duty to provide water for fire fighting.

2.8 We would urge the Government to consider further the environmental safeguards that would need to be applied to new entrants to the market. Without safeguards there is the potential for a “free rider” problem to emerge if the environmental custodianship carried out by the asset owning companies is not catered for in pricing.

3. Are there any omissions from the draft Bill, for example in relation to managing the financial risk and impact of flooding?

Resilience

3.1 We are concerned that the draft Bill does not adequately address the challenge of providing long-term resilient water supplies.

3.2 In the current system, water companies have a responsibility for delivering certain public policy objectives. For example the duty to prepare water resource management plans for a 25 year period. Considerable work goes into the preparation of the plans, which represent undertakers’ considered strategy for securing public water supplies for all the customers and future customers in its area.

3.3 There is an inherent tension between the market reforms proposed in the draft Bill and the validity and efficacy of water resource management planning. Whilst incumbent water companies are responsible for planning for and meeting a universal service obligation, the delivery would now rely on multiple service providers. In fairness to all providers, and in the interests of customer confidence, new market entrants must be required to make a similar long-term commitment to water resource planning.

3.4 At present, the water supply and demand balance is based on actual usage. Reservoirs are built according to demand from customers. In future, however, water resource planning will need to be based on volumes which have been reserved under contract. These are likely to be higher than actual demand, bringing forward the need to build new reservoirs and find new resources. We need Government to provide a strategic overview of the quality and capacity of water and wastewater infrastructure to ensure resources are directed to where they are needed rather than where they can achieve the greatest returns.

3.5 We need a strategy for resilience, planning for future trends in extreme weather such as floods and drought experienced this year. This includes the UK climate change scenarios of exceptional droughts in the future. Historically drought plans have been based on the worst drought experienced to date. This is no longer adequate to deal with the extent of the challenge we face.

3.6 The recent drought has shown the importance of collaboration between government agencies and water companies in maintaining a resilient supply. To protect against future droughts we believe there is a need for national resilience standards, established through collaboration across the industry. Government should play a key role in setting and maintaining these standards with agreement from the water industry, to ensure customers have consistent protection against drought wherever they live.

3.7 We believe the best forum to take a strategic overview of resilience would be a National Water Resource Group,¹ which would bring together all relevant government departments, representatives from the water industry and wider stakeholders.

Impact on household customers

3.8 Government must assess the impact of reforms on household customers, and include any measures that might be required to protect them in this draft Bill. There is a danger that introducing competition in the non-household market could result in household customers subsidising businesses. With the removal of the costs principle,² it is important that whatever replaces it ensures a fair allocation of costs across water users. The methodology needs to be sufficiently detailed and defined to be usable and to provide confidence to market participants.

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¹ The proposal is for The National Drought Group to evolve into a National Water Resource Group. Members of the group currently include: DEFRA, DCLG, the Cabinet Office, the Environment Agency, Water UK, Consumer Council for Water, the Met Office, Natural England, the Association of Drainage Authorities, Blueprint for Water, NFU, and CLA.

² The costs principle details the terms of which an undertaker grants access to their systems to allow licensees to supply customers. Currently the access price is the prevailing retail price minus the costs saved by not supplying the target customer.

Written evidence submitted by Blueprint for Water coalition

SUMMARY

1. The Blueprint for Water coalition (“The Blueprint”) welcomes parts of the draft Water Bill, in particular:
 - 1.1 The alignment between Water Resource Management Plans and drought plans, and the potential for them to be formally linked to price review timetables.
 - 1.2 The removal of the requirement for Ofwat to agree all water company tariffs every month, to increase their use of social tariffs (which should support a faster move to full metering).
 - 1.3 The revision of the process of charging developers for water and sewerage infrastructure—Blueprint would like to see this linked with resources via a scarcity element (variable charge).
 - 1.4 Ministerial statements to the effect that increased competition will support greater water efficiency in the non-domestic sector.
2. However, we believe that the recent drought has highlighted the urgent need to place water resources and water industry regulation on a more sustainable footing. This has led us to conclude that the Bill has serious omissions. It should therefore be amended to:
 - 2.1 Include an enabling legislative framework for abstraction reform that gives the Government the powers to reform the abstraction regime from 2015—according to the Principles set out in the Water White Paper, *Water for Life*—and to be in effect and operational within a 10 year timeframe.
 - 2.2 Remove red tape that prevents water companies rolling out compulsory metering in areas outside of water scarce areas, even when there is a clear business case to do so.
 - 2.3 Elevate Ofwat’s current duty to sustainable development to a primary duty, to redress the bias towards supply-side measures.

ADDRESSING CURRENT UNSUSTAINABLE ABSTRACTION

3. *Water for Life* included welcome plans for dealing with the environmental legacy of unsustainable abstraction, which, as the drought has demonstrated, is a problem here and now. We agree with the Government that the current approach to tackling damaging abstraction has failed to encourage quick or cost-effective change. *Water for Life* provides some solutions, including: bringing water company *Restoring Sustainable Abstraction* schemes into the price review; the development of an Abstraction Incentive Mechanism to encourage companies to take less water from environmentally vulnerable sources, and; clear intention to start using the power from Water Act 2003 to revoke or vary abstraction licences that are causing serious environmental damage. It is essential that these proposals are implemented quickly—they do not need additional legislation to be progressed.

A SUSTAINABLE ABSTRACTION REGIME

4. The draft Water Bill should include an enabling legislative framework for abstraction reform, giving the Government powers to reform the abstraction regime from 2015—according to the Principles set out in *Water for Life*—and be in effect and operational within a 10 year timeframe. *Water for Life* included welcome plans for dealing with the environmental legacy of unsustainable abstraction, which, as the drought has demonstrated, is a problem here and now. It is essential that these proposals, which do not need additional legislation, are implemented quickly. However, *Water for Life* also set out a compelling case for systemic change of the abstraction regime. With a rising population and a changing climate the existing system will be increasingly unfit for purpose, placing limits on economic growth as abstractions fail and continuing to threaten the integrity of our freshwater ecosystems.

5. To address this, *Water for Life* set out a vision of a future, sustainable abstraction regime with clear goals for the design of the regime (eg the need for abstraction licences to signal availability, reflect the value of water, protect the environment and drive efficient use) and four principles for the transition (new licences to take account of existing rights, amendment of licences without compensation, not using the transition to address the legacy problems and not creating barriers to investment). These are a vision, goals and principles which the Blueprint fully supports and we are working with the Government—through the Abstraction Reform Advisory Group—to help develop the necessary detail to turn this into a clear implementation strategy.

6. While we understand that the Government intends that the reforms will be rolled out from 2018, it seems it will be the late 2020s before the regime is in place across the country. We are extremely concerned that the Government has delayed legislation on abstraction reform until the next Parliament, which is likely to result in greater uncertainty and a more expensive transition for abstractors if they are not given sufficient time to adapt their business planning. The important work underway to develop the detailed implementation plan should not hold up the legislative process; instead, the Water Bill should provide for reform to be brought in at a later date by secondary legislation, after sufficient consultation.

KEEPING BILLS AFFORDABLE AND REDUCING WATER WASTE THROUGH METERING

7. The draft Water Bill should remove red tape that prevents water companies rolling out compulsory metering in areas *outside water scarce areas*, even where there is a clear business case to do so. Widespread metering, with tariffs to protect the vulnerable, provides a vital foundation for fair, affordable, sustainable and reliable water supplies. Significant reductions in leakage and per capita consumption are unlikely without widespread metering. There is clear evidence of the benefits of metering both to customers and the water environment.³ Presently, however, red tape means that only water companies with areas designated as “Serious Water Stress” can install meters on a compulsory basis. Unfortunately, the official designation of Serious Water Stress is a blunt tool, which ignores the many places outside these areas that can face water shortages. Significantly, it also means that customers outside the designated areas are denied the option of widespread metering, when it would be in their best interests as a method of addressing affordability issues and limiting bill rises. The Government and Ofwat are now devolving more power to customers to decide the outcomes of the water price setting process—we believe this should include customer choice over compulsory metering.

A SUSTAINABLE WATER SECTOR

8. The draft Water Bill should elevate Ofwat’s duty to sustainable development to a primary duty, to redress the bias towards supply-side measures. Effective demand management is a cornerstone of a sustainable water sector. However, this is not pursued on the level that is needed, partly because the system does not reflect the value of water and is biased to supply side options. The lack of a statutory commitment to demand management in *Water for Life* means that these decisions have been devolved to companies and customers. The updated Water Resource Management Planning guideline sets out clear requirements on demand management though, which are to be welcomed. Ofwat therefore has a leading role in ensuring the development of a sustainable water sector, characterised by reduced water demand.

9. Ofwat has a duty to “contribute to the achievement of sustainable development”. However, this is a secondary duty, which means that it is ignored if the contributions interfere with Ofwat’s primary duty (ie if there are significant financial implications for companies). The practical effect of this, as seen in the 2009 price review, is that Ofwat is forced to strike out investments that would deliver demand management in “over abstracted” areas, or areas in which it would address supply deficits that exist beyond the five-year planning horizon.

10. Giving Ofwat a primary duty to sustainable development would be in line with the primary duty of Ofgem, the energy regulator (a duty which has been critical in driving cultural change both within the regulator and across the energy industry).

ABOUT THE BLUEPRINT FOR WATER COALITION

11. The Blueprint for Water coalition is a unique coalition of environmental, water efficiency, and fishing and angling organisations that is calling on the Government and its agencies to set out the necessary steps to achieve “sustainable water” by 2015 (www.blueprintforwater.org.uk). The Blueprint for Water is a campaign of Wildlife and Countryside Link.

12. This submission is supported by the following 14 organisations:

- Amphibian and Reptile Conservation.
- Angling Trust.
- Buglife—The Invertebrate Conservation Trust.
- Freshwater Biological Association.
- Pond Conservation.
- Marine Conservation Society.
- National Trust.
- Royal Society for the Protection of Birds.
- Salmon & Trout Association.
- The Rivers Trust.
- The Wildlife Trusts.
- Waterwise.
- Wildfowl and Wetland Trust.
- WWF-UK.

September 2012

³ Walker, A. (2009) *The Independent Review of Charging for Household Water and Sewerage Services: final report*; also www.fairnessontap.org.uk.

Written evidence submitted by Business Stream

INTRODUCTION

1. This evidence is submitted by Business Stream, the leading water retailer in Scotland. Business Stream was created in 2006 in response to the Water Services etc (Scotland) Act 2005. It is a wholly owned subsidiary of the Scottish Water Group, a public corporation. At the time of market opening Business Stream was separately financed, governed, operated and managed; this remains the case.

2. We welcome the publication of the Draft Water Bill on 10 July 2012 and we are pleased that another step towards giving customers more choice, keener prices and better service has been taken.

3. We have seen previous attempts to facilitate competition in the past fail and there is a duty on us all not to fail customers again.

4. We are confident, with some revisions, the Draft Bill can deliver the policy objectives set out in the Water White Paper (Water for Life).

5. The main challenge will be translating the positive policy direction and legal framework into a coherent, effective and efficient delivery plan.

A SUMMARY OF OUR RESPONSE

The call for evidence sets three questions, our response is summarised below.

1. Are the powers contained in the Draft Bill sufficient to achieve the policy aims set out in the Water White Paper?

- We believe the powers in the Draft Bill are sufficient to achieve the policy aims set out in the Water White Paper.
- However, the drafting could allow market reforms to be frustrated and customer benefits delayed, particularly if there was a continuation of “negotiated access” rather than “regulated access”.
- Strong oversight from Ministers and putting customer requirements at the heart of delivery proposals will be essential to delivering policy aims.

2. Are the Draft Bill's proposals necessary, workable, efficient and clear?

- The proposals are necessary and workable but could be made more efficient and clarification can be provided on implementation.
- The Draft Bill leaves latitude and freedom for Ofwat to implement change in a number of ways. This may create risk that incumbents could frustrate progress, particularly if negotiated access (particularly pricing) is expected to be the norm. That in turn will delay customer benefits being realised.
- We would expect negotiated access to lead to costly and lengthy competition law cases being taken.
- Inefficient incumbents will not be able to exit the retail market thus building in a degree of inefficiency into the industry.
- Customers are calling for increased consistency of service and prices they can compare. The proposals may not lead to harmonisation of service levels and may actually create more complex sub-regional charges.

3. Are there any omissions from the Draft Bill, for example in relation to managing the financial risk and impact of flooding?

- The draft bill would benefit from some clarification or additional clauses relating to:
 - Not allowing incumbents to enter into non-standard contractual arrangements with customers before market opening. Allowing this would create a barrier to entry.
 - Ensuring any existing “non-standard” contractual arrangements are published and transferable. This would remove a barrier to entry and protect customers.
 - Clarity on non-discrimination and separation to ensure a level playing field is created.
- We welcome the introduction of a High Level Group and the statement that the market will open in 2017. Momentum now needs to be built. This could be achieved with an ambitious timetable for reforms which uses experience from other markets and does not allow progress to be frustrated.

More detailed overview

1. The Draft Bill is another positive move forward for customers across Scotland and England (and potentially Wales).

2. The legal framework presented has the potential to deliver choice, keener prices, better service and increased innovation for customers.

3. The Draft Bill could further increase the efficiency of the industry by allowing inefficient operators to exit the retail market or consolidate, therefore realising economies of scale. This is not possible with the current drafting. That approach may also protect investor interests if divestment of retail activities was deemed desirable.

4. The risk of benefits not being realised by customers can be minimised if the ability for incumbents to negotiate access (particularly pricing) is the exception and not the norm. Negotiated access will lead to protracted legal cases, prolonged commercial discussions and the risk of wholesale price gaming which will all negatively impact on customers.

5. The Draft Bill sets a positive framework but, to reduce risk, detailed implementation plans must be published by Ofwat and WICS. Any implementation plan must include timescales and a set of “principles” detailing:

- What the definition of retail activities includes.
- An assumption of regional pricing harmonisation within a region.
- Harmonisation of tariff bandings and service levels across regions.
- A requirement to harmonise default service levels across regions which link to the above retail tariffs.
- Governance proposals and non-discriminatory market structures to ensure a level playing field is created.
- How this links to market codes, registration & settlement systems.
- How existing “non-standard” contracts would be dealt with in a competitive market.

1. BACKGROUND

1.1 This evidence is submitted by Business Stream, the leading water retailer in Scotland. Business Stream was created in 2006 in response to the Water Services etc (Scotland) Act 2005. It is a wholly owned subsidiary of the Scottish Water Group, a public corporation. Business Stream is separately financed, governed, operated and managed.

1.2 We welcomed the publication of the Draft Water Bill on 10 July 2012, we are pleased that another step towards giving customers more choice, keener prices and better service has been taken.

