House of Commons
Environment, Food and Rural Affairs Committee

Regulation of the water industry

Eighth Report of Session 2017–19

Report, together with formal minutes relating to the report

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The Environment, Food and Rural Affairs Committee

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Committee staff

The current staff of the Committee are Sian Woodward (Clerk), Ben Street (Second Clerk), Xameerah Malik (Senior Committee Specialist), Andy French (Committee Specialist), Thomas Smallwood (Committee Researcher), James Hockaday (Senior Committee Assistant), Ian Blair (Committee Assistant) and Annabel Russell (Committee Assistant).

Eliot Barrass (Clerk) and Daniel Schlappa (Second Clerk) were also Committee staff during the inquiry.

Contacts

All correspondence should be addressed to the Clerk of the Environment, Food and Rural Affairs Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 7341; the Committee's email address is efracom@parliament.uk.
Background

1. The UK has just experienced one of its warmest summers on record. The 2018 heatwave and subsequent drought across the UK led to a hosepipe ban in Northern Ireland and drought permits in north-west England. Weather fluctuations aside, water supplies will become scarcer: the water efficiency body Waterwise stated that “we can expect more frequent, more intense and longer droughts right across England and Wales in the next few decades” and that rivers were “already drying up”. The Committee on Climate Change explained that although “population growth and climate change are projected to have the greatest impact on water resources in London and the south east of England”, the “risk of water scarcity may also increase in the north and the west of the UK by mid-century”. The 2018 report Preparing for a drier future: England’s water infrastructure needs by the National Infrastructure Commission (NIC) concluded that increasing drought resilience would “require a twin-track approach combining demand management (including leakage reduction) with long-term investment in supply infrastructure”.

2. The water industry has also been under pressure this year over supply interruptions after an extreme cold weather event dubbed “the Beast from the East” in February and March. The rapid thaw that followed the cold weather led to burst water pipes and over 200,000 customers cut off from supply for more than four hours, with tens of thousands cut off for days. Several water companies were criticised by Ofwat, the water industry regulator, for poor planning and response to customers. In addition, the water industry has also been in the spotlight over the financial behaviours of large water companies, including public criticism from the Government.

3. In the light of these challenges facing water companies, we held an inquiry on the regulation of the water industry to explore whether the current system is still fit for purpose, almost 30 years since the industry was privatised. We launched a call for evidence on 9 May 2018, and invited written submissions on the following terms of reference:

   a) Is regulation of the water industry improving outcomes for consumers and the environment?

   b) Is the water industry adequately delivering a “twin-track approach” of increasing water supplies and reducing water demand?

   c) How can innovation be increased in the water industry?

   d) Are penalties and enforcement mechanisms encouraging responsible behaviour?

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1 Met Office, Summer 2018: a possible record-breaker?, August 2018
2 Northern Ireland Water, Hosepipe Ban Northern Ireland, June 2018; Drought permits allow for more water to be taken from the environment by a water company; see United Utilities, Drought permits and orders, July 2017
3 Waterwise (RWI0019) para 8
4 Committee on Climate Change (RWI0006) para 1
5 National Infrastructure Commission, Preparing for a drier future: England’s water infrastructure needs, April 2018, p 3
6 Ofwat, Out in the cold: water companies’ response to the ‘Beast from the East’, June 2018
7 Ofwat, Out in the cold: water companies’ response to the ‘Beast from the East’, June 2018
8 Ofwat, Out in the cold: water companies’ response to the ‘Beast from the East’, June 2018
9 Department for Environment, Food and Rural Affairs, A water industry that works for everyone, March 2018
e) Are there any potential benefits for the environment that could be achieved though regulatory divergence post-Brexit?10

We received around 40 written submissions and held four evidence sessions including witnesses from environmental groups, water companies, regulators and Defra. We would like to thank everyone who provided written and oral evidence to our inquiry.

**Water companies and regulators**

4. The water industry comprises a diverse range of companies providing various services. There are currently nine large companies in England that cover specific geographical regions and provide both water supply and sewerage services.11 There are also several smaller, local water and sewerage companies.12 Twelve companies provide water but do not provide sewerage services.13 England is the only country to have fully privatised its water and sewerage system.14 Although private, Dŵr Cymru/Welsh Water is owned by a single-purpose company without shareholders.15 Water and sewerage services in Scotland are provided by Scottish Water, a publicly owned company that is economically regulated by the Water Industry Commission for Scotland (WICS).16 Northern Ireland Water is a Government-owned company.17 In addition to the companies that physically supply water and sewerage services, the industry includes water retail suppliers which provide customer-facing services, such as billing, to non-domestic consumers.18

5. The water industry in England and Wales was privatised in 1989. However, customers, with limited exceptions, cannot choose their water company. As such, most water suppliers are regional monopolies that supply customers in their region by default, thus making market competition impossible without intervention. Therefore, the economic activities of water companies in England and Wales are regulated by the Water Services Regulation Authority, or Ofwat, whose predecessors were established when the industry was privatised.19 Ofwat is a non-ministerial Government department that is financed by licence fees from water companies.20 Ofwat’s duties originate from the Water Industry Act 1991 and include promoting competition, protecting the interests of consumers and ensuring that water companies carry out their statutory functions and licensed activities properly.21

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10 Environment, Food and Rural Affairs Committee, *Regulation of the water industry inquiry launched*, May 2018
11 Anglian Water, Northumbrian Water, Severn Trent Water, South-West Water, Southern Water, Thames Water, United Utilities, Wessex Water and Yorkshire Water
12 For example, Albion Water, Independent Water Networks, Peel Water Networks, SSE Water, Thames Water Commercial Services and Veolia Water Projects
13 Affinity Water, Bournemouth Water, Bristol Water, Cambridge Water (South Staffs), Cholderton and District Water, Dee Valley Water, Essex and Suffolk Water (Northumbrian), Hartlepool Water (Anglian), Portsmouth Water, South East Water, South Staffs Water and SES Water
14 “Privatised water costs consumers £2.3bn more a year, study says”, Financial Times, 6 June 2017
15 Dŵr Cymru Welsh Water, *Company information*, accessed September 2018
16 Scottish Water, *How the water industry is run in Scotland*, accessed September 2018
17 Northern Ireland Water, *About us*, accessed September 2018
18 Ofwat, *Business retail market*, accessed September 2018
19 Ofwat, *Water sector overview*, accessed September 2018
20 From 2015–16, the amount Ofwat is allowed to recover through fees is set by Government as part of the Comprehensive Spending Review; see Ofwat, *Ofwat’s five-year business plan: 2015–16 to 2019–20*, accessed September 2018
21 Ofwat, *Our duties*, accessed September 2018
6. Defra and the Welsh Government guide Ofwat via strategic policy statements. The environmental activities of water companies, such as abstraction and sewage discharge to the environment, are regulated by the Environment Agency and Natural Resources Wales. Drinking water quality is regulated by the Drinking Water Inspectorate (DWI). The roles of key regulatory bodies are summarised in the table below.

**Who regulates the water industry in England and Wales?**

<table>
<thead>
<tr>
<th>Organisation</th>
<th>Regulatory role</th>
</tr>
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<tbody>
<tr>
<td>Defra and Welsh Government</td>
<td>Set the overall water and sewerage policy framework in England and Wales, including setting standards, drafting legislation and creating special permits (for example, drought orders)</td>
</tr>
<tr>
<td>European Union</td>
<td>Sets European water, wastewater and environmental standards</td>
</tr>
<tr>
<td>Ofwat (England and Wales)</td>
<td>Promotes competition, sets price limits, ensures that water companies can finance and properly carry out their functions, promotes economy and efficiency</td>
</tr>
<tr>
<td>Environment Agency (England) and Natural Resources Wales</td>
<td>Regulate water quality and industry waste, work with partners to reduce flood risk and promote sustainable development</td>
</tr>
<tr>
<td>Drinking Water Inspectorate (England and Wales)</td>
<td>Checks that water companies supply water that is safe to drink and meets the standards set in the Water Quality Regulations, by carrying out inspections and checking tests that water companies carry out on drinking water</td>
</tr>
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7. Ofwat regulates the water industry by setting “the price, investment and service package that customers receive”, which includes “controlling prices companies can charge their customers” through price reviews. In doing so, Ofwat attempts to “balance consumers’ interests with the need to ensure the sectors are also able to finance the delivery of water and sewerage services” as well as ensuring “they are able to meet their other legal obligations, including their environmental and social duties”. Through the price review process Ofwat puts pressure on water companies “by mimicking the penalties and incentives they would be exposed to in a competitive market”. The current price review, PR19, will set “wholesale price controls for water and sewerage companies for 2020 to 2025”. Ofwat published its draft PR19 methodology in July 2017 and water companies submitted their business plans to Ofwat in September 2018. Ofwat will assess company business plans in early 2019 and set final price limits in December 2019.

