House of Commons

Committee of Public Accounts

Economic regulation of the water sector

Fifteenth Report of Session 2015–16

HC 505

House of Commons
Committee of Public Accounts

Economic regulation of the water sector

Fifteenth Report of Session 2015–16

Report, together with formal minutes relating to the report

Ordered by the House of Commons to be printed 16 December 2015

HC 505
Published on 13 January 2016
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine "the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit" (Standing Order No. 148).

Current membership

Meg Hillier (*Labour (Co-op), Hackney South and Shoreditch*) (Chair)

Mr Richard Bacon (*Conservative, South Norfolk*)

Harriett Baldwin (*Conservative, West Worcestershire*)

Deidre Brock (*Scottish National Party, Edinburgh North and Leith*)

Chris Evans (*Labour (Co-op), Islwyn*)

Rt Hon Caroline Flint (*Labour, Don Valley*)

Kevin Foster (*Conservative, Torbay*)

Mr Stewart Jackson (*Conservative, Peterborough*)

Nigel Mills (*Conservative, Amber Valley*)

David Mowat (*Conservative, Warrington South*)

Stephen Phillips (*Conservative, Sleaford and North Hykeham*)

Bridget Phillipson (*Labour, Houghton and Sunderland South*)

John Pugh (*Liberal Democrat, Southport*)

Karin Smyth (*Labour, Bristol South*)

Mrs Anne-Marie Trevelyan (*Conservative, Berwick-upon-Tweed*)

Powers

Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No. 148. These are available on the Internet via www.parliament.uk.

Publication

Committee reports are published on the Committee's website at www.parliament.uk/pac and by The Stationery Office by Order of the House.

Evidence relating to this report is published on the inquiry page of the Committee's website.

Committee staff

The current staff of the Committee are Stephen McGinness (Clerk), Mark Ewbank (Second Clerk), Claire Cozens (Committee Specialist), James McQuade and George James (Senior Committee Assistants), Sue Alexander and Ruby Radley (Committee Assistants) and Tim Bowden (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Committee of Public Accounts, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 4099; the Committee's email address is pubaccom@parliament.uk

Contents

Summary

The Water Services Regulation Authority's (Ofwat's) approach to setting price limits for water companies in England and Wales has not resulted in the best possible deal for customers. By consistently overestimating financing costs, Ofwat has allowed companies to make windfall gains which have not been shared in a structured way to ensure customers get a fair deal. Ofwat uses comparisons between water companies to help improve overall efficiency, but acknowledges that it should do more to benchmark companies' costs with other sectors and internationally, to ensure that the amounts customers are charged are minimised. Ofwat should also do more to promote water trading between companies instead of developing expensive new supplies.

Introduction

The water industry in England and Wales, privatised in 1989, now includes 18 large independent privately-owned companies who are monopoly suppliers to 22 million households and to most of the 2 million non-household customers. The Department for Environment, Food and Rural Affairs and the Welsh government set the policy and legislative framework for the water industry in England and Wales. Ofwat is the independent economic regulator of the water industry. Its main statutory duties include: protecting the interests of consumers; securing the long-term resilience of water supply and wastewater systems; and ensuring that companies carry out their functions and are able to finance them. Companies are funded from customer bills and financed through private investment. Ofwat sets limits to the prices companies may charge for 5-year periods, allowing for operational and financing costs of delivering services to customers, and making assumptions about the efficiency improvements that companies should make. The average household bill in 2014–15 was £396.

Conclusions and recommendations

1. **Ofwat has consistently over-estimated water companies' financing and taxation costs when setting price limits.** As a result, companies have made substantial windfall gains from customers' bills being higher than they needed to be. In setting water companies' price limits, Ofwat makes allowance for investors to earn a return on capital invested. Ofwat, like other economic regulators, has repeatedly overestimated the cost of finance in successive price reviews. For the 2010 price review Ofwat also set an allowance for corporation tax charges which was not adjusted to reflect the falls in the headline tax rate that subsequently occurred. As a result, water companies made windfall gains of at least £1.2 billion between 2010 and 2015 from bills being higher than necessary. Other regulators have adopted different approaches to setting revenue allowances for tax and debt costs. For example, the energy regulator Ofgem updates these allowances annually to reflect changes in corporation tax and the market cost of debt for companies with similar characteristics to those it regulates.