1.3 We have reviewed the Draft Bill and we are confident that with some minor revisions it can deliver the policy objectives of the Water White Paper (Water for Life).

1.4 The main challenge will be translating the positive policy direction and legal framework into a coherent, effective and efficient delivery plan.

2. THE DRIVERS FOR CHANGE

2.1 The Draft Bill has been delivered in response to the Water White Paper published in December 2012. Set alongside the Draft Bill introduction and explanatory notes, a very clear strategic direction has been set by Government.

2.2 We have seen previous attempts to facilitate competition in the past fail and there is a duty on us all not to fail customers again.

2.3 In considering our response we have sought to understand what the desired outcomes of these policy aims are. Our interpretation is the desired outcomes are to:

- (a) deliver non-domestic customers:
 - (i) more choice;
 - (ii) keener pricing with a spill over to domestic customers; and
 - (iii) better service with a spill over to domestic customers;
- (b) allow customers to access consistent service levels in an Anglo-Scottish market;
- (c) increase innovation including service innovation into the industry with a view to managing water more efficiently; and
- (d) make the market more attractive for new entrants.

Our experience gives us a unique insight to understand how legislation and policy needs to be translated into practical delivery plans in order to realise benefits for customers.

3. *What needs to be implemented to deliver the policy*

3.1 We reviewed the Draft Bill with a practical slant to understand whether it would enable Ofwat to deliver market solutions which would work for customers.

3.2 We first considered what a market would need to operate efficiently in practice. We came to the following conclusions:

- 3.2.1 A template/standard “wholesale” contract—This already exists in Scotland and England. The main difference is that the contract in England does not include any guaranteed wholesale service levels—The Draft Bill allows for this to be delivered.
- 3.2.2 Market/operational codes—These already exist in Scotland but do not exist in England. These documents outline the “rules of engagement” once the market is fully functioning—The Draft Bill allows for this to be delivered.
- 3.2.3 Regulated wholesale prices—This already exists in Scotland but does not exist in England. Regulated access ensures entrants get a fair commercial deal with incumbents and reduces the risks of gaming. This is a critical element of delivering an orderly market—The Draft Bill could allow this to be delivered but it is not currently a requirement. The Draft Bill is open to interpretation and should be made clearer.
- 3.2.4 Full access for all businesses to choose—This already exists in Scotland and is clearly proposed in the Draft Bill ie reducing the threshold to OML and including waste/sewerage services.
- 3.2.5 Regulator sets retail default tariffs and services—These exist in Scotland and have provided a benchmark for customers. The Draft Bill suggests that companies might set retail tariffs and that Ministers set service levels.—There is a risk that this approach will not meet the needs of customers and that service levels will differ in England and Scotland. If not implemented this will lead to:
 - inconsistent service levels;
 - inconsistent service delivery;
 - a lack of transparency/comparability for customers when choosing their supplier; and
 - potentially less protection for customers or certain customer groups.
- 3.2.6 Non discrimination—Separation has helped create a level playing field in Scotland. Optional separation is included in the Draft Bill and can help facilitate a level playing field in England too. However, it is important that implementation includes transfer pricing rules, governance codes, separation of staffing, and details of the compliance regime.—The Draft Bill allows this to be delivered but implementation plans are not defined. This is a concern as for matters such as this scope for interpretation should be minimised.
- 3.2.7 Efficient retail operations—Separation helped Business Stream drive down costs by allowing an improved focus on each cost driver. A cost base which would previously have been immaterial within the context of an integrated company was no longer so.—The Draft Bill allows this to be delivered.
- 3.2.8 An efficient market—The Draft Bill does not allow incumbents to exit the retail market. This means customers in regions which have an inefficient retailer will be financially worse off, unless they switch. This also means the market is unlikely to realise the full potential of economies of scale which might be achievable.—Allowing market exit in the Draft Bill would ultimately deliver the most economically efficient outcome for customers.
- 3.2.9 Removal of in area trading—This is being delivered via the Enterprise and Regulatory Reform Bill.
- 3.2.10 An automated switching and settlement system—This is not mentioned in the Draft Bill but exists in Scotland. This is an essential tool if there is a significant scale of switching. Visibility of market data through this system makes market entry more attractive for new entrants and formalises charging and registration processes too.

4. *Are the powers in the bill sufficient to achieve the policy aims?*

4.1 We have compared our practical assessment above with the policies set out in the Water White Paper and the introduction and explanatory notes in the Draft Bill.

4.2 The table below attempts to summarise the practical requirements which are outlined in the Water White Paper and whether the Draft Bill constrains or limits their creation.

<i>Broad Policy area</i>	<i>Practical “Policy” requirement in Water White Paper</i>	<i>Section in White Paper</i>	<i>Does Draft Bill enable this to happen?</i>	<i>Implementation to guidance/amendment required</i>
Regulated market entry	Regulated template contract/ remove need for access	5.3.7 negotiated	Yes	Guidance ie is this exception or norm

<i>Broad Policy area</i>	<i>Practical “Policy” requirement in Water White Paper</i>	<i>Section in White Paper</i>	<i>Does Draft Bill enable this to happen?</i>	<i>Implementation guidance/amendment required</i>
Customer protection/ access	Regulated market codes	5.3.8	Yes	Guidance
	Regulated operational code	5.3.8	Yes	Guidance
	Regulated wholesale prices/ reduce discriminatory pricing	5.4.1	Yes	May benefit from amendment
	No consumption threshold	5.3.5	Yes	Guidance
	Regulator (Ofwat) set default tariffs	5.6.1	Yes	Guidance including cross border view
	Regulator (Ofwat) set default service levels	5.6.2	No, Secretary of State sets standards	Guidance including cross border view.
Level playing field	Non-discrimination clause/ compliance regime	5.4.4	Using Ofwat powers	Guidance
	Increase efficiency of retail operations	5.3.2	No exit possible	May benefit from amendment
An effective/ efficient market	Remove in area trading	5.4	Yes ⁴	Guidance
	Automated switching system	Technical report 2.4	Yes, not directly included	Guidance
	An attractive market for new entrants	5.2.7	Yes, subject to regulated access	Guidance required on discrimination
	An efficient & attractive market for new entrants	5.2.7	No exit clause included	May benefit from amendment

4.3 Our analysis suggests that the Draft Bill broadly delivers what is required for customers and can deliver the tools to create an effective market.

4.4 While the framework provides the power to deliver a more competitive and customer focused market it also creates risk that the vision of the Government could be frustrated in the delivery phase (between now and 2017). We expand on how the proposals could be frustrated in the following sections.

5. *Are the Draft Bill s proposals necessary, workable, efficient and clear?*

5.1 The Draft Bill creates the necessary legislative changes to enable the policy drivers to be delivered.

5.2 However, there is scope for significant interpretation of how the Draft Bill might be implemented.

5.3 If the implementation plans allow incumbents to vary wholesale prices and tariff bandings across regions this could lead to gaming and ultimately delays for customers. We believe that regional harmonisation of tariff bandings is critical.

5.4 Implementation plans need to ensure that the market works efficiently and that the competition courts do not become the primary route for resolving issues in the first few years of operation. This is a genuine risk if negotiated pricing was the norm rather than the exception.

5.5 There are two areas which could be revised to create more clarity for market participants and a more efficient market. We also discuss potential omissions in section 6.

Revision Area One, Section 66E—”Rules about charges”

5.6 This section allows Ofwat to introduce standard wholesale charging schemes. However, we have concerns that the drafting leaves too much scope for market failure to be introduced. We would recommend the following amendment:

66E(1) “The Authority must issue rules about charges that may must be imposed by a water undertaker under a section 66D agreement unless agreed with the Authority”

5.7 The above change is necessary to reduce the risk of gaming by incumbents and discriminatory pricing.

5.8 We would recommend the addition of a clause (to 66E(2) perhaps). This clause would require that there should be no discrimination in the way a new entrant is treated versus an incumbent s retail arm.

5.9 We would recommend the addition of a clause (to 66E(2) perhaps) which would presume that there should be regional harmonisation of wholesale prices across a water company s region.

Revision Area Two, Standards of performance—Water Supply License (Clause 20 and 21)

5.10 We understand the principles contained in these clauses but are unsure that inclusion in legislation is the best approach.

⁴ Enterprise and Regulatory Reform Bill

5.11 We recommend that Clauses 20 and 21 are removed. These could easily be added into license conditions for retailers. Inclusion of this type of performance standard in legalisation appears burdensome and may reduce flexibility in the future.

5.12 When defining performance standards these should focus on “wholesaler” activities as market forces will penalise poor performing retailers for activities they are in control of.

6. Are there any omissions from the Draft Bill, for example in relation to managing the financial risk and impact of flooding?

6.1 We consider there is an omission relating to situations where incumbents enter into contracts in advance of the market opening.

6.2 Ideally Ofwat would prohibit incumbents from entering into non-standard agreements before market opening including bundling of licensed and unlicensed activities.

6.3 However, if this is not achievable a clause should be added to ensure that these historic agreements are “transferable” to new entrants and that any margin available is not squeezed. A comparable arrangement is included in Schedule 3 of the Water Service etc (Scotland) Act 2005.

6.4 The Draft Bill would benefit from more clarity around what separation requirements will be. That would make the market more attractive for new entrants.

6.5 The Draft Bill omits any significant mention of non-discrimination. There is a risk that in the absence of that pricing or service discrimination could create barriers to entry.

6.6 The Bill omits details of timings for implementation. That is understandable in many respects but again we would expect Ministers would want to be kept abreast of progress if freedom is provided around implementation plans.

Implementation

6.7 We welcome the introduction of the High Level Group. We hope this group can help inform a positive, ambitious but realistic timetable for implementation.

6.8 We have noted the Draft Bill leaves significant scope and latitude for Ofwat to deliver a plan which fits their vision; it will be important that plans match the aims of Government Ministers and customers.

6.9 The minor revisions we recommended are made to:

- 6.9.1 Help ensure a level playing field for all participants.
- 6.9.2 Reduce the risks of gaming which could occur if entrants have to negotiate wholesale charges.
- 6.9.3 Increase the efficiency of the market by allowing consolidation and inefficient operators to exit the market.

6.10 It would also be useful to have a published high level implementation plan. This would ensure that in advance of a Water Bill receiving Royal Assent, no ambiguity exists between plans for market development and the legislative framework.

6.11 An implementation plan might include details on the:

- Definition of retail activities.
- Principles for charging (clarification on negotiated v regulated access).
- Regional harmonisation of tariff banding and charging.
- Harmonisation of service levels across regions.
- Link between default pricing and service levels.
- Details of registration/settlement systems.
- Compliance and governance—ie the level playing field.
- Contractual arrangements.
- Way in which existing “non-standard” contracts would be dealt with in a competitive market.

Written evidence submitted by Consumer Council for Water

1. INTRODUCTION

1.1 The Consumer Council for Water (CCWater) is the independent, non-departmental public body representing the interests of water and sewerage consumers across England and Wales. We have four local committees in England and a committee for Wales.

1.2 We have worked with the water industry and its regulators since 2005 to get the best results for water consumers. In that time we have:

- been central to achieving the customer focused outcome from the 2009 price review, which was over £1 billion better for water customers than the 2004 price review when CCWater did not exist;
- convinced water companies to return over £286 million to customers through either additional investment or bill reductions;
- dealt with over 101,000 complaints;
- helped customers get over £14.7 million in compensation from water companies; and
- cost 21 pence for each water bill payer in 2012–13.

1.3 We welcome the opportunity to submit evidence to the Environment, Food and Rural Affairs (EFRA) Committee inquiry to conduct pre-legislative scrutiny of the draft Water Bill.

1.4 Our evidence is provided from the perspective of water consumers, both household and non-household, and is based on our wide ranging consumer research undertaken over the past seven years, as well as our experience in helping customers with their complaints and enquiries.

2. SECTION ONE—OVERALL RESPONSE

2.1 Issues in the draft Water Bill that we believe will help deliver improvements for water customers

2.1.1 CCWater broadly welcomes the draft Water Bill as it addresses a number of issues on which CCWater has been working on behalf of water customers, such as:

- Increasing choice for non-household customers by encouraging new water and sewerage service suppliers into the market and extending competition to all non-household customers in England, without the additional cost of legal separation.
- Ensuring the non-household and household customers' voice is heard. Having CCWater as a consultee on issues such as the development of market codes, the wholesale access pricing regime, and the approval of charges schemes process is a positive step.
- Extending the time period during which Ofwat can levy a financial penalty on water companies, and increasing Ofwat's information gathering powers.
- Making the best possible use of water resources by exploring cost-effective bulk supplies and water trading between companies and with new entrants.

2.2 Issues in the draft Water Bill that we believe need exploring further to ensure customers see benefits not detriment from new legislation

2.2.1 These are:

- Making sure the new market mechanisms, systems and frameworks can cope with the level of activity that further market reform could generate, and that the set up of the new market is done efficiently to minimise the cost and maximise the benefits to all customers.
- Ensuring CCWater is consulted about appropriate mitigation measures to protect customers when water companies merge.
- Requiring in legislation water companies to consult with CCWater about their charges schemes to ensure proposed changes in tariffs do not result in any detriment to customers.

RESPONSES TO THE EFRA COMMITTEE'S QUESTIONS

3 *Are the powers contained in the draft Bill sufficient to achieve the policy aims set out in the Water White Paper?*

3.1 Broadly the draft Water Bill contains the necessary powers to achieve the policy aims set out in the Water White Paper, but there are some exceptions, which we have outlined below:

Affordable water supply

3.2 The EFRA Committee is aware that CCWater believe the Government's objective for everybody to have access to an affordable water supply may not be fulfilled by customer-funded social tariffs alone. We welcome the UK Government funding of £50 million to help address fairness issues for South West Water's household customers, and also the concept of social tariffs, but believe more direct funding is needed by the UK

Government to achieve their overall policy aims for an affordable water supply. We have mentioned previously that estimates of the annual cost to effectively address the affordability problem range from around £160 million to £450 million. A customer-funded social tariff could only provide around £40 million.

Market reform

3.3 We believe the legislation on market reform ought to deliver the overarching aims of the Water White Paper. However, we have several concerns which are set out below.

3.4 With potentially over one million non-household customers being given the opportunity to change supplier, it is important that the new market mechanisms, systems and frameworks are able to cope with the level of activity that the market could generate. This includes ensuring that data accuracy issues are addressed before the market extends. Without it non-household customers who switch could suffer detriment and the market itself become unworkable, causing customers to lose confidence.

3.5 It is therefore important that the water industry works together to produce a switching mechanism, market codes and a pricing regime that:

- encourages new entrants to the market;
- gives non-household customers the confidence to change supplier;
- achieves the smooth transition to a joint retail water and sewerage services market across England and Scotland, without unnecessary duplication in processes and workload; and
- does not result in detriment to household customers.

