



House of Commons
Environment Food and Rural
Affairs Committee

The Water White Paper

Second Report of Session 2012–13

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Additional written evidence is contained in Volume II, available on the Committee website at www.parliament.uk/efracom

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Environment, Food and Rural Affairs Committee

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Summary

The importance of managing water wisely has come to the forefront of public consciousness during the course of our inquiry, with much of England gripped by a severe drought and some areas simultaneously experiencing widespread flooding. Defra's much anticipated White Paper, *Water for Life*, follows a series of Government-commissioned reviews of water policy and sets out how the Government plans to tackle some of the key challenges facing the water sector over the coming years.

The White Paper warns that the twin challenges of climate change and population growth mean that water scarcity is likely to become an increasing problem in the future. It is therefore disappointing that *Water for Life's* proposals on abstraction reform and metering lack ambition and are unlikely to deliver meaningful change within acceptable timescales. Defra must bring forward its timetable for long-term reform of the abstraction regime and should set a clear target for increasing levels of metering. The Department should also ensure that implementation of provisions in the Flood and Water Management Act 2010 to improve the management of surface water is not subject to further unnecessary delay.

The affordability of water bills is becoming an increasing problem for many households. Defra must do more to ensure that all those who can afford to pay their bills do so, and should implement the relevant provisions of the Flood and Water Management Act 2010 without delay. It is unacceptable that hard-pressed households are subsidising bad debt in the sector to the tune of £15 every year.

We welcome Defra's decision to open up the water market to new entrants as we believe that increased competition in the sector will deliver real benefits to customers. It is critical that the legislation implementing the market reforms provides a framework for a healthy competitive market, and we have made recommendations about how this can best be achieved. Legislation should be brought forward swiftly and we look forward to publication of a draft Water Bill before the summer recess.

1 Introduction

1. With much of the UK gripped by a severe drought in the first half of 2012, the importance of managing our water resources effectively has been brought to the forefront of public attention. Defra's much-anticipated Water White Paper, *Water for Life*, was published on 8 December 2011. It builds on a series of independent reviews of aspects of water policy beginning with Sir Michael Pitt's 2008 report on the devastating floods of 2007,¹ and culminating in David Gray's Review of Ofwat and Consumer Representation, published in 2011. The previous Government had also commissioned independent reviews into competition and innovation in the water market (Cave, 2009)² and charging for water and sewerage services (Walker, 2009).³

2. The Flood and Water Management Act 2010 implemented some of the reforms proposed by these reviews, in particular Pitt's recommendations on flooding. Later in 2010 this Committee inquired into flooding and water management policy with a view to assessing progress and identifying key priorities for the forthcoming Natural Environment and Water White Papers. The Committee's First Report of Session 2010-12, *Future flood and water management legislation*, was published in December 2010 and recommended that the Water White Paper should:

- set out specific proposals to enable the wider value of water to be reflected in policies and charges, including a clear programme for reform of the abstraction licensing regime;
- propose a clear strategy for implementation of a wider programme of metering and variable tariffs to help spur water efficiency while protecting those on low incomes from unaffordable price rises;
- propose stronger measures to enable water companies to recover bad debts; and
- pave the way for measured introduction of competition into the water industry, which maintains certainty for investors over the future regulation and structure of the industry.⁴

3. The publication of the Water White Paper presented an opportunity to return to these and other issues which we considered in *Future Flood and Water Management Legislation*. We announced our inquiry on 20 December 2011 and invited written evidence addressing "whether the White Paper's aims are supported and the likelihood of these objectives being effectively fulfilled by the approach it proposes".⁵ We received almost sixty written submissions and held four oral evidence sessions. On 22 February 2012 we heard from

1 Sir Michael Pitt, *Learning Lessons from the 2007 Floods*, June 2008

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

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

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

5 Complete terms of reference for the inquiry can be found at www.parliament.uk/efracom

Ofwat and the Water Industry Commission for Scotland. On 6 March we took evidence from the Environment Agency and the Consumer Council for Water. Water UK, Anglian Water and United Utilities, followed by WWF-UK and Action for the River Kennet, gave evidence on 7 March. Our final session, with Richard Benyon MP, Parliamentary Under-Secretary of State for Natural Environment and Fisheries, took place on 27 March. We are grateful to all those who gave evidence in person or in writing.

The Water White Paper

4. The Secretary of State's foreword to *Water for Life* states that it describes a "vision" for water management "in which the water sector is resilient, in which water companies are more efficient and customer focused, and in which water is valued as the precious resource it is."⁶ The White Paper contains a raft of measures which set out how the Government intends to tackle the increasing pressures on our water resources caused by climate change and population growth. It sets out the principles and timetable for an overhaul of the abstraction regime, which governs how and when water can be taken from the environment for use by business, agriculture and the public; and explains how improved interconnections between water catchments will allow water to be moved more easily around the country to areas of need. It details Government policy on charging for water and providing help to those who struggle to afford their bills. Proposals in the White Paper to reform the water market, currently characterised by its regional monopoly structure, will see competition introduced for all business users of water, with the ultimate aim of increasing efficiency in the sector and reducing bills for both business and domestic customers.

5. Many of the proposals included in the White Paper, not least the market reforms, will require primary legislation. During the course of our inquiry the Water Industry (Financial Assistance) Act 2012 was passed, addressing a specific commitment in the White Paper to provide Government funding to reduce disproportionately high water bills in the South West region. However, the bulk of the legislation implementing the White Paper's reforms is expected to be contained in a comprehensive draft Water Bill which the White Paper said would be published "in early 2012".⁷ We note that with the summer recess fast approaching, no draft Bill has yet been produced. We call on Defra to publish the draft legislation as soon as possible to provide a greater level of certainty to water companies, regulators and the public about what the White Paper's proposals will mean in practice. We welcome the Minister's assurance that the draft Bill will be made available to this Committee for full pre-legislative scrutiny and we look forward to examining it in due course.⁸

6 *Water for Life*, p3

7 *Ibid*, p9

8 Q 256

2 Managing water resources

Abstraction reform

6. Anyone wishing to withdraw more than 20 cubic metres of water a day from a river or aquifer is required to obtain an abstraction licence from the Environment Agency.⁹ The current abstraction licensing regime was introduced in the 1960s and was not designed to manage the competing demands for water which we see today. It was widely recognised in our evidence that the current system fails to strike the right balance between the need for a reliable supply of water and the environmental damage caused by abstracting too much water from any one particular source. In extreme cases of over-abstraction, entire sections of rivers may run completely dry. The World Wildlife Fund-UK (WWF-UK) described the environmental effects of over-abstraction, exacerbated by the recent drought, as “devastating”¹⁰ and Action for the River Kennet told us that the situation on their river was “a crisis”.¹¹

Dead fish on a dry river bed



Les Wilson/Action for the River Kennet

7. The White Paper sets out a two-pronged approach to tackling over-abstraction. First, it commits to a comprehensive reform of abstraction licensing over the next 15 years.

⁹ There is a very limited class of exceptions which can be found on the Environment Agency website <http://www.environment-agency.gov.uk/>

¹⁰ Ev 3

¹¹ Q 223

Second, it proposes measures to tackle site-specific unsustainable abstraction in the shorter term.

Long term reform

8. In *Water for Life*, Defra set out the high-level principles that will underpin reform of the abstraction regime. The new regime will seek to better reflect the availability and value of water, to be flexible and responsive to changes in supply and demand, and to encourage more efficient use of water.¹² Defra intend to consult on detailed proposals for reform in 2013, with legislation to be brought forward in the next Parliament for the new regime to be in place by the mid-to-late 2020s.¹³

9. WWF-UK welcomed the Government's decision to reform the abstraction regime and the overarching principles for reform set out in the White Paper. However, they called for the changes to be implemented to a "much faster timescale", arguing that "the longer action takes the longer water environments are exposed to the risk of damage".¹⁴ They were concerned that momentum would be lost during the lengthy lead-in period. Water companies, on the other hand, urged caution, with Anglian Water welcoming the "thoughtful" proposals which they said would give the industry time to plan for change.¹⁵ Similarly, United Utilities warned that "overnight changes to abstraction can cause quite significant risk to continuity of supply".¹⁶ The Environment Agency also acknowledged the need for a "medium-term" timescale and felt that putting the changes in place by the mid-2020s would "be in good time" to be prepared for the future pressures on supply identified in the White Paper.¹⁷

10. The recent drought has underlined the importance of introducing a reformed abstraction regime able to provide sustainable and reliable supplies of water. The timescales set out in the White Paper lack ambition and unnecessarily risk further environmental damage. We believe that ten years is an adequate period in which to plan and implement reform of the abstraction regime and recommend that the reformed regime be in place no later than 2022.

11. Even with this shorter timescale, momentum may be lost. We recommend that the Government work with regulators, water companies and environmental groups to produce a workplan setting out key milestones for the duration of the reform period, and annually report on progress against them.

12. Farmers need a reliable and affordable supply of water to provide for livestock and irrigate crops, and they were worried by Defra's suggestion that a new regime would seek to encourage increased trading of abstraction licences. The NFU warned that a new regime should not simply see abstraction licences sold to the highest bidder, fearing that this

12 *Water for Life* p 23

13 *Ibid*, p24

14 Ev 3

15 Ev 27

16 Q 177

17 Q 94

would lead to a “David and Goliath” like struggle for water in which farmers would be unable to compete.¹⁸ The Environment Agency sought to assure us that they recognised that the interests of farmers should be protected:

Our responsibility is to make sure that, in balancing the competing demands, agriculture does not lose out, and we are determined to make sure we do that.¹⁹

The Minister told us that the reformed abstraction regime would need to be “equitable and fair” and that Defra was working closely with farming groups to make sure that they had adequate water.²⁰

13. We are pleased that the Environment Agency and the Minister acknowledged the importance of ensuring that the agricultural sector retains access to a reliable water supply. As the reforms go through, we recommend that the Environment Agency maintains a constructive dialogue with farmers and food producers, recognising their key role in promoting self-sufficiency and food security.

14. The White Paper suggests that farmers take steps to improve their preparedness for drought by developing their own water supplies, including the development of on-farm reservoirs for water storage.²¹ We would be concerned should the Environment Agency’s forthcoming safety guidance on high risk reservoirs act as a barrier to the construction of such reservoirs. We welcome the Environment Agency’s recent consultation on this matter and look forward to a proportionate approach to risk in the final guidance. Defra has also commissioned reviews of two key guidance documents produced by the Institution of Civil Engineers for reservoirs engineers: *A guide to the Reservoirs Act 1975* and *Floods and Reservoirs Safety guidance, 3rd edition*. We are disappointed that the review of *Floods and Reservoirs Safety guidance* is not expected to be completed for almost two years.²² **We urge Defra and the Environment Agency to work with the Institution of Civil Engineers to complete the reviews of both *A guide to the Reservoirs Act 1975* and the *Floods and Reservoir Safety guidance* by December 2012.**

Short-term reforms: Restoring Sustainable Abstraction

15. Alongside the wholesale reform of the current abstraction regime, the White Paper also sets out how Defra will take more urgent action to tackle abstraction that is already damaging the environment. Currently the Environment Agency’s Restoring Sustainable Abstraction (RSA) programme provides a mechanism for licences to be removed where an abstraction is causing environmental damage. Licence holders who object to the removal of their licences are eligible for compensation, which is funded through an annual levy on abstractors (the Environmental Improvement Unit Charge or EIUC). It can take years for the fund to build up enough money to compensate licence-holders, during which time damaging abstraction is able to continue. The RSA process was widely recognised in our

18 Ev w50

19 Q 95

20 Q 263

21 *Water for Life*, p53

22 HC Deb, 6 March 2012, Col 674W

evidence as being unsatisfactory, with WWF-UK describing it as having “effectively stalled”.²³

16. The White Paper proposes that the costs of compensating water companies for removal of licences under the RSA programme should be incorporated into the price review process, thus speeding up licence removal.²⁴ Environmental groups welcomed this proposal: WWF-UK felt that it was “crazy” that the RSA programme currently fell outside the price review process given it incorporated almost all other aspects of a water company’s planning cycle.²⁵ However, both they and Action for the River Kennet (ARK) were concerned that the change might not be implemented in time for the 2014 price review and called for urgency in putting the necessary processes in place.²⁶

17. Ofwat gave conditional support to this call, with the caveat that the interests of customers would need to be protected.²⁷ Defra said that “good progress” had been made and they were “hopeful” that agreement could be reached in time for the change to be reflected in Ofwat’s draft methodology for the next price review, due to be published later this year.²⁸

18. The current mechanism for the removal of environmentally unsustainable abstraction licences is clearly unsatisfactory and is causing ongoing and severe damage to the environment. We recommend that the White Paper’s proposal that funding for the Restoring Sustainable Abstraction Programme be incorporated within the price review process be implemented as a matter of urgency. Defra should work with Ofwat and the Environment Agency to ensure that this change is made in time for the RSA programme to be funded from the 2014 price review.

Bulk trading and interconnections

19. At any one time, some parts of the country may be in drought whilst others have a plentiful supply of water. One of the challenges in managing our water resources is how best to move water around the country from areas of plenty to areas of scarcity. Our witnesses pointed out that water is heavy and transporting it over long distances can be extremely expensive.²⁹ The White Paper notes that a purely local approach to tackling future supply deficits would, given the variation in supply and demand across the country, require the development of expensive infrastructure or severe constraints upon water use in some areas. It proposes an increase in “strategic” interconnections over short distances, for example across the boundary of neighbouring water companies, to incrementally build a more integrated network and to make bulk transfers of water more economically viable.³⁰ The Environment Agency has been tasked with taking an overview of interconnection

23 Q 232

24 *Water for Life* p42

25 Q 233

26 Ev 3, Ev 29

27 Ev 18

28 Q 260

29 Q 115 (Environment Agency), Q 185 (Water UK)

30 *Water for Life* p25

options so that, where appropriate, water companies' assessments of whether bulk transfers are viable can be challenged.³¹

20. Our witnesses were generally supportive of the White Paper's approach with Anglian Water describing it as "spot-on".³² However, it was recognised that it was important for the Government to keep an open mind about the possibility that larger infrastructure or 'mega-structures' may be needed in the future as the impact of climate change becomes clearer. Water UK commented that:

You might want to think further outside the box and ask what kind of projects and connections, in addition to bulk trade and interconnections that of course we are focused on in terms of resilience, would be a sensible idea or possibility... we have said to Defra that these insurance mega-structures would be a possibility and would need to be looked at, and if they were to be looked at, we certainly as an industry would be happy to do that.³³

21. Building infrastructure capable of transporting large quantities of water over long distances—a 'national grid' for water—has been proposed in the past but has been argued to be both environmentally and economically unsustainable.³⁴ The Environment Agency considered the issue in 2011, when it issued a position statement concluding that large-scale transfers to the south of England from the north of England or from Wales were unlikely to be necessary to meet current forecast demand.³⁵ The uncertainty surrounding future water availability patterns across the country is another factor to be taken into account, with the potential for expensive projects to become obsolete if areas which currently have a plentiful supply of water become drought-stricken in future.

22. United Utilities suggested that there may be an opportunity to build a water pipeline alongside the new High Speed 2 rail line, which might reduce the possible economic and environmental impacts of the project. Whilst they emphasised that this suggestion was part of a process of "putting ideas into the pot" rather than a concrete proposal, we were interested in the suggestion that a more joined-up approach to infrastructure development could make long distance transfers of water more viable.³⁶

23. Defra's decision to focus on maximising "strategic" interconnections allowing water to be transferred over relatively short distances is a sensible starting point and we look forward to the Environment Agency's forthcoming overview of interconnection options. Defra should remain open to considering whether large-scale infrastructure may be an appropriate and cost-effective solution in some circumstances. Defra and the Environment Agency should in particular look to exploit interconnection opportunities presented by other large infrastructure projects, thus minimising environmental impact and economic costs.

31 *Water for Life*, p26

32 Q 186

33 Q 185

34 Water UK briefing paper: *Should the UK have a national water grid?*, 2006.

35 *Large-scale water transfers Position Statement*, Environment Agency, July 2011.

36 Q 184

Floods, drainage and the automatic right to connect

24. Following the devastating flooding which affected much of the country in the summer of 2007, the previous Government commissioned Sir Michael Pitt to review the events which led to the floods and to make recommendations to improve the UK's preparedness for future flooding events. Pitt's report, *Learning lessons from the 2007 floods*, was published in June 2008 and made 92 recommendations for improving the way in which flooding was managed. All of these recommendations were accepted by the then Government. In January 2012 the current Government published a final progress report setting out the action that had been taken in response to Pitt's recommendations.³⁷ Five of the 92 recommendations are no longer expected to be implemented fully, or not implemented as originally envisaged by the Pitt Review. Defra's Business Plan commits to completing the outstanding work needed to fully implement the remainder of Pitt's recommendations by May 2015.³⁸

25. Pitt concluded that the damage caused by the 2007 floods was exacerbated by rainwater running off into public sewers which struggled to cope with the volume of water being discharged into them. He recommended that the automatic right for surface water drainage from new developments to be connected to the public sewer system be ended,³⁹ thus encouraging greater use of Sustainable Drainage Systems, or SuDS, which are designed to mimic the effects of natural drainage and include swales, wetlands and underground storage. Pitt recognised that a lack of clarity about who should be responsible for 'adopting' SuDS after they had been constructed was a barrier to their construction. His report recommended that Government resolve the ownership and maintenance issues and concluded that either local authorities or sewerage undertakers would be best placed to fulfil this role.⁴⁰

26. The Flood and Water Management Act 2010 addressed both of these recommendations: placing the responsibility for adopting and maintaining SuDS on local authorities through establishment of a SuDS Approval Body or SAB; and including provisions to end the automatic right to connect by making connections subject to approval by a SAB.⁴¹ Defra has recently consulted on detailed measures for the implementation of these provisions.⁴² In *Water for Life*, Defra says that it is working with the water industry and retailers to provide better information to householders about the benefits of SuDS⁴³ and will seek to encourage their use "wherever they will be effective".⁴⁴

27. Blueprint for Water, a coalition of environmental, water efficiency, fishing and angling organisations, welcomed the White Paper's references to the benefits of SuDS but argued

37 *The Government's response to Sir Michael Pitt's Review of the summer 2007 Floods: Final Progress Report*, January 2012.

38 *Defra Business Plan 2012–15*, p11.

39 *Learning lessons from the 2007 floods*, p73

40 *Ibid*, p96

41 Flood and Water Management Act 2010, Schedule 3

42 *National Standards for sustainable drainage systems*, Defra, 2011

43 *Water for Life*, p 83

44 *Ibid*, p58

that it “falls short of providing a full framework to enable the uptake of SuDS including their retrofitting to existing areas where surface water or pollution is a problem”. They also pointed to “ongoing policy inertia” holding up the delivery of SuDS.⁴⁵

28. In oral evidence Defra told us that an implementation date for the Flood and Water Management Act’s provisions on SuDS had not yet been confirmed but that it was “more likely that we are looking at April 2013 than October 2012.”⁴⁶ The Minister said that “retrofitting is a key part of our policy moving forward” but noted that retrofitting large SuDS was complicated, although not impossible.⁴⁷ He felt that technological improvements would play a part in increasing their uptake:

Technology that can put in a multitude of different weather patterns and the impact that can have down to household level is now available, so that can start informing the retrofitting of sustainable drainage systems, or where there is a bottleneck that causes back flooding of culverts and how you can improve that... I think we will see a lot more houses protected by such means in the future.⁴⁸

29. Five years on from the devastating floods of 2007 we are not convinced that Defra’s work to improve the management of surface water has been carried out with sufficient urgency. Defra must ensure that implementation of the relevant provisions of the Flood and Water Management Act is not subject to any further unnecessary delay. The White Paper says disappointingly little about the retrofitting of Sustainable Drainage Systems and we recommend that Defra develop more concrete proposals to encourage this.

Flood insurance

30. Insurance for homes at risk of flooding is currently provided in line with a “Statement of Principles” agreed between the Association of British Insurers (ABI) and Government in July 2008. Under the Statement of Principles, insurers agreed to provide flood insurance to the vast majority of households and small businesses in areas of “significant flood risk” where plans exist to reduce the risk below “significant” within five years. With the Statement of Principles due to expire at the end of June 2013, no agreement has yet been reached between Government and the industry concerning its replacement.

31. In *Future Flood and Water Management Legislation*, we concluded that there was “an urgent need” for agreement between Government and the ABI to be reached, and we noted evidence from the Local Government Association that should the insurance industry’s agreement to provide cover to the over 5 million properties in flood risk areas be withdrawn, there was a danger of blight, with significant impacts on the housing market and social cohesion.⁴⁹ The challenges associated with providing insurance to homes at risk

45 Ev w45

46 Q 275

47 Q 278

48 Q 279

49 *Future flood and water management legislation*, paras 40–41

of flooding serve to underline the need to avoid inappropriate development in flood risk areas.

32. It is deeply worrying that with only a year remaining until the current Statement of Principles on flood insurance is due to expire, and eighteen months on from this Committee's call for urgency in establishing its replacement, Government has not yet been able to reach agreement with the industry. Defra must redouble its efforts to achieve a workable and affordable solution to this issue.

3 Water Efficiency

33. The Environment Agency published an analysis of the impact that climate change and population growth will have on future water availability alongside the White Paper.⁵⁰ Their modelling predicted that less water would be available in the future for businesses, people, and the environment, and that pressures on availability would not be limited to the south and east of England. As water resources come under increasing strain, it will become imperative that water is used wisely and its waste is minimised.