8. PR19 was a key focus of our inquiry and is a recurring theme throughout our Report. Because of the importance of drought resilience, the first two chapters of our Report are structured according to the twin track approach for managing water: Chapter 1 looks at increasing supply through abstraction and water transfers; and Chapter 2 examines demand reduction, including metering. Chapter 3 examines the performance of water supply in England and Wales.
companies and Chapter 4 explores competition in the sector, with a focus on the water retail market. Our overall conclusions on the regulation of the water industry, including PR19, are in Chapter 5.
1 Increasing supply

Abstraction

9. Increasing the supply of water is one part of the twin track approach to increasing resilience, particularly in the context of the increased likelihood of drought. Water companies mainly take water from lakes, reservoirs and rivers (and underground sources to a lesser extent): this is termed abstraction.30 Water companies are not the only companies that abstract water. In 2015, water companies in England and Wales abstracted over 15 million litres of water per day to produce drinking water; around a third of the total volume of water abstracted daily.31 By comparison, 70 per cent was for other uses such as industrial processes and electricity production and less than 1 per cent was for agriculture.32 There are around 19,000 abstraction licences in force in England; of which 1,400 are for public water supply.33 Abstraction is regulated by the Environment Agency (EA), which provides licenses to anyone taking or transferring more than 20,000 litres of water a day.34 The EA controls “how much, where and when water is abstracted” through its licensing system and it has “the power to amend or revoke existing licences” where abstraction is deemed to be damaging the environment.35

10. Sir James Bevan, Chief Executive Officer of the Environment Agency, explained that the abstraction licensing system was “designed for a period where there was no water stress […] and far fewer people”.36 He told us that “many of the abstraction licences have no limits on the amount of water that you can take out of the ground, and many of those abstraction licences are very long-term”.37 The water abstraction licensing system, “many aspects of which date back to the 1960s” is being reformed by the Government.38 Defra identified that there was a lack of flexibility in coping with increasing demand for water and that the abstraction service was outdated and paper-based.39 In January 2016, Defra published its Water Abstraction Plan, including solutions such as “developing a stronger catchment focus”, a principle that was supported by some who responded to our inquiry.40 The Government will report to Parliament by May 2019 on the progress made regarding abstraction reform.41

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30 Discover Water, Where water comes from, accessed September 2018
31 Discover Water, Where water comes from, accessed September 2018
32 Discover Water, Where water comes from, accessed September 2018; these figures do not represent use of water from mains supply, i.e. that which is provided by water companies.
33 Figures for 2016; Department for Environment, Food and Rural Affairs, Number of abstraction licences in force by purpose and EA regional charge area: 2012 to 2016, May 2018
34 Environment Agency, Apply for a water abstraction or impoundment licence, April 2018
35 Environment Agency, Managing water abstraction, 2016, p 6
36 Q 270
37 Q 270
38 Committee on Climate Change (RWI0006) para 2; Department for Environment, Food and Rural Affairs, Water abstration plan, May 2018
39 Department for Environment, Food and Rural Affairs, Water abstriction plan, May 2018
40 A catchment is the geographic area of land drained by a river; For example, EnTrade (RWI0029) paras 9–10, Blueprint for Water (RWI0020) para 3.2
41 Department for Environment, Food and Rural Affairs, Water abstraction plan, May 2018
11. There appeared to be uncertainty over whether abstraction reform would be underpinned by legislation. The Committee on Climate Change stated that "final reform proposals were originally expected in a draft Bill later in 2017, but this was not completed and there is some uncertainty as to whether time can be found in the parliamentary schedule to take this forward". The Chartered Institution of Water and Environmental Management (CIWEM) stated that:

For a significant period of time, there was a recognised need for primary legislation to provide the Environment Agency with powers to revoke certain unsustainable abstraction licences and allow increased optimisation of licences through trading. Due to the legislative programme created by Brexit the chances of new water legislation were considered minimal and therefore a more voluntary and regulatory approach has been taken which, whilst it theoretically could achieve results and which proposes measures which [we are] supportive of, may fail to achieve the required savings in the longer term without legislative teeth.

WWF-UK similarly stated that "the plan’s success is heavily reliant on voluntary approaches" and that:

To protect rivers from over-abstraction, statutory environmental flows must be protected in all rivers, through caps on all abstraction licences when river flows go below an agreed level (“hands-off flows”). This would provide welcome regulatory underpinning to the proposed approach and encourage innovation in terms of efficiency; trading, storing and sharing water; and driving down demand.

12. Sir James Bevan, however, stated that “at the moment, we are finding that the water companies understand the importance of reducing unsustainable abstraction and we are concluding agreements with them […] to ensure that we are at sustainable abstraction levels”. He acknowledged that “those levels will have to come down further in future” but considered that the EA had “the powers that we need to get to where we want to get to”. Sir James stated that he “would rather try to reach voluntary agreements than wield a big stick”, a sentiment echoed by Dr Thérèse Coffey MP, Parliamentary Under Secretary of State for the Environment, who considered that “it is often quicker to get the voluntary approach going than trying to prepare legislation”. Dr Sebastian Catovsky, Deputy Director for Water Services, Defra, stated that “many of the changes that we need to deliver to reduce over-abstraction come from water company licence changes” and that:

[Defra] and the Environment Agency have set clear targets for how much we want to achieve through the current approach in terms of reducing over-abstraction. We want to get to 90% of surface water bodies and 77%
of groundwater bodies being in good ecological status as a result of water resources. If we do not achieve that by 2021, we will look again at what additional powers are needed.\textsuperscript{48}

13. Reform of the abstraction system was long overdue, and we welcome the focus on catchment-based approaches. \textit{The Government and Environment Agency must make a rigorous assessment of whether a voluntary approach will be sufficient to protect water resources and the natural environment in the long-term. The legislative demands of Brexit must not prevent statutory reform, should it become necessary. In its update to Parliament in 2019, the Government should include an assessment of the need for statutory reform.}

\textbf{Water transfers and trading}

14. As water becomes scarcer, it will not be always possible for water companies to increase supply by abstracting more water. Another method is transferring and trading water between regions, particularly where there are areas of surplus and deficit. A 2018 report by the National Infrastructure Commission (NIC) on drought resilience was particularly supportive of water transfers and explained that “a range of studies have all found a positive cost-benefit case for greater transfers and water trading”.\textsuperscript{49} Ofwat has also commissioned studies that “identified scope for increased trading levels” and “identified savings of £810 million (net present value, 2015–16 prices) from increased trading between water companies”.\textsuperscript{50} Despite this, transfers currently only make up around 4 per cent of total supply, a level that has barely changed since 1989.\textsuperscript{51} We therefore decided to explore the feasibility of water transfers and trading as part of our inquiry.

15. Water trading is “where a water company responsible for supplying water in an area buys it from someone else (either another water company or third party provider)”.\textsuperscript{52} Both raw and treated water can be traded, and trades “are typically agreed as part of the water resources management plan (WRMP) process to ensure long-term water supply in an area”.\textsuperscript{53} Water trades are sometimes referred to as bulk supplies, and Ofwat maintains a register of these transactions.\textsuperscript{54} Water companies agree the price and terms and conditions through “bulk supply agreements”.\textsuperscript{55} Rachel Fletcher, CEO of Ofwat, explained that “where there are trades between companies, there are commercial arrangements in place that govern the terms of those trades, both in terms of the volume and the price, including what happens when there is water-resource pressure”.\textsuperscript{56} She stated that “there are very low levels of water resource transfers between water companies” despite there being “water-rich and water-scarce companies side by side.”.\textsuperscript{57} She added that “it begs the question of why transfers are not happening to improve resilience”.\textsuperscript{58} Ofwat has “introduced a number of

\begin{footnotesize}
\begin{itemize}
\item[48] Qq 310–11 [Sebastian Catovsky]
\item[50] Ofwat, \textit{Water trading}, accessed September 2018
\item[52] Ofwat, \textit{Water trading}, accessed September 2018
\item[53] Ofwat, \textit{Water trading}, accessed September 2018
\item[54] Ofwat, \textit{Water trading (‘Bulk supplies’) register 2017–18}, accessed September 2018
\item[55] Ofwat, \textit{Water trading (‘Bulk supplies’) register 2017–18}, accessed September 2018
\item[56] Q 263
\item[57] Q 260
\item[58] Q 260
\end{itemize}
\end{footnotesize}
measures to promote increased trading” in PR19, such as water trading incentives; these are “targeted financial incentives that lower the costs of importing water and increase rewards for exporting water”.  

16. Steve Robertson, CEO of Thames Water, explained some of the challenges associated with transferring water:

   i) When the likelihood of simultaneous drought is high, “we have to be careful about assuming that we would be able to transfer water”;  

   ii) Water is heavy, so “if you want to transfer it, it is quite expensive because you have to pump it up and down hills”;  

   iii) There are “environmental issues that also need to be handled in terms of invasive species”; and  

   iv) Combining “different sources of raw water presents a specific set of challenges.”

In addition, CIWEM considered that leakage in the water system created a “risk of losing a significant amount of […] water before it gets to its destination”. The NIC found that the scale of the required infrastructure “goes well beyond that seen in the plans currently proposed by water companies” and “is likely to need strengthened regional approaches and perhaps an independent national framework”.

17. Despite the challenges, Rob Lawson, Chair of Water Resources Panel, CIWEM, told us that increasing water transfers between companies was “certainly possible” and that:

   Water Resources in the South East, which is the collection of various companies that have collaborated on water resource planning in the south-east over the past 10 years or so, is looking at quite a lot of intercompany transfers of that scale, in that part of the country.