3.6 It is also important that the set-up of the reformed market is paced appropriately. We welcome the draft Water Bill paper's suggestion of April 2017 as a target date, and believe regularly reviewing progress towards this date is essential.

3.7 The different market regimes in England and Wales could cause confusion for non-household customers. This could particularly occur at the border areas. Work by the water companies and CCWater to inform non-household customers around the border about switching opportunities will be required as the market opens up in England.

Metering

3.8 The draft Water Bill supports the Water White Paper's stance on metering, but we note the EFRA Committee's position on this in their Water White Paper inquiry report.

3.9 There are some circumstances where compulsory metering can be appropriate, for example in water-stressed areas. But any approach to compulsory metering must take account of local circumstances, and importantly the likelihood that some customers could see significant increases in their water bills. Where there are significant increases mitigation measures would be needed for those who are struggling to pay.

Abstraction regime reform

3.10 We note that the reform of the abstraction regime is due to be considered under future legislation. We think this is the right approach as time is needed to properly evaluate environmental benefits, and to ensure there is no detriment to water consumers.

Retaining CCWater

3.11 We welcome the EFRA Committee's recognition of the need of water consumers to have a "strong voice" to represent their interests as the water sector is reformed. We also welcome the recognition that non-household customers will continue to need representation after the market is opened up.

3.12 The market changes for non-household customers, as a result of the Water Bill, will present many opportunities for those customers to get a better deal from their water supplier, but they also raise the risk of some customers ending up worse off, and experiencing new problems. CCWater will work with the industry-led High Level Group to ensure the customers' voice is heard and potential problems anticipated and accounted for.

4 Are the draft Bill's proposals necessary, workable, efficient and clear?

4.1 Yes, except where we have outlined concerns about potential consumer detriment. Additional comments are below.

Upstream market reform

4.2 To make sure that drinking water quality standards are maintained and supply security is not compromised through upstream market reform, we seek assurance that the regulators will be appropriately resourced to fulfil this vital role.

5 Are there any omissions from the draft Bill, for example in relation to managing the financial risk and impact of flooding?

Mergers

5.1 We support the two-tier approach, and urge Ofwat to be transparent in how it will put a value on the loss of the comparator. We support the proposal for legislative change to allow the Office of Fair Trading (OFT) to keep the threshold for mergers under review, and to amend it through secondary legislation.

5.2 To help mitigate against consumer detriment from water company mergers, CCWater should be consulted if OFT decides that undertakings should be made to compensate for the loss of a comparator. This will ensure all aspects of potential consumer detriment are considered and the most appropriate remedy is delivered.

Charges scheme approval

5.3 To ensure customers are adequately protected the legislation should require water companies to consult with CCWater annually on their charges.

5.4 CCWater currently works with water companies to identify and address existing and proposed charging policies which may be detrimental to customers. This work is underpinned by Ofwat's current requirement that companies consult CCWater on any changes to their charges.

5.5 Making CCWater a statutory consultee would ensure CCWater is able to continue to influence charging policies on behalf of customers and can alert the regulator to any risks of customer detriment. This would help to avoid any damage to consumer confidence which might otherwise result from problems being identified and not addressed until after implementation.

6 TAKING THE BILL FORWARD

The draft Water Bill outlines some issues that may be included in the final Bill. CCWater has comments on one issue listed in the draft Water Bill document.

Ofwat's complaints work

6.1 The draft Water Bill paper suggested the Water Bill might include proposals for Ofwat to have greater discretion about the types of casework it handles. We support the Government considering the findings of Defra and the Welsh Government's Review of Ofwat and consumer representation in the water sector "the Gray Review", which suggested that "all customer complaints are dealt with by an appropriate body and the route for complaint is clear".

6.2 If Ofwat is given greater discretion on the types of cases it deals with, CCWater is ready to work with Ofwat to ensure that the route for complaint is clear, and that consumers see benefits, not detriment from any change.

6.3 In working with Ofwat, we would want to ensure:

- an improved service for customers; and
- no gaps in consumer representation.

6.4 CCWater will work with Ofwat to ensure all the above issues are considered as the details of any legislative change is worked through.

September 2012

Supplementary written evidence submitted by Consumer Council for Water

1. The Consumer Council for Water (CCWater) is responding to the EFRA Committee' request at oral evidence session on 30 October 2012, for potential Clauses to ensure upstream reforms do not lead to regional de-averaging of prices and to ensure domestic customers are not disadvantaged by the abolition of the costs principle.

2. *Our Aims for the proposed modifications to Clauses on market reform are:*

2.1 To ensure that domestic customers, and other customers ineligible for competition are not disadvantaged by the abolition of the "costs principle".

2.2 To ensure that the introduction of upstream reforms does not lead to further geographic de-averaging of prices within an undertaker's area.

3. We have outlined potential changes to one Clause—highlighted in yellow below—to ensure these aims are achieved, but it is likely that the principles we outline also apply in other areas of the Bill, such as on the charges for bulk supplies at 40E. The proposed Clause changes would need scrutiny and development by lawyers.

Clause (CCWater proposed changes highlighted)

Page 94—For section 66E (costs principle) of the Water Industry Act 1991 there is substituted—**66E Rules about charges**

- (a) The Authority must issue rules about charges that may be imposed by a water undertaker under section 66D agreement.
- (b) The rules may in particular specify:
 - (i) What types of charges may imposed.
 - (ii) The amount or the maximum amount, or a method for determining the amount or maximum amount, or any type of charge.
 - (iii) Principles for determining the amount of any charge that may be imposed.
- (c) The rules will in particular include principles in the rules to:
 - (a) ensure household customers and other ineligible premises are no worse off from increases in charges resulting from the introduction of a competitive market in water and/or sewerage services.
 - (b) ensure access charges are set to protect household customers and other ineligible premises from further de-averaging within an undertaker's area, due to their geographical location, as a result of upstream competition.

Inclusion of this proposed change would affect the numbering of the current (c) and (d).

4. PROPOSED MODIFICATION TO CLAUSE ON RULES ABOUT CHARGES SCHEMES—CLAUSE 14

4.1 The Committee is aware through our written and oral evidence that CCWater have raised the issue of protecting customers when water companies are drafting their charges schemes.

4.2 A potential change could require water and sewerage undertakers to consult CCWater about their draft charges schemes.

4.3 The aim is to allow CCWater to conduct timely challenges on water and sewerage undertakers' draft charges schemes to avoid the risk of customers experiencing problems when bills arrive.

CCWater proposed changes highlighted. Page 56

143B Rules about Charges Schemes

(2)—Rules

under this section may in particular—

- (a) specify what types of charge may be imposed;
- (b) specify the amount of the maximum amount, or a method for determining the amount of maximum amount, of any type of charge;
- (c) specify principles for determining what types of charge may or may not be imposed;
- (d) specify methods and principles for determining the amount of any charge that may be imposed;
- (e) require particularly schemes of charges to be available in specified cases.

(3) The rules

under this section will require water and sewerage undertakers to consult with the Council on their draft charges scheme.

This would affect the numbering of the current number 3 onwards.

5. OTHER REQUESTS FOR INFORMATION

5.1 The EFRA Committee also requested CCWater submit its research into social tariffs and its views on Ofwat's—Section 13 proposals for changing water company Licences.

5.2 Our cross-subsidies and social tariffs research was submitted to the Clerk on 31 October and can be viewed on our website; (http://www.ccwater.org.uk/upload/doc/Cross_subsidies_and_Social_tariffs_FINAL_8_June_2010.doc).

Sections of interest to the Committee are 1.3.2, 1.7.3, Section 4.1—bullet 6. An overview of the South West Legacy conclusions are at 1.6, with detail at Section 6.

5.3 Our supplementary evidence on Ofwat's Section 13 proposals will follow.

November 2012

Further supplementary written evidence submitted by Consumer Council for Water

In response to the EFRA Committee's request raised during CCWater's oral evidence before the Committee on 30 October, we outline below our views on Ofwat's Section 13 Licence Modification proposals.

1. We agree that licence modifications are required to create separate wholesale and retail price controls to help enable retail market reform for business customers required by the draft water bill.

2. However, the Ofwat proposals for greater flexibility for the economic regulator seem to go beyond what is needed in the draft bill. We are concerned that Ofwat's consultation paper does not identify the benefits to customers of this additional flexibility.

3. There may be risks for customers arising from company and investor uncertainty with this additional flexibility. Recent reports by several equity research companies, and a ratings agency, have shown how this uncertainty may be seen as a risk by investors. If this results in an increase in (or an unnecessarily high) cost of capital, we would be very concerned. This could outweigh the customer benefits of an expansion of the retail market for business customers. Given these risks and the lack of clarity in terms of impact on customers of Ofwat's licence proposals, CCWater is unclear that the additional flexibility sought by Ofwat is beneficial for customers.

4. Ofwat's consultation is also somewhat unclear as to the circumstances when companies will be able to appeal to the Competition Commission on licence modifications in the future.

If the Committee need further thinking from CCWater on this this or other issues, we will be happy to provide it.

November 2012

Written evidence submitted by the Department for Environment Food And Rural Affairs (Defra)

DRAFT WATER BILL PRE LEGISLATIVE SCRUTINY

Thank you for the recent opportunity to discuss the draft Water Bill. I promised to write to the Committee on a few aspects I was unable to answer fully at the time and I also thought I would include a few other points for clarity.

MARKET REFORMS

The draft Bill is only one part of our work to deliver the vision for the sector we set out in the Water White Paper. It provides a legislative framework to deliver our market reform objectives, enabling greater competition in the water and sewerage sector and removing unwelcome barriers. The water sector is seen as a great success, rightly so, and therefore we are adopting an evolutionary rather than a revolutionary approach. However, as the White Paper states, the sector needs to be able to deal with increasing pressures on water resources through climate change and an increasing population—not all of which was foreseen at the time of privatisation. We need the sector to find better ways to source, use, re-use and treat water. Bringing in new players and encouraging new ways of thinking will drive forward the innovation and efficiency needed to achieve this, whilst protecting the environment and harnessing market forces to keep customers' bills down.

Our decision to reduce the level of detail set out on the "face of the Bill" is deliberate. The Bill provides a framework that gives us the flexibility to support these new markets without constraining them, to allow innovation to flourish and to adapt to any unforeseen changes.

The opposite approach, as with existing water legislation, would risk being less successful in delivering our objectives in what will be an evolving market, particularly as rigidity of the legislation would make it harder and more time consuming to make any changes that are needed. As I mentioned to the Committee, an example of where legislation is too complex and rigid is the provisions within the Flood and Water Management Act for Sustainable Drainage Systems. With hindsight this probably should have been much more flexible. It has taken a good deal more time and effort to develop a workable system as a result, but we are now close to achieving that and as I said we will implement these provisions in April 2014. More relevant to the Bill is the example of the "costs principle", where an overly prescriptive approach has effectively created barriers to competition.

We are aware of some concerns around this approach, as we recognise that Parliamentarians and stakeholders want to understand now in detail how markets will work in practice. We cannot answer all these questions now—not least because we need to work through the details of market design and implementation with all the players in the market, and have set up the High Level Group to drive forward this work. Instead we have included safeguards in the Bill to enable Government to set a clear policy framework for implementation and

ensure it delivers benefits and that the markets work efficiently. Ministerial guidance and market codes will be key, and we are working closely with industry and regulators to develop these. Attached at Annex A is an outline of the structure of the draft Bill, how the different guidance, charging rules and market codes fit together, the level of scrutiny and who is responsible. It is our intention to share as much information as we can throughout this process, but we should not rush this—hence the anticipated delay between Royal Assent and market opening.

GOVERNMENT'S CHARGING GUIDANCE

A key part of that policy framework for the market will be the guidance Ofwat receives from the Governments, both the UK and Welsh. We discussed this charging guidance in our session. We agree this will be critical to the future functioning of the market and to ensuring that our reform package delivers benefits without having undue effects either on particular groups of customers, or on water companies' abilities to finance their operations. We are fully committed to ensuring that water companies can operate within a stable and predictable regulatory framework that enables them to continue to attract competitively priced investment to the sector. We will need to strike a careful balance in our guidance—water companies must be able to generate a return on their existing infrastructure and finance future investment, but we will also want to enable market entry to secure our policy goals from reforming the market.

I remain convinced that it would be inappropriate for these charging principles to be set out on the face of the Bill rather than in guidance for the reasons I have explained. Our approach is also likely to evolve over time as the market develops. We will, however, want to give a broad indication of the proposed approach as the Bill goes through Parliament. I confirmed at my oral evidence session that this is statutory guidance, so it will be laid before Parliament. We are also open to considering whether we could give Parliament a greater role in scrutinising Ministerial charging guidance in draft.

As the independent economic regulator we do not envisage Ofwat's charging rules (or market codes) being scrutinised by Parliament in the same way; but in any case the public policy will be established in our charging guidance, which Ofwat will be required to take account of when developing their charging rules. As a Non-Ministerial Government Department, Ofwat will continue to be answerable to Parliament and, as Regina Finn said in her evidence, always open and willing to come before your Committee.

TIMETABLE FOR MARKET OPENING

I would like to clarify some confusion about the introduction of the market reforms set out in the draft Bill. We currently anticipate retail market opening in April 2017, but have asked the High Level Group to confirm the viability of that target date, which would of course be dependent on the timing of Royal Assent. We have always anticipated upstream competition being introduced in a phased manner on a slower timescale.

It is worth pointing out that upstream competition would not be entirely new. The current Water Supply Licensing regime already allows for upstream entry to the water supply market for customers that use five megalitres of water or more a year (in Welsh Water's and Dee Valley Water's areas it is currently 50 megalitres).

RETAIL COMPETITION: VOLUNTARY EXITS

There has been much discussion on whether water companies should be allowed to exit the retail market. The position on this is more complex than suggested during our session, with different views held across the water sector. The Consumer Council for Water supports our approach and Water UK has not taken a collective view, given the disparity of views among companies.

At the moment we remain convinced by the arguments that many water companies and their investors used against separation prior to the publication of the White Paper and we believe there will be benefits for customers, especially households, in retaining vertically integrated water companies. We are also very concerned about possible unintended consequences of making such a significant change to water company licences.

It is essential that the water companies remain responsible for the whole business. If they wish they are able to outsource the retail function, but they must retain overall responsibility. The example of Yorkshire Water working in partnership with Loop, which provides their customer services, is an excellent example of what contracting out retail services can achieve. Furthermore, we believe it is a matter for Ministers and Parliament to debate and decide if or when separation should become available. The ongoing debate around Ofwat's licence modification proposals illustrates the risks around licence changes.

