House of Commons
Environment, Food and Rural Affairs Committee

Regulation of the water industry: Government and Ofwat Responses to the Committee’s Eighth Report

Fourteenth Special Report of Session 2017–19

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The Environment, Food and Rural Affairs Committee

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

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Committee staff

The current staff of the Committee are Philip Aylett (Committee Clerk), Sian Woodward (Committee 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), Annabel Russell (Committee Assistant) and Joe Williams (Media Officer).

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The Environment, Food and Rural Affairs Committee published its Eighth Report of Session 2017–19, *Regulation of the Water Industry* (HC 1041), on 9 October 2018. The Government response was received on 18 December 2018 and the Ofwat response was received on 7 December and are appended to this report.

**Appendix 1: Government Response**

The Government thanks the committee for its report and submits its response to its conclusions and recommendations.

**Increasing supply**

1. *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.*

In 2017 Defra published the abstraction plan.1 This sets out what the government is doing to reform the management of water abstraction and respond to the main issues facing our current abstraction management system. The plan seeks to reduce unsustainable abstraction, improve access to water and create a more equitable licencing system.

Progress has been made this year with: four initial priority catchments starting work to develop local solutions to abstraction issues, a number of digital reforms to move licences away from a paper based system, and work to review licences. Our report to Parliament in 2019 will review the progress that has been made so far. The government will continue to monitor progress and will look at alternative methods if necessary.

2. *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.*

Defra and the regulators have been clear with the industry that we expect more transfers between water companies.

Since privatisation, the capacity of water supplied by transfers has remained static at around 4%. Evidence from the National Infrastructure Commission suggests that strategic transfers could provide around double the capacity they supply currently. This evidence and the need for transfers along with other infrastructure to meet our water supply needs, is reflected in the recently laid draft National Policy Statement for Water Resources Infrastructure.2

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We expect water companies to take all reasonable steps to pursue transfers where they are the most efficient way of addressing future needs. This should be through regional planning groups, looking at both intra and inter regional options, as we set out in the joint letter from Defra and the regulators to water companies in August this year.³

Direct financial incentives for water trading were introduced for the last price control period (PR14). In our strategic policy statement for Ofwat, we set the objective of furthering a reduction in the long term risk to water supply, including through increased water trading. In developing the methodology for PR19 and as part of discussions with Defra on the methodology, Ofwat considered whether existing incentives should be altered to support greater trading, and consulted water companies and others to inform its analysis. Ofwat concluded that at present amending the existing incentives was not justified.

Ofwat, together with the other water regulators, will explore economic, regulatory and commercial barriers to trading ahead of the next round of water resources management planning. This work will be alongside the national framework for water resources that the Environment Agency is developing, which will identify barriers to collaborative working and the development of regional schemes, including transfers, and propose solutions to overcome them.

3. 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.

We have been pushing water companies to be more ambitious on leakage targets for some time, including through our Strategic Policy Statement⁴ to Ofwat and the industry.

Water company draft business plans suggest that there has been a positive response by water companies to the calls for greater action to reduce leakage. Companies have proposed commitments to deliver leakage reductions averaging 16% by 2025, broadly in line with Ofwat’s original challenge. This would be the most significant programme to reduce leakage in 20 years. Ofwat is currently scrutinising company proposals. In addition water companies have publicly confirmed their intention to meet the NIC’s 50% target by 2050.⁵ This target includes leakage through customer side leakage, as approximately a quarter of leakage is lost through customer supply pipes. Fixing these leaks is the responsibility of customers. However, some companies offer a free or subsidised repair.

The government endorses the water industry’s commitment to halve leakage by 2050. We will review progress on this target every 5 years, in line with the regulatory process and the Environment Agency’s modelling for its national framework on water resources will also test different levels of leakage ambition and set expectations for regional groups of water companies.

Ofwat has committed to keep their challenge to companies on leakage under review at future price reviews. The regulator will continue to challenge companies in line with advances in technology and the best available evidence on driving leakage reduction.

**Reducing demand**

4. *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.*

To support the government’s commitment in the 25 Year Environment Plan and as set out in the government’s water conservation report, we will launch a call for evidence on setting an ambitious target for per capita consumption (PCC). This will be a national, non-binding target that we will use to judge the effectiveness of our actions and those of the water industry in reducing water use.