34. *Water for Life* includes proposals to improve water efficiency by encouraging and incentivising consumers to use water wisely. Measures include Defra working with companies and regulators to carry out a campaign to save water and protect the environment; research into the reasons why individuals currently do or do not seek to conserve water; and using the opportunities presented by the Government's "Green Deal" programme to promote water efficiency. The possibility of using product labelling to inform customers about the efficiency of products such as dishwashers and washing machines is also discussed in the White Paper.⁵¹

35. Blueprint for Water was critical of the White Paper's overall approach to water efficiency:

...the policy drivers for water efficiency are distinctly lacking. We are concerned that the expectations on reducing demand are too oblique and not supported by policy instruments (such as incentives for demand management) that will deliver real savings.⁵²

Metering

36. At present, about 40% of domestic customers across England and Wales are metered,⁵³ meaning that for over half of the population there is no direct connection between the amount of water that they use and the size of their water bill.

37. Previous reviews and inquiries have examined the case for increasing levels of metering. Anna Walker's *Independent Review of Charging for Household Water and Sewerage Services* concluded that universal metering could save about 16% of average household demand.⁵⁴ Walker concluded that the benefits of metering varied from region to region and that, perhaps unsurprisingly, benefits were high in those areas where water was scarce. She recommended that Government set a target for metering penetration to reach 80% in England by 2020.⁵⁵ The Committee on Climate Change has also considered the issue: the Chair of its Adaptation Sub-Committee, Lord Krebs, told us that his Committee

50 A Case for Change: Current and Future Water Availability, Environment Agency, December 2011

51 *Water for Life* pp 86–88

52 Ev w44

53 *Exploring the costs and benefits of faster, more systematic water metering in England and Wales*, Ofwat, October 2011

54 Walker, p74

55 Walker, p81

believed that “consumers will not make sufficient effort to reduce water use unless there is a clear price signal”.⁵⁶

38. We heard persuasive evidence about the role that metering plays in reducing demand during the course of our inquiry. Wessex Water told us that metering was the single most significant measure in promoting water efficiency and that fitting a meter on a change of occupancy reduces average consumption by 15% and peak consumption by over 20%.⁵⁷

39. The White Paper does not contain any specific objective to increase levels of metering, but simply encourages water companies to actively promote metering to those who would benefit.⁵⁸ Environmental groups were highly critical of what the Chartered Institution of Water and Environmental Management described as a “weak” approach to metering,⁵⁹ with WWF-UK saying that they were “extremely disappointed”.⁶⁰ The suggestion that water companies promote metering to those who would benefit was described as “pointless; clearly they would take up the option and the rest would necessarily pay more to compensate”.⁶¹ There was a call for a more strategic approach to metering, with Waterwise commenting that it was:

disappointing that the Government rules out a strategic transition to full metering in favour of a patchwork of local solutions... A Government commitment to a managed increase in metering, to meet Walker’s 80% target for England by 2020 – supported by water efficiency retrofit and advice, and social tariffs – would have been more effective.⁶²

40. The Minister defended Defra’s approach, saying that whilst metering is “an important part of making people more aware of the water they use”, it was not “the total solution”. He cited particular concerns about the costs of switching to a metered supply for households on lower incomes.⁶³ We consider affordability issues later in this report, but it is worth noting at this point that Anna Walker concluded that paying for the volume of water supplied was in fact the fairest method of charging customers.⁶⁴

41. It is extremely disappointing that a White Paper that places such an emphasis on valuing water says so little about metering. With water set to become an increasingly scarce resource, we believe that the Government must use water meters as a means to encourage responsible use of water. We recommend that the Government set a clear and ambitious objective to increase levels of metering, taking account of Anna Walker’s recommendation that metering penetration reach 80% by 2020.

56 Ev w52

57 Ev w10

58 *Water for Life*, p65

59 Ev w36

60 Ev 4

61 Ev w5

62 Ev w15

63 Q 268

64 Walker, p70

42. We are conscious that a switch to metering could see bills rise for some poorer households as their bills reflect the amount of water that they use rather than the value of their homes. We believe that the provision of appropriate support for such households is a distinct issue which should be addressed alongside, but separately from, the clear imperative to increase levels of metering.

Rainwater Harvesting and Recycling Water

43. The recent drought has highlighted the importance of retaining the water that falls as rain. The Rainwater Harvesting Association suggested that rainwater harvesting should be better incentivised and in some cases required, for example by incorporating it within the Code for Sustainable Homes and encouraging its incorporation in the design of schools and commercial and industrial buildings.⁶⁵ The Environment Agency agreed that the planning system could encourage water efficiency without the need for legislative change:

It may be that, instead of going for all-out legislation to achieve it, just by doing some relatively small things with the planning system, with new construction and with making guidance available to everyone, you could actually get quite a lot of change.⁶⁶

44. The White Paper recognises that there is scope for recycling of ‘black-water’ which is not treated to drinking water standards but could be used for other functions such as flushing toilets or irrigation.⁶⁷ The Environment Agency said that they were “actively looking” at this area⁶⁸ and Defra told us that they expected that the White Paper’s market reform proposals would encourage new entrants to come forward with solutions to improve levels of water recycling.⁶⁹ **We recommend that Defra take more active steps to promote rainwater harvesting and water recycling and seek to incorporate incentives or requirements for their inclusion in the design of new developments.**

Leakage

45. With 3,365 million litres of water lost to leaks every day in England and Wales,⁷⁰ reducing leakage levels could play a major part in improving water efficiency. Water companies have already made some progress, with a 36% reduction in levels of leakage since 1994-95.⁷¹ Leakage targets for each company are set by Ofwat with the aim of moving companies to the Sustainable Economic Level of Leakage (SELL), the point at which it would cost more to reduce leakage further than it would to save water in different ways or to develop additional supplies. The Water White Paper notes that the current methodology

65 Ev w18

66 Q122

67 *Water for Life*, p58

68 Q 96

69 Q 261

70 Figures provided by Ofwat

71 *Water for Life*, p50

used to calculate SELL does not fully reflect the long-term sustainability of the water environment, and Defra has committed to review SELL.⁷²

46. In addition to the water wastage that is directly attributable to leaks, the Consumer Council for Water argued that leakage can have a damaging effect on efficiency by making customers less likely to take their own measures to conserve water. They describe customers' negative perceptions of leakage as the "biggest barrier" to customer engagement with water efficiency and argue that this should be taken into account in the calculation of SELL, noting that at times of water scarcity customer engagement becomes increasingly important:

Obviously, the perception issue becomes that much more acute during times of drought, because they are being asked to save water and if their perception is that companies are not doing the same then obviously that can affect their appetite to actually play their part. It is a very important point and one we should not underestimate.⁷³

Water companies acknowledged this, with Anglian Water commenting that "one visible leak that is not repaired undermines... all the messages we send out to customers as to what we want them to do in terms of water efficiency. That is a clear challenge we have to take on."⁷⁴

47. We recognise the progress that water companies have made in reducing leakage levels but urge companies and the regulator to do more to reduce the amount of water that is wasted through leakage. We recommend that in reviewing guidance to companies on the Sustainable Economic Level of Leakage, the Government and regulators should take account of the impact that leakage levels have on customers' willingness to engage with efficiency measures, if necessary carrying out further research to seek to quantify this impact.

72 *Water for Life*

73 Q 149

74 Q 189

4 Affordability

48. With household budgets coming under increasing strain, the affordability of water bills matters ever more. Figures from Ofwat show that the impact of water bills on household finances is rising, with 23% of households spending more than 3%, and 11% spending more than 5% of their income on their water bill.⁷⁵

49. Those households which are not metered are charged a flat rate for their water and sewerage charges based on the rateable value (RV) of their property. This provides an inherent element of cross-subsidy between customers, with those in homes with a high RV paying higher bills than those in homes with a lower RV. To the extent that it can be assumed that households with a higher RV are likely to be wealthier than those with a low RV, the current non-metered system of billing therefore provides a level of adjustment of bills to reflect relative wealth. In practice, however, RV is a crude measure of household income and the inherent cross-subsidy is poorly targeted. Anna Walker found that only 30% of the cross-subsidy provided to houses in the lowest RV band went to the poorest households,⁷⁶ and she concluded that the RV system is “unwinding” as more and more households switch to meters, with less and less money remaining in the pot to cross-subsidise lower income households.⁷⁷

50. Some schemes do already exist to help customers struggling with affordability issues. A national scheme, WaterSure, caps the bills of metered households where the occupants are in receipt of certain means-tested benefits or tax credits and include either someone with a medical condition necessitating a high use of water or three or more children under nineteen years old. Some water companies also operate charitable trusts which can provide support to other lower income households.⁷⁸

51. Defra consulted on options to tackle affordability issues in 2011 following the Walker review,⁷⁹ and in the White Paper they set out their approach to supporting those customers who struggle to pay their water bills. The White Paper does not propose any additional government funding but instead relies on cross-subsidy between customers at a individual company level through the introduction of company social tariffs.⁸⁰ Defra has recently consulted on the guidance to water companies which will provide the framework for these tariffs.⁸¹ The Consumer Council for Water expressed grave doubts that company social tariffs would raise enough money to achieve Government’s aim that everybody have access to an affordable water supply, noting that there was a gap between the amount that customers were prepared to pay to fund social tariffs, and the amount that would be

75 *Affordable for all—how can we help those who struggle to pay their water bills?* Ofwat, May 2011

76 Walker, p61

77 Walker, p127

78 For example, the United Utilities Trust Fund, established in 2005, had paid out £22.2 million in grants to individuals and families struggling to pay their bills at the end of the last financial year—see <http://www.uutf.org.uk>

79 *Affordable water: a consultation on the Government’s proposals following the Walker Review of Charging*, Defra, 2011

80 *Water for Life* p63

81 *Company Social Tariffs: Consultation on guidance to water and sewerage undertakers and the Water Services regulation Authority under Section 44 of the Flood and Water Management Act 2010*, Defra, October 2011

needed to fully address affordability issues in the sector. They acknowledged that some customers might “fall through the safety nets”.⁸²

52. Given the potential limitations of company social tariffs it is essential that those who can afford to pay their bills are made to do so. This is not currently the case: bad debt adds approximately £15 to each customer’s bill.⁸³ While in some cases this can be attributed to customers who are genuinely struggling to pay their bill (the ‘can’t pays’), a significant proportion of bad debt is down to those who simply ‘won’t pay’. Bad debt from those who ‘won’t pay’ is particularly rife in the rental sector—according to Ofwat, up to 80% of people in water debt live in rented properties⁸⁴—as there is no obligation on landlords to provide water companies with details of their tenants, meaning that the water company may be left unable to pursue debts. Thames Water described those who ‘won’t pay’ as “in effect, stealing from honest customers”.⁸⁵

53. The Government has already introduced legislation to address this problem. The Flood and Water Management Act 2010 contained provisions which would allow companies to bill landlords in the event that they were not provided with details of tenants within a reasonable time.⁸⁶ However, these provisions have not yet been implemented and Defra has recently consulted on an alternative approach which would seek to make it easier for landlords to provide this information voluntarily.⁸⁷ The Minister told us that he had concerns about the “burdensome nature” of imposing a statutory obligation on landlords, but acknowledged that money clawed back from debtors would be “money in the pocket of people who do pay their bills, some on very low incomes”.⁸⁸

54. Water companies were heavily critical of Defra’s failure to implement the provisions of the Flood and Water Management Act. Water UK noted that the provisions had received cross-party support when the Act was passed, and called on Defra to stop delaying and “frankly, to get on with this”.⁸⁹ The Consumer Council for Water was also in favour of a statutory approach, expressing doubts about whether a voluntary approach would be effective.⁹⁰

55. It is simply unacceptable that, at a time when so many are struggling to afford their water bills, customers face the additional burden of subsidising those who refuse to pay what they owe. Legislation already exists that would make it easier for water companies to recover bad debt and the Minister acknowledged that money recovered from debtors would be “money in the pocket” for those who do pay their bills. We urge the Department to implement the relevant provisions of the Flood and Water Management Act without further delay.

82 Q 135

83 *Water for Life*, p66

84 Ofwat response to Defra’s consultation on tackling bad debt in the water industry

85 Ev w47

86 Flood and Water Management Act 2010, Section 45

87 *Tackling bad debt in the water industry*, Defra, January 2012

88 Q 284

89 Q 207

90 Q 141

Access to information

56. Water companies have called for access to information on their customers to allow them to better target their social tariffs (for example, details of those customers receiving means-tested benefits). In the White Paper Defra acknowledge these calls and say that they will seek to make such information available “wherever this is legal and feasible”, but note that the sharing of personal data is subject to tight legislative constraints.⁹¹ The Consumer Council for Water acknowledged that if personal data were provided to water companies it would need to be used sensitively, but they supported the call for this information to be made available:

We think that anything that would help the water companies target their help—social tariffs or any other form of help—to the customers who most need it would be beneficial.

They noted that take-up of existing support schemes such as WaterSure was relatively low compared with the number of eligible customers despite the fact that they and water companies actively promote such schemes.⁹²

57. A possible model for data sharing is the Department for Energy and Climate Change’s Warm Home Discount scheme under which Government shares information with energy providers about people in receipt of a subset of Pension Credit Guarantee. Defra argued that it would not be straightforward or desirable to operate a similar system for the sharing of information with water companies due to the more diverse profile of people who were likely to have water affordability issues:

In their scheme, DECC were able to identify a clear group at risk of fuel poverty—older, poorer pensioners, who were well represented amongst the recipients of a subset of Pension Credit Guarantee. However, the profile of people at risk of water affordability problems is less clear... [and] does not present a clear group of benefits recipients who could be automatically eligible for a discount via a data sharing scheme.⁹³

58. According to Defra it would, however, be open to the Department for Work and Pensions to ask all recipients of benefits whether they consent to their details being shared with their water company.⁹⁴

59. Take-up levels of WaterSure suggest that many of those who currently qualify for help with their bills do not receive it, and we are concerned that company social tariffs will face similar barriers to take-up. We recommend that the Government take a more proactive approach to publicising the help that is available to poorer customers. Defra should work with the Department for Work and Pensions to ensure that all means-tested benefit claimants are given the option to consent to the sharing of their data with their water company for the purposes of help with affordability issues, and should also

⁹¹ *Water for Life*, p63

⁹² Q 138

⁹³ Ev 40

⁹⁴ Ev 39

use the opportunity to inform claimants of existing support, such as the WaterSure tariff.

60. Research from Ofwat shows that the majority of customers facing affordability issues are not in receipt of benefits.⁹⁵ It is important that in designing company social tariffs, water companies ensure that they do not place over-reliance on benefits data as a means of identifying those customers in need of assistance and targeting the promotion of social tariffs. **We recommend that the Government make clear that the design and promotion of company social tariffs should not focus exclusively on customers in receipt of benefits to the detriment of others who may struggle to afford their bills.**

⁹⁵ *Affordable for all—how can we help those who struggle to pay their water bills?* Ofwat, May 2011

5 Market Reforms

61. One of the most widely anticipated elements of the White Paper is its proposals for reform of the water and sewerage industry. At present, the industry in England and Wales is made up of 21 regional monopoly, vertically integrated, water companies, which provide a ‘source to tap’ service: obtaining water from source through abstraction, treating it to an appropriate standard, and providing it to customers’ taps via company-owned infrastructure. Customers are directly billed by their water company for the provision of this service, with prices controlled by the regulator, Ofwat.

62. The vast majority of both domestic and business customers have no choice about who supplies their water. The resulting lack of competition can result in time-consuming and expensive administration for businesses with several sites across the country who have to process multiple bills from different suppliers. The White Paper’s market reform proposals seek to increase levels of competition in the sector in order to encourage efficiency, with the ultimate aim of reducing customers’ bills. The introduction of greater competition at the retail end of the market would see new entrants buying water wholesale from incumbent companies at prices regulated by Ofwat and seeking to win business from incumbents by offering preferable prices and/or services to their customers. Retail competition in Scotland, introduced in 2005, has saved the Scottish public sector an estimated £20 million and over 50% of non-household customers have renegotiated the terms of their supplies.⁹⁶

63. The Water Act 2003 introduced competition to the water market but limited it to those customers using more than 50 million litres of water a year. This ‘water supply licensing’ (WSL) regime has had minimal impact, with the White Paper noting that only one customer switched supplier under this regime in the last six years.⁹⁷ Defra has already reduced the threshold to 5 million litres and proposals in the White Paper would lower the threshold to zero, greatly increasing the number of customers who would be eligible to switch supplier. As well as increasing the size of the potential market, the White Paper sets out further reforms intended to remove the current barriers to new entrants to the market. These include the introduction of a transparent wholesale access pricing regime to replace the current ‘costs principle’, which has been criticised for being over-complicated and deterring new entrants; the extension of the current WSL regime to sewerage services, meaning that companies can tender for water and sewerage services at the same time; and establishing statutory market codes to increase transparency and make it more straightforward for customers to switch supplier.⁹⁸

64. Reforms will not be limited to the retail market: the White Paper also includes proposals to increase ‘upstream’ competition which will enable new entrants to sell water to incumbent companies and take sewage and wastewater out of the network for treatment, removing the current requirement that providers of upstream services must also provide a retail function. A new network licence will be introduced which will allow new entrants to

96 Ev 6

97 *Water for Life*, p68

98 *Ibid*, pp70–72

operate their own infrastructure which they can connect to an existing network and use to supply their own customers and other new entrants.⁹⁹

Timescales

65. Reform of the water market will require legislative change and preparatory work to be undertaken by water companies and regulators. We took evidence on the likely timescales of the changes. It was clear that, although the White Paper was a welcome signal of intent, water companies and regulators were keen to see more detailed proposals for the reforms as soon as possible. These are expected to be contained in a draft Water Bill which it is anticipated will be published before the Summer recess.

66. Given the uncertainties about when legislation would be in place, witnesses were reluctant to put forward a market opening date, preferring to provide indicative timescales of how long would be needed once legislation was on the statute book. Ofwat felt that a timescale of three years from the date of legislation “could be achievable”;¹⁰⁰ the Water Industry Commission for Scotland (WICS) felt that April 2017 was realistic (based in part on the concept that three years from legislation would be possible) but that any earlier “would be really pushing it”.¹⁰¹ Water UK were less willing to suggest a particular timescale, emphasising that the retail market should open “when it is ready”,¹⁰² with Anglian Water warning that “it is much better to spend the time getting the set-up right to avoid potentially unintended consequences”.¹⁰³

67. Water companies had particular concerns about the timescale for implementation of the upstream market reforms to the WSL regime, noting that unlike the retail reforms, there would be no Scottish experience to draw on. They were particularly concerned that a near-simultaneous introduction of reforms to the retail and upstream market might coincide with changes to the price review process,¹⁰⁴ and warned that investor confidence in the sector could be under threat,¹⁰⁵ calling for a stepped approach to the introduction of the reforms with the introduction of retail reforms taking place first.¹⁰⁶ Ofwat accepted that the financial sustainability of the sector was crucial,¹⁰⁷ but were not persuaded that the White Paper’s proposals would put this at risk. They described investors’ response to the White Paper as “positive” and noted that share prices on the day that the White Paper was announced had shown very little movement.¹⁰⁸ They pointed out that Defra’s impact assessments, published alongside the White Paper, estimated the net benefits of upstream

99 *Water for Life*, pp72–73

100 Q 40

101 Q 3

102 Q 220

103 Q 176

104 Ev 35

105 Ev 37

106 Ev 35

107 Ev 18

108 Q 44

reform to be £1,952 million¹⁰⁹ and argued that “it would not be sensible to delay obtaining those benefits beyond what is necessary to allow successful implementation”.¹¹⁰

68. Increased competition in the water sector will bring clear benefits to customers. The Government should not delay reforms because of an overcautious approach to investor confidence. We recommend that Defra open the retail market three years from Royal Assent to a Water Act. Reforms to the upstream market may necessarily follow a different timescale to the retail reforms, but they should not be unduly delayed.

The Scottish experience

69. Business customers in Scotland are already able to choose their supplier. The Water Services etc. (Scotland) Act 2005 introduced competition for all non-household customers, with the retail market opening for business in 2008. There are significant differences between the Scottish and English water industry; most notably, there is only one wholesale water provider in Scotland, the state-owned Scottish Water, whilst 21 privately owned water companies operate south of the border. Nonetheless, it was widely recognised by our witnesses that the recent Scottish experience of introducing a competitive retail market for water would be highly valuable when designing and implementing retail competition in England.

70. The Water Industry Commission for Scotland (WICS) drew our attention to various lessons that they had learned from implementing the Scottish retail market, commenting that the following aspects of the reforms had been particularly complex and time-consuming:

- development of competitive retail tariffs, reflecting appropriate retail cost drivers and scope for savings;
- design of wholesale charges, taking into account the definition of wholesale activities and the results of the next price review and the appropriate retail margin for each customer class;
- ensuring that data accuracy issues were ironed out before market opening; and
- agreement of registration and settlement processes and transparent governance rules to enable efficient market entry, exit and alteration of market codes.¹¹¹

71. The experience of introducing a competitive water market in Scotland and the lessons learned from it must be fully exploited as the White Paper’s proposals for market reform are implemented.

¹⁰⁹ Benefits accrue to incumbent water companies in the first instance but are expected to be passed on to end customers in the form of lower bills.