INSET REGIME

The Committee asked why we would continue to keep the existing inset regime alongside the new markets. There are still some benefits in doing so, and there was support for this approach in response to the last government's consultation on repealing the regime. We have therefore drafted the Bill so that incumbents and inset appointees can continue to operate in the inset market as per their existing rights but, upon commencement of the provisions, new entrants will generally only be able to operate under the Water Supply Licensing regime.

Should it be decided in the future that the inset regime does not provide the best way to operate the market for new developments there is a power within the Bill for Ministers to maintain existing levels of competition by applying retail infrastructure licensees to supply household customers instead of insets. However, as stated above, this is a long term issue and the draft Bill also allows the inset regime to continue in Wales.

IMPACT ON SCOTLAND

The Committee queried the relationship between the Water Bill and Scotland, in light of concerns raised by the Water Industry Commission for Scotland (WICS) that the Bill might impact on their market arrangements. At the moment we do not fully understand the issue that WICS has raised and will be exploring this further with them. We currently believe that changing the regime in England and Wales will not make any substantive difference to the legal position in Scotland under the Competition Act.

OFWAT: SUSTAINABLE DEVELOPMENT DUTY

The Committee queried our intended approach towards a sustainable development duty for Ofwat, as there was a suggestion that Ofgem (the gas and electricity regulator) has a primary sustainable development duty.

As I said in my oral evidence, we are currently carefully considering the case for elevating Ofwat's current duty to promote sustainable development to primary status, and will no doubt continue to be challenged on this. We feel that the draft Strategic Policy Statement establishes clearly the Government's priority, Ofwat's role and also includes a direction on them to keep their contribution under review.

In terms of the Ofgem duty towards sustainable development, there appears to be a misunderstanding of the relevant legislation. The Energy Act 2008 inserted a new provision into the Gas Act 1986 (and the Electricity Act 1989) requiring the Secretary of State and Ofgem to have regard to the need to contribute to the achievement of sustainable development when pursuing the principal objective of protecting the interests of consumers. This had the effect of moving the sustainable development duty up the hierarchy of secondary duties, but is not the same as making it a primary duty.

RESERVOIRS GUIDANCE

Finally, I promised to write to you about the reservoirs guidance. The reviews of both "*A guide to the Reservoirs Act 1975*" and "*Floods and reservoir safety, Third edition*" are in progress by the Institution of Civil Engineers, working with the Environment Agency. The review of the guide to the Reservoirs Act is focused on changes to the legislation and will be completed once the amendments set out in Schedule 4 of the Flood and Water Management Act have been commenced.

The review of floods and reservoir safety has a primary focus on technical matters with a remit to take into account current guidance and research and relevant changes to UK reservoirs legislation. It was commissioned in August 2011 with a target timescale of two years, subject to consideration of a detailed programme and budget. We are working with the Institution's working group and intend to publish their guidance to the Reservoirs Safety Act in April 2013. This will coincide with the implementation of the amendments needed for the application of the Environment Agency's new risk-based methodology for reservoir classification.

I hope this is useful for the Committee and aids your understanding of the draft Water Bill and what we are trying to achieve. I look forward to receiving your report in the new year.

Richard Benyon

Minister for Natural Environment and Fisheries

December 2012

Annex A

THE GUIDANCE, CODES AND RULES

The Water Bill: Provides a framework to allow greater competition and sets out where there needs to be charging guidance, market codes and charging rules. These are:

Ministerial Charging Guidance: Provides statutory guidance to which Ofwat must have regard, from the Secretary of State or Welsh Ministers, to Ofwat on their charging rules for the following water company charges:

- (i) Charges to the end-user customers of water and sewerage companies.
- (ii) Connection charges and requisition charges for new developments, etc.
- (iii) Bulk water supplies to incumbent water companies (including inset appointees).
- (iv) Sewerage mains connections with incumbent sewerage companies (including inset appointees).
- (v) Charges by incumbent water companies to new entrant licensees providing retail and upstream water supply services.

- (vi) Charges by incumbent water companies to new entrant licensees providing retail and upstream sewerage services.

The Government is committed to producing guidance for all these charging regimes and is currently considering the merits of merging its guidance into a single document. Ministers will be required to consult with Ofwat, incumbent water companies (and, where appropriate, new entrants), the Consumer Council for Water and such other persons as are appropriate. Ofwat must have regard to this guidance when producing its charging rules.

Ofwat Charging Rules: The Bill also requires Ofwat to produce charging rules for (i), (ii), (v) and (vi). It is not under a duty to produce charging rules under (iii) and (iv) because it is not clear whether the market for bulk supplies between water companies needs to be regulated in this way; however the Bill contains a power for such rules to be made. There is a strong case for charging rules to regulate bulk supplies and mains connections in the inset market and therefore the Government will expect to issue guidance to Ofwat to make this market operate more effectively. In preparing its rules, Ofwat, in the main, must consult Ministers, water companies, new entrants (where appropriate), the Consumer Council for Water and other appropriate persons.

Ofwat Market Codes: The Bill provides Ofwat with a power to produce market codes for agreements made under (iii) to (vi) above. These codes are therefore only required where a water company potentially has dealings with third party suppliers rather than its own customers. Ofwat will be required to consult Ministers, the Drinking Water Inspectorate (where a code covers upstream water or bulk supplies), the Environment Agency (where a code covers bulk water supplies and sewerage services, including mains connections), water companies, new entrants (where appropriate), the Consumer Council for Water and other appropriate persons. The Secretary of State or Welsh Minister may require Ofwat to withdraw or amend a code within 28 days of the consultation period if they have any concerns.

Written evidence submitted by Ofwat

INTRODUCTION

1. Ofwat is the economic regulator of the water and sewerage sectors in England and Wales. Our primary duties are to:

- protect the interests of consumers, wherever appropriate by promoting effective competition; and
- ensure that efficient water and sewerage companies can carry out and finance their functions.

2. We also have a range of secondary duties. These include:

- contributing to sustainable development;
- promoting economy and efficiency;
- ensuring there is no undue discrimination against particular customers; and
- to have regard to the principles of best regulatory practice.

3. Since privatisation, a stable and independent regulatory framework has enabled the water and sewerage sectors to deliver £108 billion of investment—resulting in major service improvements to customers and a better water environment—while our efficiency challenge has kept bills £120 lower than they otherwise would have been.

4. But the sector now faces unprecedented challenges. The impact of climate and demographic change on water resources and growing customer expectations demand a new approach from government, regulators and the industry. We welcome the ambition of the Water White Paper and the recent draft Water Bill, which propose some essential legislative changes that will, in turn, allow the sector to adapt effectively and efficiently to future challenges.

5. Examples of the provisions we welcome include those that:

- give non-household customers choice in their supplier and the services they receive;
- enable more sustainable use of water resources to benefit the environment;
- allow Ofwat to take proportionate and targeted action where companies fail; and
- reduce the burden of regulation.

6. These changes will be essential to drive innovation and new services. And they can also help drive cost reduction and efficiency, all of which are crucial to support economic growth.

7. The provisions in the Bill will enable the delivery of Government's aims for a sustainable sector as set out in the Water White Paper in a way that this is workable and clear. We explain below how we believe the intended benefits can be most effectively delivered. We also set out the areas where we consider some amendments would enable the Bill to drive even greater benefits to customers, investors, the environment and the broader economy.

GOOD FOR CUSTOMERS—TODAY AND TOMORROW

Extending retail choice

8. The draft Bill will, for the first time, allow all business, charity and public sector customers to choose their water supplier—something which seven out of 10 of these customers have been seeking for some time.⁵ This is expected to bring direct net benefits of some £160 million⁶ that—when added to the £370 million of net benefits that we expect to achieve through our own regulatory reforms—delivers more than half a billion pounds of net benefits.⁷ Collectively this is equivalent to creating more than 12,500⁸ jobs in the broader economy.

9. The provisions in the Bill will allow non-household customers to:

- choose water and sewerage services that are tailored to meet their requirements, including more water efficiency services;
- choose a single supplier for water and sewerage services for all premises in England and Scotland, reducing significantly the overheads they currently incur in dealing with multiple suppliers and multiple bills; and
- benefit from the improved efficiency in service delivery as competing retailers vie for their business and put greater pressure on wholesalers to reduce costs.

10. Choice will give organisations, large and small, power to influence the services they are offered. In the charity sector, for example, some large organisations with multiple sites are treated no differently to individual households and do not receive the services they want. We understand that Barnardo's benefits from just two electricity suppliers and a single gas supplier, but for its water it must deal with almost two dozen companies.

11. Similarly, multi-site businesses—like supermarkets and hotel chains—will gain from choosing a single water retailer. As a Policy Exchange report in July 2011⁹ explained, reducing one customer's 4,000 paper bills each year to a national electronic bill could save perhaps £80,000–£200,000 for that customer alone.

12. In this context, we support the proposals for a joint English–Scottish market and the benefits that this will generate. We welcome the opportunity to learn from the Scottish experience, where retail has existed for some time, and are encouraged by the early work of the high level group to support the development of these changes.

Innovation and efficiency for all

13. Water retailers will, in turn, expect the company from whom they purchase wholesale water and sewerage services (the existing monopoly providers) to deliver an improved service. The pressure to seek new and better ways of delivering retail and wholesale services will also indirectly benefit household customers. For example, if retailers improve their billing and customer relationship management systems for business customers, the same technology can be used to serve household customers more efficiently. Ofwat can also observe the efficiencies in the non-household sector and use this evidence to challenge the monopoly incumbents' services to households harder in future price reviews.

14. These retail reforms will also encourage more efficient use of water by those customers who have choice. Experience in Scotland—where all non-household customers are able to choose their water and sewerage provider—shows that retailers often try to differentiate their services from other suppliers by providing these water efficiency services at heavily discounted rates or even for free. For example, in a recent procurement exercise across the public sector, Business Stream offered free automated meter reading water efficiency services to all sites across the public sector in Scotland, as well as £18–£25 million in price savings over three years.¹⁰ In fact, Business Stream alone has already saved non-household customers approximately £10 million

⁵ Results based on two separate consumer research studies commissioned by CCWater and Ofwat between 2007 and 2010. Large business customer research was based on telephone surveys with 684 large businesses in England and Wales that MVA conducted in June 2007. This showed that 84% supported competition in principle. Small and medium business research was based on telephone surveys that Accent conducted in June 2010 with 1,515 businesses with less than 250 employees. This showed that 69% supported competition in principle. See: www.cwater.org.uk.

⁶ The UK Government's impact assessment ("Introducing retail competition in the water sector", HM Government, 2011, <http://archive.defra.gov.uk/environment/quality/water/documents/www-ia-retail-1346.pdf>) suggests a net benefit of £190 million (NPV over 30 years) based on a market opening date of April 2015. Assuming a market opening date of 2017 and applying changes to the price base year reduces this figure to £160 million.

⁷ "Future price limits—statement of principles. Appendix 1: Impact assessment", Ofwat, 2012, http://www.ofwat.gov.uk/future/monopolies/fpl/pap_pos201205fplimpact.pdf.

⁸ Using a gross value added per employee of about £42,000 a year (taken from "United Kingdom National Accounts—the Blue Book 2012", Office for National Statistics, 2012, <http://www.ons.gov.uk/ons/rel/naa1-rd/united-kingdom-national-accounts/the-blue-book—2012-edition/united-kingdom-national-accounts—blue-book—2012-edition.pdf>) gives a result of more than 12,500 job years.

⁹ , "Water retail services competition in England and Wales: Still Hobson's choice?", Policy Exchange, July 2011, <http://www.policyexchange.org.uk/images/publications/water%20retail%20services%20competition%20in%20england%20and%20wales%20-%20jul%202011.pdf>.

¹⁰ See: <http://www.scotland.gov.uk/Topics/Government/Procurement/directory/Utilities/Water>.

worth of water through efficiency measures, which has also reduced CO₂ emissions by 5,000 tonnes since the market opened in 2008.¹¹

Protecting household customers who will not have choice

15. Some stakeholders have expressed a concern that the introduction of choice for non-household customers could lead to an increase in costs for household customers.

16. This would be contrary to our regulatory framework, our statutory duties and, potentially, wider competition and consumer law. Fundamentally, household customers will not be made to pay for competition to non-household customers and we will use all of the tools available to us to make sure that this is the case.

17. As part of our “future price limits” project our existing regulatory proposals already provide protection against this risk- we have already required companies to separate the costs of serving these different groups of customers and they already publish separated accounts. We are also proposing to set separate price limits for both groups of customers- limiting the amount of revenue that can be recovered from each group. We will consult further on the measures needed to both police this boundary and ensure a level playing field exists between entrants and incumbents, as we prepare for the market to open in 2017.

Removing barriers to competition

18. To ensure that the benefits of effective choice can be delivered, the draft Bill includes critical provisions that remove barriers to competition.¹²

19. In particular, the Bill proposes replacing the costs principle with a power for Ofwat to set charging rules for access to water and sewerage networks. The costs principle has been widely recognised as anti-competitive¹³ and a significant barrier to competition. Its removal is crucial and will allow us to work with the industry (existing companies and new entrants) to develop more transparent and flexible access pricing rules and adapt these as markets develop.

20. We note that some appointed companies have continued to ask for the retention of the costs principle. But most stakeholders, including many companies, can see the need for change.¹⁴ We fully support the provisions in the Bill as the existing arrangements unfairly favour incumbents and act as a significant barrier to achieving the Government’s objectives. We would be pleased to provide more detailed technical briefing on the costs principle and the detrimental effect it has.

Better customer protection

21. The Bill itself will protect customers better by extending the time limit for Ofwat to take appropriate action against companies where they fail. This provides a strong incentive for companies to avoid failures that put service to customers at risk.

22. We also recommend that the final Bill should include a provision to enable Ofwat to prioritise enforcement action to achieve the greatest benefit for customers overall. This would allow us to choose to allocate our limited resources to the cases that are having most detrimental impact and that, if resolved, would provide greatest benefit to customers.

23. This would support us in establishing a more efficient, timely and effective framework for individual non-household and household customers to seek redress when things go wrong. This could be done in a way that aligns with the Government’s proposed reform of the consumer landscape and with effective redress schemes in other sectors.

24. Together, these provisions would deliver more effective, proportionate dispute resolution and more targeted enforcement focused on areas that are of high value to consumers. We would be happy to provide further briefing on this if it were required.

GOOD FOR THE ENVIRONMENT

More efficient and sustainable water resources services

25. A key focus of the Bill (and the Water White Paper before it) is on improving the management of our precious and scarce water resources. The relevant provisions in the Bill are designed to do this by allowing new entrants to sell water into the public supply network and to build new assets.