In their draft Water Resource Management Plans (WRMPs) companies set more ambitious PCC targets than ever before, with an average PCC of 123 litres per person per day (l/p/d) by 2045. However, we expect them to propose even more ambitious targets in their final plans. Reducing water consumption is not just a long term goal but needs ambition in the short term. As such, we are looking to companies to set more challenging and stretching PCC targets for 2025 in their final business plans.

5. *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.*

Alongside the PCC call for evidence we will hold a consultation to examine the policy options required to support the target. This will include exploratory questions around the labelling of water-using products, improving building standards, the future role of metering, and behaviour change including improving information for consumers.

All water companies can install a water meter in domestic properties upon a change of occupier (when either a tenant or homeowner moves out of the property) and charge on the volume of water used. Additionally all water companies can install meters but can only charge by the metered use if in an area of water stress, or if the customer opts in. It is a decision for the water company whether to install smart meters or ‘traditional’ meters, but with evolving technology, smart meters may help consumers and companies in demand reduction.

In areas categorised as water stressed companies can roll out universal metering programmes, whereby all customers in that area are required to have a meter and pay for their water according to how much they use. The last classification was in 2013, and there are currently seven water company areas designated as facing serious water stress and four of those companies have chosen to roll out universal metering.

There are significant safeguards in place for the most vulnerable customers, such as social tariffs and payment plans. In their draft business plans most companies are setting
themselves targets to extend the reach of the support they offer to customers. For example, at least two companies have committed to eradicate water poverty in their regions. Water UK’s summary estimates that by 2025 1.4 million customers will receive help with their bills, an increase of nearly 90% from the current 760,000, reflecting increased ambition of water companies. In addition to measures for vulnerable customers, there are a series of safeguards in place for the average customer who would find changes to their bills difficult to manage.

**Water company performance**

6. **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.

We agree that there is scope for water companies to do more to resolve customer complaints quickly and effectively. CCWater recently published a report showing the wide differences in water company performance in this area.

Following encouragement from Ofwat, earlier this year Water UK commissioned an independent review of the post-company complaints handling process. This review will investigate the alternative dispute resolution mechanism and make recommendations for improvement from a customer perspective. The outcome of this review, and any action consequently taken by the industry, will help determine whether further action should be taken.

7. **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.**

The Secretary of State has been clear that he wants to see a robust approach to ensuring that companies reform their financial and corporate practices. We are pleased that Ofwat have taken a proactive approach to this through their Putting the Sector Back in Balance package.

Water companies’ draft plans for the price review period 2020–2025, submitted to Ofwat in September, provide initial indications of companies’ proposed responses:

- a planned total investment of around £50bn (an increase of 13% on the previous price review period, PR14);
- a planned average reduction in bills of 4% (£15);
- several companies have proposed measures to share outperformance benefits with customers;
- dividends lower than Ofwat’s 5% guidance are planned by several companies; and

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all companies have committed to work towards closing their offshore holdings by the end of the year.

Ofwat is scrutinising these plans and will publish their initial assessment by January 2019.

8. 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.

Ofwat has powers to modify licence conditions with a water company’s agreement, following consultation on the proposed change. If a company does not agree, Ofwat can refer the proposed change to the Competition and Markets Authority for a decision on whether the change is in the public interest and, if so, Ofwat can then make it.

We have already indicated that if Ofwat is unable to implement their proposals in full without the need for government intervention or legislation, we will consider how government can give stronger powers to amend licences if necessary. ⁸

9. 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.

Combined Sewer Overflows (CSOs) require an Environment Agency-issued permit to discharge. The permit will normally include conditions to mitigate the impact of a storm spill to the environment, along with monitoring and reporting requirements. The Environment Agency has the power to vary permits to further protect the environment where necessary. Any non-compliance will be subject to appropriate action by the Environment Agency under enforcement and sanctions guidance. Changes to sentencing guidelines in 2014 have allowed unlimited fines to be applied to water companies in the event of serious pollution incidents, along with a wider range of enforcements and sanctions.

The Environment Agency is part way through a programme to improve the management of CSOs through the installation by water companies of Event Duration Monitoring (EDM) on the vast majority of CSOs by 2020. EDM data on spills has already informed the planning for 800 investigations and 236 improvement schemes by water companies and will likely generate more improvement schemes in the future.

Water companies have also commenced the development of new drainage and wastewater management plans. These will facilitate a more comprehensive assessment of drainage, sewer and treatment work capacity and the risk of these assets to the environment, including the use of CSOs.