¹¹⁰ Ev 18

¹¹¹ Ev 7

A joint Anglo-Scottish market

72. The White Paper envisages a joint Anglo-Scottish retail market, in which businesses would be able to choose one supplier for all of their premises in both England and Scotland.¹¹² Whilst welcoming the joint market in principle, we had some concerns about the regulatory consequences, including the possibility of duplication or conflict between the Scottish and English regulator. It was clear that at this stage, details of how the joint market will operate remain to be developed. Both regulators sought to assure us that the possibility of conflict or duplication would be dealt with in advance of market opening, with Ofwat suggesting that a joint protocol or memorandum of understanding would govern how the regulators would work together on matters including the revocation of licences.¹¹³

73. We welcome the proposed joint Anglo-Scottish water market but would be concerned should this lead to any duplication or conflict between regulators, or any additional bureaucracy for water companies and their customers. We recommend that Defra work with the Scottish Government to ensure that the most effective regulatory model is adopted, including an assessment of whether a single regulator for the joint market may be appropriate. The Government should ensure that protocols setting out the relationship between, and respective duties of, the English and Scottish regulators are in place before the joint market opens.

Future structure of the water sector

74. The White Paper's aim to increase competition in the water sector will only be realised if new entrants to the industry are able to compete effectively with the incumbent monopoly water companies. The failure of the Water Act 2003 to introduce any meaningful competition to the sector has been partly attributed to the legal barriers facing new entrants and the practical difficulties of seeking to win business from incumbents.¹¹⁴

75. Professor Martin Cave's report on *Competition and Innovation in Water Markets* considered a range of options for introducing effective competition into the water sector. He concluded that given the difficulties that new entrants faced in competing with incumbent companies, Government should mandate the legal separation of incumbents' retail operations from the rest of their business, thus minimising the likelihood of unfair discrimination and encouraging new entrants to the market.

76. In the White Paper, Defra explains why it has taken the decision not to implement Cave's recommendation on legal separation:

We do not want to take risks with a successful model given the challenges we face in building the resilience of the sector...we have heard persuasive arguments that mandating structural change would undermine [investor] confidence.... Ensuring the

¹¹² The Welsh Government has decided to retain the current 50 million litre threshold at which non-household customers become eligible to switch supplier. Customers whose water use exceeds this threshold will be eligible to participate in the new market arrangements (see *Water for Life* p70).

¹¹³ Ev 19, Q 26, Q 68

¹¹⁴ *Water for Life*, p68, 71

sector remains an attractive prospect for investors will enable water companies to deliver continued investment at costs that customers will find acceptable.¹¹⁵

They argue that retail separation is not essential for the growth of a healthy competitive market and they will instead rely on the regulator to police discrimination by introducing statutory market codes and establishing a wholesale access pricing regime to govern the price and service levels which new entrants are offered by incumbents.¹¹⁶

77. A constant refrain throughout the evidence we received was the need for a ‘level playing field’ to ensure that new entrants could compete effectively with incumbents and would not be subject to discrimination by water companies keen to protect their own retail arms. Such discrimination could be direct (for example the provision of less preferable wholesale prices) or indirect (the provision of less preferable services, such as delays in fixing leaks for customers of a new entrant). Ofwat told us that they had a range of tools at their disposal to police discrimination, including accounting separation, the requirement for no undue discrimination, transfer pricing, and licence conditions; and that their track record of taking enforcement action was “a big deterrent.”¹¹⁷ The Water Industry Commission for Scotland, with experience of introducing competition in Scotland, agreed with Defra’s decision not to mandate legal separation. However, it felt that in seeking to establish a ‘level playing field’ Government should send a clear signal that those companies which voluntarily chose to separate their retail arms could expect a lighter regulatory burden.¹¹⁸

78. Ofwat’s preference would have been for legal separation, which they felt would have been “cleaner”.¹¹⁹ In the absence of legal separation, they were clear that some form of ‘functional’ separation between the retail and wholesale arms of incumbent companies would be required, with internal memoranda, agreements and codes of conduct forming a ‘Chinese wall’ within the company. They felt that the detail of how this would be policed was best left to the regulator, but wanted to establish “as clear a degree of separation as we could get”.¹²⁰ **Defra should consider setting out a requirement for functional separation in the draft Water Bill. Defra should also consider setting out in legislation a lighter-touch regulatory regime for companies which have legally separated their retail and wholesale functions.**

79. Under the current WSL regime, incumbent companies’ licence obligations require them to provide a retail function. Ofwat argued that Government had missed an opportunity to enhance competition by introducing separate licences for wholesale and retail activities, thus providing a mechanism by which incumbent companies could choose to exit the retail market should they wish to focus on wholesale activities only:

¹¹⁵ *Water for Life*, p 68

¹¹⁶ *Ibid*, pp71–72

¹¹⁷ Q 51

¹¹⁸ Ev 11

¹¹⁹ Q 51

¹²⁰ Q 55–56

This would leave retail services to those better able to deliver them and provide scope for new entrants to innovate in this area. It would also allow customers to gain from the clear economies of scale in retail activities through mergers.¹²¹

In oral evidence Ofwat expanded on this point further, arguing that the opportunity for less successful retailers to exit the market was an important factor in creating a “well-functioning” and “dynamic” market.¹²²

WICS agreed that separate licences would benefit competition:

It would clearly be better for [less successful] retailers to realise some value from disposing of their remaining customers than to continue to incur losses in their retail activities... Not to allow this could lead to higher bills for all those customers (including householders) who continue to be served by the unsuccessful retailer.¹²³

Defra told us that there were “risks” attached to allowing companies to voluntarily exit the market, with the Minister explaining that:

If you were to allow exits you could see competition authorities at some point being able to push, for example, towards a more legally separated route, and that is one we have firmly rejected for a variety of reasons, the principal one being that we want to secure continued investment.¹²⁴

Ofwat’s evidence, however, suggested that they did not believe that providing a mechanism for voluntary exits through the issuing of separate retail and wholesale licences would adversely affect investment, arguing that it would in fact do just the opposite, with investors and companies able to choose the most efficient structures for their businesses.¹²⁵

80. We are not persuaded by the Minister’s arguments against allowing a mechanism for companies to voluntarily exit the retail market and we agree with the English and Scottish regulators that providing an exit route should enhance competition and efficiency in the sector. We note in particular Ofwat’s view of the importance of an exit mechanism in achieving a well-functioning and dynamic market. We recommend that Defra include such a mechanism in the legislation implementing the market reforms.

Consumer representation

81. The monopoly characteristics of the water industry, which will continue for domestic customers even after the competitive retail market opens for business customers, make it essential that a strong body represents the interests of customers. Currently that representation is provided by the Consumer Council for Water (CC Water), an independent statutory body established in 2005 which represents both business and domestic customers.

121 Ev 17

122 Q 70

123 Ev 15

124 Q 299

125 Ev 17

82. In October 2010, the Cabinet Office announced that it would consult on the future of a number of consumer representative bodies, including CC Water, with a view to possible abolitions or mergers. David Gray's 2011 *Review of Ofwat and consumer representation in the water sector* subsequently recommended that the current arrangements regarding CC Water should be retained, noting in particular the need for a strong consumer view to be maintained throughout the forthcoming challenges to the sector.¹²⁶ The White Paper commits to retaining CC Water in its current form until the 2014 Price Review.¹²⁷ In evidence, CC Water explained why they should be retained beyond this date:

...the alternative proposals for CC Water do not really address business customer issues; it is all around domestic customers. Business customers who, today, have got issues with the water industry and probably will have during the implementation of the competition regime, would be unprotected in that sense.¹²⁸

83. Evidence from Whitbread Hotels and Restaurants gave some flavour of the issues that CC Water alluded to, describing the process of making complaints as a “time consuming and frustrating process” and accusing water companies of lacking customer focus.¹²⁹

84. It is essential that there is a strong voice to represent the interests of consumers through the far-reaching reforms to the water sector to be implemented over the coming years. We recommend that Defra commit to retain the Consumer Council for Water in its current form for a period of three years after the White Paper's market reforms are implemented. Any new arrangements for consumer representation which are introduced subsequently must take account of the unique needs of business customers.

126 Gray, p84–85

127 *Water for Life*, p76

128 Q172

129 Ev w68

6 Conclusion

85. Water, in the words of the White Paper, is “in many ways our most precious resource”¹³⁰ and it is clear that the challenges posed by climate change and population growth will require careful management of our water resources over the coming years. In many areas the White Paper sets out the right direction for change, but it is lacking in both ambition and urgency. In particular, the reform of the abstraction regime must be brought forward more quickly if we are to limit the environmental damage caused by over-abstraction: our rivers are already running dry. The White Paper is also disappointingly weak in its approach to metering. As water becomes increasingly scarce it becomes ever more important to encourage consumers to use it wisely: the evidence points to metering as one of the most effective ways to do that.

86. We welcome the decision to increase competition in the water market, delivering efficiencies which should result in lower bills for customers. We have recommended changes to the proposed reforms which we believe will enhance competition and benefit customers further.

87. We expect the conclusions and recommendations in this report to be taken fully into account as Government draws up the draft Water Bill. We look forward to the timely publication of the draft Bill for Parliamentary scrutiny.

¹³⁰ *Water for Life*, p3

Conclusions and recommendations

Long term reform

1. The recent drought has underlined the importance of introducing a reformed abstraction regime able to provide sustainable and reliable supplies of water. The timescales set out in the White Paper lack ambition and unnecessarily risk further environmental damage. We believe that ten years is an adequate period in which to plan and implement reform of the abstraction regime and recommend that the reformed regime be in place no later than 2022. (Paragraph 10)
2. Even with this shorter timescale, momentum may be lost. We recommend that the Government work with regulators, water companies and environmental groups to produce a workplan setting out key milestones for the duration of the reform period, and annually report on progress against them. (Paragraph 11)
3. We are pleased that the Environment Agency and the Minister acknowledged the importance of ensuring that the agricultural sector retains access to a reliable water supply. As the reforms go through, we recommend that the Environment Agency maintains a constructive dialogue with farmers and food producers, recognising their key role in promoting self-sufficiency and food security. (Paragraph 13)
4. We urge Defra and the Environment Agency to work with the Institution of Civil Engineers to complete the reviews of both A guide to the Reservoirs Act 1975 and the Floods and Reservoir Safety guidance by December 2012. (Paragraph 14)

Short-term reforms: Restoring Sustainable Abstraction

5. The current mechanism for the removal of environmentally unsustainable abstraction licences is clearly unsatisfactory and is causing ongoing and severe damage to the environment. We recommend that the White Paper's proposal that funding for the Restoring Sustainable Abstraction Programme be incorporated within the price review process be implemented as a matter of urgency. Defra should work with Ofwat and the Environment Agency to ensure that this change is made in time for the RSA programme to be funded from the 2014 price review. (Paragraph 18)

Bulk trading and interconnections

6. Defra's decision to focus on maximising "strategic" interconnections allowing water to be transferred over relatively short distances is a sensible starting point and we look forward to the Environment Agency's forthcoming overview of interconnection options. Defra should remain open to considering whether large-scale infrastructure may be an appropriate and cost-effective solution in some circumstances. Defra and the Environment Agency should in particular look to exploit interconnection opportunities presented by other large infrastructure projects, thus minimising environmental impact and economic costs. (Paragraph 23)

Floods, drainage and the automatic right to connect

7. Five years on from the devastating floods of 2007 we are not convinced that Defra's work to improve the management of surface water has been carried out with sufficient urgency. Defra must ensure that implementation of the relevant provisions of the Flood and Water Management Act is not subject to any further unnecessary delay. The White Paper says disappointingly little about the retrofitting of Sustainable Drainage Systems and we recommend that Defra develop more concrete proposals to encourage this. (Paragraph 29)

Flood insurance

8. It is deeply worrying that with only a year remaining until the current Statement of Principles on flood insurance is due to expire, and eighteen months on from this Committee's call for urgency in establishing its replacement, Government has not yet been able to reach agreement with the industry. Defra must redouble its efforts to achieve a workable and affordable solution to this issue. (Paragraph 32)

Metering

9. It is extremely disappointing that a White Paper that places such an emphasis on valuing water says so little about metering. With water set to become an increasingly scarce resource, we believe that the Government must use water meters as a means to encourage responsible use of water. We recommend that the Government set a clear and ambitious objective to increase levels of metering, taking account of Anna Walker's recommendation that metering penetration reach 80% by 2020. (Paragraph 41)

Rainwater Harvesting and Recycling Water

10. We recommend that Defra take more active steps to promote rainwater harvesting and water recycling and seek to incorporate incentives or requirements for their inclusion in the design of new developments. (Paragraph 44)

Leakage

11. We recognise the progress that water companies have made in reducing leakage levels but urge companies and the regulator to do more to reduce the amount of water that is wasted through leakage. We recommend that in reviewing guidance to companies on the Sustainable Economic Level of Leakage, the Government and regulators should take account of the impact that leakage levels have on customers' willingness to engage with efficiency measures, if necessary carrying out further research to seek to quantify this impact. (Paragraph 47)

Affordability

12. It is simply unacceptable that, at a time when so many are struggling to afford their water bills, customers face the additional burden of subsidising those who refuse to pay what they owe. Legislation already exists that would make it easier for water

companies to recover bad debt and the Minister acknowledged that money recovered from debtors would be “money in the pocket” for those who do pay their bills. We urge the Department to implement the relevant provisions of the Flood and Water Management Act without further delay. (Paragraph 55)

13. Take-up levels of WaterSure suggest that many of those who currently qualify for help with their bills do not receive it, and we are concerned that company social tariffs will face similar barriers to take-up. We recommend that the Government take a more proactive approach to publicising the help that is available to poorer customers. Defra should work with the Department for Work and Pensions to ensure that all means-tested benefit claimants are given the option to consent to the sharing of their data with their water company for the purposes of help with affordability issues, and should also use the opportunity to inform claimants of existing support, such as the WaterSure tariff. (Paragraph 59)
14. We recommend that the Government make clear that the design and promotion of company social tariffs should not focus exclusively on customers in receipt of benefits to the detriment of others who may struggle to afford their bills. (Paragraph 60)

Market Reforms: Timescales

15. Increased competition in the water sector will bring clear benefits to customers. The Government should not delay reforms because of an overcautious approach to investor confidence. We recommend that Defra open the retail market three years from Royal Assent to a Water Act. Reforms to the upstream market may necessarily follow a different timescale to the retail reforms, but they should not be unduly delayed. (Paragraph 68)

The Scottish experience

16. The experience of introducing a competitive water market in Scotland and the lessons learned from it must be fully exploited as the White Paper’s proposals for market reform are implemented. (Paragraph 71)

A joint Anglo-Scottish market

17. We welcome the proposed joint Anglo-Scottish water market but would be concerned should this lead to any duplication or conflict between regulators, or any additional bureaucracy for water companies and their customers. We recommend that Defra work with the Scottish Government to ensure that the most effective regulatory model is adopted, including an assessment of whether a single regulator for the joint market may be appropriate. The Government should ensure that protocols setting out the relationship between, and respective duties of, the English and Scottish regulators are in place before the joint market opens. (Paragraph 73)

Future structure of the water sector

18. Defra should consider setting out a requirement for functional separation in the draft Water Bill. Defra should also consider setting out in legislation a lighter-touch regulatory regime for companies which have legally separated their retail and wholesale functions. (Paragraph 78)
19. We are not persuaded by the Minister's arguments against allowing a mechanism for companies to voluntarily exit the retail market and we agree with the English and Scottish regulators that providing an exit route should enhance competition and efficiency in the sector. We note in particular Ofwat's view of the importance of an exit mechanism in achieving a well-functioning and dynamic market. We recommend that Defra include such a mechanism in the legislation implementing the market reforms. (Paragraph 80)

Consumer representation

20. It is essential that there is a strong voice to represent the interests of consumers through the far-reaching reforms to the water sector to be implemented over the coming years. We recommend that Defra commit to retain the Consumer Council for Water in its current form for a period of three years after the White Paper's market reforms are implemented. Any new arrangements for consumer representation which are introduced subsequently must take account of the unique needs of business customers. (Paragraph 84)
21. We expect the conclusions and recommendations in this report to be taken fully into account as Government draws up the draft Water Bill. We look forward to the timely publication of the draft Bill for Parliamentary scrutiny. (Paragraph 87)

Formal Minutes

Wednesday 20 June 2012

Members present:

Miss Anne McIntosh, in the Chair

Thomas Docherty
Richard Drax
George Eustice

Mrs Mary Glendon
Neil Parish
Amber Rudd

Draft Report (*The Water White Paper*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 87 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Second 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 27 June at 2.00 pm]

Witnesses

Wednesday 22 February 2012

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Alan Sutherland, Water Industry Commission for Scotland and **Mark Powles**, Business Stream Ev 1

Regina Finn and **Keith Mason**, Ofwat Ev 8

Tuesday 6 March 2012

Lord Chris Smith, **Dr Paul Leinster** and **Ian Barker**, Environment Agency Ev 18

Tony Smith, Consumer Council for Water Ev 24

Wednesday 7 March 2012

Pamela Taylor, Water UK, **Peter Simpson**, Anglian Water, and **Steve Mogford**, United Utilities Ev 31

Dr Rose Timlett, WWF-UK, and **Dr Geoffrey Findlay** and **John Lawson**, Action for the River Kennet Ev 42

Tuesday 27 March 2012

Richard Benyon MP, **John Bourne** and **Gabrielle Edwards**, Department for Environment, Food and Rural Affairs Ev 49

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3	United Utilities Group PLC	Ev 63
4	Water Industry Commission for Scotland	Ev 65: Ev 66: Ev 69: Ev 74
5	Ofwat	Ev 74:Ev 77: Ev 78
6	Consumer Council for Water	Ev 82
7	Anglian Water Services Ltd	Ev 85: Ev 87
8	Action for the River Kennet	Ev 88: Ev 89
9	Water UK	Ev 93: Ev 96
10	Environment Agency	Ev 97
11	Department for Environment, Food and Rural Affairs	Ev 98

List of additional written evidence

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

1	David Linnell	Ev w1
2	Barri Hitchin	Ev w1
3	T Martin Blaiklock	Ev w1
4	Howard Glenn	Ev w5
5	David J Martin	Ev w5
6	Scottish Water	Ev w6
7	British Chambers of Commerce	Ev w6
8	UK Environmental Law Association	Ev w7
9	RM Water Services	Ev w7
10	Wessex Water Services Ltd	Ev w10
11	SSE Water Ltd	Ev w11
12	SSE plc	Ev w12
13	Waterwise	Ev w13
14	Water-Value	Ev w15
15	UK Rainwater Harvesting Association	Ev w16
16	Portsmouth Water Ltd	Ev w18
17	London Borough of Hammersmith and Fulham	Ev w21
18	David Wilks, Varyflush Ltd	Ev w23
19	River Chess Association	Ev w24
20	Major Energy Users' Council	Ev w25
21	Sembcorp Bournemouth Water	Ev w26
22	Wolseley UK	Ev w28
23	Kelda Group	Ev w32
24	Woodland Trust	Ev w34
25	Chartered Institution of Water and Environmental Management	Ev w35
26	Economic and Social Research Council Centre for Competition Policy, University of East Anglia	Ev w37
27	Lucy Borland	Ev w38
28	CBI Minerals Group	Ev w40
29	Mineral Products Association	Ev w41
30	Chartered Institute of Plumbing and Heating Engineering	Ev w42
31	Blueprint for Water coalition	Ev w44
32	Thames Water	Ev w45
33	South West Water Limited	Ev w48
34	National Farmers' Union	Ev w50
35	Committee on Climate Change, Adaptation Sub-Committee	Ev w52
36	Food and Drink Federation	Ev w53
37	Association of Electricity Producers	Ev w54
38	Country Land and Business Association	Ev w57
39	Northumbrian Water Ltd	Ev w58
40	Chilterns Conservation Board	Ev w60

41	Home Builders Federation Ltd	Ev w61
42	Local Government Association	Ev w63
43	Carillion Energy Services	Ev w64
44	Severn Trent Water Ltd	Ev w66
45	Whitbread Hotels and Restaurants	Ev w68
46	Mayor of London	Ev w69
47	Environmental Industries Commission	Ev w70

List of Reports from the Committee during the current Parliament

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

Session 2012–13

First Report	Greening the Common Agricultural Policy	HC 170
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Session 2010–12

First Report	Future Flood and Water Management Legislation	HC 522 (HC 922)
Second Report	The Marine Policy Statement	HC 635
	Government response to the Committee's Second Report published as an Un-numbered Act Paper on 17 March 2011	
Third Report	Farming in the Uplands	HC 556 (HC 953)
Fourth Report	The draft National Policy Statement (NPS) on Waste Water	HC 736
	Government response to the Committee's Fourth Report contained in <i>The Government Response to Parliamentary Scrutiny of the Draft National Policy Statement for Waste Water</i> , published on 8 February 2012	
Fifth Report	The Common Agricultural Policy after 2013	HC 671 (HC 1356)
Sixth Report	Implementation of the Common Fisheries Policy: Domestic Fisheries Management	HC 858 (HC 1485)
Seventh Report	Pre-appointment hearing: Chair of Gangmasters Licensing Authority	HC 1400-I & -II
Eighth Report	EU proposals for the dairy sector and the future of the dairy industry	HC 952 (HC 1548)
Ninth Report	The Welfare of Laying Hens Directive—Implications for the egg industry	HC 830 (HC 1664)
Tenth Report	The outcome of the independent Farming Regulation Task Force	HC 1266 (HC 1669)
Eleventh Report	The draft National Policy Statement for Hazardous Waste	HC 1465
Twelfth Report	EU proposals for reform of the Common Fisheries Policy	HC 1563
First Special Report	The National Forest: Government response to the Committee's Fourth Report of Session 2009–10	HC 400
Second Special Report	Dairy Farmers of Britain: Government response to the Committee's Fifth Report of Session 2009–10	HC 401

Oral evidence

Taken before the Environment, Food and Rural Affairs Committee on Wednesday 22 February 2012

Members present:

Miss Anne McIntosh (Chair)

Thomas Docherty
Richard Drax
George Eustice
Barry Gardiner

Mrs Mary Glendon
Neil Parish
Ms Margaret Ritchie

Examination of Witnesses

Witnesses: **Alan Sutherland**, Chief Executive, Water Industry Commission for Scotland, and **Mark Powles**, Chief Executive, Business Stream, gave evidence.