¹¹ “Competition in the Scottish water industry: Achieving best value for water and sewerage customers: 2009–2010”, WICS, 2010, p. 15, <http://www.watercommission.co.uk/UserFiles/Documents/Competition%20report%20-%20final.pdf>.

¹² As identified by Professor Martin Cave in his independent review of the competition arrangements in 2009. See: “Independent review of competition and innovation in water markets: Final report”, M Cave, April 2009, <http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/documents/cavereview-finalreport.pdf>.

¹³ The costs principle has been widely criticised: by Ofwat (www.ofwat.gov.uk/competition/pap_con_reviewmrktcomp.pdf), by Professor Martin Cave in his independent review (<http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/documents/cavereview-finalreport.pdf>), and by the Competition Appeals Tribunal (www.catribunal.org.uk/files/Jdg1046Albion181206.pdf).

¹⁴ See: www.stwater.co.uk/response-to-the-water-white-paper-announcement.

26. This will improve our water management in a number of ways. First, it increases the potential sources of water a company can access, improving resilience and providing that company with a wider choice of solutions. For example, a commercial site with unused water abstraction rights and available water would be able to offer this surplus water for public water supply. This benefits the natural environment because that available water could be traded, instead of increasing abstraction pressures at existing sources.

27. Second, it allows new, innovative players to source water in new environmentally sustainable ways.

28. Third, it will help encourage decisions on water management that are driven by the revealed value of the water to society and the environment over time. This should lead to investment decisions that are more sustainable in the long term.

29. For example, with a wider range of water sources, a company might find that it is more efficient to build interconnection capacity and buy water instead of developing additional sources in its own area, perhaps through carbon intensive capital solutions.

30. Work we have carried out indicates that there is the potential for interconnection to deliver benefits of about £1 billion over 30 years.¹⁵ Similarly, the Water Resources in the South East Group identified potential savings of about £500 million if companies in the south east of England built interconnectors and traded water instead of developing new resources.¹⁶

31. The UK Government's impact assessment calculates that these "upstream" reforms will deliver nearly £2 billion of benefits over 30 years—the equivalent of more than 46,000 jobs.¹⁷

32. We support the proposed measures in the draft Bill. In fact, our own regulatory proposals will complement them. In particular, our proposed regulatory incentives to encourage water trading and discourage abstraction from unsustainable sources also seek to improve resilience and protect the environment.

Innovation in sewerage and networks

33. The Bill also contains provision for the same type of new entry into the sewerage system or the wider network. Again, these provisions will allow new, innovative players to offer more environmentally friendly and efficient ways of managing wastewater.

34. Further work is needed to develop the proposed reforms but we support their introduction in line with the recommendations of the independent review conducted by Professor Martin Cave in 2009.

35. Our own work with the OFT¹⁸ identified a range of barriers in the market for sludge treatment and disposal and noted that greater market forces could drive significant benefits and cost reduction, both through competition between existing companies and from new players.

Continued environmental protection

36. Some stakeholders have raised concerns that increased competition may undermine the existing arrangements in place to protect the environment and ensure safe drinking water. Clearly, as with any reform, there are risks to be managed—but we do not consider that the provisions in the Bill have this effect at all.

37. All quality and environmental standards will remain in place and will continue to be policed by the Drinking Water Inspectorate and the Environment Agency. These obligations will extend to all players including any new entrants—just as they do now under existing arrangements. And, while safeguard measures remain in place to ensure environmental and quality standards, the provisions of the Bill are designed to free up existing and new players to deliver those standards in new, innovative and sustainable ways.

GOOD FOR GROWTH

More flexible company structures

38. The Bill proposes a new and more proportionate approach to assessing mergers of water companies. The new "two stage" approach will allow a sensible first assessment of a merger, its potential benefits and detriment, and any potential actions that would enable the merger to proceed without the full burden of a Competition Commission referral. We support this approach.

¹⁵ "Harnessing upstream water markets: what's to play for?" Ofwat, March 2010, and "A study on potential benefits of upstream markets in the water sector in England and Wales", Ofwat, March 2010. See: http://www.ofwat.gov.uk/competition/review/prs_web_1003up.

¹⁶ The Water Resources in the South East Group is a group of water companies and others seeking to share new and existing water resources in the most efficient and effective way to maintain security of supply, protect the environment and minimise costs to customers. It undertook joint research to build a least cost optimisation model, which suggested that some £500 million of savings could be achieved in the South East through greater interconnection and trading of water.

¹⁷ Using a gross value added per employee of about £42,000 a year (taken from "United Kingdom National Accounts—the Blue Book 2012", Office for National Statistics, 2012, <http://www.ons.gov.uk/ons/rel/naa1-rd/united-kingdom-national-accounts/the-blue-book—2012-edition/united-kingdom-national-accounts—blue-book—2012-edition.pdf>) gives a result of more than 46,000 job years.

¹⁸ See: www.ofwat.gov.uk/OFTwork/markets-work/organic-waste/.

39. In the Water White Paper the UK Government also suggested that it is “minded to” raise the threshold of the special merger regime in the sector. This provision is not in the draft Bill. Defra has since issued a call for evidence on this and our evidence is available¹⁹. In summary, we do not support this proposal and do not believe it will be in customers’ interests.

40. But we recognise that, as the other reforms in the Bill come into effect, and where customers have true choice of supplier, the merger regime could indeed be relaxed, providing significantly greater corporate freedom for companies to merge and allowing beneficial mergers to proceed easily and at low cost.

41. This could drive benefits to customers who would see better performing companies increasing their market share. It would also benefit companies that wished to exit the retail market by selling their retail business to concentrate on their wholesale business.

42. To achieve these benefits, and to give companies the freedom to choose their corporate strategy, the Bill would require an additional provision to allow companies to have separate retail and wholesale licences if they wished. This would improve flexibility, allow a retail market to work effectively by allowing both entry and exit and deliver real choice to customers. Significant savings could be delivered through mergers and consolidation in retailing.²⁰ This would benefit both retail companies and the customers they serve. We would be happy to provide further briefing on these issues if required.

Less burdensome regulation

43. The Bill’s proposed approach will allow us to reduce the regulatory burden, while improving the level of customer protection.

44. Specifically, clause 14 removes our requirement to approve companies’ charges schemes and replaces it with a set of rules that those schemes must comply with. This removes the unnecessary burden of approving all individual charges, while ensuring appropriate customer protection through adherence to principles. Appropriate targeted regulatory action can be taken if there are any breaches of those principles.

45. We also suggest that the legislation includes measures to introduce a process and legal procedure for amending companies’ licences by collective consent. As legislation and regulation continue to evolve to address changes in the sector, the requirements imposed on licensed companies will also need to evolve. This process would preserve the rights of companies and their investors to appeal any proposed licence changes while also making sure that there was an appropriate forum for collectively discussing licence amendments with the whole industry—as is common in other regulated industries.

Sustainable investment

46. The Bill is evolutionary in its approach. This is necessary to maintain the confidence of investors who have provided high levels of investment in the sector at low cost of capital over the past decades. To continue to attract a low cost of finance, we need to maintain that stability and transparency of the regulatory framework.

47. There are calls to elevate Ofwat’s existing sustainability duty to a primary duty. We remain unconvinced of the necessity of this and see a risk of creating the perception of instability in the regulatory framework among investors if there is a change in our primary duties.

48. Our existing duties allow us to play our full role in promoting sustainability in its fullest and balanced sense—environmental, economic and social. They are reflected in our strategy for “sustainable water”.

CONCLUSION

49. Ofwat supports the proposals in the draft Water Bill and consider them necessary and workable. We have suggested some further measures that we consider would enhance the existing provisions and increase the benefits to customers and the economy.

50. Our future price limits work is putting in place a regulatory framework that would complement the changes set out in this draft Bill and make sure that the regulatory framework supports the UK Government’s ambitions.

¹⁹ See: www.ofwat.gov.uk/publications/ofwatsubmissions/res_ofw201209ukgspecialmerger.pdf.

²⁰ Ofwat’s relative efficiency assessments also show the potential benefits of retail mergers. These suggest that retail mergers would be expected to reduce the operating costs of the acquired company by 12% (and this would be an on-going saving). Applying this saving conservatively to the 7–11 smallest companies’ retail operations (based on an independent report provided by Stephen Littlechild into the level of minimum efficient scale in energy—see “Smaller suppliers in the UK domestic electricity market: Experience, concerns and policy recommendations”, Electricity Policy Research Group, 2005, page 19, <http://www.eprg.group.cam.ac.uk/wp-content/uploads/2008/11/littlechildsuppliers.pdf>) would suggest further potential on-going savings of £50–£210 million for customers.

51. This Bill will mean that we and others can go further in reducing regulatory burdens, promoting innovation and investment, giving choice and better service to customers and enabling more efficient use of scarce water resources.

October 2012

Supplementary written evidence submitted by Ofwat

Thank you for your letter dated 7 November 2012 requesting the following further information after Ofwat's oral evidence session with the Committee on 30 October. As promised, I have enclosed a note on the various appeals mechanisms that exist within the sector and how, if at all, these will be affected by the draft Bill.²¹

1. Do you agree with the Consumer Council for Water that the complaints systems should be streamlined, with CCWater playing a greater role (Q53)?

We are very pleased that, through working with CCWater, the system for answering enquiries and handling complaints from water customers has been streamlined. Under an agreement with CCWater, Ofwat directs all first time enquiries and complaints to CCWater as a "one stop shop" for customers. Under our agreement CCWater will share the data it gathers from these complaints so that we can use this rich source of customer information to help inform how we develop and implement our regulation. This is working well.

A second area where we believe service to water customers could be improved is in the provision of more formal redress systems. This is where a customer complaint has not been adequately dealt with and the customer wishes to seek a formal resolution. Currently there are many areas where there is no such recourse for water customers. For example, in other sectors, if a customer has been mistakenly billed, they can seek retrospective redress over a six-year period under the Consumer Protection Regulations. These do not apply in the water sector. And there are some customer disputes where Ofwat has a formal dispute resolution role—for example, in the case of a refusal to install a meter.

Given wider changes in the consumer landscape in the UK and developments at a European level on redress systems for consumers, we consider that it is timely to look at whether water customers could be better served. We are exploring this with all interested parties including CCWater and will shortly publish a discussion document on the issues.

In the meantime, we will continue to exercise our formal dispute resolution powers in line with our duties to protect customers.

2. Do you agree with CCWater that Ofwat must ensure that the benefits of mergers are shared with customers, rather than being kept exclusively for shareholders (Q54)? If so, how do you propose to give effect to this?

The special merger regime in the water sector provides for mergers of water companies to be examined by the competition authorities (the OFT and the Competition Commission), not Ofwat. Where a merger is permitted, Ofwat has no power to require any company to share the benefits (if any) of that merger with customers immediately. Companies may volunteer commitments to the Competition Commission to share benefits of mergers with customers but the Competition Commission has limited powers to require such commitments.

The proposal in the draft Water Bill to introduce a two-stage process for water mergers is a very welcome proposal that will help address this. Under the new provisions, rather than all mergers being automatically referred to the Competition Commission, the competition authority (currently the OFT) would be able to assess the merger in the first instance and, if appropriate accept commitments from the merging companies in lieu of a referral to the Competition Commission. This will place a much greater incentive on the companies to offer to share merger benefits with customers and will enable the competition authority to ensure these benefits are shared immediately with customers. We strongly support this development.

In the meantime, under the current and any future merger regime, where mergers deliver cost savings, Ofwat will continue to ensure that these cost savings are passed on to consumers at the first possible opportunity—that being when we next set price limits.

3. Evidence from the Water Industry Commission for Scotland was submitted to the Committee following the evidence session on 30 October. What is your response to the arguments made in this evidence about the potential for upstream reforms to lead to regional de-averaging of prices? (Qs 65, 112, 128 and 129 are relevant)

At present, water and sewerage customers usually pay the same prices within an appointed company's area, even if the costs of serving them are very different. For example, costs in rural areas could be higher, because the treatment works are smaller and (or) the water mains and sewers are longer than in urban areas.

²¹ Not printed

As I said in answer to question 129, there is no need for a change in the approach of charging domestic customers a geographically averaged price as a result of the Water Bill reforms. Indeed, this issue was explored in a paper we published in 2010²² by Professor George Yarrow of the Regulatory Policy Institute in Oxford, who wrote:

“So long as transportation of the relevant commodity remains a regulated monopoly, there is no reason to think that the introduction of competition into other activities undertaken in a sector will give rise to any immediate and direct pressures for a major change in the geographic pattern of pricing.”

So while the draft Water Bill allows for entry in the bulk and local distribution systems, the distribution network will remain regulated. This will allow us to protect both household and non-household customers from large price changes, if this is the right thing to do.

There is clearly an argument for giving non-household customers, particularly heavy users of water and sewerage services, cost-reflective price signals, so that they make efficient decisions—for example, on where to locate. In developing market reform, in line with our duties we must consider economic efficiency but also the effect on different classes of customer and specifically those in rural areas.

The concern that WICS raises about increased supply or reduced demand having the potential to make existing capacity redundant exists now, both in England and certainly in Scotland. Indeed, section 29E of the Water Industry (Scotland) Act 2002 (the Act) as inserted by section 21 of the Water Services etc. (Scotland) Act 2005, allows any customer that can demonstrate they have reduced wholesale cost to apply for and receive a discount on their wholesale price. And the potential for a competition law challenge exists at present.

So, it is not necessary for upstream competition to be introduced in England for this challenge to be faced in Scotland—it is faced now by virtue of the effect of retail competition. Despite this challenge, retail market reform in Scotland has been beneficial overall, as WICS evidenced in their 2011–12 annual report.²³ Indeed, the example of the rural dairy industry reducing its use of trade waste services and hence its costs is one of the ways Business Stream and its competitors have been helping customers in Scotland.

Scottish Water may not be able to reduce its costs immediately in line with the loss of revenue, but over time it will need less new capacity, or even be able to abandon existing capacity, and save the on-going operating and maintenance costs. Similar arguments apply to upstream entrants providing additional supply. There may also be environmental benefits of reducing consumption—for example, because of abstracting less water from the environment.

I hope these responses adequately address the Committee’s questions. As ever, should this not be the case, or should you require any further assistance please do not hesitate to contact me.

November 2012

**Supplementary written evidence submitted by Robert Leask Senior Portfolio Manager, Utilities,
Scottish Government Procurement Division**

REF: ORAL EVIDENCE, TUESDAY 30 OCTOBER 2012

I write with reference to my appearance before the Committee on 30 October 2012.

The Committee requested that I write to confirm details of the facts and figures related to the benefits of water competition to the Scottish Public Sector. I have duly recorded these below.

Metrics

- £73 million pa spend (Approx 20% retail market).
- 99% of public sector volumes on the contract (< two months).
- 180 + participating bodies across 15,300 sites.
- Contract management process delivering customer led improvement.