On the basis of the above, we will keep the current system of regulating and controlling sewer overflows under review and consider proposals to minimise CSO discharges.

The water retail market

10. As market frictions are reduced, we would like to see water retailers attracting more SME customers. Ofwat should consider ways to incentivise this.

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.

We agree that all eligible customers should be able to take advantage of the benefits that a choice of supplier can bring, and want to see more SME customers engaging with the market. The government has always felt it is important for micro and small business customers to benefit from the business retail market. The environmental benefits of reduced water consumption was, along with delivering customer choice, one of the key drivers to opening the market to competition.

Ofwat have identified a number of factors which influence engagement with the market. Ofwat is continuing to work with stakeholders to address the frictions which have been identified in the market, and over time would expect that SME customers will benefit from future improvements. Ofwat always expected efficiency to be something suppliers would be keen to offer, and they will explore the reasons for this not being the case. We are working with Ofwat and the Market Operator (MOSL) to look at ways to address these issues to see improved customer outcomes over the next year and beyond.

Ofwat will continue to undertake annual reviews of the retail market.

Is regulation fit for purpose?

11. 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.

The National Infrastructure Commission has been commissioned by the Government to conduct a review of economic regulation in the water, energy and telecoms sectors, to ensure necessary levels of investment and innovation whilst maintaining affordability. This review will conclude in summer 2019.

Ofwat’s December 2015 consultation into the regulatory framework for the 2019 price review concluded that the five-year price review cycle should be maintained. To facilitate long-term planning, the five-year price review cycle is complemented by Water Resource Management Plans (WRMPs). In these plans, water companies set out proposals to meet their supply and demand balance requirements for at least the next 25 years.

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Appendix 2: Ofwat response

Leakage

**Recommendation:** “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.”

**Ofwat response:**

We welcome the Committee’s focus on leakage and recognise that reducing leakage will play an integral part of the “twin-track” approach to achieving resilience across the sector. At future price reviews, we intend to continue to review the leakage challenge we set companies to ensure that targets stay in line with advances in technology and the best available evidence on driving leakage reduction.

We have challenged companies to reduce leakage by 15% over the five-year price review period from 2020 (PR19). The 15% figure represents an improvement on the most ambitious company’s leakage performance commitment in PR14. We are pleased that companies have responded positively to this challenge and we are reviewing the proposals in their plans for PR19 to ensure that each company is facing a genuinely stretching performance commitment on leakage. We will be happy to provide an update to the Committee as the process of finalising companies’ leakage commitments progresses.

We note that water companies have, via the trade body Water UK, committed to reduce leakage by at least half by 2050 “at the latest”. We also note the National Infrastructure Commission’s recent recommendation to the sector of reducing leakage by half by 2050. However, we also believe that a significant increase in industry collaboration and innovation is likely to be necessary to achieve continued improvements in leakage performance. As part of our review of our regulatory strategy, we will consider the appropriate role for Ofwat in relation to collaboration and innovation.

Water transfers

**Recommendation:** “Defra 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.”

**Ofwat response:**

We agree that water transfers have an important role to play in securing a resilient and efficient water supply. We have made it clear to water companies that we are disappointed in the progress in this area and believe that there is are economic, environmental and a resilience benefits to be achieved from planning more effectively across company borders.

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Financial incentives to trade water between companies were introduced at PR14. In developing our methodology for the 2019 price review, we considered carefully, including through consultation with water companies and others, whether any changes to our existing incentives were merited and concluded that, whilst we would retain them, there was no justification for strengthening the incentives at this time. We consider that the principal remaining barriers to trading water relate to coordination problems, environmental and water quality constraints, and commercial practice, rather than the level of direct financial incentive.

Earlier this year, the National Infrastructure Commission, in its first National Infrastructure Assessment, made recommendations to increase the volume of water transferred between company areas. Building on these recommendations, Ofwat, together with Defra and the Environment Agency, has challenged companies to step up regional coordination in water resource planning. Three companies are in active discussions about establishing a joint venture to develop proposals for a major north-south transfer, and we are exploring a regulatory alliance to assess multi-company infrastructure options and drive regulatory alignment and cooperation where possible. We will progress discussions with Government in the coming months.

A further component of the joint efforts to increase effective coordination within and across regions is the National Framework for Water Resources Planning which is currently being led by the Environment Agency. This will provide an important source of shared intelligence to inform effective planning by water companies, and we look forward to continuing to work with the Environment Agency to develop the framework.