United Utilities expected “that future resilience in water supplies will depend upon an increased level of water trading across company boundaries” and that “operating in a region with a relatively strong water resources position, we have promoted the possibility of a north-south water transfer of up to 180 ML/day from Lake Vyrnwy [Wales] to the River Thames, via the River Severn and a new interconnector pipeline”. Steve Robertson, CEO of Thames Water Utilities Ltd, considered that water transfers were “a really important part of the overall solution”, although not “a silver bullet”.

59 Ofwat, Water trading, accessed September 2018  
60 Q 158  
61 Q 158  
62 Q 158  
63 Q 158  
64 Q 50 [Rob Lawson]  
65 National Infrastructure Commission, Preparing for a drier future: England’s water infrastructure needs, April 2018, p 10–11  
66 Q 49  
67 United Utilities (RWI0003) para 11  
68 Q 158
18. The Government was supportive of water transfers: Sebastian Catovsky, Defra, considered that water transfers were “crucial” for resilience in the context of increased population and more climate change incidents. He suggested that the 4 per cent that is currently transferred between companies “probably needs to double over 10 to 20 years”. The Minister, Thérèse Coffey MP, stated that “there should be more on water transfers” and that the Government recognises that it “is not happening yet but [is] starting to see some more relationships happening between water companies, recognising the challenges they face”. To increase transfers, water companies may need a change of mindset; Rachel Fletcher suggested that in emergencies, companies should be “co-operating and collaborating so that customers get the best possible service” rather than “thinking about this as a commercial transaction”.

19. Although there are infrastructure and environmental challenges to be overcome, water transfers should play an important role in increasing supply and resilience. Although transfers might be difficult to put in place during short-term episodes of drought, they would help companies to manage their resources effectively in the long-term. It is therefore disappointing that only 4 per cent of water is currently traded. This suggests that Ofwat’s incentives are not strong enough.

20. We note Defra’s suggestion that 8 per cent of total supply will need to be transferred in the next 10 to 20 years. The Government and Ofwat should make a strategic assessment of the need for water transfer infrastructure and confirm a long-term target for water transfers. We are concerned that existing incentives in PR19 are not strong enough to incentivise water companies to invest in water transfers.

Leakage

21. Abstraction and transfers are two methods of increasing the amount of water supplied to water companies. However, taking a wider view of increasing supply to customers, the issue of leakage becomes pertinent. Water companies in England and Wales are responsible for 343,865 kilometres of water pipes, which vary in age and construction material. An estimated three billion litres of water are lost through leakage every day—enough to fill 1,273 Olympic swimming pools. Leakage figures for 2017–18 showed that, on average, 9.3 cubic metres of water were leaked per kilometre of water pipe per day, with the worst performer being Thames Water (22.1 cubic metres per kilometre per day).

22. Water leakage matters for two reasons. First, the loss of water through leakage has an impact on how much water is abstracted; the Environment Agency indicated that water companies have relied on abstraction to respond to rising demand and that they should instead “invest more in infrastructure to address leakage”. Second, it impacts on consumer perceptions of the industry and their willingness to reduce water use. The Consumer Council for Water (CCWater) stated that “consumers are discouraged from becoming more water efficient because they believe that companies should be doing
more to tackle levels of leakage”. CCWater’s research has shown that “three quarters of consumers in England felt that companies do not do enough to save water, and 72% would do more to save water themselves if they could see that water companies were also doing more”. Demand reduction is examined in the next chapter.

23. Detecting water leaks is challenging. Steve Robertson, CEO of Thames Water, told us that it had a “massive network” that was “very dense”, particularly in London. He explained that “if you think about any pipe network, every time there is a connection, there is an opportunity for a leak to happen”. He added that “98% of the water that we lose in leakage is under the ground. You would never see it”. However, he explained that “in terms of finding leaks and sorting them, there is a lot of quite cool technology that is now available”, such as drones, and acoustic loggers, which “listen to the water going through the pipe and help to narrow down the area where a leak may be”.

24. Although overall leakage has reduced by around a third since its peak of 5 billion litres per day in the early 1990s, much of the reduction occurred in the first decade after privatisation, with only incremental improvements made since. CIWEM added that “the industry has made little progress in improving leakage during the last 5–10 years” and noted that “the current replacement rate is about one in every 200 years, so it will take 200 years to replace the current distribution network”, which is “obviously not sufficient”. Ofwat told us that it wanted “to see a renewed push” and has set “a challenge for the next price review [covering 2020 to 2025] to see leakage cut by a further 15% - which would save enough water for 3.1 million people”. Defra’s 25 Year Environment Plan contains the same target.

25. We discussed this target with witnesses. Waterwise considered that “the 15% leakage target outlined in the PR19 methodology is driving ambition in companies and Sebastian Catovsky, Defra, stated that “the 15% will feel like quite a step change in the next five years so it will be quite ambitious to deliver nationally”. However, Sir James Bevan, CEO of the Environment Agency, told us that he “would like to see even stronger leakage targets” and highlighted that the National Infrastructure Commission (NIC) had suggested a leakage reduction target of 50 per cent by 2050.

26. In September 2018, water companies submitted their business plans for 2020–2025 to Ofwat. The industry’s Manifesto for Water, published at the same time, highlighted “proposals to cut leakage by more than 16% over the five years, with some companies intending to go even further”. However, many water companies only set themselves the minimum target of 15% by 2025, including some of the worst performers for leakage (such

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77 Consumer Council for Water (RWI0004) para 3.4.1
78 Consumer Council for Water (RWI0004) para 3.4.1
79 Q 138
80 Q 138
81 Q 138
82 Q 138
83 A group of UK water sector investors (RWI0027) para 3; “Reality Check: Have water companies cut leaks by a third?”, BBC News, 6 August 2018
84 Chartered Institution of Water and Environmental Management (RWI0021) para 45
85 Ofwat (RWI0016) para 29
86 Department for Environment, Food and Rural Affairs, A Green Future: Our 25 Year Plan to Improve the Environment, January 2018
87 Q 298
88 Q 266
89 Water UK, Ambitious new vision for water, 3 September 2018
Regulation of the water industry

A few water companies also published long term leakage reduction targets, such as 50% by 2050 (Thames Water) and 50% by 2045 (Anglian Water).

Failure to tackle leakage can incur penalties from Ofwat; for example, in June 2018, Thames Water incurred £55 million in penalties for “missing the commitment it made to customers to cut leaks” and has agreed to pay an additional £65 million back to its customers.

A shocking amount of water is lost through leakage daily. As well as being wasteful, it gives a poor impression to the public about the value of water. Reducing leakage should be a top priority for the water industry.

We are pleased that Ofwat has shown enthusiasm to levy strong penalties on water companies that fail to reach their leakage reduction targets.

Ofwat’s target for water companies to reduce leakage by 15% by 2025 is not ambitious enough and Ofwat should set a long-term target for water companies to reduce leakage. This would help focus efforts beyond the five-year period of PR19. We consider that continuing the trajectory set by the target of 15% by 2025, the water industry should collectively be aiming to reduce leakage by 50% by 2040, rather than 2050.

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92 Ofwat, Thames Water’s failure to tackle leakage results in £65m package for customers, June 2018
2 Reducing demand

31. Demand reduction is the second part of the “twin track” approach. Demand reduction comprises a range of worthwhile activities, some of which fall outside the remit of our Report (for example, improving the water efficiency of domestic appliances). We have chosen to focus here on how water companies and regulators intend to encourage customers to reduce demand.

Domestic consumption targets

32. The first step to reducing demand is to identify current levels of water consumption and then set a target for reduction. Water consumption by domestic customers is commonly measured as Per Capita Consumption (PCC), which is the average litres of water used by each person that lives in a household property per day. Waterwise stated that “targets for personal water consumption have been shown internationally as a successful option in driving forward innovative approaches for water efficiency” and it has advocated that PCC targets be used as the “most appropriate common commitment measure for water efficiency in PR19”.

The current PCC for England and Wales is 141 litres per person per day. Water usage has been shown to vary according to whether customers have a water meter (average PCC of 129 litres per person per day) or not (average PCC of 162 litres per person per day). PCC also varies widely by region, with the two extremes being non-metered customers in the South-West region using 198 litres per person per day and metered customers in the Yorkshire region using around 55 per cent of that amount, at 108 litres per person per day.

33. There were different views on what the PCC target should be. The NIC recommended a PCC of 118 litres per person per day. The Environmental Audit Committee recently recommended a PCC of 110 litres per person per day for all new buildings. Building regulations are the responsibility of the Ministry of Housing, Communities and Local Government (MHCLG).

Nicci Russell, Managing Director of Waterwise, told us that “we would like to see all the water companies in England and Wales committing to 100 litres per person or less, within that 25-year water resource management plan period”.

Ofwat stated that it had “recently commissioned a study of the long term potential for deep reductions in water consumption” which “suggested it is possible to achieve average daily consumption of between 50 and 70 litres per person in 50 years, compared to around 140 litres today, without a reduction in the level of utility or quality of water use”.