FINANCIAL SAVINGS

	<i>Previous Contract</i>	<i>Year 1</i>	<i>Year 2 (Estimated)</i>	<i>Year 3 (Estimated)</i>
HEFE	-£323,116	-£665,737	-£991,300	-£1,210,159
Central Gov	-£125,357	-£368,293	-£548,399	-£669,474
NHS	-£237,479	-£1,059,086	-£1,577,006	-£1,925,176
LAs	-£706,512	-£3,078,048	-£4,583,295	-£5,595,191
Grand Total	-£1,392,463	-£5,171,164	-£7,700,000	-£9,400,000

²² http://www.ofwat.gov.uk/competition/rpt_com_201004rpi/markets.pdf (see page 38 onwards)

²³ [http://www.watercommission.co.uk/UserFiles/Documents/WICS_AnnualReport_26May%20\(3\).pdf](http://www.watercommission.co.uk/UserFiles/Documents/WICS_AnnualReport_26May%20(3).pdf)

ADDITIONAL SAVINGS & BENEFITS

	<i>Financial</i>	<i>Water</i>
Efficiency Savings	£ 2,234,769	1,117,385,000 litres
Further Identified Savings	£1,692,250	910,986,000 Litres
AMR Savings	£700,000	
Total	£4,627,019	2,028,371,000 Litres

- 3000 Free AMR devices.
- Reduction in AMR charges for remaining supply points > 40%.
- Avoidance of 63 OJEU tender exercises.
- Improved service levels (customer satisfaction ratings >90%).
- Efficiency savings from e-billing.

Sustainability benefits from the contract include

- Free Automatic Meter Reading technology valued at £3 million.
- Leak detection and repair.
- Free Benchmarking.
- Free Tariff Optimisation.
- Free Water audit.
- Water Saving devices.
- Waste minimisation advice.
- Field based Functional and metering experts.
- Free Trade Effluent Advice.
- Free Carbon labelling.

A further 10% saving on additional services via a bespoke rate card was also achieved, together with efficiency savings from e-billing and online data management and management information. Additional services include:

- Water efficiency surveys and audits.
- Groundwater (borehole) desktop study.
- Grey-water and rainwater recycling.
- Ground radar & utility Surveys.
- Mains location and mapping.
- Flow and pressure testing.
- Water & drainage impact assessment.
- Diverting and laying mains and sewers.
- Trade effluent survey/waste minimisation audit.

November 2012

Written evidence submitted by Severn Trent Water
SUMMARY OF OUR POSITION

1. Severn Trent strongly supports plans to reform the water industry and welcomes the publication of the draft Water Bill. We are particularly supportive of:

- Plans to increase retail competition to the water sector. The Severn Trent Costain joint venture has been established to enable us to compete in this anticipated market.
- The promotion of water trading between regional water companies (which we have been advocating for some time). This will enhance national resilience and reduce costs for customers.
- The introduction of effective upstream competition to the water sector. This will promote more efficient use of water.
- The proposed reform of the mergers and acquisitions regime for water companies. This should help to promote a more efficient water industry structure.

2. The primary policy areas in which we would encourage further consideration are as follows:

- Encouraging a greater level of non-household retail competition by giving incumbent suppliers an option to efficiently compete in other incumbents' regions by being able to voluntarily separate their retail and wholesale functions (see row 6 of the table below). Without this option, they will face the complexity and bureaucracy of setting up separate legal entities.

- Balancing the proposed extension of Ofwat's enforcement powers with an efficient appeals mechanism (see paragraph 9).
- Encouraging increased generation of low carbon energy as a by-product of sewage treatment processes. Severn Trent Water already self-generates almost one-quarter of our energy using a process known as anaerobic digestion, but we could do more if the regulatory barriers were removed. (see paragraphs 10 and 11).

3. We note that a strong characteristic draft Bill is that it relies heavily on ministers issuing guidance in the future to for how they want specific measures to be interpreted. The risk of this approach is that it can lead to uncertainty; the benefit is that it maintains flexibility. On balance we think the benefits outweigh the risks as long as there is appropriate consultation on future guidance.

QUESTIONS POSED BY THE COMMITTEE

4. This submission seeks to answer the three questions posed by the committee in its call for evidence, that is:

- Are the powers contained in the draft Bill sufficient to achieve the policy aims set out in the Water White Paper?
- Are the draft Bill's proposals necessary, workable, efficient and clear?
- Are there any omissions from the draft Bill, for example in relation to managing the financial risk and impact of flooding?

5. The table below addresses the first of these two questions. It lists the key policy areas set out in the White Paper, assesses the draft Bill's effectiveness in fulfilling these objectives and, where appropriate, makes recommendations how the Bill could be enhanced.

6. We then address the committee's third question about omissions from the draft Bill.

Questions One and Two: Does the draft Water Bill deliver the policy objectives of the Water White Paper?

7. The table below summarises our assessment of the extent to which the Bill delivers the key policy ambitions set out in the Water White Paper.

<i>White Paper policy objectives</i>		<i>Good for customers?</i>	<i>Bill powers sufficient?</i>	<i>Proposals necessary, workable, efficient and clear?</i>	<i>Recommendations</i>
1	Water (interconnectivity between water companies)	trading Yes	Yes	Yes	N/A
2	Capital market competition (reforming the special mergers regime)	Yes	Yes—if ministerial guidance to Ofwat follows	This depends on the content of subsequent ministerial guidance.	<i>Ministers should commit to publishing draft guidance to Ofwat to coincide with the introduction of legislation. We propose two options. Option A would be to scrap the special regime and to rely on normal merger and competition controls. Option B would be to incorporate the special controls into the overarching guidance issued by the Competition and Markets Authority, as has been done with other sectors (such as rail). This guidance should also set a clear value on “comparative competition”.</i>
3	Unbundling the WSL licence so that new water supply entrants are obliged to provide retail services.	combined Yes	Yes	Yes	N/A
4	Extending access to new operators to incumbent’s treatment and storage systems rather than just the mains and pipes.	Generally yes—but there is a risk some users will end up paying more.	Yes—but	Yes	<i>First, the Government should consider whether it really wants to encourage regional de-averaging of prices, which would be the result of the Bill in its current form. Some customers would benefit, but many would face higher bills. Second, legislation should make it clear incumbents can connect to new entrants’ infrastructure.</i>

5	<i>White Paper policy objectives</i>	<i>Good for customers?</i>	<i>Bill powers sufficient?</i>	<i>Proposals necessary, workable, efficient and clear?</i>	<i>Recommendations</i>
	Allowing new entrants to own and operate their own infrastructure (mains, pipes, storage and treatment) connected to the incumbent's network.	Yes	Yes	Yes	<i>Minimum standards for connection need to be reviewed and made clear. These standards should be comparable to those faced by incumbents.</i>
	Introducing non-domestic retail competition	Yes	Partially	Retail competition will be hindered by, as things stand, the 21 incumbent water companies being unable to provide non-household retail services in other incumbents' regions. To take advantage of the market, they will have to set up separate companies at arms length to their core business. The retail model in Scotland is more workable as it allows legal separation of the contestable non-household retail arm.	<i>Regional incumbent suppliers should have the option to separate their retail and wholesale functions so they can compete efficiently for non-household retail business in other incumbents' regions (that is, Option 4 of the choices considered by the government should be adopted)</i>
	Removing "costs principle"	Yes	Yes—subject to further guidance	Yes, but the extent depends on the guidance that is published.	<i>Ofwat should be obliged to set a date by which it will publish draft guidelines and to confirm that it will consult widely, including with the Competition and Markets Authority, before this guidance comes into force.</i>
	Creation of Anglo-Scottish market	Yes—in principle	Probably	Ofwat and WICS have different powers—WICS does not have Competition Act powers, for example. The risk is that companies could seek lowest common denominator regulation; the upside is that it could encourage regulatory innovation. On balance, we believe the benefits outweigh the risks.	<i>Ministers should set out basic "core standards" for both regulators.</i>

Question three: omissions from the draft Bill

8. There are four areas in which we believe the draft Water Bill could be strengthened further. These are set out below.

Balancing Ofwat's enforcement powers

9. The draft Bill makes provisions to extend Ofwat's enforcement powers. This includes additional powers to request information in the event of suspected Guaranteed Standards of Service non-compliance and an extension of Ofwat's powers to take action for retrospective licence contraventions from 12 months to five years. We are not opposed to this extension, subject to three safeguards:

- The development of an appropriate appeals mechanism. Currently, if a company is aggrieved with a penalty, it may make an application to the High Court under the Water Industry Act 1991 (WIA). The grounds on which a company can make an appeal are limited, either (i) the imposition of the penalty was not in the power of the authority, (ii) where the authority has not complied with section 22A WIA or (iii) that it was unreasonable of the authority to require the penalty to be paid by the date set. Other than these grounds, the WIA specifically states the validity of a penalty will not be questioned by any legal proceedings whatever. This position is unsustainable with an increase in Ofwat's powers. We consider that the Competition Appeal Tribunal (CAT) is better placed to consider enforcement action and penalties imposed by sector regulators. Together with competition law and merger reviews, the CAT already reviews decisions made by OFCOM and/or the Secretary of State in certain circumstances. We also believe that the grounds of appeal should be reviewed, for example, to consider whether the penalties are fair and proportionate (in accordance with the newly published guidance of the OFT)."
- Confirmation that current standards (and interpretations of standards) will not be imposed retrospectively. The new time limit would only apply to contraventions occurring after the clause has come into force; the same principle should apply the standards used to judge any alleged contravention are those that were in force at the time of the suggested infringement.
- When using its extended powers, Ofwat should take a proportionate approach and seek to minimise the burden of bureaucracy for regulated companies in line with the Government's "Reducing Regulation Made Simple" December 2010 policy document.

New connection charges

10. The Bill introduces changes as to what charges are imposed for new connections to the water and waste water systems (clauses 15–17), changes that will be set out in Ofwat "Charging Rules" at a later date. In our response to the Ofwat Consultation re: Charges for New Connections, we highlighted problems relating to the current charging mechanism, made worse by an absence of any clear guidance from Ofwat. This leaves both undertakers and developers in a difficult position. We therefore very much welcome the proposed changes. However, given the current difficulties faced by the industry in this area we would welcome clearer timelines in the Bill as to when Ofwat will be required to publish such Charging Rules.

Anaerobic digestion

11. As well as introducing market reform, the Government should progress other parts of its already announced reform agenda. The promotion of Anaerobic digestion should be a priority.

12. There is scope to increase anaerobic digestion, a process that generates energy from sewage sludge, reducing customers' bills and the water industry's carbon footprint. Severn Trent Water already self-generates about a quarter of our energy needs, principally through anaerobic digestion. We could do significantly more, however, if the Government accepted the recommendations of the Office of Fair Trading following its 2011 review of the market for treating organic waste. The Government should consider whether it would be appropriate to use the Bill to implement these recommendations.

Sustainable Urban Drainage Schemes

13. Sustainable Urban Drainage Schemes (SuDs) have the potential reduce the risk of flooding, improve water quality and enhance our physical environment. Pushing ahead with implementation of the Flood and Water Management Act, and particularly the provisions relating to Sustainable Urban Drainage Schemes (SuDs), should be a priority.

Written evidence submitted by SSE plc (formerly Scottish and Southern Energy plc)

ABOUT SSE WATER

1. SSE Water Ltd (SSEW)—a wholly owned subsidiary of SSE one of the UK’s largest energy companies—is one of the largest new entrants in the water market. It installs, owns and operates water infrastructure and has been appointed to supply water and/or sewerage services to over 17,000 new properties across England and Wales. It is actively involved in, and at the forefront of, the developing competitive framework in the water industry.

2. SSEW became the first new water and sewerage service provider in England and Wales since the privatisation of the industry in autumn 2007 when it was appointed as the water provider to a new housing development and replaced the incumbent water company for the geographic area of the site concerned—sometimes known as an “inset” appointment. Since then SSEW has been seeking to develop its business by pursuing further inset appointments for new developments in England and Wales. Inset appointments of this kind are currently the only existing viable route to providing competition in the market.

SUMMARY

3. SSEW welcomes the legislation’s focus on market reform. It welcomes the introduction of statutory market codes and the increase in transparency that this will bring, along with the proper flexibility for these to develop over time to correct inconsistencies, deal with unforeseen consequences and cater for developments in the market.

4. This welcome is tempered by some uncertainty on how the untried licensing regime, as developed in the draft Bill, will co-exist with the inset regime that SSEW currently uses to develop its competitive business in the water market.

5. One area where SSEW has experienced barriers to date concerns connection charges by incumbent water companies to new housing developments. The powers given to Ofwat in the draft Bill may be sufficient to address these but, in case greater certainty of outcome can be established by additions to the draft Bill, the background to this perceived barrier is set out in some detail below, along with some further commentary on the provisions of the draft Bill in relation to the policy aims in the White Paper.

Discussion on wholesale charges for new entrants to the water market

6. SSEW’s main interest in the reforms set out in the draft Bill concerns the provisions made for the continuation and enhancement of the inset regime that it currently uses as new entrants in the water market. It recognises that the draft Bill has addressed the continuation of this framework as well as providing a new parallel route for companies interested in providing water and sewerage infrastructure for new developments. The new route extends the existing water supply licensing regime to include authorisations whereby licensees can provide local water and sewerage infrastructure. It is stated in paragraph 63 of the discussion preceding the draft bill wording as being intended to “completely replace the inset regime” for new developments in due course. It therefore appears that the two regimes will have to co-exist; this being the case, it would be sensible to ensure that wholesale charging frameworks work in the same way for both approaches to competition in providing local infrastructure.

7. SSEW supported the proposals in the White Paper for the introduction of transparent market codes to determine the rights and responsibilities of all market participants in relevant market processes and to establish a transparent wholesale access pricing regime. It therefore welcomes the provisions in the draft Bill which give Ofwat a range of powers, together with some duties, to develop such statutory market codes covering different aspects of the commercial interactions in the market. SSEW agrees that the flexibility necessary to allow market processes to develop is better served by establishing regulatory ownership of the codes rather than seeking to set these out on the face of the legislation.

8. The draft Bill provides Ofwat with a range of powers to develop rules for charging, as follows:
- charging rules for bulk supply agreements between undertakers (clause 8);
 - charging rules for main connection into sewerage system agreements between undertakers (clause 9);
 - rules for charges by undertakers for connection to and reinforcement of existing systems of the undertaker (clause 15); and
 - rules for charges by undertakers to licensees under supply and sewerage licensing arrangements (schedules 2 and 4 respectively).