   Recommendation: ***Ofwat should review its approach to setting allowances for the cost of debt and corporation tax, taking into account the methods used by other economic regulators, and report publicly on what actions it intends to take to improve its performance.***

2. **Ofwat's efforts to ensure that the windfall gains made by companies were shared with customers secured limited results that varied significantly from company to company.** In the absence of any statutory powers to compel water companies to share windfall gains with their customers, Ofwat in 2013 sought voluntary agreements from companies to raise their bills in 2014/15 by less than the regulator had originally permitted. Only six out of the ten largest water and sewerage companies heeded this call, though the sector eventually shared some £400 million with their customers once absorbed costs and additional support for customers struggling to pay are taken into account. Ofwat did not quantify the scale of the windfall gains by company, provide guidance on what an appropriate share for their customers might be, or pass this information on to customers.

   Recommendation: ***Ofwat should monitor water companies' windfall gains, report publicly on their scale and set out what actions it intends to take to ensure all companies provide a proper share of windfall gains that arise in future to their customers.***

3. **Ofwat does not do enough to benchmark the efficiency of water companies against comparators from outside the sector.** Ofwat uses cost data from the companies it regulates in England and Wales to set the sector's efficiency targets. This approach has generated benefits in the past but these have diminished over time–Ofwat assumed £39 of new efficiency savings in the average household bill between 2000 and 2005, but this fell to £11 between 2010 and 2015. Ofwat's focus on comparing the companies it regulates means it lacks evidence on whether some activities are undertaken more efficiently by international water companies or by other UK-based industries which undertake similar activities. Comparisons from these sources could result in a more exacting efficiency challenge to the water sector and lower bills for customers.

Recommendation: ***Ofwat should use comparisons with other sectors and international suppliers to develop a clearer picture of what services should cost if provided efficiently.***

4. **Financial support for customers who struggle to pay water bills varies substantially from company to company.** For the 10% of lowest income households, water bills on average represented 5.3% of spending in 2013, compared to 2.3% for the average household. Water companies have several schemes to help customers who struggle to pay, including social tariffs which provide discounts to vulnerable consumers, paid for by slightly higher bills for other customers. Companies consult with their customers on what financial support should be provided and to whom. Currently 14 of the 18 large companies in the sector have introduced social tariffs. The water companies and the Consumer Council for Water recognise that there are varying levels of customer awareness around eligibility for these schemes which is an obstacle to take-up - especially where customers are served by different water and sewerage suppliers.

Recommendation: ***Defra and Ofwat should ensure that all companies provide a minimum threshold of support for low-income customers who are struggling to pay, and oblige companies to advertise clearly the support they provide to all customers. Defra and Ofwat should monitor take-up rates to identify priority areas where improvements are needed.***

5. **Customers in areas of water scarcity are paying to develop expensive new capacity when water trading with other companies might be a more cost-effective option.** Since privatisation, companies have made significant investments in integrating their own water supply networks, but the volume of water traded between companies has remained fairly constant at about 4–5% of total supplies. The potential benefits from greater water trading are substantial: Ofwat estimated in 2010 that it could yield benefits of £1 billion over 30 years, but did not set explicit targets for the sector. Changes brought in by the 2014 Water Act will from 2019 make it easier for new entrants to provide water resources, but the lack of visible prices for water resources continues to be an obstacle to a well-functioning market.

Recommendation: ***Ofwat should set out what it intends to do to promote more water trading between companies and greater transparency of costs, to encourage new more cost-effective suppliers to enter the market.***

1 Ofwat's price controls

1. On the basis of a report by the Comptroller and Auditor General, we took evidence from the Water Services Regulation Authority (Ofwat), and the Department for Environment, Food & Rural Affairs (the Department) on the economic regulation of the water sector in England and Wales[1]. We also took evidence from Thames Water, United Utilities and the Consumer Council for Water.