93 Waterwise (RWI0019) para 20; Correspondence from Waterwise to Ofwat, Ofwat consultation on Delivering Water 2020 - consulting on our methodology for the 2019 price review, 30 August 2017
94 Figures for April 2017 to March 2018; Discover Water, The amount we use, accessed September 2018
95 Discover Water, The amount we use, accessed September 2018
96 Discover Water, The amount we use, accessed September 2018
97 National Infrastructure Commission, Preparing for a drier future: England’s water infrastructure needs, April 2018, p 25
98 Environmental Audit Committee, Ninth report of session 2017–19, Heatwaves: adapting to climate change, HC 826, para 99
99 Ministry of Housing, Communities and Local Government, Our policies, accessed September 2018; The Chartered Institution of Water and Environmental Management (RWI0021) para 50
100 Q 59
101 Ofwat (RWI0016) para 27
34. Rachel Fletcher, CEO of Ofwat, believed that the 2019 draft water resource management plans (WRMPs) published by water companies were “really lacking in ambition” on the demand side, with “quite low ambitions around reducing per capita consumption, even over a large number of years”.102 She considered that “there are really huge opportunities for the companies to do more” and “in the next price review period [PR19] we will ask every company to make a performance commitment around reducing per capita consumption”.103 Waterwise identified “a wide variation in PCC ambition” between water companies and suggested that “Ofwat could require a PCC reduction of up to 22% - between 0 and 28 litres per day.”104

35. Defra’s 25 Year Environment Plan committed to working with industry to set “an ambitious personal consumption target and agree cost-effective measures to meet it”.105 Sebastian Catovsky explained that Defra “would like to” publish an ambitious target in the autumn.106

36. Per capita consumption (PCC) targets provide an incentive for water companies to help consumers reduce demand for water. Ambitious targets can also lead to more innovation in the water industry.

37. It is disappointing that the Government has not yet supported a specific PCC target. A cross-Government target for PCC reduction over the next 25 years should be published, alongside plans for how the target could be achieved.

## Metering

38. Water consumption is measured using water meters. Knowing how much water is used can incentivise customers to use less, and therefore reducing demand for water will partly depend on the use of water metering.107 As well as reducing water consumption, meters can help water companies and customers identify where leaks are happening.108

39. Water meters may be fitted throughout the water supply system, but our Report primarily focuses on meters within domestic premises. The main factors affecting whether properties are metered include customer choice, the age of the property and whether the property is in a designated area of water stress. All homes built after 1990 have water meters and bills reflect the amount of water used, whereas water bills for homes built before 1990 may be based on the rateable value of the property.109 Domestic customers cannot change the rateable value of their property and can only opt to be metered for their water use instead. Water companies must install a water meter free of charge at a customer’s request.110 After a meter is fitted, customers can usually choose to revert back

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102 Q 260
103 Q 260; Q 249
104 Waterwise (RWI0019) para 21–22
105 Department for Environment, Food and Rural Affairs, A Green Future: Our 25 Year Plan to Improve the Environment, January 2018, p 70
106 Q 347
107 Investors in Water (RWI0027) para 8
108 Chartered Institution of Water and Environmental Management (RWI0021) para 44
109 Rateable values are an assessment of the annual rental value of a property and were last fully updated in 1973. They are fixed and cannot be changed. Rateable values are used by water companies to calculate unmeasured water and sewerage charges. See: Ofwat, Unmetered customers, accessed September 2018
110 Installation at the customer’s request can be denied if the property’s pipe work does not allow it or the installation cost is unreasonable; Consumer Council for Water, Rateable values, accessed September 2018
to an unmeasured charge within 12 months. Water companies in areas of water stress are allowed to introduce compulsory metering as part of demand management. In 2013, the following water company regions were classified as areas of serious water stress: Affinity Water; Anglian Water; Essex and Suffolk Water; South East Water; Southern Water; Sutton and East Surrey Water; and Thames Water. Meters can also be introduced under other, limited circumstances, such as if the property has an automatically filled pond or swimming pool or when there is a change of occupier.

40. Water metering in England increased from 17 per cent in 1999/2000 to 51 per cent in 2016/17. Current levels of domestic metering vary from 85 per cent in the Southern Water region to 40 per cent in the region covered by United Utilities. Southern Water, the first company to implement a “universal metering programme”, has found that “customers reduced consumption by up to 16.5%” and that “average PCC is 15% lower”. Southern Water now has a target to “reduce average PCC to 100 litres per day by 2040”. Metering has also generated data on consumption, which is being used to “target water efficiency campaigns in areas of above average consumption”. CIWEM explained that most companies in water stressed areas, such as Southern Water, were using their powers but “outside such areas, meter penetration remains relatively low, with the average at around 53%”. However, future projections anticipate metering potentially increasing to 61 per cent by 2020, and 87% per cent by 2045.

41. Although there was widespread support among witnesses to our inquiry for increased metering, there were mixed views on whether metering should be compulsory. Mel Karam, Chief Executive Officer of Bristol Water, considered that:

> the focus, at least for the next few years, should be on customer education and water efficiency. There is a place for compulsory smart metering later on but unless we have the customers and the public on our side that water is precious, water should stay in the environment and that we should reduce water use, compulsory metering may have a negative impact and backfire.

42. CIWEM stated that “households that have chosen to have a meter tend to […] save money on their water bill, largely because they have lower than average occupancies and/or consumption”. CIWEM also considered that “comprehensive metering coverage in all water company areas […] should be permitted” but added that “this should also be accompanied by robust schemes to deal with financial hardship and to smooth bill increases for segments of society for which the impacts of moving to a metered supply would be particularly significant”. Some support already exists, such as Watersure.

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111 Ofwat, Water meters - your questions answered, 2013, p 10
112 Department for Environment, Food and Rural Affairs, Water stressed areas: 2013 classification, August 2013
113 House of Commons Library, Water meters: the rights of customers and water companies, February 2016
114 House of Commons Library, Water meters: the rights of customers and water companies, February 2016; Qq 362–369; Dr Thérèse Coffey (RWI0044)
115 Environment Agency (RWI0005) para 5
116 Investors in Water (RWI0027) para 25
117 Southern Water (RWI0036) para 35
118 Southern Water (RWI0036) para 37
119 Southern Water (RWI0036) para 36
120 Chartered Institution for Water and Environmental Management (RWI0021) para 13
121 Investors in Water (RWI0027) para 8; Environment Agency (RWI0005) para 5
122 Q 142
123 Chartered Institution for Water and Environmental Management (RWI0021) para 10
124 Chartered Institution for Water and Environmental Management (RWI0021) para 43
which caps bills for metered customers at the average metered bill amount for their area, if the customers meet certain criteria such as receiving benefits or needing to use a large amount of water for medical reasons.\textsuperscript{125} The use of such schemes to help customers transition to metering was generally supported by water companies.\textsuperscript{126}

43. Southern Water advocated universal metering as “the most cost-effective method of reducing household consumption”.\textsuperscript{127} The National Infrastructure Commission (NIC) has recommended that Defra “should enable companies to implement compulsory metering by the 2030s beyond water stressed areas, by amending regulations before the end of 2019 and requiring all companies to consider systematic roll out of smart meters as a first step in a concerted campaign to improve water efficiency”.\textsuperscript{128} Rachel Fletcher, Ofwat, stated that Ofwat has “a number of incentives on the companies that might drive them to look again at the case for metering”, including the “performance commitment around reducing per capita consumption” in PR19.\textsuperscript{129} Rachel Fletcher added that Ofwat expects companies to be “talking to their customers about metering” and “helping customers understand the benefits that can come from water meters”.\textsuperscript{130}

44. We consider that using meters to ensure customers pay for the water they use, rather than basing bills on the outdated system of rateable values, sends a strong message to customers about the value of water. There is strong evidence that metering helps to reduce water use and to detect leaks.

45. Allowing compulsory metering only in water-stressed areas causes regional disparities that are inappropriate given the national need to conserve water. We endorse the recommendation of the National Infrastructure Commission that Defra should amend regulations by the end of 2019 to allow all water companies to implement compulsory metering, using smart meters. Water companies should use these powers to help achieve ambitious PCC reduction targets, while also engaging customers about the value of water and the benefits of using a meter. Support for economically vulnerable customers should be strengthened should metering lead to significant bill increases.

\textsuperscript{125} Citizen’s advice, Watersure scheme – help with paying water bills, accessed September 2018

\textsuperscript{126} For example, Qq 145–146

\textsuperscript{127} Southern Water (RW/0036) para 38

\textsuperscript{128} National Infrastructure Commission, Preparing for a drier future: England’s water infrastructure needs, April 2018, p 12

\textsuperscript{129} Q 249

\textsuperscript{130} Q 249
### 3 Water company performance

46. Our inquiry also covered the performance of water companies in areas such as customer satisfaction, financing and governance and environmental pollution. This chapter explores these concerns in turn.

#### Customer satisfaction

47. Overall, customers are satisfied with the service they receive from their water company; Defra stated that “93% of customers are satisfied with water companies’ services and 73% consider it good value for money”.