Q1 Chair: Gentlemen, good afternoon. Apologies for the delay. It was nothing sinister and nothing to do with this subject; we had other business to deal with. We are very grateful to you for your patience. Thank you very much indeed for being with us this afternoon and contributing to the first formal evidence session of our inquiry into the Water White Paper. For the record, could I invite each of you in turn to introduce yourselves—who you are and who you represent? Alan, we have seen each other three times in three days. This is a treat.

Alan Sutherland: I know.

Chair: You are welcome. Could we start with you, Alan?

Alan Sutherland: My name is Alan Sutherland. I am Chief Executive of the Water Industry Commission for Scotland. I have held that post since 2005. Prior to that, I was the Water Industry Commissioner for Scotland, a ministerial appointee, since 1989.

Mark Powles: I am Mark Powles. I am the Chief Executive of Business Stream, the largest water and waste-water retailer in the competitive market in Scotland. I have been there for five years, and was brought in to set up Business Stream prior to the opening of the Scottish market.

Q2 Chair: Thank you very much indeed. Could we test the water, so to speak, relying on your expertise? Alan, if I can start with you, how long would you say the whole process took—I know it is in your written submission—to implement the framework from start to finish? That is both the legislation and the rolling out on the ground.

Alan Sutherland: I first included some thoughts on retail competition and separation of activities in 2001. There was Scottish Government interaction during 2002 and 2003. By the end of 2003 it was fairly clear that this was a policy that the Scottish Government was going to pursue. During 2004 we did our first work looking at the resources and time that it would take to do the work. In 2005, we set a deadline of April 2008 for opening the market. At the time we thought we had allowed ourselves more than enough time. We only just made it, and there were those who, even a month or two before, were saying, “Could we

have a bit more time?” Start to finish, serious effort—four very, very hard years. I have just about recovered.

Q3 Chair: You are looking very well on it. Looking at the fact that it was a special market—a unique market—and looking at the context of the Water White Paper and the fact that most parties are calling for early legislation, what do you think would be a realistic timetable, both for the legislative process and also for market opening?

Alan Sutherland: I said to Defra officials and to Mr Benyon, before the White Paper, that were he to pursue a retail market, April 2017 would be the earliest sensible date for a market opening, unless some form of staged opening was what he wanted to achieve. That was the advice I gave him then. I do not see any particular reason to change that.

Clearly it would be helpful to have legislation sooner rather than later to achieve that end point, but there is much that can be done before the legislation is passed. Even if the legislation were to be a little delayed—it is better to be a little delayed and good legislation than rushed and not good legislation—I still think April 2017 could be achieved. It would be a reasonable date. Any earlier would be really pushing it.

Q4 Chair: Thank you very much indeed; that is very helpful. Mr Powles, is there anything you would add to that from your perspective?

Mark Powles: I look at it from a customer point of view. Customers are overwhelmingly telling us that they want to share the benefits they have started to receive in Scotland as soon as possible. As an operator Business Stream was created in November 2006. We had to physically separate from Scottish Water, and were ready on 1 April 2008 when the market opened. A lot of the effort in shaping the market is the role of regulators and market participants—to be able to contribute to how the model should look—but physically creating the company, preparing the strategy and being ready to compete took us just under 18 months.

Q5 Chair: That is helpful, thank you very much indeed. In view of the experience you have with the

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Scottish legislation and setting the Scottish framework, do you think, Alan, that while it would be helpful to have earlier legislation, it would be ambitious or possibly nigh-on irresponsible to introduce it in 2016?

Alan Sutherland: I can only comment on my own experience. I certainly do not want to tell others how to do their jobs, or you how to reach your conclusions, but I would not like to have to try to do it by April 2016 for a second time. I have done it once, and that was quite painful. I would not be keen to try to do it again by April 2016.

Q6 Chair: That is helpful, thank you very much indeed. Mr Powles?

Mark Powles: Potentially you would not be starting from scratch. Much of what Alan and his team and the participants had to do was to start from a blank piece of paper. If there is a commitment to try to create an Anglo-Scottish market, there are a lot of things in Scotland that might need adapting but are pretty much fit for purpose. We have had four years of testing them and adapting them to make the Scottish market work more effectively. Depending on how the regulators work together and how the market is shaped, there is a lot of good material that would need to be adapted, rather than starting from scratch. That may help.

The other factor is that separation was not within the scope of the White Paper. If I look at it from an operator point of view, one of the big efforts for us was to physically separate.

Chair: That is helpful, and leads naturally to Thomas Docherty.

Q7 Thomas Docherty: To clarify, for my own sanity, you are saying that the 2017 is based on a 2013–14 session Bill with Royal Assent. If, for argument's sake, it was a fourth session—i.e. it was the last year of the Parliament when we got Royal Assent—effectively it would become 2018. If we got a Bill—he says laughingly—in the next session of Parliament, it would shift forward. Is the 2017 date based on the concept of three years to the following April?

Alan Sutherland: That would be part of the rationale, yes. I am cautious. I accept what Mark said; it is largely down to the companies to do the work and most of the work is with the companies, not with the regulator, but the one thing that is demonstrably new and very big is the setting of wholesale charges. To set wholesale charges one needs to have had a level of wholesale revenue set by the regulator. That almost certainly means you would need a determination of charges. We had one in 2005. We used that as the opportunity to set wholesale revenue for the first time, and then we were able to take that and convert it into a series of charges tariffs, and to use that as the price that the retailers would pay the wholesaler.

Q8 Chair: May I interject? Could they do that as part of the 2014 price review?

Alan Sutherland: Yes, they could. If I were looking at the process, that is the way I would do it. I would be looking to set either a revenue cap or a price cap for the wholesale activities, and some form of default

retail cap to ensure that no business or organisation was worse off as a result of the changes. I would be doing the two things in parallel, but once you have done that you then have the effort to put together these new wholesale charges. It is the first time it will have been done, and it is quite challenging, simply because the things that determine wholesale charges are slightly different from those that determine retail.

You will no doubt get evidence that about 10% of the bill is retail and all that, but once you get into smaller businesses, as a percentage of their bill, it is much higher than the 10%. It is much lower when you get into the very large companies, but much higher when you get into the small companies. You have to get those sums right, because otherwise the incumbent gets left with all the customers that are more expensive to serve, with not enough revenue to do it. That leads to perverse outcomes in the market, which none of us should want to achieve.

Q9 Thomas Docherty: Turning to the issue of separation: first, on the issue of legal separation, Mr Powles, you mentioned that you are legally separated from Scottish Water. Mr Sutherland, how important has it been to have that legal separation? Mr Powles, what is your experience of that?

Alan Sutherland: There are two things I would say: first, the legal separation in Scotland came about because Scottish Water is a statutory corporation, and it was easier to require Scottish Water to separate its retail activities legally than it was to unpick the various statutes that underpinned Scottish Water the statutory corporation. That is why the legal separation decision was taken. It was not an ideological decision; it was not a governance-based decision—it was almost a practicalities-based decision.

In Scottish Water's case, because at the time it was still relatively new to regulation and the overall regulation environment, it probably was quite useful in terms of getting the sorts of clarity of behaviour that are desirable between the retail and wholesale sides. Can you achieve the same thing in a different way? The answer would have to be yes, but it would require increased transparency and potentially it would require a more onerous governance code if there is less separation, but you can achieve it.

The critical thing is aiming for a level playing field, so that the new entrant can genuinely enter the market and not feel like someone will be dashing down the corridor saying, "Can you fix my customer's leak?" rather than fixing a new entrant's leak, for example. That is the sort of environment that is not going to be conducive to the development of a fair and equitable market with the consequences of innovation and value for money that we would all want to see.

Mark Powles: We have positioned our brand to sit on the side of the customer, and to do that we need to be independent. In a conflict situation, when there is a part of the network that customers may be suffering from, we want to be on the side of the customer and challenging the network operator to fix it, and fix it to the customer's satisfaction. Separation helped in that regard, in that I consider Scottish Water as a supplier. They are my parent company as well, but in terms of the way we operate, it is as a supplier and a customer.

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That is one of the cornerstones of how we have positioned ourselves, and why we have been fairly successful; we have always been able to sit on the side of the customer and represent their interests.

Culturally it has meant that we have taken some people that were TUPE-transferred over from the core Scottish Water business and thrust them into the competitive retail world. We have had to equip them with a new set of skills. We have had to give them the confidence to give a far superior quality of service, because if we do not customers will switch elsewhere. That has been quite a galvanising force: to be separate and to stand on our own two feet.

Q10 Thomas Docherty: What kind of practical things have you done to reinforce the separation? It was not just that you got legal separation; what are the other practical things that you have done?

Mark Powles: The regulator set us three tests: to be financially independent, to be independent in terms of decision making, and from a governance point of view to be transparent in the way we worked with Scottish Water as a supplier. We are in a physically different location. We have separated all of our IT systems. We own all our own data and all our own processes. We have cut the umbilical cord with Scottish Water in terms of the way we operate. We have our own board and our own management team, so we are free to make the decisions that serve our business in terms of creating our own business plan and direction for the business.

The regulator has put constraints on the relationship we have with Scottish Water; we cannot jointly contract with anything. If we want to do anything, we have to get the regulator's approval to do so. It is fairly robust separation. Alan talked about the level playing field. It is important to new entrants to know that the incumbent's behaviour has been moderated, and they do not get an unfair advantage in terms of the way they serve customers. I look at it as an incumbent in Scotland, and as a potential new entrant and a challenger in England. I want to be sure that there is a level playing field of competition.

Q11 Thomas Docherty: Mr Powles, do you have any concerns about competing over the border with companies that are not going to be legally separated?

Mark Powles: It goes back to what Alan said. If you do not separate you need to put a compliance regime around it so that incumbents do not have an unfair advantage. Without separation, regulators need to consider how robust that is. If new entrants do not believe they are getting a fair crack of the whip, they will challenge that.

Thomas Docherty: Thank you.

Q12 Chair: I am not sure that I quite understand. You are legally separate, but you are still part of a monopoly? Effectively there are two legal persons within one company. Is that correct, Alan?

Alan Sutherland: Public corporations are creatures of statute, and as creatures of statute they tend to be entities that do not have a holding company structure built into them, so the actual operating company is the company. Because of that, when separating Business

Stream we had to take a number of steps to ensure that in creating a subsidiary, the operating company was demonstrably governed differently from the retail subsidiary. That is the different board and the rules that Mark talked about.

Although Business Stream is technically a subsidiary of Scottish Water—indirectly—it is entirely separate in terms of how it operates and is accountable. They are able to do what is in the interests of the customer. What this has always been about is trying to empower customers, and trying to get to a position where customers are able to influence the service they get, and it is not, as I like to say, the school dinner service—take it or leave it—which is what has characterised the industry a bit too much.

Mark Powles: I do not think I can add any more to that.

Q13 George Eustice: There was concern among some of the English water companies when there was a suggestion that there should be this legal separation. From what you say, you do not seem to think there has been a problem with that. Why do you think they were so concerned about it and lobbied the Government so hard to back away from it?

Mark Powles: I am not sure, to be honest. In my experience of being hired into a business with an obligation to separate, I have used it to my advantage. I have been able to create the right systems and supply base appropriate for the size of our business, and not for a big integrated water company with 5,000 people. We have managed to reduce our cost base as a result of separation. There were some set-up costs to go with it, but we have been able to create a business that is right for the customers we serve and the market opportunity that we have. It is all the things I have said before: culturally it worked for us, in terms of speed to market, and being able to serve customers in a more flexible and tailored way. Separation has worked for us. As a new entrant going into England, I want a level playing field, whether that is through separation or with a governance code. I want to be clear that I am on a level playing field with an incumbent operator.

Q14 George Eustice: They specifically said that it would shake investor confidence: that was the problem. Is there a difference in that because Scottish Water is set up differently you do not have the same problem? You are not reliant on shareholders.

Alan Sutherland: We are not reliant on private capital; that is obviously true.

Q15 Chair: Could I just interject? Where is the level playing field if you are not reliant on private capital, but the English companies that you are going to be competing with are?

Mark Powles: I feel the pressure of controlling my own balance sheet and making sure I have enough cash to pay the bills. Be under no illusions; we run this business as a commercial venture in the same way as any other private sector business would. When we lose a customer, we hurt. We hurt from a reputational point of view, but we hurt due to the impact on our profit and loss account and on our balance sheet. I

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come from 25 years of private sector organisations, and I run this business in no different way.

Alan Sutherland: If Business Stream does not earn the return that is set out in its governance code, it is in breach of its licence. That return was set having taken advice from half a dozen leading investment houses. It may be public capital, but it is public capital that is working very hard to earn good private sector returns.

Mark Powles: As well as the physical separation, the regulator also set us certain other licence conditions that are unique to us as the incumbent: the need to publish our tariffs and the need to make sure that any deal we do with a customer is cost reflective, and to make sure that we do not cherry pick customers. If we offer a discount to one customer in one class, we have to offer it to all the customers in that class. We have certain obligations that new entrants do not, and that was a way of creating that level playing field.

Q16 Mrs Glindon: Mr Sutherland, I address this question to you: how have you ensured that wholesale prices are fair to Scottish Water retailers and customers?

Alan Sutherland: In the 2005 determination we set a level of wholesale revenue that reflected—as the current determination would do in England—the level of revenue that the wholesale part of Scottish Water was going to need. A lot of this work has to be closely collaborative. We worked very hard with Scottish Water, new entrants and retailers to ensure that we had a set of wholesale tariffs that were fair, and were going to allow enough difference between retail tariffs and wholesale tariffs for all the costs the retailers were going to have in serving that particular class of customer.

The wholesale tariff bit is still regulated. The retail bit is regulated as a safety net, but there is flexibility for customers to pay more if they want better services, customers to pay less and get better services, or customers to do nothing and pay the regulated price. It is for the customer to decide, but we have put safety nets in place to ensure no customer can be worse off.

Q17 Mrs Glindon: Has the requirement for new entrants to pay the wholesaler in advance, or provide other financial guarantees, hampered competition in Scotland?

Alan Sutherland: I am often asked about this. I will be honest: when we set out doing this, I never envisaged asking retailers to pay in advance of wholesalers. It is not what you would immediately expect to have happen; you would expect suppliers to buy something on credit and that sort of thing. But on examining the economics of it all—trying to make sure that the market was sustainable and was going to work well—you ended up with a question: how am I going to assess the creditworthiness of the people coming into the market? How am I going to make sure that they are going to fulfil their obligations? The more we thought about that, the more we said, “It would be better if the entrants prepaid.”

In terms of Scottish Water and separating the wholesale and retail bits, that was essentially moving some money around in the accounts; it was not a

difficult job. When we started talking with new entrants, at the rate they acquire customers, finding the capital to acquire those customers is not terribly difficult. If you look at the actual returns on the capital employed, the margins are very low, but the returns on the capital employed are very high. In that sense, there is no particular reason not to put the limited amount of capital in by prepaying.

We have had one very large English water company participating in the market—clearly working capital is not really an issue for them; but we have had two very small entities. One was quite literally a few men in a start-up entity, who have probably been either the most or the second most successful of the new entrants. They have not been hampered by the prepayment in any way. We can be a lot less bureaucratic in how we regulate the market, because we do not have to worry about the creditworthiness of each of the retailers all of the time. If we had been going through the financial crisis with small entities, and with payment in arrears, who knows whether they would have been able to meet their obligations, and whether that might have had a detrimental impact on Scottish Water, and then potentially on customers as a whole.

It is very important to set up a world where we can be absolutely sure that the household customer is protected and we can be absolutely sure that the wholesale business receives a fair return for the activities that it does. If we do that, then hopefully we can have a successful market in England, just as we have in Scotland.

Mark Powles: That is from the market structure point of view. From a retailer point of view, it forces you to do creative things in the way you do tariffs. We have a tariff that gives a pretty good discount to customers if they pay us in advance, so we take away the impact of having to pay the wholesaler in advance, because we have encouraged our customer to give us the money up front in return for a discount. It just needs the retailer to be more innovative and creative in the way they transact with their customers.

Q18 Neil Parish: Water for Life envisaged an Anglo-Scottish market for water in which Ofwat and WICS would mutually recognise licences granted by either regulator, share information, and produce market codes. What do you expect to be the key challenges in establishing this new Anglo-Scottish market?

Alan Sutherland: The first thing to say is that we are a very small office. We like to think we punch a bit above our weight maybe—even my weight—but we try hard to do the right thing. We will certainly work with anyone, anytime, anywhere, as it were, to try to get to a market that is better for customers. As the Committee may know, we have advocated and tried to explain what we have been doing in Scotland to regulators, Government, companies, customers—to anyone that will listen. We do that for purely selfish Scottish reasons: we think customers in Scotland are better off with more choice, and we hear from many multi-site customers in Scotland that they would like one bill across the whole of Britain.

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That is why we have pursued what we have pursued: it is very much customer-driven. We are aware that there has been an exchange of ministerial correspondence between London and Edinburgh that suggests a quadripartite forum involving ourselves, Ofwat, the Scottish Government and the Westminster Government. We think that is a good idea. We would be happy to contribute our experience—contributing our mistakes may be even more important than the things we have got right—and work from that.

Q19 Neil Parish: Who do you expect to be granting licences where? Do you expect Scottish Water or WICS to be granting licences in England, and do you expect Ofwat to be granting licences in Scotland? Will this cause a great deal of confusion if you are not careful?

Alan Sutherland: I suppose there could be confusion. My understanding of the legislation is that if you are licensed in Scotland, then Ofwat would recognise that licence in England, perhaps with an amendment—I do not know. Similarly, if you were licensed by Ofwat, the idea would be that we would recognise that as fit for purpose in Scotland. If that is what we are talking about, it is fairly clear. I would be hopeful that companies that are active in England would think it worthwhile to come and experiment a bit in Scotland and see what it is like to try to win customers in a competitive market before the reform is fully operational in England.

Chair: Can we come back to this, because we are coming on to that in just a moment? Could we turn to market codes, if we may, and then come back to the regulatory model?

Q20 George Eustice: You have touched on the structure and how you all might get around the table and discuss how to make this thing work, but what would a successful market code look like, particularly a joint market code? Mr Powles, you hinted at concerns that it might not be a level playing field. What would it look like? What are the key headlines you would like to see to protect your position?

Mark Powles: I would probably go back to what was just talked about. I do not mind who licenses me, as long as I know what obligations I am taking on as part of a licence to operate both across border and across territory, in different regions within England. If you take a multi-site retailer operating in Scotland and England with branches across the different water regions, I want to be able to present them with one bill that they can understand and that has very clear service standards. I do not want to put in 30 pages of contractual small print that says in this region we will respond to a query within 10 days, but in that region it will be in 15 days. I need some sort of harmonisation of service standards in terms of the obligations that the wholesaler has to us and to the customer.

Those are the critical things to us. We recognise that pricing might be slightly different by region, but as a retailer I am happy to take on that complexity and to be able to present a bill to a customer that they understand. I want to be clear what obligations I am taking on as a licensee, and how I can service that

customer and deliver what I promised. That is what customers want as well.

Q21 George Eustice: Do you envisage this setting out response times to a broken water pipe—that type of thing?

Mark Powles: The principle in Scotland is that there is a regulated wholesale price that is the same price for every participant in the market, but a set of service standards comes with that, and there is a capped retail price. Any customer at the very worst is going to be able to get the default retail price in return for a set level of service standards and obligations that are placed on the retailer that serves them. It is transparent, it is easy to understand, it protects the customer and it means that you can deal with wholesalers in a transparent and easy way and do not have to negotiate different things all the time. That has been one of the successes in Scotland: the simplicity and transparency of regulated access. Those are the sorts of things I would like to see in an Anglo-Scottish market.

Q22 George Eustice: Is there anything missing from the Scottish code that you think should be in there, or do you think we should just dust off the Scottish one and say that it now applies across the UK?

Mark Powles: We need to recognise that England is a bigger beast: there are 21 regions and a lot more customers. I cannot think of anything particularly that I would say, “That has definitely got to change.” But there does need to be a meeting of minds in terms of creating something that is going to work in a much more enlarged market. That is where the regulators need to sit down and find that common ground.

Q23 George Eustice: Where do you think the sticking points will be? If you were to say, “Let’s apply the Scottish code to the UK,” what would be the objections south of the border?

Mark Powles: There needs to be a harmonisation of service standards, because different companies work in slightly different ways. On the issue about paying in advance or paying in arrears, as a retailer if one does it one way and one does it the other, that is not a problem for me, so that might be a slight difference between the two. In the main it is ensuring that there is a regulated price that is transparent and easy to contract with. The whole basis of contracting with a wholesaler to be able to serve a customer, and to be able to switch a customer easily, is very important. The glue that sticks all this together is the registration and switching system—the market dataset and how the mechanics work. That is the area that needs a lot of care and attention to ensure customers’ transactions can move freely between the parties, and customers can switch easily.

Chair: Thank you. Could we now turn to the regulatory model?

Q24 Thomas Docherty: If I understand correctly, Defra and the Scottish Government are proposing a mutual recognition of each other’s licences and, as far as practicably possible, harmonisation of market codes. What are the arguments for and against having

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one of the two regulators effectively acting as a regulator for the joint market, rather than duplicating with two regulators?