2. The sector provides water and wastewater services to around 22 million household and 2 million non-household customers. It was privatised in 1989, and now includes 18 large companies which operate as regional monopoly suppliers to all but the largest users of water.[2]

3. Ofwat is the economic regulator of the water industry in England and Wales.[3] Ofwat's responsibilities include protecting the consumer interest, and ensuring that companies fulfil their statutory duties, and can finance themselves to do so. The Department and the Welsh Government set the legislative framework within which Ofwat operates in England and Wales.[4] Ofwat limits the prices that water companies can charge customers in its five-yearly price reviews, through setting a revenue allowance consistent with its view of the amount an efficient company would require to fulfil its duties. The bills which customers pay go towards funding the water supplies and wastewater services that they receive from companies, as well as investment in infrastructure to ensure a sustainable supply for future customers. Bills also cover expenditure on activities aimed at improving environmental quality, for example of rivers and beaches.

4. At each price review, Ofwat uses regulatory data and assumptions to set a revenue allowance for water companies' costs for five years at a time. Ofwat's approach allows companies to make gains if costs turn out to be lower than it has assumed when setting price limits. However, companies bear the risk of losses if costs turn out to be higher than expected. The approach aims to encourage efficiency by allowing companies to keep benefits from any efficiency savings they make. But some aspects of company costs, including financing and taxation, are outside of their control–which can result in windfall gains for them, or losses.[5]

5. Ofwat told us that the settlement reached with companies in its 2009 price review now looked generous with hindsight, but that this had not been readily apparent at the time, given the then difficult environment for securing debt.[6] However, the Consumer Council for Water told us that it thought that the 2009 settlement looked too generous at the time, and noted that the Competition Commission had set a lower cost of debt than Ofwat for Bristol Water when that company appealed against Ofwat's 2009 determination.[7] Although recognising that Ofwat's financial assumptions for the 2014 price review were much tighter than in the past, the Consumer Council for Water told us that the system of economic regulation had overall been too generous to investors.[8] An investment in water

1 C&AG's report, The Economic Regulation of the Water Sector, Session 2015-16, HC 505, 4 October 2015
2 C&AG's report, para 1 and 1.2
3 C&AG's report, para 2 and 1.8
4 C&AG's report, para 2 and 1.13
5 C&AG's report, para 13
6 Qq 67, 69, 81
7 Qq 12, 19
8 Q 9

company stock at privatisation would have beaten an investment in the FTSE 100 all-share index made at the same time.[9] Water companies have relatively stable businesses, with a largely captive customer base, meaning that returns to water investors could reasonably be expected to be lower than for companies in other sectors.[10]

6. Other regulators have adopted different approaches to setting the revenue allowance for the cost of debt. In particular, the energy regulator Ofgem updates these allowances annually to reflect changes in corporation tax and the market cost of debt for companies with similar characteristics to those it regulates.[11] We asked Ofwat why it had not adopted a similar approach to that used by Ofgem in setting the cost of debt allowance for water companies. Ofwat told us that it had considered introducing such an approach for the 2009 and 2014 price reviews but had decided against it.[12] It considered that companies were better placed to manage interest rate risk than customers, and that adopting the approach used by Ofgem would increase the volatility of bills–which it said customers care about.[13] The Department told us that there were examples of sharing gains in a contractual environment in the rail sector, which could provide useful lessons for the regulatory framework, and Ofwat said it was willing to consider such arrangements for future price reviews.[14]

7. Ofwat told us that it did not have formal powers to claw back windfall gains from regulated companies but that it had raised the issue with companies.[15] In October 2013, Ofwat contacted companies to suggest they voluntarily consider foregoing a proportion of bill increases they were entitled to in 2014–15, in light of the generous price review settlement and affordability pressure on households. Only 6 of the 10 largest water and sewerage companies did so, and one company (Thames Water) continued to pursue a request to increase prices above that allowed for in its settlement.[16]

8. In total, between 2010–11 and 2014–15, customers saw an estimated £435 million of additional benefits in the form of absorbed costs, support for customers struggling to pay, and bill increases which were lower than the regulator had allowed.[17] However, the National Audit Office estimated that over the same period companies had made windfall gains of at least £1.2 billion from lower than expected financing and taxation costs. Ofwat did not use its understanding of how much companies had gained to tell companies how much it expected them to share; nor did it communicate this information to customers.[18]