Customers that are not satisfied should usually complain to their water company in the first instance. The company should respond to complaints within 10 working days. If the customer is still dissatisfied, they can contact the Consumer Council for Water (CCWater), a non-departmental public body funded through the licence fee that water companies pay Ofwat. If the complaint is still unresolved, customers can use the Water Redress Scheme (WATRS), the “independent adjudicator for disputes between customers and the water and sewerage companies or supplier of England and Wales”. Although CCWater has no formal powers, WATRS will provide “a final resolution that is binding upon water and sewage companies”. If the customer does not accept the adjudicator’s decision, they can pursue their claim through the courts.

Some specific types of complaints fall under Ofwat’s remit instead, such as those concerning water and sewerage connections and anti-competitive behaviour.

48. CCWater publishes an annual Complaints and Enquiries report, highlighting which companies it receives complaints about. Tony Smith, CEO of CCWater told us that there are “over 2 million complaints and unwanted contacts to the industry a year”. CCWater received 9,746 consumer complaints about water companies in 2017–18, an increase of 11% on the previous year. Tony Smith explained that “the growth area is billing problems” and that “over 50% of the cases to the industry and to us are around billing issues, particularly unexpectedly high bills”. CCWater secured £1.4 million of financial redress for consumers in 2017–18, which equates to around £144 per complaint handled, or £500 per complaint upheld.

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131 Department for Environment, Food and Rural Affairs (RWI0018) para 8
132 Consumer Council for Water, Your right to complain about your water or sewerage company, 2015
133 Consumer Council for Water, Your right to complain about your water or sewerage company, 2015
134 Department for Environment, Food and Rural Affairs (RWI0018) para 12
135 Water Redress Scheme, About us, accessed September 2018
136 Q 222; Water Redress Scheme, How we work, accessed September 2018
137 Water Redress Scheme, How we work, accessed September 2018
138 Ofwat, Complaints and disputes we can help with, accessed September 2018; Ofwat, Alternative dispute resolution routes, accessed September 2018
139 Consumer Council for Water, 2017–18 Complaints and Enquiries Report, June 2018
140 Q 219; “Unwanted contacts” includes when customers have reported a service issue or had to chase their water company for action to be taken
142 Q 219
49. Tony Smith explained that “the complaints system works a lot better than it used to” and that complaints had “fallen by 65% over the last few years” because CCWater had “put pressure on the bad-performing companies” and Ofwat had changed “the regulatory system around complaints”.\(^{144}\) However, he had concerns about the complexity of the complaints procedure, stating that:

some of the companies take several stages to resolve a problem, so the customer is losing the heart to go through this process already, even by the time they have got to the end of the company’s process. They might have three stages themselves before it comes to [CCWater], so that is one of the things we need to rationalise so it is much slicker.\(^{145}\)

Rachel Fletcher, Ofwat, concurred that “there are a number of hand-off points in [the process] and we see large dropout rates at each of those hand-off points”.\(^{146}\) Tony Smith and Rachel Fletcher both agreed that the complaints process could be streamlined.\(^{147}\) Tony Smith considered that customers should “get what they need at the first point, ideally”, and that companies themselves should resolve more cases.\(^{148}\) Rachel Fletcher also highlighted that:

In other sectors, once a customer’s complaint has not been resolved for a particular period of time with the company, the company then effectively ends up paying automatically for that complaint to go to the ombudsman for review. That does tend to focus minds somewhat. […] these are the kinds of things that we need to look at.\(^{149}\)

50. Some water companies have unnecessarily convoluted processes for dealing with customer complaints, resulting in customers giving up before their complaint is properly resolved. Ofwat should review how the complaints process within water companies could be streamlined. This could include a mechanism whereby water companies either automatically pay complainants a fixed sum or escalate complaints to CCWater if the complaint is not resolved by the company within 15 days.

**Financing and governance**

51. In March 2018, The Rt Hon Michael Gove MP, Secretary of State for Environment, Food and Rural Affairs, attacked water companies for “playing the system for the benefit of wealthy managers and owners, at the expense of consumers and the environment”, and suggested that they had “shielded themselves from scrutiny, hidden behind complex financial structures, avoided paying taxes, have rewarded the already well-off, kept charges higher than they needed to be and allowed leaks, pollution and other failures to persist”.\(^{150}\) The Secretary of State added that “in cash terms, over £18.1 billion was paid out to shareholders of the nine large English regional water and sewerage companies between 2007 and 2016” and that “95% of the profit went in dividends to shareholders”. The remuneration packages of chief executives also attracted disapproval from the Secretary of

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\(^{144}\) Q 219
\(^{145}\) Q 220
\(^{146}\) Q 218
\(^{147}\) Qq 218–219
\(^{148}\) Qq 219–220
\(^{149}\) Q 225–226
\(^{150}\) Department for Environment, Food and Rural Affairs, *A water industry that works for everyone*, March 2018
State.\textsuperscript{151} CIWEM stated that “there has been criticism from a range of quarters concerning the performance of water companies as monopoly providers of an essential public service”, particularly “in the context of levels of executive pay, shareholder dividends, debt ratios, or the lack of transparency in relation to company ownership and tax contributions”.\textsuperscript{152} Dr Kate Bayliss and Professor David Hall stated that “debt, dividends and directors’ pay put upward pressure on prices as these are all financed by customer bills”.\textsuperscript{153} In addition, it can reduce investment.

52. Ofwat explained to us that it had “set out proposals to confront the behaviours that undermine public trust” and consulted on financial engineering, dividend policies and linking executive bonuses to delivering for customers.\textsuperscript{154} In July 2018, Ofwat published its proposals to “put the sector back in balance”.\textsuperscript{155} Rachel Fletcher explained to us that the proposals would mean “companies must share any benefits that they get from having high levels of debt in their structure” and that Ofwat was “pushing the companies to have much more financially resilient structures”.\textsuperscript{156} However, she clarified that “the financing arrangements and exactly what balance of debt and equity they want to have is a decision individual companies should be making”.\textsuperscript{157} Defra told us that it “supports the proposals of the economic regulator, Ofwat” and stated that “water companies are responding positively to this challenge with a range of measures”.\textsuperscript{158}

53. Some witnesses to our inquiry highlighted Ofwat’s role in creating the problem. For example, Wessex Water Services Ltd considered that “responsibility lies with both the particular investors and former regulators who allowed companies to be highly geared to the benefit of shareholders, rather than customers”, however it acknowledged that Ofwat “recognises the issue and is working hard to correct the excesses of the past”.\textsuperscript{159} When we asked Rachel Fletcher why Ofwat had not tackled this problem before, she responded that:

For about five years now, Ofwat has really been pushing on the agenda to make sure that companies are acting as you would expect from a monopoly provider of an essential service. We have put in […] a very low rate of return in the current price review. We have been pushing as well to improve the governance of the companies.\textsuperscript{160}

54. Between July and August 2018, Ofwat consulted on proposals to review and update the board leadership, transparency and governance principles that it expects water companies to apply.\textsuperscript{161} These principles cover requirements such as reporting on company performance, having independent members on company boards and a Chair independent of investors and management.\textsuperscript{162} Rachel Fletcher explained that Ofwat’s principles were voluntary, and that “even with a voluntary set of principles in place we

\textsuperscript{151} Department for Environment, Food and Rural Affairs, \textit{A water industry that works for everyone}, March 2018
\textsuperscript{152} Chartered Institution of Water and Environmental Management (\textit{RWI0027}) para 25
\textsuperscript{153} Dr Kate Bayliss, SOAS, University of London and University of Leeds and Professor David Hall, PSIRU, University of Greenwich (\textit{RWI0028}) para 13
\textsuperscript{154} Ofwat (\textit{RWI0015}) para 9
\textsuperscript{155} Ofwat, \textit{Putting the sector back in balance – summary of Ofwat’s decision on issues for PR19 business plans}, July 2018
\textsuperscript{156} Q 196
\textsuperscript{157} Q 231
\textsuperscript{158} Department for Environment, Food and Rural Affairs (\textit{RWI0018}) para 5
\textsuperscript{159} Wessex Water Services Ltd (\textit{RWI0024}) para 11
\textsuperscript{160} Q 196
\textsuperscript{161} Ofwat, \textit{Consultation on revised Board Leadership, Transparency and Governance principles}, July 2018
\textsuperscript{162} Ofwat, \textit{Board leadership, transparency and governance – principles}, January 2014
have seen improvements in corporate governance”. Nevertheless, she considered that “it is time now that those companies should be bound to those principles through the licence” because:

our powers to impose new licence conditions on water companies are constrained. If a water company does not agree with our proposals, our only recourse is to refer the matter to the Competition and Markets Authority. We feel that that slows things down, it hampers our ability to drive through important changes and, ultimately, were there to be a legislative opportunity, that is the kind of new power that we would really welcome.

55. The financing arrangements of some water companies fall below the standards that we expect from providers of an essential public service. High levels of executive pay, shareholder dividends and debt ratios risk reducing public trust in the water industry. We welcome the Secretary of State’s focus on this issue and consider that water companies should instead invest more in their businesses. Ofwat should have firmly tackled the imbalances in the financial models of some water companies much earlier, and we were not satisfied with its explanations as to why it had not done so.