Mark Powles: That is a matter for Government. As a retailer, I do not really mind, to be honest with you. As long as I know what my obligations are, as long as I can contract easily with wholesale businesses, and have clear, visible, transparent, simple service standards and pricing, I can operate. I go back to what I said about central registration and the market system: in Scotland that is run by the participants. The regulator keeps a close eye on it and can still influence it, but the participants run the market, and that might be the glue that sticks together two regulators cross-border; there might be a role for that market administrator in terms of managing those sorts of issues.

Alan Sutherland: Mark is right: that is a political call. We have our experience, we lay it out; we will talk with anyone and explain the mistakes we made, the things that we think we got right by luck and the things we might have got right by a bit of planning. We would work with whoever is charged with doing it to ensure that we get to a decent outcome. We have to recognise that we are a small organisation—we have 16 people—and this was implemented by about five of us. It was a huge amount of work; we were fortunate to be that small, because it meant we communicated very well with each other and, hopefully, with the others that were involved in helping us. It was a big collective effort of all the parties.

There is clearly a political decision about who runs it, but the key message has to be that customers, potential entrants, incumbent wholesalers, water and sewage companies, or water-only companies have to be involved in the process. They have to be bought into this, because everyone needs to work together to pull this off. You cannot go away and do this in an ivory tower somewhere; it is a big collective effort. We will play our part if that is what is wanted from us. We will try.

Q25 Thomas Docherty: Out of those 16 members of staff, how many are doing retail in the non-domestic market?

Alan Sutherland: About two and a half full-time equivalents.

Thomas Docherty: That is fine.

Alan Sutherland: That includes my time on it.

Q26 Thomas Docherty: Mr Sutherland, the way Defra envisaged it, and I am assuming the Scottish Government are the same, is that with the two regulators there is the potential for some disputes. For example, Tesco have a contract in Carlisle and Annan, and Thames Water have that contract; Tesco are unhappy with Thames Water, and, as Defra set out, they would complain to you, Mr Sutherland, about their Annan store, and to Ofwat about their Carlisle store. If one regulator revokes the licence and one does not, how would you envisage that kind of dispute? It is the worst case, but how would you try to resolve disputes between two regulators?

Alan Sutherland: I hope, Mr Docherty, that situation does not arise.

Thomas Docherty: We all do.

Alan Sutherland: My answer to you would be this: we should not have got ourselves into that situation in the first place. The reason for having commonality around settlement and registration, which Mark has already talked about, is that you have clarity on what the rules of the game are. If that clarity exists, there should be clarity for the customer that whether they technically have to come with a licence issue that is Scottish directed or English directed, they are going to get the same answer, because the rules are there—they are transparent, they are written down, and everyone understands the way in which those decisions are going to be taken. This should not be something where there are huge degrees of discretion. To the maximum extent possible, it is really important that we get a commonality of view and some clear rules written down so that customers know where they stand. If we do not have customers knowing where they stand, we are not going to have them as engaged as we want them to be.

Q27 Neil Parish: You have both made reference to the importance of data quality in your written evidence. What impact did data quality issues have on the Scottish market?

Alan Sutherland: I am going to do a complete mea culpa here. People told me I should worry more about data quality. I said, "It can't be that bad; we'll get through it." To be fair, we have got through it. Things in general work pretty well, but that does not mean that the data is anything like as good as it should be. There are reasons for that. You need much better data when you have two entities using the same sort of data and they have to interact and talk to each other—knowing where the meter is, knowing whether the billing address is the same as the premises that is being supplied, knowing what the shorthand that someone might have written in the billing system 20 years ago might actually mean.

All sorts of things like that need clearing up, and it is more difficult in the water sector than it is in electricity or gas, because when someone is disconnected in water, if you are really disconnected you are talking about cutting the pipes. It is a real physical act, not just the flicking of a switch. The practice is that you do not tend to physically disconnect; you turn the stop valve off.

Q28 Neil Parish: Knowing where the meters are is sometimes a headache.

Alan Sutherland: Knowing whether there are six dials or five dials in the meter can be a headache. Which way does the meter count? I know it sounds ridiculous, but these are the sorts of things we have had. What has tended to happen is there has been a bit more angst than there should have been when customers have switched, as a consequence of relatively poor data in some instances. It is not huge numbers; we are talking a very small percentage, but that does not mean that we have addressed the problem as well as we should have done. I recently wrote to Mark and the other licence providers and

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Scottish Water on the subject of a collective initiative to up our game on this. Hopefully, by the end of this calendar year we will have got the data to the point where it is as good as it can reasonably be, which will not be perfect. I would imagine that each company in England will have more or less the same issues.

Q29 Neil Parish: Yes. I was going to ask what English water companies can gain from the Scottish experience.

Alan Sutherland: I think to address the matter earlier than we did.

Mark Powles: I wish we had done more pre-market opening than post-market opening. Alan alludes to it: the data quality that you would need within an integrated water company, those informal rules and flows, are very different from what you need in a market. The market dataset is what new entrants will use to quote on a customer, to identify a customer, and to switch a customer. We have had to build a lot of new processes and expertise into our business to ensure we get data right from a market obligation point of view, but also ensuring that we are serving customers well by billing them properly, with the right services, with the right tariffs, and all those sorts of things. It is probably the most important thing, but be under no illusions: data in utilities is always going to be a challenge. You will never get to the end of the journey; it will always be an ongoing refreshing job.

Q30 George Eustice: This is really for Mr Sutherland. You have your next strategic review of charges in 2014. What impact will these proposals have on that, and to what extent will you factor what is proposed into that review?

Alan Sutherland: It will have no effect on our determination, I think, simply because we already set a wholesale charge. The default retail tariffs will be what they will be. We are in the process of learning a lot of lessons about what a more responsive Scottish Water can deliver to its customers, so we learnt lots of lessons in that form, but in terms of the mechanics there will be no extra expenses for customers. Prices will be a bit lower than they would otherwise have been, because Scottish Water has saved money. Things like that will be positive. Fortunately we have been through the exercise that the English companies and their regulator are going to have to go through in their next price review, which I suspect will be altogether more painful.

Q31 George Eustice: Is there a point at which, if you get sufficient competition at the retail end, it does start to affect the prices you would set at the wholesale end, or do you always see a very hard separation? That was the concern of the water companies in England, which is why they objected.

Alan Sutherland: There are two things. In terms of the end customer, already over 60% of customers in Scotland are paying less than the default tariff. Without switching, they are better off: they are getting a better service and they are getting a better price. That is the impact of competition working through the system. Hopefully that scores a tick with everyone; we all want our economies to be going in the right

direction. In terms of the wholesale level, clearly we all want a sustainable wholesale water business that can do the right things for the environment, for public health, and serving households and all of that, so that will be in essence regulated price.

We have built into the framework an element I regard as very important, which is that should someone come along with an innovative idea that reduces the costs of the wholesaler, the benefits that are achieved by that are shared out. They are shared out between the customer, the retailer, and the wholesaler, so that everyone pulls in the same direction in order to achieve the innovation or the improvement—the reduction in cost. It is done in a way that it is a win-win win, if you like.

What can that be? It can be giving extra water efficiency advice in an area where the supply-demand balance is such that if less water were not being used, some new asset would have to be commissioned. It could be about taking waste water out of the wastewater system and partially treating it or recycling it for use in loo flushing, or car washing, or other activities like that. That is already happening. Different sorts of initiatives are possible, but we want to see as much innovation come through as possible. If innovation is going to stick, it is going to be customer-led: it will be things that customers want to pay for, or want as part of their service. We are keen to get as many incentives into the process as possible to reward customers for doing things that are good for the environment or good for other customers, because if we can do that, the whole system starts to become more efficient.

Q32 Chair: If competition is believed to drive innovation, why is upstream competition not allowed in Scotland?

Alan Sutherland: There are a couple of horrible myths that seem to get quoted about Scotland all the time. One is that we have a messianic ambition to take things over or something.

Q33 Chair: Some might say the cream always rises.

Alan Sutherland: All I can tell you is what we think. All we are trying to do is get to a better outcome for the customer. It is just that.

Q34 Chair: I am possibly missing the point. Why have you limited competition to wholesale and not extended it to upstream?

Alan Sutherland: The law in Scotland says that common carriage—the issue four, five, six, seven years ago probably—is not allowed in Scotland unless Scottish Water agree to it, or the Scottish Government agree to it if Scottish Water have not agreed to it. In that sense it is not a ban on competition upstream. Government has reserved itself the right, on public health grounds—because the Scottish Parliament could not legislate on anything to do with competition—to say, “We do not want that to happen.” People who say there is a ban, and I know in the political process people will often say there is a ban, are not actually correct in saying that. There is not a ban; there is just a sort of deferred reference process.

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Q35 Chair: May I ask it in a slightly different way? Why would it be deemed to work in England if it is not deemed to work in Scotland?

Alan Sutherland: Maybe I do not understand what is being proposed in England well enough, but my sense is that if there were opportunities for Scottish Water to buy water from Northumbrian Water, or from United Utilities (UU) across the border, there would be no particular issue in doing that if it were a mutually beneficial transaction to both Northumbrian or UU and Scottish Water. I do not think there would be an issue about that.

Clearly the number of times that water and sewerage companies touch each other in England and Wales leads to potentially more opportunities for cross-border transfers of water. I would not for a second want to suggest to you that there could not be more transfers of water between regions, but it ought to come about as a result of a process of collaboration, rather than some sort of situation where someone might sell water that they then run short of, and that person has got a problem because they have sold it, and the person who has got the water is quite pleased because they have got it when they would have been short. The process needs to be a more collaborative and co-operative one than that, otherwise I do not think that you are going to see the sort of benefits that are potentially achievable.

Q36 Chair: It is possibly another area where there will be no level playing field, because Scottish Water or Business Stream can buy into UU or Northumbrian Water, but they cannot buy into—

Alan Sutherland: I do not think there would be any issue with Scotland supplying water to England. I suspect politically that would probably work quite well.

Q37 Chair: We will possibly ask you to clarify it in writing; we will put the questions in a more specific way, if we may, because it would be very helpful. Mark, regarding something you said about making it easier to transfer customers, the example that we have seen is the energy market; I know they are talking about household customers, but it has not always been easy or successful for customers to transfer. Why do you think the experience in the water market might be better?

Mark Powles: It has worked pretty well in Scotland since it opened; a customer can switch in a maximum

of 20 days, from deciding they want to go to a new entrant to registering that transfer with the registration system. As the incumbent we get five days to review it, to see if there is any reason why that customer should not be able to switch. After that the process works, and in 20 days from start to finish the customer switches. That gives the customer confidence, because if the customer wants to switch but it is going to take three or four months to happen, they lose confidence. The system has worked pretty well.

Q38 Thomas Docherty: Very briefly, we have talked a lot about price, but water is also a resource. How has competition helped to shape that debate? What examples can you give of how competition has dealt with water as a resource?

Mark Powles: We try to get into the head of our customer and what drives their world. Different customers have different things that are important to them. Some want to save money, some want to save time, some want to improve their environmental credentials, others want to reduce risk, and others want to be more in control. The suite of services that we have had to put together to make sure that customers want to stay with us, rather than go to a new entrant, has responded to that. From a water efficiency point of view, we have proactively done everything from water audits, to benchmarking tools, to sending people in to do process improvements, to putting smart meters on to supply points. That has driven around £20 million of pure consumption savings for customers since the market opened.

We work with customers that want to save time; we have embraced the internet. Approaching 50% of our customers now trade with us electronically. Multi-site customers that were getting 200 bills a quarter are now getting one electronic file on a monthly basis from us. That has saved them money, but also reduces our costs. That saves money. It saves time, and makes the whole understanding of what, when, and why you are using water far more visible to customers.

You used the word innovation. We have had to innovate in a lot of different ways. We have gone from a range of six services when we launched to having almost 60 different propositions that we give to customers today, and that is the reason why I think we have been successful.

Chair: Thank you. Can I thank you both very much indeed on behalf of the Committee for being so generous with your time and contributing so fully to our inquiry? Thank you very much indeed.

Examination of Witnesses

Witnesses: **Regina Finn**, Chief Executive, and **Keith Mason**, Senior Director of Finance and Networks, Ofwat, gave evidence.

Q39 Chair: Good afternoon and welcome. Thank you both very much for agreeing to participate in the first evidence session of our inquiry into the Water White Paper. For the record, could you introduce yourselves?

Regina Finn: My name is Regina Finn. I am Chief Executive of Ofwat.

Keith Mason: I am Keith Mason. I am Director of Finance and Networks at Ofwat.

Q40 Chair: Thank you very much indeed. Our first set of witnesses shared with us the experience in Scotland, and we had the opportunity to ask them about the legislative time frame and the time it took

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to take the proposals to market. They are on record as saying that in their view 2017 would be the earliest opportunity, without being over-ambitious, both of bringing the legislation forward and bringing the proposals into market operation. Would you share that time frame?

Regina Finn: The important thing about the time frame for implementing the proposals in the Water White Paper is that there is an issue of elapsed time from the implementation of legislation. It is a somewhat moving timetable in that a quite considerable time ago we at Ofwat were asked for indicative timetables, which we provided based on assumptions around legislation. We do not know precisely when legislation will be put in place to implement those proposals, so that will be the first determinant of the time it takes to implement the proposals.

The fact that we now have the White Paper means that we can develop the work plan to implement the proposals, and that is what we are working to do now. Our indicative work in Ofwat, which we did in response to people's requests for information about timetables, shows that a timetable of approximately three years from the implementation of regulation could be achievable for market opening. Clearly that is subject to quite a bit of work, because we have only had the proposals since just before Christmas, and we are now in a position to work with the various stakeholders to figure out what can be done.

We have quite a lot of experience in terms of market opening. I have been involved in market opening for three other sectors, and we have the experience of market opening north of the border, in Scotland for water, so there is a lot we can learn. There are differences and there are similarities, and we are on the path of being able to develop that timetable to firm it up. For now, we are still on the page where our indicative timetable would say three years from the date of legislation, but that is dependent on legislation, and it needs more work.

Q41 Chair: If you look at the Scottish example, it took approximately three to four years from the date that there was a commitment in the legislation to bring it to market. Obviously the English market is much bigger. Do you think you were being over-optimistic in the White Paper?

Regina Finn: There are similarities and there are differences. There are 21 companies south of the border whereas there is one in Scotland, so that might make it more complicated. On the other hand, we already have a water supply licensing regime, which puts in place quite a number of the elements already here south of the border, so that would help. We already have accounting separation implemented for a number of years with the companies, so that will help. We also have the benefit of learning from the published and implemented market codes north of the border, which will help.

Some elements would go towards making things more complicated, and some elements in our case are perhaps simpler. Government has made it very clear that it is not going to require legal separation of companies, so we do not have to implement that

element. It is swings and roundabouts, and this is where we need to work through the detail to come up with a firmer timetable with all the stakeholders.

Q42 Chair: We will come to legal separation in a moment; Gray argued forcibly for it, but we will park that to one side for the moment. Your bottom line, though, is that the Government should bring forward legislation as soon as possible.

Regina Finn: We think the publication of the White Paper has been an excellent step forward; it sets out the long-term direction of travel and it allows us to get on with some of this work. Publication of legislation as swiftly as possible would help with that, because it will provide ever more clarity on what the Government wants to achieve. So, yes, we think the opportunity is there for Government to publish as soon as possible so all parties know what they are trying to achieve.

Q43 Chair: I am familiar with what Ofwat are saying the savings are going to be, but have you done an assessment at Ofwat of what the upfront costs to the water companies are going to be?

Regina Finn: The decision to proceed with the policy of market opening was a Government decision, so the impact assessment for the Water White Paper, which includes both costs and benefits, includes our input on the costs to the sector of what needs to be done. We have provided the information to Government to do its own impact assessment to make its policy decision. Clearly the impact assessment came out overwhelmingly positive for the package of reforms that is in the Water White Paper. Now that is set out, the next step will be to start turning those original estimates into more detailed work.

Q44 Chair: What is your initial assessment of investors' response to the market reform proposals? What do you think are their key concerns?

Regina Finn: Investors' response to the Water White Paper has been generally to welcome it. We have seen published analysts report. I have met with a lot of investors myself, and Keith, in his role in Ofwat, has met with all of the rating agencies. Their general view is that it is sensible and cautious, and both the Government and Ofwat's parallel publications underpin Ofwat's commitment to ensuring the low-cost finance to the sector remains protected, and that means ensuring that it remains attractive to investors. I think the general response has been positive, and the package of measures is broadly welcomed.

Keith Mason: It would be difficult to distinguish the Water White Paper reaction from our Framework Paper reaction, so they probably took the two together. What they felt was helpful was that the two seemed complementary: the things proposed in our Framework Paper chimed well with what was proposed in the Water White Paper. As Regina said, you can look differently at equity investors and debt investors, but broadly both of them were reasonably positive. Equity investors were probably slightly more positive, because they could see greater differentiation and greater opportunities for higher returns. Debt investors are more interested in ensuring their interest

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payments are received and protecting their capital. But overall it was positive, and share prices on the day of the Water White Paper announcement did not move very much at all.

Q45 Chair: Who do you think will end up paying for the costs under the White Paper? Will they be passed on to the customer?

Regina Finn: Taking the package of measures in the Water White Paper and the package of reforms, they incur both costs and benefits. Clearly they are only worth proceeding with because the benefits to customers outweigh the costs that customers will incur. There will be cost to customers, but the clear view of Government and the impact assessment demonstrates that those costs will be outweighed by benefits, which means that overall bills to customers will be lower than they would otherwise have been.

Q46 Chair: Do you recognise the figure that a small increase in the cost of finance would be enough to wipe out the benefits? Your calculations show that the radical changes that you propose to make in the price review at the high end would yield savings of £2.5 billion over a 30-year period, but your calculations also showed that an increase in the cost of capital of just 0.2% would more than wipe out these benefits?

Regina Finn: The challenge is to take a balanced, stepped, evolutionary approach to change that ensures we capture benefits, not just for today's customers but for future customers, and do so in a way that retains the investor confidence and the low cost of finance that we have managed to achieve in this sector over this period. We are incredibly conscious of the need to strike that balance throughout all our work, and I would echo what Keith said about alignment between our work on price limits and the work of the Government on the White Paper. It also recognises the need to strike that balance.

The important thing is that we do proceed, and in the way it is set out in the White Paper and in the way our price limit reforms are set out, they are evolutionary changes designed to ensure that this sector is not in a position where we do not capture the ability to rise to the challenges that are definitely coming down the road. We have seen drought declared over great swathes of the country recently, and we must put in place the reforms necessary to enable this sector to prepare for those sorts of challenges better in the long term, while at the same time protecting that efficient cost of financing. We are very conscious of that balance.

Q47 Chair: Are you able to assure the Committee this afternoon that the impact on customers' bills will be proportionate and affordable?

Regina Finn: Our core twin duties are to protect the interests of consumers and to ensure that efficient companies can finance their functions. I can assure the Committee that we will discharge those duties with the same zeal as we always have, and that is at the centre of our focus.

Chair: I am sure we will return to these points at a future date. Thank you.

Q48 Barry Gardiner: The water companies must be jumping up and down for joy, mustn't they, with Defra saying that they are not going to require legal separation?

Regina Finn: The Government decided not to require legal separation on precisely the basis of wanting to avoid causing investors any concern. They wanted to avoid that. That has been described by commentators as "cautious". That was the Government's choice. Having said that, the package of reforms and the introduction of choice for customers can be implemented without legal separation.

Q49 Barry Gardiner: Of course it can, but the point is that Professor Cave's independent review said that it should be compulsory. The written evidence from Business Stream in Scotland states that legal separation was fundamental to their success, enabling them to create their own "identity, brand, and culture" and to challenge their wholesaler to provide a consistently high level of service. In England we are going to lose all that, aren't we?

Regina Finn: The first point is that we also agreed with Martin Cave that legal separation would be a preferred route.

Q50 Barry Gardiner: Are you still shouting about that to Defra?

Regina Finn: It would be a cleaner route. Government policy choice has been not to do that, and it is perfectly possible to introduce market competition without legal separation. It has been done in many sectors in the past.

Q51 Barry Gardiner: But to the detriment of new entrants into that marketplace: that is the point. The Government has talked about you being so smart. I think you are a very smart woman; I have no doubt about that, but it talks about Ofwat using "smart ways" of getting round that. What are these "smart ways"? I have not got very much confidence that, no matter how smart you are, it would not be a damn sight better if there was legal separation.

Regina Finn: I would agree that legal separation would be cleaner. The tools that we have to police non-discrimination are both ex post and ex ante. I apologise for using jargon. We have a number of tools to police discrimination, some of which I mentioned earlier. We have accounting separation, whereby we require the companies to account separately for the businesses. We have a requirement for no undue discrimination, which we can police, and if we find discrimination we can take enforcement action, and we do. We have a system called transfer pricing, whereby we reveal the transactions between the two parts of the business. We can place a range of licence conditions on companies to ensure that they do not abuse that scene; we can require maximum transparency. There is a wide range of tools. If there are transgressions, there are tools we have to take enforcement action, and we have a track record of taking enforcement action where companies do not comply with the rules. That is a big deterrent.

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Q52 Barry Gardiner: Thank you for that, and I hope you apply every one of those different elements. But look at the track record in other sectors. I look across to the electricity sector, where you had wholesalers and retailers, but even where you have a split, there is common ownership. You know the difficulty is getting real transparency and real liquidity into that market, and that has been the problem for new entrants. How are you going to get round that in the water industry?

Regina Finn: I would say it is not just the electricity market. I have overseen the liberalisation of telecommunications markets, gas markets, and electricity markets, and I have every sympathy with new entrants and the need for them to have confidence in the regulatory regime and that it will protect their interests. The thing that is really helpful to us in the White Paper is that it proposes to give us tools to require *ex ante* regulatory terms and conditions on which new entrants can access the networks of incumbents. That is incredibly important, and a very important step forward from where we are now, where those new entrants must come in and must negotiate individually, without any transparent terms and conditions or common codes or contracts.