In addition to measures aimed at directly increasing transfers between water companies, we also note the potential for other measures to increase the scope for water trades. The Water Act 2014 contained provisions to create bilateral markets in water resources, which would allow third parties which own water resources to sell water directly to retailers. This should bring efficiencies and may lead to an increase in levels of water trading between water companies by increasing the amount of water available to trade. Decisions on implementing the provisions in the 2014 Act are for the Government.

Complaints process

**Recommendation:** “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”.

**Ofwat response:**

We share the Committee’s interest in ensuring that companies’ complaint handling processes deliver the right outcomes for customers in a timely and effective way. The process for handling complaints within water companies is at variance with those in comparable sectors in a number of ways, including in the absence of a “deadlock” mechanism for automatic payments or referral to a third party where a complaint is not resolved within a given time. We believe there is scope to make the overall complaint handling process
much more streamlined and accessible for customers and for the intelligence coming from customer complaints to be used more powerfully to drive real change in the way water customers treat their customers.

We want companies to take ownership of issues which affect their customers and have been pushing companies to ensure that the complaints handling process (both within company and the post-company stages) is fit for purpose. Our current Service Incentive Mechanism (SIM) provides a direct incentive to companies to manage customer contacts, including complaints, appropriately, while the Customer Measure of Experience which is to replace SIM in PR19, will ensure that companies’ customer service, including complaints handling, is compared with the best companies from other sectors. As part of our ongoing strategy review, we will be considering how we can best use our existing powers to protect customers and ensure they receive excellent customer service.

Earlier this year, at Ofwat’s urging, Water UK commissioned an independent review of the post-company complaints handling process. The scope of the review is to examine the effectiveness of the current processes for delivering the right outcomes for customers and to provide recommendations to improve the customer experience.

In the short term, the review will inform the re-tendering of the contract for the alternative dispute resolution scheme (WATRS) set up by the sector. The conclusion of this review, and how the sector takes this forward, will provide important evidence which will help determine whether we should take further action. We encourage the sector to be swift and ambitious in taking forward the recommendations from the review. We will closely monitor the sector’s progress.

**Business retail market**

**Recommendation:** “Ofwat should consider ways to incentivise water retailers to attract more SME customers.”

**Ofwat response:**

We agree with the Committee that SMEs are not yet experiencing the same benefits that larger customers receive from the retail market. We have identified a number of frictions which are hindering the market from reaching its full potential, and these include:

- a lack of complete, accurate and timely market data;
- poor aggregate performance of wholesalers against the industry standards; and
- poor interaction between wholesalers and retailers which has sometimes made it hard for retailers to operate and offer services in the market.

These frictions can raise retailers’ costs and hinder their incentives to engage with certain customer groups, particularly small businesses.

All parties in the market have a role to play to ensure that customers can engage. We have been engaging with stakeholders to identify the drivers behind the frictions and will look to ensure that initiatives to improve interactions between wholesalers and retailers
are taken forwards. In November 2018, we published a call for inputs looking at issues affecting wholesaler performance in the business retail market and the quality of service received by retailers. We will follow this up in 2019 in the light of views received.

We are also working with market participants, including the Market Operator, MOSL, to address these market frictions. MOSL is currently undertaking a scheme of work in order to improve the data in the Central Markets Operating System.

We will continue to closely monitor and regulate the new business retail market and will step in to protect customers where required.

**Recommendation:** “Ofwat should undertake annual reviews until the market is shown to be delivering real competition and water efficiency”.

**Ofwat response:**

We acknowledge that there is untapped potential in the market. Currently, the business retail market is not delivering the benefits which we would expect from a mature market.

We will continue to issue annual reviews and plan to publish our next annual report, concerning the second year of the market, in early summer 2019.

**Financial and corporate reform**

**Recommendation:** “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.”

**Ofwat response:**

The changes we made as part of our [Putting the sector back in balance](#) package which we finalised July 2018, set out our expectations for how companies’ business plans for PR19 should set out clear approaches to dividend policies and executive performance pay, and address the need to share with customers the financial gains of adopting highly geared structures. We are currently scrutinising these business plans as part of our price review process.

We will be taking forward discussions with companies on a range of these issues following our initial assessments of business plans. We will be pleased to provide the Committee with a written update on the progress of our ‘back in balance’ policy when we have concluded these discussions later in 2019.

We will, of course, continue to push companies to deliver the outcomes that benefit customers and will use our regulatory tools to ensure that customers’ interests are protected.