56. In the absence of real competition in the sector, Ofwat must strike a difficult balance between consumer interests and making it financially worthwhile for water companies to satisfy their investors. That balance has been skewed in favour of the latter. The regulator’s proposals to “balance the sector” are now heading in the right direction but we are sceptical about whether they go far enough. Ofwat should review the changes implemented by water companies on financial engineering, dividend policies and linking executive bonuses to delivering for customers and publish a written update to us by April 2019.

57. After Ofwat has published the results of its consultation on governance principles, the Government should give Ofwat powers to bind water companies to the principles through licence conditions.

Penalties for pollution

58. Another area where water companies’ performance was criticised was pollution of the natural environment. The Environment Agency recently published The Water and Sewerage Companies’ Environmental Performance Report, which found that “although there has been a gradual improving trend in environmental performance over recent years, the industry is not doing enough to reduce serious pollution incidents and comply with permits”. The report notes that in 2017, there had been “a rise in the most serious pollution incidents” and “previous reductions in serious (Category 1 and 2) incidents have also plateaued continuing at around one incident per week”. The Environment Agency (EA) has issued “almost 25,000 permits and licences” to water companies which “set out the necessary conditions for water companies to meet their environmental obligations”.
Compliance, which includes “monitoring of systems and the environment, inspections and audits”, was considered by the EA to be “generally good”.\[^{168}\] Non-compliance can lead to penalties such as fines.

59. WWF-UK considered that “the current system of enforcement of water company pollution incidents—particularly for sewer flows—is not fit for purpose”.\[^{169}\] It expressed concerns that there was a reliance on self-reporting and a lack of follow-up to pollution incidents.\[^{170}\] By contrast, CIWEM noted that “current penalties and enforcement mechanisms are driving improvements, although there are clearly still issues with unsatisfactory intermittent discharges and pollution incidents occurring”.\[^{171}\] Similarly, the EA believed that “the increase in fines and wider range of enforcement options available are an incentive for water companies to reduce the number of serious pollution incidents and non-compliance with permits”.\[^{172}\]

60. In March 2017, Thames Water was fined £20 million for sewage pollution that occurred over 2012–2014.\[^{173}\] The high-profile nature of this case attracted much attention in our inquiry. Blueprint for Water, a coalition of environmental groups, stated that “although record breaking, the fine to Thames Water was equivalent to just ten days’ worth of the company’s operating profits”.\[^{174}\] Changes in Sentencing Guidelines have enabled “record fines for the sector”, with “more than £21 million […] issued as a result of 16 successful prosecutions by the Environment Agency”.\[^{175}\] Sir James, CEO of the EA, told us that “it is good that the sentencing guidelines have been increased, so the principle now is that the fine should be proportionate to the turnover of the company. […] in Thames’ case, £20 million is 1% of their turnover”.\[^{176}\]

61. The continued failure of water companies to prevent serious pollution incidents may have been exacerbated by previous penalties being merely seen as operational costs. We are pleased that fines for pollution incidents have increased and consider that the threat of fines of up to 1 per cent of company turnover should apply sufficient pressure on water companies to reduce pollution.

62. We recommend that the Government reviews whether the Environment Agency has the necessary powers and resources to enforce a drastic reduction in sewage overflows into our rivers.

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\[^{168}\] Environment Agency (RWI0005) para 4
\[^{169}\] WWF-UK (RWI0035) para 4
\[^{170}\] WWF-UK (RWI0035) para 4.1–4.2
\[^{171}\] Chartered Institution of Water and Environmental Management (RWI0021) para 68
\[^{172}\] Environment Agency (RWI0005) para 20
\[^{173}\] Blueprint for Water (RWI00020) para 4.3.1
\[^{174}\] Blueprint for Water (RWI00020) para 4.3.1
\[^{175}\] Environment Agency, Water companies need to do more to protect the environment, report shows, July 2018
\[^{176}\] Q 247 [Sir James Bevan]
4 The water retail market

63. A relatively new part of the water industry is the retail market. In April 2017, the water retail market opened for business, bringing, according to Ofwat, “the biggest change to the water sector since privatisation.” Ofwat, Business retail market, accessed September 2018. Before the market opened, around 26,000 large business customers could choose their provider of retailer services in England and Wales. Ofwat, Open for business: Reviewing the first year of the business retail water market, July 2018, p 3. The 2017 change meant that an additional 1.2 million non-domestic customers, such as businesses and charities, could choose who to buy their water services from. Ofwat, Open for business: Reviewing the first year of the business retail water market, July 2018, p 60. According to Waterwise, retailers provide “the ‘customer-facing’ services including billing customers, handling payments, reading meters, and taking calls from customers about network related issues” but not “water resources management, water and sewerage treatment, or management of water or sewerage networks”, which are “referred to as upstream or wholesale services”. Waterwise, Water Efficiency in Retail Competition – experience so far, January 2018. Customers buy water services from retail suppliers, who buy the physical supply of water and/or removal of wastewater from wholesalers (the water companies that own and operate the network of pipes, mains and treatment works). Ofwat, Business retail market: who is eligible?, accessed September 2018. Competition results from customers being able to switch their supplier, which can be either the regional water company or a retail supplier. Ofwat, Business retail market, accessed September 2018. The new market works alongside the existing retail market in Scotland, which is regulated by the Water Industry Commission for Scotland (WICS) and has been operating since 2008.

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<th>Who can choose their water services supplier</th>
<th>Who can’t choose their water services supplier</th>
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<tr>
<td>Business customers supplied by an appointed company whose area is wholly or mainly in England</td>
<td>Domestic/household customers in England and Wales</td>
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<tr>
<td>Business customers supplied by an appointed company whose area is wholly or mainly in Wales AND using a minimum of 50 mega litres of water a year</td>
<td>Business customers supplied by an appointed company whose area is wholly or mainly in Wales using less than 50 mega litres of water a year</td>
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64. CIWEM considered that “the introduction of competition into the water industry has provided increased choice for non-household customers [and] has increased the focus on customer service as well as on additional services like water management and water efficiency”. Chartered Institution of Water and Environmental Management (RWI0021) para 17. Bristol Water stated that “the successful, on-time, introduction of the business retail market […] is a welcome change that will help to ensure that business customers get the service they need from the water industry.” Bristol Water (RWI0040) para 1.3.
innovative”.

The retail market has also enabled many water companies to exit the market; Bristol Water, for example, “no longer competes with the retailers.” To date, 16 water companies have exited the retail market.

65. The opening of the water retail market was viewed positively by most of our witnesses. However, there were two areas where the market had not lived up to expectations: water efficiency services and the number of small and medium enterprises switching suppliers. These are addressed below.

### Water efficiency

66. Blueprint for Water was concerned that “whilst Government, Ofwat and the environmental regulators have rightly been pushing the water company wholesalers to drive efficiency improvements on domestic use, we are not seeing parallel efforts, ambition or transparency from the retail business market.” Waterwise also criticised the performance of retailers in delivering efficiency services, stating that although “water efficiency (and energy efficiency) was a key benefit identified in Scotland, and a key stated goal for Government and regulators in England, we have yet to see this at scale, and some wholesalers have reported non-household water use increasing since market opening.”

In addition, Waterwise found that “less than 50% of water retailers were identified as offering key water efficiency services, such as leak detection” on their websites and “most offer it to some customers, but very few to SMEs, and most charge extra for this service.” Waterwise recommended that the Government “should clearly state that it expects water retailers to play their role in ensuring resilient supplies.”

67. When we asked John Reynolds, CEO of the water retailer Castle Water, whether water retailers were offering enough water efficiency services, he explained “we try really hard to offer efficiency, and we are trying even harder to get the customers to take it up, but it is not always an open door.” He provided some examples of customers showing low interest in water efficiency:

> We had our annual customer conference about a month ago. Half of the conference was external experts talking about water usage. None of the customers present asked a single question about the usage. We currently have an advertising campaign giving free automatic meter reading, which is smart metering, to farms. That is national. We have only had six farmers take it up. We have a section on the website giving water efficiency advice. We have offered water efficiency audits when taking on new customers in the voluntary sector with care homes. On the first day of the contract I phoned them and said, “When can we do the efficiency audit we have offered to do for you?” They have said, “Actually, we are too busy to do it.”