The White Paper suggests a number of new tools, particularly market codes, upfront common contracts and new transparent access pricing, which we will certainly police. It is giving those to the new entrants and providing that transparency that will encourage them and give them the transparency they need.

Q53 Barry Gardiner: Will you be separately reporting on the accessibility of the market to new entrants in your reports each year?

Regina Finn: We will be working to ensure the architecture is everything that new entrants need to get into the market. The point I was making to the Chair a moment ago was that now that we have the White Paper and the sooner we have a draft Bill, we can engage with those entrants and with the incumbents about exactly what the rules need to be to ensure that new entrants can get fair, non-discriminatory access to this market.

Q54 Thomas Docherty: On the issue of separation, if Defra say, "We do not even need them to leave the building, and we do not need them to separate their staff; they can share staff and offices," do you think that will help or hinder confidence that they are playing by the rules?

Regina Finn: I read the White Paper to say that there is a decision not to require legal separation, but there is a clear signal in the White Paper that Ofwat should be empowered and should use all the tools available to police non-discrimination. We need to develop the suite of what those tools are and how we apply them, but my reading of that is that it is very clear that it is to be properly policed, so that Government policy, which is to open up the market, can happen effectively. I would read that to mean that we can put in place the appropriate level of rules. I would not read it as constraining us in putting in place those rules, but these are the details we will need to work out.

Q55 Thomas Docherty: Would you be surprised if Defra were to suggest to you that they did not think that they even needed to leave the building—that they could sit literally side by side? Would you be comfortable if Thames Water said, "We are not going to move them out of the building—they will sit in the same corporate offices, sharing functions, sharing staff, and sharing the IT"? Would your instinct be that you would be comfortable with that, or would you want to put in place some physical or cultural distance?

Regina Finn: We will want to assess the degree of separation of the functions that would be appropriate. The famous words are "Chinese walls"—you use Chinese walls, which are codes of conduct, internal memoranda and agreements. There is a wide scale that you can go to on that. Ofwat were clear that we felt the full legal separation would be preferable, so clearly rowing back from that—the further we would row back from that—the less preferable it would be. We would like to have as clear a degree of separation as we could get.

Q56 Thomas Docherty: I am sorry to have to press you, but if Defra say, "We do not want them to separate; we are quite relaxed; they can sit literally side by side in the same office suite," that would be less than favourable?

Regina Finn: If that were hardwired into legislation I would be incredibly surprised, because that is not the sort of thing that should be put into legislation. It is something that should be for the market design between the regulator and the participants. The first point is that I would be very surprised, because it does not sound like a policy; it sounds like operation. If that level of detail were to be prescribed, it would be unhelpful.

Q57 George Eustice: On the same issue but from the industry's point of view, are their concerns irrational, effectively, and it is just short-term market sentiment—the share price flickered, because there were worries, they had a panic attack and have not thought it through? If you have a regulated wholesale price, that should underpin the investment that you need to invest in the infrastructure, which is what they claim they are worried about. Is it just an irrational fear that they have got, or is it the case that their model requires them to rip off their customer?

Regina Finn: As Keith said, we did not see a reaction in the share price when the White Paper and our Framework Paper were published.

Q58 George Eustice: No, but in the run-up to it my water company was coming to me and saying, "You have already trashed our share price by even thinking about this idea."

Regina Finn: The fact is the evidence does not support that, because the share prices have not been affected at all, so the first point is that perhaps that is a little bit misleading. The share prices were not affected by what we said. That leads me to believe that investors are perhaps a little bit more rational than was being represented to you. I think investors understand exactly the point you have made, which

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is we have made a commitment to protection of the monopoly wholesale business, and the investment in that, including the regulatory capital value (RCV) and the return for efficient companies. Investors, by and large, understand that.

Certain investors do not like any change of any kind, because it involves trying to figure out what it means, but in this case we have had an extensive round of communication. They understand that the change is evolutionary, and that they have that protection. The evidence of that is that the share price has not been trashed, and it has stayed steady, that these companies are continuing to raise finance at good rates and where there have been takeovers of these companies recently, they have been bought at significant premiums. That to me smacks of a sector that still attracts investors quite strongly.

Q59 George Eustice: They would argue that is because you took out the bit they objected to: the idea of separating the retail from the wholesale.

Regina Finn: I would argue that probably is not the case. If Government decided for conservatism reasons and for their concerns that it would rattle investor confidence, then we are here to implement Government policy and we will work with that. It is perfectly possible to achieve market opening without legal separation, even though it would be cleaner to have legal separation.

Q60 George Eustice: You think the reaction of the water companies was kneejerk conservatism rather than a rational view?

Regina Finn: If the water companies were representing to people that their investors were going to take flight from the sector, the water companies were not correct, because their investors did not, and I do not think would have.

Keith Mason: Northumbrian was taken over by CKI, prior to us issuing our Framework Document, prior to the Water White Paper, and that still attracted a premium of around 20%-25% on the share price. Obviously, CKI felt that they were buying into a sector that had value for them, even given the fact they were not completely sure what framework they might be following post White Paper, and post our Framework Paper.

Regina Finn: At that stage they may well have been assessing that there was a possibility that legal separation would be put in place, but they still paid that premium because they still valued the company.

Q61 Mrs Glindon: How will you ensure that abolition of the cost principle does not result in household customers subsidising big business?

Regina Finn: We can certainly do that very easily, because cost principle or not, whatever the access pricing is we already have in place a “no unfair discrimination” clause in licences, so we already ensure that household customers do not cross-subsidise big businesses. That is part of our regulatory framework as it is, and we do that through understanding the costs and the revenues for both parts of the businesses, and by ensuring what we call transfer pricing rules, whereby there is transparency

between each set of customers paying for their own costs and not subsidising the other. Those tools are already in place.

The cost principle acts as a significant barrier to the introduction of choice for business customers. The removal of the cost principle means that we will want to replace it with a fairer set of access pricing rules, and there are many precedents for that: it is very possible to do. Whatever set of access pricing rules comes into play, the existing protections to ensure no cross-subsidisation of the kind you mention are already in place. We are very well tried and tested with them, and I can assure you we will continue with them and police them.

Chair: I think we covered time scales earlier, so I will turn to upstream competition.

Q62 Mrs Glindon: Would you support a step-by-step approach to reform with upstream reforms delayed until the retail market reforms have been implemented?

Regina Finn: Our view is that the Water White Paper has a lot of strength, because it is a package of reforms that together deliver benefits, and that includes retail competition and upstream reforms. If you look at the impact assessment for the Water White Paper, the upstream reforms—although it says they will certainly take longer, so they are staged, or already stepped—will overwhelmingly deliver a huge chunk of those benefits. We believe it is important to take it forward as a holistic package. That is particularly important when you think about the big pressures on this sector. The pressure is about availability of water in the face of rising population, climate change, volatile weather, and the drought declaration we have just seen across huge swathes of the country.

I was at an event recently where a number of commentators talked about this. We know those challenges are there. We must reform the upstream part of the sector to enable the water companies to meet those challenges of the future. We have known that these problems are here for a long time now. Now is the opportunity to tackle them. Our view is that it is very important to set out the legislation and the enabling steps to facilitate that upstream reform, albeit the Water White Paper already says it is staged and it will take longer, but if we do not take it forward as a package, if we ignore the upstream issues, we will be ignoring the sustainability of this incredibly precious resource for future generations.

Q63 Thomas Docherty: You were far too polite to say to George that the water companies were lying through their teeth, but I will certainly do that. On the issue of joint working, what do you think will be the key challenges in establishing the Anglo-Scottish joint market?

Regina Finn: My experience in setting up markets across different jurisdictions—I have done this personally, setting up a single electricity market in the South and North of Ireland—is that there are challenges, because there are differences. There are differences in duties and there are differences in the remits of the regulators, but the opportunity is that a joint market will deliver economic benefits for both

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jurisdictions. Therefore, it is an administrative or economic issue that regulators can handle and can put in place mechanisms and systems to deal with. Now that we have the White Paper, we can start to sit down and identify the maximum degree of joint working and harmonisation that we can put in place.

We need to do that so that the customer sees a seamless experience on both sides of the border, and the new entrants see, as far as possible, a seamless experience, which means aligning market codes, which is very doable; Scotland has a great precedent for us to learn from. Then we need to recognise that there are some issues where we will have to manage the differences. WICS in Scotland has a duty to do no harm to Scottish Water and we in Ofwat have a duty to ensure financeability of efficient companies. They are slightly different duties, but we need to manage ways of ensuring that those differences can be handled. My experience is they can be handled.

The challenge is to sit down and set up a set of governance structures—how we meet and manage the decision making that affects both markets. I have experience of one set-up that did it. I am not saying that is the answer here; we need to work with our colleagues to find the best solution for England and Scotland. But in the example I gave you, we set up a joint committee of regulators to make decisions where they were affecting both sides of the market, and it worked very well. The reason it worked well is that there were benefits for all, and both regulators had an objective to maximise those economic benefits.

Q64 Thomas Docherty: I do not know if you heard the question we asked Mr Sutherland earlier on. It sounds as if there is going to be a great deal of duplication and overlap between the two regulators. What are the pros and cons of having a single regulator, rather than both regulators, who would regulate the retail sector?

Regina Finn: The challenge to us and WICS is not to have that duplication, and essentially that means we work together to share out the work that needs to be done, and we share resources. That is very doable. You can do that whether you are one organisation or two organisations: it is an administrative issue, and my personal experience is you can manage that. The idea of setting up another regulator—

Q65 Thomas Docherty: I did not say that. I said one or the other regulator regulating the retail sector. I would be grateful if you could also clarify why you do not think there is duplication, given that you are both going to have to recognise licences?

Regina Finn: To take the duplication issue first, we are going to have to have licences for all players. We already have licences here in England and there are licences in Scotland, so we know we have licence texts. The piece of work we would need to do jointly, which goes back to my experience in other sectors, is to ensure those licences can be aligned and harmonised as much as possible, and that they can be recognised. I do not think that is duplication of work; it is a necessary element that you would need to put in place anyway, because the licences in England are going to be issued under a different piece of

legislation from the licences in Scotland. The only way you could change that would be to set up a new piece of legislation that enabled you to issue licences for all of Scotland and England. That means you get back into the need to set up new legislation, if that is what you want to do.

Q66 Thomas Docherty: I am not sure I follow that. Using the example of railways, the Scottish Government, through Transport Scotland, issues the franchise for the railway. In England it is DfT, yet ORR is the regulator for both parts.

Regina Finn: Frankly, you can establish a single regulator for England and Scotland. You can do that.

Q67 Thomas Docherty: I am not saying that we necessarily should, but what are the arguments for and against?

Regina Finn: In my experience, to set up one single regulator, or to give one regulator the functions for the entire market, will require legislation and a revision of duties, and allocation of duties to one or other organisation. You will have to go back to the primary legislation and make changes there. That raises issues of jurisdiction, devolution and responsibility, which is perfectly fine. That is something that politicians here will probably know more about than I do, and that is something that would need to be tackled. I am not sure how long that would take or what would be involved. The argument for co-operation to create a market and make it work is that you do not need to create new legislation and revise duties of the two regulators. You would certainly need to revise duties of one or more of the regulators if you wanted to give one or other of them jurisdiction over England and Scotland. You do not have to do that to achieve the outcomes. From a pragmatic regulator's point of view, I believe you can achieve the benefits without that necessary overhead and without the necessary delay that would cause to things. That does not mean you cannot do it. You can use any institution you want to achieve the outcome you want, but the existing institutions are quite well placed to do it.

Q68 Thomas Docherty: That is helpful. Looking at an example of potential disagreement—this is the worst-case scenario—Tesco have a contract, for argument's sake, with Thames Water for both Annan and Carlisle. Defra's view would be that WICS would have the regulatory responsibility for Annan and that you would have the responsibility for Carlisle. Tesco are unhappy with Thames Water and they complain to both regulators, which is the model that Defra are proposing—with the Scottish Government, to be fair. Let us say you and WICS take a different decision on revocation of the licence. How do you resolve those kinds of issues?

Regina Finn: The challenge is to deal with that up front. There is work to be done on this with WICS, the Scottish Government, and Defra. If I was designing that now, I would ensure that, before you got to that situation, there was a protocol of agreement as to how you would handle that sort of issue. The decision making might well be done jointly between WICS and Ofwat. We would set up an arrangement

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whereby we would jointly decide how to deal with that and how to handle the outcome, so that you would not get to the stage where two regulators had investigated something, ended up with different conclusions, and then you have a conflict.

Q69 Chair: Could we pursue this in writing? Could we ask some further questions in writing?

Regina Finn: I would be very happy to follow it up if you would like.

Q70 George Eustice: In your written evidence to us you talked about this idea of two licences for the incumbent operators, one for retail and one for wholesale, so that you could encourage them to exit and have consolidation. Could you explain what the advantages of that would be—why that would help the customer?

Regina Finn: If you look at the objective of the proposed policy, the policy in the Water White Paper is to ensure that business customers have choice, and that means that they can choose the supplier that gives them what they want—the best supplier. Essentially, we are talking about an effective market for that part of the business. In those circumstances some companies are going to be more efficient at delivering that retail service, and therefore able to give customers what they want, so customers will go to those more efficient operators.

In any well-functioning market, a company that perhaps is not very good at providing retail services—and it costs it quite a lot—would say, “We’re not doing well here. We’d like to sell this business, get out of the business, and focus on something else.” Therefore, they exit. New entrants come in, some people exit—that is how you get the dynamic market. We understand the Government’s decision not to require legal separation. However, we are concerned that—perhaps inadvertently, perhaps not—the requirement to keep the vertically integrated licence prevents the incumbents from saying, “I’m doing a retail business, but I’m not doing very well at it; I’ve decided I want to get out of the market.” That incumbent will not be able to get out of the market, because they will have a single vertically integrated licence that requires them to deliver a service to retail customers. So they will not be able to do that. We are not saying anybody should be required to enter or exit the market, but we think it is better not to constrain the market from delivering the best outcome.

Q71 George Eustice: Did you flag this proposal up with Defra before they published the White Paper?

Regina Finn: We have had discussions at working level, but until a clear policy decision was made about what the degree of separation would be or would not be, which was a matter for Ministers in the run-up to the final decisions about the White Paper, it was not possible to tease through all of the options. We have certainly made Defra aware of our concerns around this.

Q72 George Eustice: What has their reaction been? Have you had a reaction to that idea?

Regina Finn: We have not had a direct reaction. We have explained our concern, and it has been acknowledged. Officials understand it. I have not yet been able to talk in any detail with Ministers about that. It comes back to the point about seeing draft legislation: that is an opportunity to widen the debate to see whether our concerns might be shared by other people, and whether they think it would be a good idea perhaps to adjust that part of the proposals. We look forward to that debate, and we are open to the debate.

Q73 George Eustice: Do you think that should be a provision very early on in the system, or is it something that might evolve down the line? I was struck, in terms of what has happened in Scotland, that Business Stream still seems to dominate the market, with 97% of the market. It is pretty limited in terms of the number of people coming in. Are you in danger of snuffing out competition if you start removing players and consolidating it before you even have plurality?

Regina Finn: All we are suggesting is that the licences are separate; that does not require any change at all. It helps with transparency—the point that was being made earlier—because we could then align the incumbent’s retail licence with the new entrant’s retail licence, and everybody could have quite similar conditions. That would help with transparency and confidence in the market. It has a number of benefits, not just enabling exit. The Water White Paper is setting out a long-term direction of travel, but the legislation has an opportunity to put in place the enabling tools for that to happen: not force the pace, not require any specific outcome, but enable the best outcomes to emerge over time. Clarity up front, and understanding, is what tends to aid in that; it is the transparency point that we were discussing earlier.

Q74 Chair: Can I return to one of your replies to Mary Glendon for clarification? Was your answer relating to the proposals for upstream competition and changes to the water supply licensing regime? When you mentioned upstream reforms, do you mean changes to the abstraction licences, water trading, or changes to the water supply licensing regime?

Regina Finn: I mean the package. I was referring to the total package in the White Paper, which includes abstraction reform. As we know, the Water White Paper talks about abstraction reform over a very long time scale. It includes measures to improve water trading and interconnection, which we echo in our Framework Paper, and certainly the upstream licences. All those things are evolutionary; it is important to take them all in a stepped way, but it is important to set out now the enablers and the glide path. It goes right back to the point that if there is transparency on where we are going, it will really build confidence in the system.

Q75 Chair: Could I turn to the price review? How do you think the 2014 price review will be affected by the introduction of the White Paper’s market reform proposals, particularly if it becomes apparent that the

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reforms will not be finalised until after the next price review?

Regina Finn: The White Paper itself acknowledges that Ofwat's proposals on future price limits, which we published just before the White Paper, are very well aligned with the policies in the Water White Paper. We have sought to future-proof our regulations, so future-proof the next price review. We are consulting, as you know, on a separate wholesale and retail price cap, which clearly aligns with the idea of a wholesaler and a separate retailer, and market entry. We have built those tools into our future price limits framework. Therefore, we will set price limits for 1 April 2015, because they need to be set for then; that will go ahead, and that is not a timetable that will change. We believe we can do that in a way that will facilitate the implementation of the market-opening proposals in the White Paper after that, at whatever stage that happens.

Q76 Chair: In terms of the Water Framework Directive and other EU directives coming through, are they already factored into the prices?

Regina Finn: The Water Framework Directive, as you probably know, is implemented over three set periods. The costs associated with the first period have been factored into customers' bills in the current price period up until April 2015. When companies come to us with their business plans in 2014, those business plans will include the factoring in of costs that will apply in the forthcoming period—the five years we are currently proposing. Those costs will be factored in at each price review.

Q77 Chair: Returning to the earlier point, do you believe it will not negatively impact either on the ability of water companies to raise the money in the market or on customer bills?

Regina Finn: Sorry, is that the White Paper?

Chair: The totality—the collection of the reforms in the White Paper, in the proposed Bill we will eventually have, and also in the next stage of the EU directives?

Regina Finn: To be clear about my answer to this, I believe the totality of the reforms in the White Paper, added to the reforms of our regulatory regime, will deliver net benefits to customers. They will have an impact on bills, because I believe that bills will be lower overall than they would otherwise have been without this. Customers will get a more resilient and sustainable service than they would have gotten without these reforms. That is the impact that we will see coming out of this.

The challenge, and I absolutely take this challenge on, is to manage the process over a period in a way that retains stability and ensures that the sector can continue to attract the investment it needs. The evidence we have seen—the evidence of share prices, the evidence of premiums paid for these companies—is that it remains, with these reforms proposed in place, a very attractive sector for investments, and it continues to be able to raise that finance.

Q78 Chair: Do you think there should have been specific proposals on social tariffs in the White Paper, or do you believe there is scope for them in the Bill?

Regina Finn: We are conscious that Defra has consulted recently on social tariff guidance, which follows from the provisions of the Flood and Water Management Act, which enabled that to happen, so the Government has taken a step towards affordability in that arena. It has not built on that and revisited social tariffs in this White Paper, and I do not know whether it is intended to revisit it in a Bill. Our primary concern around affordability and social tariffs for vulnerable customers is that Government social policy is clear, because for private companies to implement social policy, it must be very clear to them what the parameters are. Who does Government consider are vulnerable? Who does it consider should get special support? Who does it consider should cross-subsidise that and pay for it, and by how much? Those things must be clear to the sector, and be it through guidance or through legislation—I am completely agnostic—that clarity is important.

Q79 Chair: On water efficiency, are you content with the references in the White Paper?

Regina Finn: I believe the White Paper provides a good approach to the need to balance overall our supply and demand, which includes water efficiency, as in how we all use it in our homes, but also water efficiency in that it is seeking to make the people who take the water out of the environment, treat it and deliver it to us, do that more efficiently as well. It is this holistic package: it has taken a good approach towards those two aspects.

We already have a lot of tools in place around water efficiency downstream for domestic customers, but in this White Paper we have the introduction of choice for business customers, which we have seen from evidence in Scotland actually drives those business customers to seek to be more water efficient and get their suppliers to be more water efficient. That could have strong gains potentially. The upstream proposals seek to get water companies to listen to the signals about the value of water, use the water more efficiently, and move it around where they need to, rather than build. The Paper has taken quite a holistic view of addressing efficiency in all of those areas, which is positive.

Q80 Chair: If you look at the Walker Review recommendations, some feel if there is going to be a green deal, water meters should link into that. Are you persuaded?

Regina Finn: From the point of view of the downstream issues, there are opportunities around smart metering, around Green Deal, around operational things like water efficiency targets, customer advice or labelling of white goods. All of those issues have value and merit. I believe that a lot of them are being taken forward already or at least have the enabling powers in place to be taken forward. It is not necessary to change the legislation to do those things. However, we need to do them, and that is a fair point.

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Q81 Chair: How will Ofwat assess whether catchment management schemes to improve water quality provide value for money for customers?

Regina Finn: This is a really interesting area. It is quite a new area for us. In the last price review we approved over 100 catchment management schemes, many of which are trials. It is crucially important to get the evidence from those trials to find out what works and what does not work, because by their nature, if something is experimental, some things will not deliver value or will not help. We need to find out what works and what does not.

We are doing two things: first, we are working with the industry through UKWIR—the UK Water Industry Research organisation—to input into developing a methodology for assessing costs and benefits. Crucially, in the next price review we are changing to get companies to justify directly to their customers the costs and benefits of what is happening, so having much more customer engagement in their business plans. We would expect Customer Challenge Panels to have a view on this.