9. As the draft legislation currently stands, Ofwat has the power to determine how charging rules will work for the inset framework, where clauses 8 and 9 apply. On the other hand, it has a duty to do so under schedules 2 and 4, which apply to the licensing framework. At this stage, therefore, there is some uncertainty for inset developers like SSEW on how a level playing field will be ensured between the wholesale charges applying to inset appointees compared to new supply licensees as these are covered under two different sets of rules.

10. Both inset appointees and licensed suppliers seeking to provide their own infrastructure at a new development need to seek terms for connection from the incumbent water company. The White Paper set out the intention of supporting developers (paragraphs 5.64–68) by clarifying how such connections should be charged for and also by introducing charging schemes to streamline the inset regime. Clause 15 of the draft Bill does bring in a duty for Ofwat to issue rules about connection-related charges to developers and other occupiers of premises that are qualifying persons under sections 41 and 98 of the existing Act. However, it is not clear that such charges would have to be offered in a consistent way to either inset appointees or water licensees—where both are providing local infrastructure in competition with the host water company.

11. This point may be capable of being clarified in the various charging codes that Ofwat has duties and/or powers to introduce but it would be helpful if the point was unambiguously made in the legislation. Doing so would remove a barrier that SSEW has found within the present framework and raised in previous submissions to the Committee—whereby water companies can offer more favourable terms to developers seeking connection directly from them under sections 41/98 compared to the bulk terms they offer to an inset appointee. It would thus also align with the policy aim set out in the White Paper (paragraph 5.41) of reducing the risk of discriminatory pricing.

12. SSEW would make one final point on the legislative proposals in the draft Bill. The framework for the water service licensing clearly sets out different separate authorisations for different types of retail and infrastructure-related activity. This factor, when coupled with the existing provisions (sections 17G-R) for setting and modifying standard licence conditions, will provide transparency, standardisation and flexibility in the obligations of licensees undertaking different logical types of activity in the supply chain of services to customers. This contrasts with the continuing lack of separation of the activity and framework of conditions covering incumbent water companies, even where they are undertaking similar, contestable activities to those that licensees are authorised to carry out. SSEW believes it will be harder for Ofwat, in the absence of similar separation of activities within incumbents, to develop rules and instigate the required change in culture within incumbent water companies that recognise the need to deal on a fair and non-discriminatory basis with companies who are competitors in downstream activities.

September 2012

Written evidence submitted by Water UK

1. Water UK represents the major water and wastewater suppliers in the UK at national and European level. We are happy to share our observations on the draft Bill in this written submission to the Committee's pre-legislative scrutiny of the draft legislation.

2. Some individual companies will also be giving their own written evidence to the Committee.

3. Before turning to the specific questions raised by the Committee, we would like to make some overall observations about maintaining investor confidence and resilience.

4. As the water industry depends on sustained investment, maintaining the confidence of investors has been fundamental to its success over the last twenty years—and the key to this has been the Regulatory Asset Base (RAB) model.

5. The RAB model is based on transparent, predictable and consistent regulation, reducing risk to investors and hence cost to customers. This approach to financing the industry works well, and does so in the public interest—indeed the Government now wishes to extend to the RAB model to other sectors.

6. The confidence this model has given investors has allowed the industry to invest over £90 billion in maintaining and improving services to customers, while keeping bills as low as they can be.

7. Without the confidence that the RAB model has generated, investment would either not have happened, or would have cost customers much more.

8. In deciding whether, and how, to take forward proposals in the draft Water Bill, the Government will wish to be confident that neither its actions, nor those of other stakeholders, undermine the success of the RAB model.

9. Resilience was a major theme of the Water White Paper, which recognised that the water and wastewater sectors provide infrastructure of national importance. The supporting National Infrastructure Plan also correctly predicted that population growth and a changing climate would increase the pressure on water supplies. The Government committed to take a strategic overview of the capacity of water and wastewater infrastructure, and the robustness of the sector's plans for future service delivery. However, the resilience elements of the White paper are absent from the draft Bill. We have significant concerns that the fundamental thread of resilience, central to customers' needs and expectations, could be lost under the changes suggested in the draft Bill.

Question 1. *Are the powers contained in the draft Bill sufficient to achieve the policy aims set out in the Water White Paper?*

10. Water UK broadly supports the policy aims set out in the Water White Paper “Water for Life” which was published in December 2011.

11. There is much in the White Paper that does not require legislation and we are working constructively with Government to take things forward. For example, many members are working with Defra on its long-term abstraction reform programme. We have been involved in assessing proposals for research projects and sit on Defra’s Abstraction Reform Advisory Group. We have had many constructive meetings with Defra officials to consider catchment management as a method of increasing water quality.

12. However, there are key elements of the White Paper that do require new legislation, notably market reform.

13. Water UK supports giving choice to business customers and water companies are committed to delivering more and better services to their business customers. We are pleased that the draft Bill contains powers to achieve this policy aim of the Water White Paper, but it will be important to ensure that benefits for business customers are not at the cost of others.

14. We are also pleased that Defra has taken an inclusive approach to developing a roadmap for market reform, and to testing whether April 2017 is an achievable date for retail market opening, by establishing a High Level Group, with representation from Governments, regulators, and market participants.

15. There is much work to be done to get things right for customers—both those who will benefit from a choice of supplier and those who will continue to be supplied as at present. The industry is committed to being an active partner in delivering choice to business customers, drawing on our experience of market opening in Scotland.

Question 2. *Are the draft Bill’s proposals necessary, workable, efficient and clear?*

16. Much of the substance of the draft Bill’s proposals will lie in codes, guidance, rules and regulations. This makes it difficult to know at this stage whether the proposals will be workable and efficient, or whether they will have unintended consequences, such as undermining investor confidence or increasing costs to some or all customers.

17. The codes, regulations, rules and guidance which will determine the substantive impact of the draft Bill will be produced by Defra and the independent economic regulator, Ofwat. The Committee may be concerned that Parliament has not been given a sufficient role in determining the detail of the proposals. This is in contrast to the approach previously taken when key matters such as access pricing were subject to parliamentary scrutiny.

18. There are areas where the impact of the draft Bill is unclear, including charging policy, where the draft Bill may have the unintended consequence of undermining the principle of regionally averaged charges, leading over time to significant changes in customers’ bills.

19. In addition, it is not clear whether the draft Bill will allow the Government to adopt a phased approach to the opening of new markets, should it decide that this would be an appropriate way to manage execution risks.

20. The Bill as it stands would give Ofwat sweeping powers to make changes to companies’ licences where it views them as necessary or expedient. We question whether this is compatible with maintaining investor confidence, when the certainty provided by companies’ licences allows them to raise long term finance at competitive rates to fund investment while keeping bills as low as possible

21. Companies’ licences are a key component of the stability and transparency so valued by investors and the proposal gives rise to two separate concerns. First, companies would be concerned if changes could be made on mere “expediency” grounds given how much discretion such a power would confer on Ofwat. Further, the proposals would remove companies’ existing rights under the Water Industry Act 1991 to challenge proposed changes to their licences before the Competition Commission. The industry would therefore wish the draft Bill to allow only “necessary” changes and for any such proposed changes to be subject to scrutiny by the Competition Commission to ensure that they are in the public interest and are proportionate.

22. The draft Bill provides powers to extend the Environmental Permitting Regime (EPR), for example to water abstraction. The industry has considerable concerns about the way in which Environmental Permitting was implemented for the regulation of discharges and various challenges to the appropriateness of applying EPR to discharge activities remain outstanding. The industry would be concerned if the regime were to be extended to abstraction while the issues of principle in question remain unresolved. In any event we would hope that the consultation process prior to any such extension could be both more proactive and responsive than it was for waste water and that there should be an emphasis on outcomes-based regulation.

Question 3. *Are there any omissions from the draft Bill, for example in relation to managing the financial risk and impact of flooding.*

23. The primary responsibility of the water industry is to provide wholesome drinking water and safe sanitation in order to preserve public health. Yet there are no references to public health on the face of the draft Water Bill. The industry would prefer it if the draft Bill explicitly addressed the way in which the proposed reforms will be managed to ensure that the industry's overarching responsibility to public health is not compromised.

24. An area that is not covered in the draft Bill concerns measures to address the growing burden of bad debt. Bad debt costs every household customer—including those struggling to pay—£15 a year, and while companies work hard to manage debt, they have limited tools to do so.

25. While new tools would be welcome, a good start would be for the Government to implement the measures passed with cross-party support in the Flood and Water Management Act 2010, for landlords to provide water companies with information on who lives in rented properties.

26. Most debt is from the occupiers of rented properties—so this information would allow companies to help those who are struggling to pay, and pursue more effectively those who could pay, reducing the burden of debt for all customers.

27. Resilience was a major theme of the Water White Paper, which recognised that the water and wastewater sectors provide infrastructure of national importance, yet there is no mention of resilience in the draft Bill. The supporting National Infrastructure Plan also correctly predicted that population growth and a changing climate would increase the pressure on water supplies. Government committed to take a strategic overview of the quality and capacity of water and wastewater infrastructure, and the robustness of the sector's plans for future service delivery.

28. While we do not necessarily see a need for new legislation in this area, the extended drought across 2011 and 2012 has focussed attention and public debate on how to ensure that we continue to have a resilient water supply system.

29. Recent events have demonstrated clearly how well the current Drought Planning system worked in delivering a step-by-step approach to protecting the public water supply. They have also highlighted the vulnerabilities to unprecedented, extreme and unexpected long-term weather patterns, and how implementing Temporary Use Restrictions, Ordinary Drought Orders and Emergency Drought Orders to manage those events would severely impact communities and the economy—not just water bill payers.

30. The recent drought has shown the need for Government to take a strategic overview of the capacity of all water infrastructure, looking beyond each individual water company boundary and their water resource management planning. As many conversations with stakeholders and abstractors during and after the drought have shown, Government should review and set new base levels of water infrastructure resilience, so that citizens are unlikely to ever experience extreme Emergency Drought Order measures in their lifetime. This is likely to require an expansion of infrastructure of national importance.

31. Similarly, the existing assumptions for maintaining levels of service are built on past data and experience. Increasingly, the infrastructure is being tested by unprecedented events that could not have been foreseen by any party. Such infrastructure of national importance needs to be fit for a changing future.

32. We would welcome the Government playing a key role in ensuring the robustness of water infrastructure, by establishing a new national water resource resilience group (to continue the strong achievements of the National Drought Group) and by nominating a Government body to provide a strategic infrastructure overview across water companies, water critical sectors and water catchments. This strategic overview would meet the declaration of the water White Paper, and help inform Ministerial decisions on related infrastructure projects of national significance.

33. Finally, the draft Bill does nothing to address the anomaly that water companies are not statutory consultees in the planning process despite having statutory consultee status in relation to SUDS.

October 2012

Additional written evidence submitted by Water UK

1. Water UK represents the major water and wastewater suppliers in the UK at national and European level. We are pleased to have a further opportunity to share our observations, focussing on matters arising since our oral evidence at the Committee on 23 October 2012.

2. This submission focuses on two areas: Ofwat's consultation on licence modifications, and market reform.

OFWAT'S CONSULTATION ON LICENCE MODIFICATIONS

3. Over the last few months water companies have been working with Ofwat to consider changes to their individual licences in order to facilitate greater competition as envisaged by the Draft Water Bill.

4. Ofwat has now published new proposals for the companies' licences and companies have until 23 November 2012 to consider these.

5. Ofwat has described these proposals as "designed simply to allow the changes that we know are necessary to give effect to the Water White Paper, the Draft Bill ...". It has also described the proposals as "modest" and "evolutionary".

6. Ofwat however continues to seek considerable flexibility to change the form of regulation beyond that which is necessary for the period 2015—2020, covering the companies' investment programme and the level of charges they can levy on their customers.

7. If companies do not accept Ofwat's proposals then the regulator may choose to refer the matter to the Competition Commission for it to determine.

8. Companies are not seeking to keep their licences as they are now. They have agreed that licences could be changed immediately to make the changes necessary for retail market reform, a key element of the reform that is envisaged by the Draft Water Bill, and to have separate price controls for retail and wholesale services.

9. Wider changes to companies' licences, which do not need to be made now, should be considered in the future as, and when, further changes are made to the structure of the market. This would allow us all—the industry, Ofwat and others—to focus now on changes to licences that are needed for the next price review, avoiding unnecessary distractions and risks. This would give companies a secure basis to develop plans to meet long term challenges such as ensuring the resilience of water and sewerage services.

10. Ofwat has chosen to take a different approach to that proposed by the industry. Companies may not be able to reconcile the degree of flexibility that Ofwat is seeking to introduce in their licences. Companies will want to maintain investor confidence and the low cost of financing that the sector enjoys, which keeps customers' bills as low as possible.

11. The stable, predictable and transparent regulatory regime for the industry has underpinned £110 billion of investment at low borrowing costs since 1989. Changes to the regulatory regime need to be considered carefully and implemented in a proportionate and evolutionary way, minimising the impact on investors, financing costs and bills.

12. The Government's Water White Paper stressed the importance of stability to the industry and the Prime Minister and the Chancellor have highlighted the benefits of the water industry funding model.

13. The industry notes with concern the reaction of investors, analysts and commentators to Ofwat's proposed changes. The consensus view is that Ofwat's proposals increase uncertainty and risk and will increase financing costs.

14. Notably, Moody's have noted that "Continuing uncertainty around key features of their licences is credit negative for water and sewerage companies in England and Wales" and that "The degree of flexibility that Ofwat is seeking is surprising...". Moody's also note that "the credit profile of a company where 40% of revenue is subject to as yet undefined price controls and/or competition will be different to that of the rated water companies today".

15. The share prices of the publicly listed companies have fallen by between 5–10% since Ofwat's proposals were published, while the overall market has remained flat.

16. This clearly demonstrates the risk to the investor confidence in the sector that has benefited customers over the last two decades. Losing this confidence would result in a higher cost of capital, increasing customers' bills unnecessarily.

17. The weakening of the oversight of the actions of the independent economic regulator that is proposed by Ofwat is inappropriate. In establishing the legal framework for the water sector, Parliament provided that changes to companies' licences proposed by the independent economic regulator would be subject to scrutiny against a public interest test.

18. While appeals against price control determinations would still be possible under Ofwat's proposals, this would no longer be against a public interest test.

19. The proposals made by Ofwat would therefore allow very substantial changes to be made to the framework of regulation in the sector that has served customers well since privatisation, without such scrutiny.

20. Water UK notes that in its recently published draft Strategic Policy Statement to Ofwat, Defra re-emphasises the importance of a transparent and predictable regulatory regime and of maintaining investor confidence.

21. The statement provides direction that Ofwat should prioritise avoiding regulatory uncertainty wherever possible and take account of investor views on the impact on the existing regulatory framework of any proposals for reform.