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187 Q 110
188 Q 110
189 Department for Environment, Food and Rural Affairs, Companies with approval to withdraw from the non-household retail market for water, April 2018
190 Blueprint for Water (RWI0020) para 1.3.3
191 Waterwise (RWI0019) para 33
192 Waterwise (RWI0019) para 34
193 Waterwise (RWI0019) para 35
194 Q 151
195 Q 151
68. Rachel Fletcher, Ofwat, told us that “so far, we have seen up to 500 million litres of water saved as a result of competition, but we think that is just scratching the surface of what we would expect to see as new retailers come into the market with new product offerings to attract customers”.\(^{196}\)

**Small and medium enterprise (SME) customers**

69. John Reynolds, Castle Water, told us that some organisations such as “multi-site operators who have switched to billing on a national basis” were clearly benefitting from the market.\(^{197}\) However, there had not been “enough buy-in from small and medium sized businesses” partly because “the central information to support the market, so that small customers without sophisticated buying operations can understand and trust it, is not very good”.\(^{198}\) He elaborated that:

   Even when we offer discounts, which at the smaller end of the market can be 10% of bills, customers are not opting for it. To me that suggests that there is more holding them back. It is not just that water bills in some areas are relatively low. Most people would take a saving like that for a relatively small amount of work if they trusted what was on offer. […] They do not trust switching utilities, full stop. There is not enough to support what is on offer from water to make it worth taking the risk in some cases, which is a shame because there are savings and there is also a choice of different service propositions now.\(^{199}\)

70. The impact of the retail market on SMEs was highlighted in Ofwat’s July 2018 review of the market, which found that:

   many customers are either not aware of their ability to choose a new retailer, or that they see few benefits in trying to shop around and switch. This is particularly true of smaller or lower expenditure customers. For these customers, savings available from switching may not be high compared to their perceptions of the time and effort needed to engage with the market. In light of this, we recognise the importance of continued price protections for those who have not yet engaged in the market.\(^{200}\)

Ofwat also “identified a number of market frictions that have had a negative impact on customers’ experiences of the market, for example, concerning obtaining accurate quotes, reliable billing and smooth switching”.\(^{201}\) These market frictions “raise retailers’ costs and hinder their incentives to reach out to certain customer groups, particularly smaller businesses”.\(^{202}\) John Reynolds stated that “the first year of the market has been hard work” because “a lot of the information, data, processes and systems that were in place historically are not right for the market”.\(^{203}\)
71. We questioned Rachel Fletcher on the performance of the retail market. She told us that Ofwat’s “overall assessment is that the first year has shown some promising signs, but there is a huge amount more work to be done for that market to really reach its full potential in terms of the benefits it can bring.” She considered that the risk of fragmenting the market was a “legitimate concern” that Ofwat “will be keeping a very close eye on.” She added that:

> there is a role for competition—new players coming in with products, frankly, that the water companies are quite often slow to offer to their customers. We have already opened up the market for businesses to connect new housing developments, for example, and it is through those new entrants that we are seeing the cutting edge of innovation on introducing dual water systems, grey water systems and quite interesting water efficiency systems. Unless we really allow room for new players to come in, we are constantly going to be looking to the water companies, which have lots of other things on their mind, to bring forward some of the water efficiency that we are hoping to see in the future.

Ofwat will “continue to monitor the market” and keep under review what actions it should take.

72. We also explored whether domestic customers should also be able to choose their water supplier. Tony Smith, CEO of the Consumer Council for Water (CCWater), told us that:

> the real test is how it works for small business customers, as that will give us a strong indication of how it would work for domestic customers. A couple of years ago, Ofwat did an analysis of the opportunity for domestic retail competition, which showed that although many domestic customers wanted a choice, they were disappointed with the potential savings on offer. Somewhere between £10 and £40 is really the maximum amount of money you are going to get out of the retail market. As we have seen in the energy sector, where customers are not switching for £200, that small saving was likely to create a bit of disinterest in the market.

73. It is interesting to note that the water retail market was first introduced in the UK in Scotland in the context of a publicly owned water industry. The water retail market in England and Wales is in its infancy and we expect teething problems to occur. However, the first year has delivered unimpressive results for water efficiency and we are concerned at suggestions that water retailers may not be taking water efficiency seriously enough.

74. It is disappointing that small and medium enterprises (SMEs) have not engaged well in the market as customers. Big businesses should not be the main beneficiaries of the retail market. As market frictions are reduced, we would like to see water retailers attracting more SME customers. Ofwat should consider ways to incentivise this.
75. Although water retailers are private companies, they have a key role in improving water efficiency and resilience, which are in the public interest. We are pleased that Ofwat has reviewed the state of the market. We recommend that Ofwat undertakes annual reviews until the market is shown to be delivering real competition and water efficiency.
5  Is regulation fit for purpose?

76. Much of our report has referred to the current price review, PR19, which will be finalised in December 2019, setting prices for the period 2020–2025. Ofwat considered that the last price review (PR14), covering 2015–2020, was delivering lower bills, more investment, fewer supply interruptions, reduced leakage and environmental benefits. In the next price review, Ofwat has “set four themes for companies to focus on and deliver against: resilience, affordable bills, customer service and innovation”.

77. Some water companies were supportive of the approach taken in PR19. For example, Yorkshire Water stated that it “represents a major step change in the regulation of the sector and creates clear incentives to improve services to customers”. Others were dissatisfied with the five-year timescale. For example, Anglian Water stated that:

Current regulations require water companies to submit business plans every five years against ever increasingly vast and burdensome requirements. The frequency of these reviews is arguably too high, with much of the five year period used to plan for the next. There is a case for aligning utility regulatory cycles to allow local authorities and strategic planning bodies to take a more comprehensive and consistent long term view on growth.

78. The Government’s 2011 Review of Ofwat and consumer representation in the water sector, known as the Gray review, found that “Ofwat has contributed to significant achievements in the water sector since it was established in 1989”. Although nobody had “recommended radical change to the sector’s regulatory arrangements”, Ofwat needed to “make some important changes to the way it works” to allow regulated companies to address the “substantial future challenges” facing the sector. Investors in Water stated that:

While aspects of Ofwat’s framework have become more flexible (such as its approach to outcomes), the overall complexity of the framework has increased. At a high level, the regulatory methodology and supporting appendices for the 2014 price control totalled 289 pages, whereas the 2019 price review methodology totals 828 pages (plus further supporting documents). Clearly, a regulatory settlement that covers over £50 billion worth of revenue over a five-year period should contain a degree of detail. However, it is an observable fact that the overall complexity and prescriptiveness of the framework has increased, rather than achieving the reduction in regulatory burden that the Gray Review envisaged.
In contrast, Bristol Water noted that “the regulatory framework has evolved and adapted significantly over time” and that:

The pace of change has accelerated since the review by David Gray in 2011 of Ofwat’s regulation of the water sector, which noted at that point the considerable evidence that burden of the regulatory regime meant water companies were too Ofwat-focussed and conservative in their approach. A substantial change in culture of both companies and Ofwat was felt to be required. There is evidence of a positive culture change since then, supported by changes to the regulatory regime.216

79. The Chartered Institution of Water and Environmental Management (CIWEM) suggested that:

After three decades, it would be right for an independent review to consider the ability of the water industry, as currently configured and regulated, to meet the needs of the environment and society, which are considerably different and in certain contexts more acute to those which existed 30 years ago. Such a review should take the opportunity to examine how water companies are owned, operate and are regulated in the devolved administrations and make recommendations for how the current approach may be improved.217

Rob Lawson, Chair of Water Resources Panel, CIWEM, explained that:

It is not just about prices and charges to customers. There is a much bigger need to focus on environmental outcomes. There is a much bigger need to engage with customers […] that is why we recommend a review.218

80. The Future Water Association questioned Ofwat’s “significant emphasis” on reducing bills in PR19, despite the “average water and sewerage bill [being] around £1.11 per day (or just over £400pa)”219 It stated that:

The recent customer engagement exercise by the companies as part of their PR19 Business Plan development has suggested customer priorities are more about long term resilience and continuity of water and wastewater services, reducing leakage and protecting the environment, rather than bill reductions.

It could be argued therefore that the current regulatory approach, or part of it, mitigates against the long-term outcomes for consumers and the environment.220

81. The water industry in England and Wales is diverse, and in the drive to mimic and create competition, economic regulation has become very complex. The introduction of the water retail market is an interesting experiment, the success of which remains to be seen.

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216 Bristol Water (RWI0040) para 1.2
217 Chartered Institution of Water and Environmental Management (RWI0021) para 28
218 Q 21
219 Future Water Association (RWI0041) para 1
220 Future Water Association (RWI0041) para 1
82. While Ofwat has increasingly tried to take a less prescriptive approach and focus more on outcomes, the price review methodology has become more lengthy and detailed. It is unclear whether economic regulation has overall become more or less burdensome for water companies and what the impact is.