The twin track is ensuring that customers' voices are heard on whether these schemes are delivering value for money for them as water customers, and the framework for assessing costs and benefits that we are working on with the industry. Those are the tools that we will use to ensure that we get the best value for customers.

Q82 Chair: Bulk trading and improving interconnections: what is your preferred route to promote those? Surely the cost of introducing bulk trading and improving interconnections is going to be colossal.

Regina Finn: I do not think we are talking about colossal costs. What we have identified in our work, and what Defra has identified in the White Paper work, is that at the moment we have a system where we build a lot of infrastructure, including reservoirs and treatment plants in order to supply customers, and that carries a cost with it. At times when we face what we are facing now—a drought over significant parts of the country—it does not matter how big your reservoir is; if it is empty, it is not going to be any use to you.

We want to incentivise and encourage companies to choose the more resilient and best option for their customers, which includes the lowest cost option. Based on the work we have done and our modelling, we believe that is likely to include more trading of water, and more interconnection. Our work has shown us that that would deliver a lower cost solution to meeting customers' needs, and we projected it over a 30-year period.

It is not that it would have colossal costs; it is that it would avoid costs that would not be as effective and resilient and replace them with the costs of interconnection and bulk trading, which we believe would deliver a better result. We are consulting on a suite of possible tools that we could put in place to incentivise this, to make it of better interest to water companies, including revealing better information about the relative value of water, revealing

information about scarcity to help with their planning and requiring them to consider bulk supplies.

All those measures increase transparency and give the companies better information and incentive to choose the best option. If the best option is interconnection and a bulk supply, that means it is better than the next option, and that means it is lower cost.

Keith Mason: Where sources are particularly over-abstracted, one of the incentives we are putting in place is for companies to face the real cost of over-abstracted. In looking at particular choices for their next source of water, we want to make sure that the proper full cost of over-abstracted is faced, so they do not simply take what looks on paper the cheap option for an over-abstracted source; the full cost needs to be taken into account. That may make interconnection and other potential options come more into play than they might have been if you are simply looking at, "This source only costs me 20 pence per cubic metre." If you took in over-abstracted costs and it went up to 50p or 60p, it might go down the pecking order as a choice.

Q83 Chair: There is a great emphasis on competition in the White Paper. Are you concerned that moving towards competition might destroy the collaboration that is developing, particularly through interconnections and bulk trading, between the water companies at the moment?

Regina Finn: I do not see that contradiction at all. The White Paper presents quite a balanced view. On the one hand it is seeking to harness the benefits of market forces, because market forces reveal the information that allows you to make better decisions, as well as delivering more efficient outcomes directly to customers. That does not in any way prevent collaboration where it is necessary, or essential. For example, if we had a fully competitive upstream and downstream market, it would not stop Ministers calling water companies into a drought summit if that was necessary because there was a crisis. There would be nothing to stop that happening and nothing to stop collaboration.

I would go a step further and say that if what we want is better resilience and interconnection of networks, the revealing of the signals that make that worth the water companies' while is going to improve collaboration. Whereas what we have seen so far is that despite the fact that we know we need more resilient and interconnected networks, it has not happened under the current regime, so we must improve those incentives.

Q84 George Eustice: I know it is slightly outside the scope of the Bill, but what would be the prospect in the near future of extending this to domestic customers? *Which?* magazine are running this thing with the energy companies, where they are getting whole communities to sign up and then to tender their collective electricity. Is that something you think there would be potential for?

Regina Finn: It comes back to the point about learning to walk before we can run. We do need to get this market working and make sure that we can reap the benefits of it. We think household customers will

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get some knock-on benefits. If retailers get more efficient, they will be more efficient for their existing household customers as well as their business customers. The question as to whether or not choice for household customers is another issue is something we should come back to when we consider the success of this, and can prove the benefits of it. That is a conversation I have had with Ministers and they certainly agree; it is not that you do not look at it, but that you make sure you can reap the benefits before you consider going any further, and I would support that.

Q85 Chair: In terms of Pitt especially, but also Cave, Walker and Gray, do you think that we are going to have unfinished business left over from particularly the Pitt recommendations that are not in the White Paper? Does that concern you?

Regina Finn: Listening to the Water Minister speak on this recently, it was interesting to hear that as well as the White Paper, we have a range of other things going. He mentioned Defra's consultation on SuDS, for example, which is still open and coming to an end. It is true that the entire universe is not in this White Paper, but that is partly because some of the universe is elsewhere. It is important that we ensure that if those initiatives are not explicitly in this legislation—the ones kicked off by the Flood and Water Management Act, the ones around the SuDS, the ones you, Chair, have mentioned in the past around reservoir safety and the ones around automatic right to connection—they are picked up in other areas. The

Minister name-checked quite a few other things that were going on. I cannot give you the entire universe of what is going on at the moment, but that would be the way we would want to deal with that.

Q86 Chair: If you look at it in terms of drought and the fact that building on flood plains is still going on, and that there is no end to the automatic right to connect, they do seem to be conflicting with trying to reduce water stress and eliminating drought.

Regina Finn: My point would be that there are a number of tools and vehicles that we need to make sure we harness. The White Paper sets out high level policy direction, which is exactly what a White Paper should do. One of the reasons for seeing legislation soon is that it will help us fill in the gaps and see what is going to be in there. That will help all participants in the pre-legislative scrutiny phase to answer your question, which is not one I can answer now, without sight of that detail.

Q87 Chair: That is enormously helpful. Thank you both very much indeed on behalf of the Committee for giving up your time and contributing so generously to our inquiry.

Regina Finn: Not at all. If there are any of these issues you want to follow up, either for the Committee or in bilaterals, we are very happy to do that.

Chair: Possibly one or two in writing, if we may; that would be helpful. Thank you very much indeed.

Tuesday 6 March 2012

Members present:

Miss Anne McIntosh (Chair)

Richard Drax
George Eustice
Mrs Mary Glendon

Iain McKenzie
Neil Parish
Amber Rudd

Examination of Witnesses

Witnesses: **Lord Chris Smith**, Chairman, Environment Agency, **Dr Paul Leinster**, Chief Executive, Environment Agency, and **Ian Barker**, Head of Land and Water, Environment Agency gave evidence.

Q88 Chair: Good morning and welcome Lord Smith. Thank you very much indeed for being with us and for participating in our inquiry on the Water White Paper. Before we turn to questions, would you like to introduce yourself and your team for the record?

Lord Smith: Thank you very much, Chair. I am ably assisted this morning by Paul Leinster, my chief executive, and Ian Barker, who has the very grand title of head of land and water at the Environment Agency.

Q89 Chair: Almost biblical in proportions. You are most welcome.

Are you confident that the White Paper's package of measures to address water scarcity will secure England's water supply in what may be a severe and persistent drought, not just this year but in the years ahead?

Lord Smith: Before saying yes to the question, it is worth observing that we do, of course, face a rather serious potential drought position over the course of the coming year, and our analysis of the impact that climate change is likely to have over the next 20 or 30 years shows that we are going to face such problems increasingly frequently over the years to come, so making sure that we can address those issues is really important. I think the Water White Paper does put in place quite a lot of the key building blocks for that. Especially, it talks, very seriously and rightly, about the need to value water as a precious resource rather than as something that is an infinitely available commodity as we have assumed for decades. It does have proposals for abstraction reform, for interconnectivity between water companies and for measures to protect the environment for water, which, I think, will very much help us to tackle these problems strenuously.

Q90 Chair: In terms of the recent drought summit and the immediate steps that you are proposing to take to manage the current drought situation, would you like to share those measures with us?

Lord Smith: The key to managing the current problems is working together, and it has to be ourselves working, obviously, with Defra but also with the agricultural community, the business community, the water companies and Ofwat to make sure that the competing demands for water, which include public water supply, water for industry, water for agriculture and protecting the ecology of the river system, can be properly planned and balanced. Getting everyone working regularly round the same table,

agreeing what is going to be done, is absolutely the key to making sure we can tackle this. Paul is chairing the working group that is taking this forward. Paul, do you want to say something on that?

Dr Leinster: We have just established a working group of the prime interested sectors, including the ones that the Chair has just outlined, and we will be meeting on a fortnightly basis to make sure that we have got those right approaches in place going forward. The thing is that, unless there is more rain, we will be in for a difficult time and there are difficult decisions to be made within this. There are limited amounts of work that we can do, but what we need to do in the whole process is make sure that we make the best use of water, that we minimise wastage, and people need to start the reduction in water use as of now, so that our water resources go to best effect over the coming summer. The whole programme of work is: how, together, do we do that?

Q91 Chair: I would like to ask just one question in two parts. In the longer term, my understanding is that, in both the Natural Environment White Paper and the Water White Paper, we are encouraging farms to look at building reservoirs to store water as and when it does fall, and yet that is not going to happen because we still have not had the revisions to the Reservoirs Act. Where are we in the long term on farms and others who wish to store water not falling foul of the reservoir safety provisions?

Dr Leinster: Whether or not the water storage applies to a given on-farm store will depend on the size of that storage.

Q92 Chair: Under the current rules—

Dr Leinster: The limitation in the Reservoirs Act is on the amount of that water that is above ground. There is work that is going on just now. We have just had a consultation on the size of reservoirs, which, just now, is 25,000 cubic metres. There are a number of on-farm water storage systems already in place. One of the issues has been that certain farmers have not been able to replenish those reservoirs, because of the low flows currently within rivers. We have just come out with a package of measures to make it easier for farmers to be able to refill that storage. Colloquially they were known as winter storage, because that is typically when they would be refilled. We have said that, irrespective of the time of year when high flow happens within a particular river, farmers will, with our agreement, be able to take the water to fill those

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reservoirs. In certain places, one of the things that we are doing is working with Defra to enable grants to be made available for farmers to construct new reservoirs.

Q93 Chair: Excellent. In the shorter term, you have said about the competing claims for use. Obviously, livestock farmers rely heavily on taking water to their animals. Can you give us an assurance that they will have access to the water they need for their animals in the short-term drought situation?

Dr Leinster: One of the things that certain farmers are doing just now is looking at what their stocking levels are and taking account of what the future water situation is. Some people are reducing stock levels because of that. Other farmers are also deciding what sort of crops to plant, depending on what they believe the water situation will be. This is something that we are in active discussion with the farming unions and the farming bodies about to make sure that people can make those business decisions that they need to make.

Q94 Neil Parish: Could Defra be more ambitious in setting a timescale for a long-term reform of the abstraction regime? Is it clear enough where we are going?

Lord Smith: I think it is very clear from the White Paper where we are going. The timescale is necessarily medium-term rather than immediate-term, because, where you are talking about abstraction rights that people have, in order to remove such rights overnight, you would both create problems with patterns of agricultural or business use but you would also incur very substantial compensation liabilities. What I think the White Paper sensibly does is to say, "Let us look over the course of the next eight to 10 years at how, when we get to the end of that period, we can have a much more sensible, much more sustainable abstraction pattern than we have at the moment." Ian, do you want to add any of the detail to that?

Ian Barker: It is important to understand that, although the reforms proposed in the White Paper will not commence until the mid-2020s, that does not mean that nothing will happen between now and then. There are very clear signals from the Government that the Environment Agency needs to work hard to tackle the legacy of damaging abstraction which is drying up rivers and wetlands, so that, by the time a reformed abstraction system comes into play, we have a sustainable base line in terms of the balance between the amount of water pumped from rivers and ground waters, how much the environment needs and how much is actually there.

The second critical thing is whether the timing is appropriate. The current system has worked pretty well for 50 years, but our analysis in support of the White Paper has shown very clearly that it will not be fit for purpose when the impact of climate change starts to occur and we feel the effects of population growth and increases in demand. By the time the change to the regime takes place from the mid-2020s, that should be in good time in order to be prepared for those future changes and, by then, we will have a more flexible and dynamic regime, which will be able

to respond to changing water availability and changing patterns of water demand.

Q95 Neil Parish: If you are going to create a market for water, then in the end the ones who need it the most and pay the most for it will get it. If you are not careful, you will cut back growing crops in this country to import vegetable crops from other parts of the world that are equally drought-ridden, if not more drought-ridden than we are. How are you going to protect the fact that we do need to grow crops in this country, even though sometimes people think they can import whatever they want to eat? This worries me because it is not only about abstraction. Are you going to look at recycling of water so that that can be used for crops into the future, including nutrients from recycled sewage water and what have you? Where is the strategy? What I rather fear is the idea that, because we've got a lot of people, we've got a drought situation, crops and animals are dispensable, therefore we won't bother with them; we will concentrate on people and import all our food from countries that can little afford the water to grow those crops in the first place.

Lord Smith: There is a growing realisation generally, and certainly here and now on our part, that relying on imported food over the course of the next 20 to 30 years is not a sustainable option. We have to look to as much self-sufficiency as we possibly can within the UK. That means trying to make sure that we plan the use of water so that agriculture can use water in the ways that it needs to. Part of that will be finding new ways of using water for the growing of appropriate crops, and that is something which the farming community is already doing quite a lot of work on and thinking about. Our responsibility is to make sure that, in balancing the competing demands, agriculture does not lose out, and we are determined to make sure we do that.

Q96 Neil Parish: Are you looking at ways of recycling that water so that water that has been used by people can then go back to growing crops? You will still grow your crops and then extract your water for people, and then grow your crops with the water that is discarded. Surely that, while quite an expensive way forward, could be quite competitive if you were then using the nutrients from recycled sewage water and the like. The trouble is that it is no good sitting here in 2012 and getting to 2020 and wringing our hands, because these long-term solutions will not happen overnight.

Lord Smith: They certainly will not happen overnight, but I think we will increasingly see recycling of water for a lot of different purposes. Do you want to comment on that Paul?

Dr Leinster: At present in certain areas a lot of the base flow of a river is, in fact, sewage effluent. When we do water balances and when we do water studies, we look at the water that is abstracted but also the water that comes back into the system after people have used it. That is already part of the water cycle that we look at. There is a really good example, going forward to the Olympics, where they are using, for the watering of the landscape areas, so-called black water.

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There is a water-treatment plant on site which then makes sure that that is taking raw water and treating it to a sufficient standard to enable landscape plants to grow. I think one of the things that we have to do within this study going forward and looking at all of the options is looking at what level of treatment is required for what type of water. Just now we have one level of treatment, which is to drinking-water standards, and then we tend to use that water for purposes that it is not required for. Those are areas that we are actively looking at.

Neil Parish: You are looking at them but what incentives are you doing? Lots of dry countries recycle a lot of water and yet we do not do it.

Q97 Chair: Could we just move the argument along, because we have done recycling. Farmers are concerned about a free-for-all. Could you share with us what principles you are going to use in abstracting so that it is not just the ability to pay and it is not just going to be a complete free-for-all?

Lord Smith: We certainly would not want to have what you might call a complete free-for-all. We need the right combination of market forces that are going to encourage water companies to share resources between each other, for example, at the same time as sensible regulation that looks at how you need to plan for the overall use of water. Ian, you have effectively been in charge of doing this.

Ian Barker: Thank you, yes. At present we are working with Defra to develop some understanding of what the new regime might look like, but we and Defra are very keen that we do not sit in a darkened room and then pop up with a consultation in 18 months' time or so. The intention very clearly is to engage with all sectors of water users so that they can input to the development of a reformed abstraction regime and, as my Chairman says, work towards the right balance of market forces and regulatory safeguards.

We are certainly very mindful of the concerns that we have heard from the folk in the agricultural community. They are a relatively small player but absolutely essential. Agricultural use is currently only about 1% or so of the total water used in England and Wales, but very much more in some parts of the country at some times of the year. It will be necessary to safeguard that use and potentially to increase it as, perhaps, we become more food-sufficient. To ensure that the future regime gives those proper safeguards, also in terms of water planning, it is likely that, in the future, we may need new water-resource developments. The lesson from other countries has been that, rather than just a development for public water supply, a development should also consider other uses as well, and there are precedents for that in resources that we manage, for example, on the River Severn, which are for the benefit of all water users on the whole of the River Severn catchment, not just for public water supply.

Q98 Neil Parish: One of the problems of this country is a lot of your vegetable crops are going to be grown in the Fens, where there is particularly a problem with water and with drought, so I think that is where you

are going to have to target. You are going to have to not only generally target but also target particular areas. Have you got plans for that?

Lord Smith: You are right about the importance of the Fens and East Anglia more generally, which, in many ways, is the richest agricultural land in the country. At the moment it is suffering most from drought. I caution a little against assuming that, in all years, we are going to have a superfluity of water in the north and west of the country and a shortage of water in the east of the country. That tends to be the pattern but it is not always the case, so we need to look across the country's water needs as a whole rather than just saying it is a problem in the east and the south-east.

Q99 Iain McKenzie: With reference to section 27 of the Water Act 2003, once implemented, how widely do you expect the powers to revoke licences to be used?

Lord Smith: I am going to look to Ian to answer that one, if I may.

Ian Barker: Defra consulted on the principles which would apply to the use of that particular power, and we need to await the outcome of that consultation to understand the way in which that would apply and what the definition of serious damage might be in practice.

Q100 Iain McKenzie: Have you any indication of what may be termed serious damage at this present time?

Ian Barker: The consultation illustrates a number of different examples. For example, a borehole abstraction which is drying up a wetland of special scientific interest or a Habitats Directive site, might be considered serious damage. It will be a combination of the magnitude and extent of that damage, but that will be very much a question of judgment. The consultation is designed to try and elicit views in terms of where that bar should be drawn. It would be wrong of me to try and pre-empt the outcome of that consultation.

Q101 Iain McKenzie: How do you deal with limited licences? At what sort of duration do you see them?

Ian Barker: Since 2003, all abstraction licences have been required to be time-limited, although, in many cases, earlier licences have been so restricted. As we see greater variability in water availability, it will be important that abstraction licences, like all other types of permit, should be eligible for a form of review and a stock-take. As I said earlier, the important thing is that we move to a sustainable base line and, once we have that, future changes are likely to be incremental rather than significant.

Q102 Richard Drax: In the short term, do you have any plans to encourage the increased trading of licences to tackle the current unsustainable abstraction?

Lord Smith: We are already encouraging farmers, for example, to make available spare abstraction capacity to other farmers in order to help to address some of the existing issues of drought.

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Dr Leinster: Yes, we are encouraging people to do it. It is possible to do it. There is not necessarily much of a drive to do it. In the Middle Levels within East Anglia, for example, we have got together a group of farmers, all of whom are abstractors, and they are sharing their licences and sharing the water between them. We are also working down in Hampshire just now to see if we can get a similar sort of approach down there. Some licences have got headroom within them which is not currently used. Making sure that we can find ways of encouraging that water use from a place which is relatively well supplied in a particular year to an area which is less well supplied is something that we are trying to do. That will most probably require greater interconnection between catchments and, again, we are working with water companies and others to see how we can facilitate that.

Q103 Richard Drax: What information on licences is available to allow potential buyers and sellers of water rights to identify each other?

Ian Barker: There is a public register of all abstraction licences, which is freely available. There are some security restrictions about the location of public water supply licences, for understandable reasons, but in general terms it is open access in terms of who is abstracting where and what the authorisation is for.

Q104 Richard Drax: Do you have a proactive role to push that? Can people go on it and are people aware of it?

Ian Barker: The outline details, we do make public, and we have published guidance which sets out how one might go about a water trade and the sorts of rules that we might apply.

Dr Leinster: We will certainly call those farmer abstractor groups that I was talking about together and facilitate that discussion. When you get to the larger water users, they are quite sophisticated and they know how to access that information. When you get to smaller users, us facilitating it is one of our key roles.

Q105 Mrs Glendon: Will the Environment Agency have published an overview of interconnection options before planning begins for the next round of water resource management plans in 2014?

Lord Smith: We are very keen to see the next price review round for the water companies include provision for much better interconnectivity between different water company areas and different catchments. It seems to us that it is one of the ways in which we can try to address the problems of imbalances of water availability across the country, and potentially a much more cost-effective way of doing it than creating a national grid for water, which some have occasionally demanded, and which would involve huge expense and cost in order to pump water from one end of the country to the other. Making sure that they are able to move water around relatively easily, both within water company areas, within their own patch, but also between different water company areas, has to be a crucial part of the next price round.

Q106 Mrs Glendon: You have already referred to a national grid, Lord Smith. Will the overview include a cost-benefit analysis of the different approaches to interconnection, for example by contrasting local interconnections with a national grid?

Lord Smith: We will certainly want to continue to develop that analysis. There will, I imagine, be some imaginative proposals coming from the water companies themselves in all of this. The recent bit of kite-flying by United Utilities, for example, saying that perhaps it could run a pipe alongside the high-speed rail link was an ingenious way of tackling a planning problem but might not necessarily be the best way of moving water very long distances.

Q107 Mrs Glendon: Will a cost-benefit analysis be an important part of the overview?

Lord Smith: Absolutely, yes.

Q108 Mrs Glendon: Finally, how will you assess the comparative environmental impacts of bulk transfers and abstraction?

Lord Smith: We will want to make very sure that, where an interconnection is happening in order to solve water availability issues, it does not inadvertently cause ecological problems in the process. Sometimes the content of water in one catchment is actually different from the content of the water in another, and shifting water in bulk from one to the other may have some really serious detrimental effects; it could, for example, carry invasive species across country. We will need to make absolutely sure that we are protecting the ecological and environmental issues at the same time as we are addressing water availability issues.

Q109 Mrs Glendon: Will they have equal weight?

Lord Smith: We will be very much making sure that we protect those environmental considerations.