22. The statement notes that the actions of Ofwat “should not anticipate or pre-empt policy decisions that are properly for Government to take” and re-emphasises the role of Ministers and Parliament in making changes to the fundamental structure of the water industry.

23. The statement emphasises the importance of through impact assessments, including evidence of costs and benefits, for substantive changes to the regulatory framework—which Ofwat’s proposals clearly are. To date, Ofwat has not provided an impact assessment of its proposals.

24. The Strategic Policy Statement clearly sets out the policy context within which the Ofwat’s proposals should be considered.

25. We invite the Committee to explore with the Minister what action he expects Ofwat to take as a result of this direction.

MARKET REFORM

26. Water UK fully supports giving choice to business customers and companies are committed to being an active partner in making this a reality, drawing on our experience of market opening in Scotland.

27. From the initial discussions of the High Level Group on market implementation, it is already clear that implementation will be a complex task, requiring substantial resources, sustained focus and commitment from all parties. It will also require a strong governance framework and agreed funding arrangements that are proportionate to the task.

28. We are determined to make progress, and the industry participants at the High Level Group will therefore be discussing the way forward at the group’s next meeting on 16 November to maximise the prospects of successful delivery of a competitive market in 2017.

29. The industry looks forward to working with other members of the High Level Group, and other stakeholders, to deliver choice and better services to business customers in a way that ensures that benefits for some business customers are not at the cost of others.

30. Part of this will be addressing the potential for charges to be de-averaged. Contrary to assertions by Ofwat that this is a myth, there is a real potential for charges for business customers to become de-averaged over time as the Draft Water Bill stands.

31. It is notable that this is one of the reasons why the Scottish Government took a different approach to introducing competition in the water sector to that proposed by the UK Government.

32. The potential for charges to become de-averaged arises because if another supplier was able to gain access to a water company’s assets at a de-averaged price, then, in order to remain competitive, the water company would have no choice but to de-average its own prices to business customers.

33. This would affect all business customers—including small and micro-businesses—and could be expected to result in prices in some rural areas increasing significantly.

34. So far as we are aware, this is not the Government’s intention, and we invite the Committee to explore this point with the Minister.

November 2012

Written evidence submitted by Wessex Water

Q1. Are the powers contained in the draft Bill sufficient to achieve the policy aims set out in the Water White Paper?

Metering

1. The effectiveness of the draft Bill in achieving more efficient use of water is severely limited by the absence of measures to accelerate household metering. Metering makes a very significant contribution to reduced water use.

2. We have recently completed the largest study of household metering since the early 1990s with 6,000 properties included. The study shows that fitting a meter when someone moves house reduces average consumption by 15% and peak consumption by 25%. Analysis of consumption patterns shows that much of this saving is achieved simply through better care being taken of water use, such as fixing dripping taps and overflowing toilet cisterns, as well as through reduced external use.

3. Households have been shown to be willing to accept metering at the point of moving into a property. Households tend to incorporate their new water charges as one part of much wider changes to their budget. And as most water use behaviour is driven by habit the new house gives them a good opportunity to change those habits and become more water efficient. This is a key reason why the water efficiency savings found in this study are higher than those seen under compulsory metering programmes to date.

4. The Bill should therefore take steps to change the default position for metering to one that assumes that meters will be installed free-of-charge when the occupier changes. Water companies would still be able to adopt different approaches to metering by exception where they are able to show that this new default approach would not be in the public interest in their own area of supply. This policy change would quickly reduce total household water demand but would also retain flexibility to deal with different localised circumstances.

Affordability

5. The effectiveness of the draft Bill in keeping bills affordable and protecting vulnerable customers is very limited. It is clear that social policy is a matter for Government and it is Government who has to choose whether it wants the costs to be met by other, paying, customers, or by taxpayers. We agree with the White Paper that water companies should have the primary responsibility for dealing with the practicalities of implementing water affordability issues, but they need to be given the tools by Government to achieve this. To ensure charges are affordable for all, water companies must be able to ensure that those who can pay, do pay, and to direct additional support to those who most need it.

6. Government should allow companies access to benefits data to allow assistance to be targeted efficiently and effectively and give landlords financial incentives to provide details of their tenants. Existing regulatory restrictions on water companies, such as the duty to supply and the ban on disconnection, make the recovery of debt more difficult than in other sectors. In this context new regulations on landlords are neither unduly burdensome nor intrusive, and would be valuable to help achieve the Government's objectives for affordable charges.

Q2. Are the draft Bill's proposals necessary, workable, efficient and clear?

Incentives for cross-border supplies

7. Measures to promote bulk supply trades by introducing a market code, charging rules and a model contract to govern these bulk supply arrangements are of limited value and unnecessary.

8. Instead Ofwat could do much more to promote more cross-border supplies without the need for legislation. It could de-regulate bulk supplies; it could increase the return to incentivise both the importer and exporter; and it could remove operational expenditure from comparative performance calculations.

9. In addition, where it is clear that an interconnection between two neighbouring companies would be economic or deliver an improved environmental outcome, then this infrastructure could be included in companies' plans and be funded at a price review. The issue of cross-border supplies may become more sensitive if there are big infrastructure proposals associated with them. Requiring a company to justify such interconnections in their business plan would ensure alternatives have been investigated and would also allow proper scrutiny by regulators.

Charges approval

10. We agree with proposals to remove Ofwat's duty to approve company charges. This is a positive step that will increase company accountability for their charges.

11. However, replacing this with a requirement for companies to comply with a set of published Ofwat charging principles—within which inevitable trade-offs and balances must be struck—will open companies up to challenge through the courts where individuals or groups of customers consider that the company has struck an inappropriate balance. The resulting rebalancing of charges will be a zero-sum game, with the groups with the deepest pockets most likely to win and others most likely to lose. We do not think this is appropriate.

12. We would instead recommend a return to the position prior to the 1999 Water Act, where there was no duty on Ofwat to approve charges, but with the addition of powers for the Secretary of State to give direct guidance (after due consultation) to water companies on charges. This would increase company accountability for charges while also allowing Government to give specific direction on policy issues, for instance to facilitate future proposals concerning social policy such as WaterSure.

Q3. Are there any omissions from the draft Bill, for example in relation to managing the financial risk and impact of flooding?

Restrictions

13. The recent drought has brought back into sharp relief the inappropriateness of hosepipe bans. Restrictions only reduce demand by a small amount and are accompanied by a significant loss of customer goodwill and industry legitimacy. Instead the same effect could be achieved through other measures, such as extensive cross-sector advertising to reduce demand. In our region a hosepipe ban would save 9ML/day but working with customers would save more than that.

14. Furthermore, the savings from a hosepipe ban are distributed across our region, while the environmental impacts are localised to particular rivers. During times of drought we are able to pump 90ML/day of water

into such rivers to support flows. This is ten times the amount that would be saved with a hosepipe ban. And the pumping can be targeted at the rivers most affected by any drought.

15. The Water Bill should enable licensing to become more flexible at times of drought without the need for water use restrictions to be imposed. More flexible licensing should apply in areas where river flows are healthy if companies are able to demonstrate that they are taking action to support river flows in more environmentally sensitive areas.

Drainage

16. The Water Bill is an ideal opportunity for the Government to reform drainage responsibilities in the UK. We are disappointed that the draft is quiet on this subject and does nothing to change the current disaggregated approach to the nation's drainage infrastructure.

17. Although the Flood & Water Management Act identified responsibilities that were previously unclear, it has not addressed the fundamental problems resulting from disjointed ownership, numerous funding mechanisms and multiple views of flood risk. The current arrangements continue to be a major hindrance in achieving sustainable drainage.

18. To overcome these problems, we advocate a catchment-based model for integrating ownership and responsibility for drainage assets. This would address the increasing inter-dependence between privatised sewerage companies, local authorities, internal drainage boards, riparian owners, land managers and the Environment Agency. Countries that are more progressive in this area restrict drainage responsibility to fewer parties.

19. Government should also promote greater upstream approaches to flood management, such as sustainable land management and permeable paving, and set clear policy on responsibilities for maintaining Sustainable Urban Drainage Systems.

20. Water companies should become statutory participants in the planning process. This would enable them to challenge proposals to build houses in flood prone areas and improve the viability and delivery of sustainable infrastructure. Extending and widening the scope of planning consultations can be linked with current proposals for sustainable drainage approvals by including measures for statutory consultation with water companies alongside sustainable drainage approvals. This will cover the most significant development proposals and improve consistency across functional responsibilities for water supply and foul drainage.

Market reform

21. We support many of the market reform proposals, in particular market opening for retail. This adds legitimacy to the sector in customers' eyes. The implementation of retail needs to be low risk and proceed on a sensible timetable. We should build on the lessons and systems from Scotland.

22. We believe that to facilitate a well-functioning market, provision should be made for existing companies to exit the contestable retail market. It is inevitable that some companies will choose to exit the market for retail services over the medium-term but under the current proposals a retailer must continue to offer services even if it does not wish to do so. The ability of inefficient providers to exit the market will bring forward the gains achieved through competition.

23. We also highlight the issue of criminal liability for supplying unwholesome water. With the proposed open access to distribution systems it is unclear how a contamination will be treated by the DWI. Currently, water companies are responsible for the quality of the water at their customers' taps. However, multiple licensed new entrants blur responsibility. Financial costs of failure can be allocated to a negligent party via contracts, but criminal liability cannot. The Water Bill must give clarity in this area.

24. Measures to reform the inset regime should be focused towards preventing the further splintering of the current regional provision of water services to domestic customers into small enclaves. We do not believe that the generality of customers benefits from the growth of micro-regional monopolies serving individual housing estates. To date the inset-regime has functioned largely through exploiting the arbitrage opportunities available through the regionally-averaged pricing structures when serving new housing. Measures in the draft Bill to ensure developers are paid for the network assets provided are helpful in this regard in that they help level the playing field between all players in the market. However, because this will result in a transfer of cost from developers to household sewerage bill payers it will put additional upward pressure on customer bills, which is at odds with the Government's affordability objectives. The Bill should instead remove the inset regime completely and allow the focus of market activity to be in the contestable retail sector.

Sustainable solutions

25. There are significant benefits from more sustainable, holistic solutions such as integrated catchment management, tackling pollution at source and an approach to water services rather than water supply that would engage people more deeply in the wider story of water and its management. We have significant first-hand experience of this over several years through our catchment management work, which has successfully limited nitrate and pesticide contamination of groundwater and reservoirs at several locations.

26. Pricing regimes need to incentivise these approaches and a supportive regulatory framework will be essential, with acceptance that sustainable solutions do not give the same certainty of outcome as asset-based solutions such as treatment plants. Government should give policy direction to regulators to ensure that these approaches are incentivised in the price setting regime and via greater flexibility in consents. This is essential if more innovative and lower energy treatment methods are to be given a fair opportunity to succeed. At the same time there is a risk that reliance on end of pipe treatment to deal with the next raft of quality standards, in particular for priority substances, will lead to significant increases in energy use and water bills.

September 2012

Supplementary written evidence submitted by Ofwat

Further to my appearance in front of the Environment, Food and Rural Affairs Select Committee you have asked that I provide further written evidence on specifically why we consider that our duty to contribute to sustainable development should not be elevated to a primary duty.

It is important for a sustainable water and sewerage sector that we balance customer, environmental and economic needs. Favouring one more than another will unbalance the sector and risk increasing bills, damaging the environment and wasting investment. Sustainable development is already embedded in all of our current and planned work. Indeed, the core vision of our strategy is:

“A sustainable water cycle in which we are able to meet our needs for water and sewerage services while enabling future generations to meet their own needs (“Sustainable water”)”.

For example, at the 2009 price review we allowed for 99.9% of the National Environment Programme to be funded through customers’ bills, while at the same time we were able to keep the average bill £34 lower than the companies wanted—improving the natural environment, while keeping bills down.

So we find it difficult to see that a change in our duties is necessary. Indeed, while our existing sustainable development is a “secondary” duty it is only “secondary” to the “primary” duties should there be conflict between the two. If there is no conflict, the secondary duty is equally binding on Ofwat as any of our primary duties. Furthermore, our existing consumer duty already applies to both current and future consumers. This supports the need for intergenerational fairness in our decisions—in line with the definition of sustainable development used by both Ofwat and the Sustainable Development Commission.

While we integrate sustainability into how we carry out our functions, it is necessary to recognise that economic regulators exist to perform specific functions that are generally economically focused. Ofwat’s primary duties therefore require us to balance keeping customers’ bills down and service quality at an acceptable standard while still making sure that efficient companies have enough money to fulfil their functions and deliver these essential services. We have some concerns that elevating the sustainable development duty to a “primary” duty could water down these core functions.

This was the reason why Ofgem’s duties were not expanded to take greater account of sustainability in the Utilities Act (2000). In the Lords stages of the Utilities Bill, Lord Ezra and a number of others, proposed adding the words “in the context of sustainable development” into Ofgem’s primary duty to protect the interests of consumers. This amendment was resisted and withdrawn because it was thought to “remove the priority afforded to the interests of consumers”.

Any elevation of our sustainability duty needs careful consideration as the elevation of the duty carries risks principally to the investment community. It is sensible therefore to first identify what changes Government wants to achieve by altering our duties—what is it that Government thinks Ofwat is not doing currently? Then we must be certain that elevating the duty will achieve those changes.

We have found it difficult to identify a single area where it is obviously the case that Ofwat would do things differently were the sustainable development duty elevated to a primary duty. And so elevating the duty may not produce the results that people want and it may be better to use the existing Social and Environmental Guidance that Government issues to Ofwat if there are some specific things that the Government wishes to see Ofwat doing more of. Indeed, this was also the conclusion of David Gray, a regulatory expert, who reviewed Ofwat’s duties in 2011–12 and recommended no changes to them.

The stability of the statutory duties of economic regulators is particularly important. They essentially define the objectives and purpose of the economic regulator. So those with an interest in the sectors will pay significant attention to any changes to them. This is particularly true for the investors, which provide more than £4 billion of much-needed capital in the sectors every year to maintain and upgrade the water and sewerage infrastructure—and so ensure the continued delivery of these essential services for customers and the environment. In an environment where competition for investment is strong and where the Government is keen to support growth, there is a risk that investors may view this change in a negative light and choose to put their money elsewhere.

Finally, the nature of sustainable development may require a broad balance between, for example, social, economic and environmental issues. Elevating this duty (in the absence of a clear understanding of what in fact needs to change) risks creating the perception that Ofwat’s scope has been significantly broadened. This

could create a situation where the regulator is expected to take decisions about much broader policy issues that may be considered more properly the role of Government. This risk has been highlighted in academic papers on the subject, which we would be happy to share with you.

If we can provide any more information in relation to our sustainability duty or any other issue in relation to the draft Water Bill, then please do not hesitate to contact me.

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