83. We recommend that the Government commissions an independent review of whether the water industry and regulation are fit to meet future needs such as drought resilience, as well as delivering value for money for customers. Consideration should also be given to whether the price review cycle is too short to allow long-term planning in the industry. Our recommended review should begin immediately so that it can influence the 2024 price review. A strong, independent regulator will be needed in England and Wales in the future, under all circumstances.
Conclusions and recommendations

Increasing supply

1. Reform of the abstraction system was long overdue, and we welcome the focus on catchment-based approaches. The Government and Environment Agency must make a rigorous assessment of whether a voluntary approach will be sufficient to protect water resources and the natural environment in the long-term. The legislative demands of Brexit must not prevent statutory reform, should it become necessary. In its update to Parliament in 2019, the Government should include an assessment of the need for statutory reform. (Paragraph 13)

2. Although there are infrastructure and environmental challenges to be overcome, water transfers should play an important role in increasing supply and resilience. Although transfers might be difficult to put in place during short-term episodes of drought, they would help companies to manage their resources effectively in the long-term. It is therefore disappointing that only 4 per cent of water is currently traded. This suggests that Ofwat’s incentives are not strong enough. (Paragraph 19)

3. We note Defra’s suggestion that 8 per cent of total supply will need to be transferred in the next 10 to 20 years. The Government and Ofwat should make a strategic assessment of the need for water transfer infrastructure and confirm a long-term target for water transfers. We are concerned that existing incentives in PR19 are not strong enough to incentivise water companies to invest in water transfers. (Paragraph 20)

4. A shocking amount of water is lost through leakage daily. As well as being wasteful, it gives a poor impression to the public about the value of water. Reducing leakage should be a top priority for the water industry. (Paragraph 28)

5. We are pleased that Ofwat has shown enthusiasm to levy strong penalties on water companies that fail to reach their leakage reduction targets. (Paragraph 29)

6. Ofwat’s target for water companies to reduce leakage by 15% by 2025 is not ambitious enough and Ofwat should set a long-term target for water companies to reduce leakage. This would help focus efforts beyond the five-year period of PR19. We consider that continuing the trajectory set by the target of 15% by 2025, the water industry should collectively be aiming to reduce leakage by 50% by 2040, rather than 2050. (Paragraph 30)

Reducing demand

7. Per capita consumption (PCC) targets provide an incentive for water companies to help consumers reduce demand for water. Ambitious targets can also lead to more innovation in the water industry. (Paragraph 36)

8. It is disappointing that the Government has not yet supported a specific PCC target. A cross-Government target for PCC reduction over the next 25 years should be published, alongside plans for how the target could be achieved. (Paragraph 37)
9. We consider that using meters to ensure customers pay for the water they use, rather than basing bills on the outdated system of rateable values, sends a strong message to customers about the value of water. There is strong evidence that metering helps to reduce water use and to detect leaks. (Paragraph 44)

10. Allowing compulsory metering only in water-stressed areas causes regional disparities that are inappropriate given the national need to conserve water. We endorse the recommendation of the National Infrastructure Commission that Defra should amend regulations by the end of 2019 to allow all water companies to implement compulsory metering, using smart meters. Water companies should use these powers to help achieve ambitious PCC reduction targets, while also engaging customers about the value of water and the benefits of using a meter. Support for economically vulnerable customers should be strengthened should metering lead to significant bill increases. (Paragraph 45)

Water company performance

11. Some water companies have unnecessarily convoluted processes for dealing with customer complaints, resulting in customers giving up before their complaint is properly resolved. Ofwat should review how the complaints process within water companies could be streamlined. This could include a mechanism whereby water companies either automatically pay complainants a fixed sum or escalate complaints to CCWater if the complaint is not resolved by the company within 15 days. (Paragraph 50)

12. The financing arrangements of some water companies fall below the standards that we expect from providers of an essential public service. High levels of executive pay, shareholder dividends and debt ratios risk reducing public trust in the water industry. We welcome the Secretary of State’s focus on this issue and consider that water companies should instead invest more in their businesses. Ofwat should have firmly tackled the imbalances in the financial models of some water companies much earlier, and we were not satisfied with its explanations as to why it had not done so. (Paragraph 55)

13. In the absence of real competition in the sector, Ofwat must strike a difficult balance between consumer interests and making it financially worthwhile for water companies to satisfy their investors. That balance has been skewed in favour of the latter. The regulator’s proposals to “balance the sector” are now heading in the right direction but we are sceptical about whether they go far enough. Ofwat should review the changes implemented by water companies on financial engineering, dividend policies and linking executive bonuses to delivering for customers and publish a written update to us by April 2019. (Paragraph 56)

14. After Ofwat has published the results of its consultation on governance principles, the Government should give Ofwat powers to bind water companies to the principles through licence conditions. (Paragraph 57)

15. The continued failure of water companies to prevent serious pollution incidents may have been exacerbated by previous penalties being merely seen as operational costs.
We are pleased that fines for pollution incidents have increased and consider that the threat of fines of up to 1 per cent of company turnover should apply sufficient pressure on water companies to reduce pollution. (Paragraph 61)

16. We recommend that the Government reviews whether the Environment Agency has the necessary powers and resources to enforce a drastic reduction in sewage overflows into our rivers. (Paragraph 62)

The water retail market

17. It is interesting to note that the water retail market was first introduced in the UK in Scotland in the context of a publicly owned water industry. The water retail market in England and Wales is in its infancy and we expect teething problems to occur. However, the first year has delivered unimpressive results for water efficiency and we are concerned at suggestions that water retailers may not be taking water efficiency seriously enough. (Paragraph 73)

18. It is disappointing that small and medium enterprises (SMEs) have not engaged well in the market as customers. Big businesses should not be the main beneficiaries of the retail market. As market frictions are reduced, we would like to see water retailers attracting more SME customers. Ofwat should consider ways to incentivise this. (Paragraph 74)

19. Although water retailers are private companies, they have a key role in improving water efficiency and resilience, which are in the public interest. We are pleased that Ofwat has reviewed the state of the market. We recommend that Ofwat undertake annual reviews until the market is shown to be delivering real competition and water efficiency. (Paragraph 75)

Is regulation fit for purpose?

20. The water industry in England and Wales is diverse, and in the drive to mimic and create competition, economic regulation has become very complex. The introduction of the water retail market is an interesting experiment, the success of which remains to be seen. (Paragraph 81)

21. While Ofwat has increasingly tried to take a less prescriptive approach and focus more on outcomes, the price review methodology has become more lengthy and detailed. It is unclear whether economic regulation has overall become more or less burdensome for water companies and what the impact is. (Paragraph 82)

22. We recommend that the Government commissions an independent review of whether the water industry and regulation are fit to meet future needs such as drought resilience, as well as delivering value for money for customers. Consideration should also be given to whether the price review cycle is too short to allow long-term planning in the industry. Our recommended review should begin immediately so that it can influence the 2024 price review. A strong, independent regulator will be needed in England and Wales in the future, under all circumstances. (Paragraph 83)
Draft Report (Regulation of the water industry) proposed by the Chair, brought up and read.

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

Paragraphs 1—83 agreed to.

Resolved, That the Report be the Eighth 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 Wednesday 10 October 9.15am]
Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee’s website.

**Wednesday 20 June 2018**

**Rob Lawson**, Chair of Water Resources Panel, Chartered Institution of Water and Environmental Management; **Stephen Wielebski**, Senior Consultant, Home Builders Federation; **Nicci Russell**, Managing Director, Waterwise; and **Hannah Freeman**, Chair, Blueprint for Water coalition

**Tuesday 3 July 2018**

**Steve Robertson**, Chief Executive Officer, Thames Water; **Mel Karam**, Chief Executive Officer, Bristol Water; **Dr Jerry Bryan**, Chief Executive Officer, Albion Water; **John Reynolds**, Chief Executive Officer, Castle Water

**Wednesday 11 July 2018**

**Rachel Fletcher**, Chief Executive Officer, Ofwat; **Sir James Bevan**, Chief Executive Officer, Environment Agency; and **Tony Smith**, Chief Executive Officer, Consumer Council for Water

**Wednesday 11 July 2018**

**Dr Thérèse Coffey MP**, Parliamentary Under Secretary of State for the Environment, Department for Environment, Food and Rural Affairs; **Dr Sebastian Catovsky**, Deputy Director for Water Services, Department for Environment, Food and Rural Affairs
Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee’s website.

RWI numbers are generated by the evidence processing system and so may not be complete.

1. A group of UK water sector investors (RWI0027)
2. Albion Water Ltd (RWI0026)
3. Amwell Magna Fishery (RWI0030)
4. Anglian Water Group Ltd. (RWI0015)
5. Blueprint for Water (RWI0020)
6. Bristol Water (RWI0040)
7. Castle Water (RWI0001)
8. Committee on Climate Change (RWI0006)
9. Consumer Council for Water (RWI0004)
10. Country Land & Business Association (CLA) (RWI0007)
11. Defra (RWI0018)
12. Dr Kate Bayliss (RWI0028)
13. Dr Kevin Grecksch (RWI0008)
14. Dr Thérèse Coffey (RWI0044)
15. Emeritus Professor of Water Economics colin green (RWI0002)
16. EnTrade (RWI0029)
17. Environment Agency (RWI0005)
18. Future Water Association (RWI0041)
19. Hannah Freeman (RWI0042)
20. Home Builders Federation (RWI0012)
21. Imperial College London (RWI0022)
22. Indepen (RWI0031)
23. Moors for the Furture Partnership (RWI0017)
24. National Farmers’ Union (RWI0011)
25. Ofwat (RWI0016)
26. Ofwat (RWI0043)
27. River Chess Association (RWI0013)
28. Severn Trent Water Ltd (RWI0010)
29. South West Water (RWI0025)
30. Southern Water (RWI0036)
31. TDS (RWI0014)
32. Thames Water Utilities Limited (RWI0038)
33. The Chartered Institution of Water and Environmental Management (RWI0021)
34 United Utilities (RWI0003)
35 University of Sheffield (RWI0009)
36 Verastar Limited (RWI0033)
37 Water UK (RWI0032)
38 Waterwise (RWI0019)
39 Wessex Water Services Ltd (RWI0024)
40 WWF-UK (RWI0035)
41 Yorkshire Water (RWI0037)
List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the [publications page](#) of the Committee’s website. The reference number of the Government’s response to each Report is printed in brackets after the HC printing number.

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