9. Ofwat's regulatory model uses company data on the costs of maintenance and construction projects to encourage greater efficiency. When setting companies' price limits, Ofwat encourages efficiency improvements by expecting companies to catch up with the leading companies in efficiency terms.[19] This approach has generated benefits in the form of lower bills, but savings have fallen over time—Ofwat assumed £39 of new efficiency savings in the average annual bill between 2000 and 2005, but this fell to £11

9 Qq 12, 19
10 Qq 98, 102
11 C&AG's report, para 13, 3.12 and 3.13
12 Q 73
13 Q 107
14 Q 104
15 Q 82
16 Ofwat written submission to the Committee
17 C&AG's report, para 13 and 3.20
18 Qq 77-91
19 C&AG's report, para 3.2 and 3.4

between 2010 and 2015.[20] Ofwat told us that in its 2014 price review it had toughened the efficiency challenge for companies by setting their revenue allowance for operational and capital expenditure as if they were three quarters of the way towards the leader in efficiency terms, instead of at the level of the average performer as in the 2009 price review. Ofwat said that it would look to make this challenge tougher still at its next price review in 2019.[21]

10. In assessing the scope for further efficiency savings by companies, Ofwat has focused solely on comparisons within the sector in England and Wales. As a result, it lacks evidence on whether some activities are undertaken more efficiently in other UK sectors, or internationally. Ofwat told us it did not currently make use of comparisons with water companies internationally because finding suitable comparators was very difficult. For instance, other countries often have small municipal water companies which do not provide reasonable comparators to the large water companies in England and Wales.[22] Ofwat noted that it was looking to get a better understanding of the different activities that water companies perform so that it could do more granular benchmarking which might enable it to bring in benchmarks from other sectors in the economy. [23]

11. The water industry has changed markedly since privatisation, with companies financed much more by debt, and with more complex, opaque corporate structures. Some of these changes have been driven by the different tax treatment of debt and equity investments.[24] As a result, it can be difficult for customers and taxpayers to see how much tax is paid by these providers of essential services.[25] Ofwat told us it has made efforts to strengthen financial and corporate resilience, and to improve corporate transparency.[26] For instance, the regulator stated that it has undertaken a range of actions to monitor the financial resilience of companies and to provide protections against risks from companies with more highly indebted structures.[27]

20 C&AG's report, para 11, 3.2 and 3.3
21 Q 112
22 Qq 113, 116, 117
23 Qq 114-116
24 Qq 41, 60; C&AG's report, para 14 and 4.4
25 Q 43, 44
26 Q 60
27 Qq 60, 61

2 Other actions to benefit customers

12. Water bills have increased by over 40% above inflation since privatisation.[28] Most of the costs of meeting planned EU requirements on environmental improvements will be paid for through customers' bills.[29] Although the average bill for water and sewerage was £396 in 2014–15, there was considerable variation around this - customers of South West Water paid £482 after a subsidy of £50 per year from the taxpayer.[30] The Consumer Council for Water noted that some of the highest bills were in geographical areas of high deprivation, where a greater proportion of customers have difficulty in paying.[31]

13. Customers on lower incomes have been hit hard by increases in bills over time, especially following the 2008 recession; a period in which growth in incomes has tended to be outstripped by inflation. For the 10% of lowest-income households, water bills on average represented 5.3% of spending in 2013, compared to 2.3% for the average household. Water companies have several schemes to help customers on lower incomes, including social tariffs (bill subsidies paid for by a company's other water customers). The Department has issued guidance to water companies on social tariffs in which it outlines an expectation that companies' proposals should be acceptable to their customer base, without specifying particular eligibility criteria or minimum levels of support.[32] This has led to companies developing their own criteria. Four of the 18 large companies in the sector have not yet introduced social tariffs but expect to do so during the 2015–20 price control period.[33]

14. Differences between companies' approaches can lead to inconsistency and confusing choices for customers, and some customers are not aware that they are eligible for financial assistance, reducing take-up rates. The Consumer Council for Water told us that confusion was particularly marked where customers were served by different water and sewerage suppliers, with different social tariffs and eligibility criteria. Currently, it is left to individual companies, engaging with the Consumer Council for Water and organisations such as Citizens Advice, to help customers to understand the opportunities for financial assistance.[34]

15. Ofwat and the Department have devoted considerable amounts of energy and resource towards preparing for the introduction of competition into non-household retail activities in England from April 2017, as provided for by the Water Act 2014.[35] But they have done less to secure benefits for household customers from developments such as encouraging more water trading between companies, which could lower prices for customers and provide greater resilience against water shortages. Since privatisation companies have made significant investments in integrating their own water supply networks within their own company boundaries,[36] but the volume traded between companies has remained fairly constant at about 4–5% of total supplies.[37]

28 C&AG's report, para 9 and 2.17
29 Qq 131, 132; C&AG's report, para 10 and 2.9
30 Qq 7-10; C&AG's report, para 9 and 1.3
31 Q 10
32 Defra, Company Social Tariffs: Guidance to water and sewerage undertakers, June 2012
33 C&AG's report, para 9 and 2.18
34 Qq 16-18
35 C&AG's report, para 4 and 1.12
36 Ofwat submission to the Committee
37 Q 119

16. Ofwat told us that the Environment Agency's mapping of water resources has identified numerous cases of areas of scarcity close to areas of abundance. According to Ofwat's 2010 study, greater levels of water trading could yield benefits of £1 billion over 30 years, relative to proposals set out in companies' draft Water Resource Management Plans.[38] Yet Ofwat has no current target or expectation regarding what proportion of water supplies this could be.[39] Ofwat told us that the lack of visible prices for water resources continues to be an obstacle to a well-functioning market.[40]

38 Ofwat submission to the Committee
39 Qq 120-130
40 Q 125

Formal Minutes

Wednesday 16 December 2015

Members present:

Meg Hillier, in the Chair

Mr Richard Bacon
Deidre Brock
Chris Evans
Caroline Flint
Kevin Foster
Mr Stewart Jackson
Nigel Mills
David Mowat
Steven Phillips
Karin Smyth
Mrs Anne-Marie Trevelyan

Draft Report (*Economic regulation of the water sector*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 16 read and agreed to.

Introduction agreed to.

Conclusions and recommendations agreed to.

Summary agreed to.

Resolved, That the Report be the Fifteenth 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 Monday 11 January 2016 at 3.30pm

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the Committee's inquiry web page.

Wednesday 4 November 2015	*Question number*
Nick Fincham, Director of Strategy and Regulation, Thames Water, **Steve Mogford**, Chief Executive, United Utilities, and **Tony Smith**, Chief Executive, Consumer Council for Water	Q1–59
David Black, Senior Director of Water 2020, Ofwat, **Clare Moriarty**, Permanent Secretary, Department for Environment, Food and Rural Affairs, and **Cathryn Ross**, Chief Executive, Ofwat	Q60–161

Published written evidence

The following written evidence was received and can be viewed on the Committee's inquiry web page. REG numbers are generated by the evidence processing system and so may not be complete.

1 Defra (REG0002)

2 Ofwat (REG0003)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the Committee's website at www.parliament.uk/pac.

Session 2015–16

First Report	Financial sustainability of police forces in England and Wales	HC 288
Second Report	Disposal of public land for new homes	HC 289
Third Report	Funding for disadvantaged pupils	HC 327
Fourth Report	Fraud and Error Stocktake	HC 394
Fifth Report	Care leavers' transition to adulthood	HC 411
Sixth Report	HM Revenue & Customs performance 2014-15	HC 393
Seventh Report	Devolving responsibilities to cities in England: Wave 1 City Deals	HC 395
Eight Report	The Government's funding of Kids Company	HC 504
Ninth Report	Network Rail's: 2014-2019 investment programme	HC 473
Tenth Report	Care Act first-phase reforms and local government new burdens	HC 412
Eleventh Report	Strategic financial management of the Ministry of Defence and Military flying training	HC 391
Twelfth Report	Care Quality Commission	HC 501
Thirteenth Report	Overseeing financial sustainability in the further education sector	HC 414
Fourteenth Report	General Practice Extraction Service	HC 503
First Special Report	Unauthorised disclosure of draft Report in the previous Parliament	HC 539