Q110 Chair: Have you done any work on the costings? Have you any idea what the cost of these interconnections will be? I think, in the drought summit, the Secretary of State made quite a big play on interconnections and it would just be good to know an idea of the costs.

Lord Smith: The answer is it will depend on where, how many and which companies are really keen to undertake it and so on. I do not know if we have got any further information than that.

Dr Leinster: No, but already companies do share resources, and also there are bulk transfers. For example, from the Bedford-Ely-Ouse system down to Abberton, there is a bulk water transfer that happens that we manage. There are other places. After the 1976 drought, Yorkshire Water made sure that there were interconnections between its different supply systems. I think, as the Chairman says, this will depend on the individual circumstances and I think this will be key work for the individual companies to carry out, doing that cost-benefit. How you balance new resource as opposed to sharing resource is one of the things that we will have to investigate.

Lord Smith: It should be work that they carry out over the course of the next two years leading up to the

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price review, because any capital expenditure that they will need to have in place over the next five-year period will need to be included within that price review.

Q111 Chair: That is my point: it is additional capital expenditure on top of plugging the leaks and everything else that they have been asked to do.

Ian Barker: We have convened all the water companies in the south-east of England and those on the periphery, such as Anglian Water and Severn Trent, to look at the available resources, the current demands and future demands, and the different options for meeting demand well into the future. Part of that work is modelling the different options for meeting demand and the costs of those different options, so that, collectively, the water companies come up with the most integrated, sustainable and cost-effective option for meeting demand over the next 25 years or so.

Q112 Iain McKenzie: How do the bulk transfers that you referred to take place currently and are they the most environmentally friendly methods?

Ian Barker: Bulk supplies can be either a transfer of raw water in a pipe, which is what is usually the case, or a transfer of treated water. They would perhaps go from a water treatment works in one water company directly into the supply of another company, or a raw-water supply from one water company into the treatment works of another one. Generally, they would be within pipelines and not getting near rivers.

Q113 Iain McKenzie: So that is restricted on distance at this moment in time?

Ian Barker: Yes.

Q114 Iain McKenzie: It can be either treated or untreated water?

Ian Barker: Yes.

Lord Smith: If you are transporting water in a pipeline from one area to an end user in another—classically, for example, the water that comes from north Wales down to Birmingham—there are very few environmental considerations that you need to have regard to. If, however, you are using river courses to transfer water, or canals to transfer water, or any other means where you are taking water from one water body and you are putting it into another water body, then you absolutely have to make sure you are safeguarding the environmental impact.

Q115 Chair: I would just say that transporting water by pipe is hardly carbon-neutral.

Lord Smith: If it is downhill all the way, it is not too bad. However, unfortunately, our country is not downhill all the way from one end of the country to the other, and pumping water uphill is both hugely expensive in terms of energy use and also carbon-generating.

Q116 Amber Rudd: You referred earlier to the proposal for the north-south pipeline alongside HS2. Do you think it has any merit?

Lord Smith: It is an ambitious idea. As and when you are building a major piece of new infrastructure of this kind, it is certainly wise to think about what other bits of infrastructure this could be used for. It might be that bits of it could be useful for some of the interconnection that we need. Whether it makes sense to aim to take water from the north-west of the country down to the south-east of the country, I am less certain.

Dr Leinster: We have to remember as well that, I suppose, probably two or three years ago, the north-west had a drought. Under those circumstances, the water would not have been available. I understand that they are also talking about potentially using water from Kielder, but you then have to go from Kielder reservoir all the way down to wherever the high-speed link is going to, so Leeds maybe or Birmingham. It is still a huge distance that you are having to transport water. I think that the proposition itself was quite silent in terms of where the water input was coming from.

Q117 Amber Rudd: It is quite a detail, isn't it?

Dr Leinster: Yes.

Q118 Chair: Was this not visited round about the time that Cow Green Reservoir was built and David Bellamy made his name on the back of saying it was uneconomic and unenvironmentally friendly to transport water long distances? That was just from Teesdale to Teesside, so how has the debate moved on in that time?

Dr Leinster: We did a study in 2006 looking at whether or not a national grid was a potential solution, and we raised all these issues then. It is one of the things that we will revisit, but I think we would come to the same conclusion, which is that it is highly carbon- and energy-intensive, and there are most probably other alternatives that are more appropriate.

Ian Barker: Kielder Water is a good illustration in terms of water planning not recognising future uncertainties. Currently, we face many uncertainties in terms of the impact of climate change on water availability and also how demand patterns may change across England and Wales in the future. Kielder was predicated on the basis that industrial demand would increase in the north-east of England, and the reservoir was designed specifically for that purpose. The industrial demand that it was designed to meet did materialise, but in China and India and not, unfortunately, in the north-east of England, which is why it still has such huge spare capacity within it.

Q119 Chair: With respect, you are talking about Kielder. I mentioned Cow Green, which flooded the blue gentians, so it is alpine flowers that will never grow in that area again.

Ian Barker: Indeed. It is a special area.

Chair: I hope we can learn from that.

Q120 Amber Rudd: Could I ask you about water metering? Do you think that the White Paper is ambitious enough or should we be trying to look further at Walker's recommendations for 80% of water meters by 2020?

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Lord Smith: Of course, any decisions on universal metering would be for Parliament and Government to decide, not for us. Our view is that metering can be a very useful way of encouraging consumers to think about the amount of water that they are consuming. One of the interesting things is that, in the south-east of the country, water metering already has a very high penetration rate. Ian, you have got the figures at your fingertips, I know.

Ian Barker: Southern Water is embarking on a programme of compulsory metering, which will see Southern Water's area up to about 97% by 2015. South East Water is also just embarking, and that will take it up to about 88% by 2020. Across the whole of the south-east of England, with the current proposals working through, by 2020 there will be 73% meter penetration. Already in Anglian Water and Cambridge Water, meter penetration is about 70%, and similarly down in the south-west. By the early 2020s, in the swathe down from the Humber pretty much to south-west England, meter penetration will be well in excess of 70%, even if nothing else were done.

Q121 Chair: Should there be incentives to metering? I think the south-west has pretty much metered voluntarily. In other parts of the country, do you believe that there is an argument to incentivise the use of metering?

Lord Smith: In a way, for many households there is an incentive already in that installing a meter reduces the household bills. Where there are very large households with very large quantities of water use, that will not necessarily be the case. One of the concomitant issues that has to sit alongside greater penetration of metering, of course, is the need to take account of those households on very low incomes with very high water needs, and the tariff system does need to take account of that.

Q122 Chair: I was slightly surprised that the Water White Paper did not include more on water efficiency and more of the Walker conclusions, some of the obvious things like households and businesses using water butts to retain rainwater and also only heating hot water to a certain level. Do you think there is a feeling that the Government will rely on legislation or do we need legislation to do this if we are going to proceed to encourage more water efficiency through existing legislation?

Lord Smith: I certainly think that there are ways in which greater water efficiency can be encouraged. Quite a lot of things like planning requirements for new construction, for example, could take account of these sorts of issues. The Government have a longstanding objective, as far as I understand it. At the moment, average water consumption per head per day is 150 litres. Their longstanding objective is to get that down over time to 130 litres per head per day. That is not a huge ask for households to think about the way in which they are using water. It may be that, instead of going for all-out legislation to achieve it, just by doing some relatively small things with the planning system, with new construction and with making guidance available to everyone, you could actually get quite a lot of change.

Q123 George Eustice: Some of the evidence that we had from the Water White Paper pointed to a tension between some aims in the White Paper, which try to develop a holistic approach and encourage co-operation between the water companies, and then, later on, the notion of competition. What do you think of the competitive market? Is that likely to reduce the possibility of companies working together?

Lord Smith: I do not see them as an either/or. I think there is room for bringing in some market incentives, especially in terms of trading water, but I think there is also room for a balanced regulatory approach that encourages collaboration between water companies. I do not think necessarily that you cannot have both. We need both if we are going to get to the desired outcome.

Q124 George Eustice: Particularly with the drought in 2006, if you had things fragmented at the retail side, that could make it difficult to encourage the public to reduce their water use, whereas, at the moment, when you have got one single water company, they are able to run quite high-profile campaigns that urge the public to cut their water use.

Lord Smith: The pattern varies around the country, of course. Very large parts of the country are covered by very large regional water companies. Parts of the south and south-east have much smaller entities, some of which are just responsible for water rather than for waste water and sewage as well, so the pattern is more variegated in the south and south-east, which makes consistent messaging perhaps a bit more difficult there, which is why bringing all of them together and making sure that they are all speaking with one voice is very important.

Ian Barker: It is important to remember also that the proposed competition items in the White Paper are for non-household customers only, and experience from Scotland has shown that, where a customer has changed their supplier, the benefits they derive come from closer engagement and promotion of water efficiency within that business. Experience suggests that that closer engagement will help to drive down consumption in any case and will create a closer relationship which should serve better during a drought. The whole ethos of the proposals in the White Paper is around moving cautiously with competition and increasing the use of markets, and that is very much in line with the recommendation from Professor Cave, whose independent review sparked the proposals in the White Paper.

Q125 George Eustice: Just finally, are there any other concerns that you have about the possible downsides of increased competition, specifically in terms of the impact on the environment?

Lord Smith: If, as your Chair said earlier, this led to a free-for-all, we would be seriously concerned because environmental considerations might go out of the window. But what is in the White Paper is not a proposal for a free-for-all; it is for a modest and timely introduction of market forces into parts of the picture. That, we think, can be beneficial. What we will be concerned to do is make sure that our regulatory responsibilities are being proportionately maintained.

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Q126 Chair: You have had a fairly fundamental reorganisation at the Agency. How many people are now, in proportion to the total number, dealing with water, flooding and drought issues at head office and in the regional offices as well?

Lord Smith: Overall, we have reduced in terms of staff numbers from 13,500 two years ago to about 11,500 now. We have taken a huge amount of cost out of the Agency. We have undertaken, as you have indicated, a lot of rather major restructuring. In terms of within that 11,500, probably we would need to separate out flood from the rest of water.

Dr Leinster: The flood side is proportionate to the funding, and just over half of our money that we get in—and we have a budget of £1.1 billion—is on flood risk management. Therefore, around half of our staff work on flood risk management. Water resources is funded via the charge payers, and so the number of

people who work in water resources has reduced by a modest number, because we have held our charges largely. In terms of the funding, we get income of about £130 million a year, so just under a tenth would be on water resource work.¹ During a drought, the nature of the work that those people does shifts, because they are diverted on to drought work rather than some of the longer-term planning work that they might otherwise be doing.

Chair: That is very helpful. Thank you for all you do, and I am delighted your people are more visible when they go around at the times of flooding. I think that is extremely important. Thank you very much, all of you, for contributing, Lord Smith, Dr Leinster and Mr Barker, this morning. We are very grateful.

¹ Note by witness: the £130 million refers to income the Environment Agency receives through charges for water resource activities.

Examination of Witness

Witness: **Tony Smith**, Chief Executive, Consumer Council for Water gave evidence.

Q127 Chair: Thank you very much for joining us this morning and for participating in our inquiry on the Water White Paper. Just for the record, could you introduce yourself and give your position?

Tony Smith: Yes. My name is Tony Smith. I am the chief executive of the Consumer Council for Water, and that is the body that represents water customers, business and domestic.

Q128 Chair: How do you perceive the role of water companies in representing the consumer generally and then, in particular, in their relationship with you as it currently stands before we introduce any competition into the sector?

Tony Smith: The water companies, obviously, should have the primary responsibility for being accountable to their customers for what they provide and the price that they provide it at, but because they are monopolies it is quite important that the system is regulated by the economic regulator and by other regulators, but also there needs to be balance in that debate about what is required by the companies as far as the environment and future requirements are concerned and how far customers' priorities are reflected in the companies' plans.

That is where our job comes in. It is quite important that we make sure that water companies listen to their customers about their willingness to pay for things and what their priorities are, and that those plans that the companies put forward to the regulators actually reflect those requirements. That is a fundamental part of our job. As I said in terms of the introduction, this is both for domestic customers and business customers, because, at the moment, obviously, there is very little competition, even for business customers. Even when there is, there will be issues that come through as a result of introducing competition—things like mis-selling and so on—where business customers will need help.

Q129 Chair: In terms of legislation, we obviously have the Water Industry (Financial Assistance) Bill before the House, whose Second Reading is today. In terms of finalising the Pitt recommendations and looking at the Gray, Walker and Cave reviews, how much emphasis do we need on legislation and how much can we be getting on with without legislation? Where we do require legislation and what, in your mind's eye, would the legislative timetable be?

Tony Smith: I think much of what the water companies and what the water industry needs to do for customers is already enshrined in existing legislation. The gaps are probably around the market reform issues—things like the removal of the costs principle and the reduction in the threshold to zero for business customers, because business customers want competition. More broadly than that, I think the other gap is potentially the issue of water affordability, where the proposals in the White Paper go some way towards addressing the south-west unfairness issue, and the social tariff proposals in the Flood and Water Management Act go some way towards addressing the affordability problem but not as far as they need to go. There will still be an issue around affordability, even with social tariffs. Those are the two gaps, really, that need to be addressed.

Q130 Amber Rudd: I wanted to ask about social tariffs. There has been much debate on how to implement them and what the best outcome might be. What principles should Ofwat use to decide whether a company's proposal for a social tariff has the broad support of its customers? How are we going to verify that?

Tony Smith: It is very important for monopoly water companies to have a degree of legitimacy for social tariffs that they are proposing, and that can come from two possible sources. One is from Government clearly saying who should get social tariffs and who should not get social tariffs, or—and I think this is reflected in the current guidance—that companies' customers

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need to give broad support for those social tariffs in order to give that monopoly water company legitimacy for cross-subsidising between customer groups. Ofwat then have the challenge, with our help, about what that actually means.

We think that it is more than 51% that would not give, in our view, broad customer support, because there would be still a large percentage of customers who would be opposed to social tariffs. I would not necessarily want to put a number on what broad customer support is, because it depends on those who are opposing social tariffs, and how strongly and for what reasons they oppose. Reflective of this, I think, is, in price reviews, we tend to look at companies' business plans in terms of the level of customer support they have, and I think our view is that if companies are getting 70% to 80% customer support, that is pretty strong customer support.

Q131 Amber Rudd: What do you mean by "customer support"? Do they "tick here" to volunteer to contribute to the social tariff?

Tony Smith: No. We have done customer research, as have a number of water companies, and customers are receptive to the idea of social tariffs but they are only receptive within fairly narrow bands of what they are prepared to add to their bill—maybe £1 or £2. If companies propose social tariffs of that sort of size, then actually I think they will get reasonably strong support, but they will need to help those customers who disagree with those social tariffs.

Q132 Amber Rudd: Will it be on the bill separately or will it just be folded into it and you have to read the fine print to realise that you are participating in it?

Tony Smith: Our view would be it would be better for it to be transparent. Certainly, customers are receptive to playing their part but they do want transparency. They do want to know if they are paying £2 towards addressing a social tariff—

Q133 Amber Rudd: They want to be told.

Tony Smith: Then they want to be told.

Q134 Amber Rudd: Is there any alternative support available for customers who do not qualify for the WaterSure scheme if their company chooses not to introduce a social tariff?

Tony Smith: Already some companies have charitable trusts that can help certain customers and some of them have what they call Restart schemes, which help customers who are in debt to get back on the payment habit. Apart from that, no; it is down to WaterSure or social tariff proposals that the companies might come forward with in the future.

Q135 Amber Rudd: Do you think some people might fall through the safety nets there?

Tony Smith: Potentially, yes. We think that social tariffs can play a part. We think that there will be limits on what customers are prepared to pay. The problem, I think, with the social tariff proposals is that our analysis suggests that customers might pay, say, £2. That is around England and Wales. That is about £40 million. Anna Walker, in her analysis of what the

affordability problem is in the water sector, I think identified that the problem is nearer a £400 million problem, so it is a big shortfall. Separately, the Government are proposing a solution to the unfairness issue in the south-west, and we support that, though, in that case as well, there is a question about whether business customers, particularly smaller business customers, might need help in that regard, because the unfairness issue affects them as well as it does domestic customers.

Q136 George Eustice: I know you mentioned just now that £2 is about as much as people say that they will pay, but I just wondered where that came up. Was that based on some kind of economic modelling you did or was it just a focus group? It seems to me, for instance, in the south-west, we are going to have a rise in bills of £50 in one year, so it is a huge rise, and £2 is quite small in the scheme of things to fund a proper tariff.

Tony Smith: We have done a lot of customer research, and so have some water companies, and it is a combination of focus groups and quantitative research. You find that customers generally are not very receptive to social tariffs until they understand what the issues are, and then they are more receptive but within this limit. It is very difficult, I think, to get customers beyond the £2 or £3 range, because then they say, "Who else is contributing to this? The water companies should be contributing to this and so should Government." They are prepared to pay to some extent, but it is limited. That is why I said there is a potential gap in the affordability provision here: it does not quite address the issue. It has got a big part to play but it does not fully address the problem.

Q137 George Eustice: Before the Government found this money to do the assistance it is giving now to the south-west, there was discussion of having a nationally funded social tariff, which could be targeted at those areas which, for instance, have much higher water bills than the national average. Do you think that would have been a better system than a social tariff based at a company level?

Tony Smith: We think a Government-funded social tariff across the country would be the preferred solution. I think customers would prefer that too. That is a separate issue than the south-west fairness issue. We think that those two issues should be separated. There is a fairness issue in the south-west, and then, separately, there is a national problem around affordability. A Government-funded solution for that is the best proposition because to use social tariffs, as I say, limits the help available.

We would not be in favour of trying to use the WaterSure tariff as a route into that solution, because WaterSure was put in for a specific purpose, and that specific purpose was to cap the bills of customers who were going to be disadvantaged because of having a water meter. The idea was that it would bring the cost to them back to the local regional average cost. There are three issues going on: there is protection for customers who have to use a lot of water, which is WaterSure; there is the affordability issue, which is social tariff; and then the third issue is the fairness

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issue in the south-west. We think those three things are separate issues, and if you try and merge those in terms of a single solution, you start distorting the effect in different parts of the country.

Q138 Richard Drax: Would you support the suggestion that Government data on customers who are likely to be in need of support—like benefits, for example—should be made available to water companies or not?

Tony Smith: Yes, we do. We think that anything that would help the water companies target their help—social tariffs or any other form of help—to the customers who most need it would be beneficial. The take-up of things like WaterSure at the moment is relatively low compared with the number of customers who could benefit from it. That suggests that, despite the fact that we and the water companies do a lot of promotion of that programme, if it could be more targeted by using that data then, we would get a higher uptake of things like WaterSure or social tariffs, and that would be beneficial to customers who need it but also to customers in general. If customers are getting into debt, it causes everybody to have to pay more, so we would be in favour of data sharing.

Q139 Richard Drax: Bearing in mind this information is very sensitive, probably, to many, what do you think customers would make of that?

Tony Smith: I think it is how it is used. I think, if it meant that customers were getting telephone calls from their water company saying, “I believe you are on a particular benefit”, then that would be inappropriate, but if being able to target information would help companies to say to customers, “This is available. You may wish to take it up”, we think that would be a beneficial thing. It would still be in the customer’s gift to say, “This is helpful to me and, therefore, I want to apply for WaterSure”, for example. That would be a helpful development.

Q140 Chair: Could I just ask a more general question on data? We are told that two issues that could delay the introduction and the path to consumer choice and competition are the lack of availability of data—not just about those on benefits but data more generally about water customers, both retail and domestic—and IT issues. Do you agree with that? How do we tackle it?

Tony Smith: I am not sure you are referring to this, but as I understand it many of the companies’ systems are actually looking after business customers and domestic customers, so this separation of the two is practically quite difficult, which is why these questions about the degree of separation between the distribution businesses and the retail businesses is quite an important issue. Our view is that there still needs to be a degree of integration of the companies so that you have customers not being given dissimilar information by different bits of the business or that they get passed around when they have, say, a water quality problem or they have gone off supply for some reason. If there is separation between the retail and distribution businesses, the incentives on those

businesses need to be consistent and complementary, so that customers are not disadvantaged.

Q141 Mrs Glendon: With regard to dealing with bad debt, should the Flood and Water Management Act’s provisions on landlord liability be enacted, or do you support trialling a voluntary approach?

Tony Smith: The voluntary approach is an interesting one but we do not think it will be comprehensive enough to address the problem. We would be in favour of making it a statutory requirement rather than the voluntary approach. We do not think that there would be enough take-up to help the companies actually address the problem.

Q142 Neil Parish: On South West Water, we welcome the £50 off the bills, which all of us representing the south-west naturally do. How is that generally perceived by the rest of the country? Do they actually recognise that we did have the highest bills and that that is justified?

Tony Smith: I think the start point is customers would not necessarily recognise the problem in the south-west until somebody tells them. Obviously, customers in the south-west are very, very acutely aware of it but elsewhere they are not. When they become aware of it, they are actually quite receptive to that issue being addressed. The issue around fairness is a very important principle and, therefore, we certainly support the Government’s proposals in the south-west, although, as I mentioned earlier, there is the issue that business customers are equally affected.

Q143 Neil Parish: Yes, I am coming to that.

Tony Smith: Certainly, customers elsewhere, when they realise there is a problem, are actually saying, “Yes, that sounds a difficulty for those customers, so that should be resolved.”

Q144 Neil Parish: I know you want it extended to business customers, and part of me says yes also, but would you not perhaps think that that extra money that would need to be spent is not better actually helping others in other parts of the country who are having difficulty paying their bills?

Tony Smith: It is difficult to trade those two things off. That is what I mentioned earlier. Absolutely, I think there are these issues. There is unfairness in the south-west; there is the affordability problem. The affordability problem, from a customer’s perspective, is actually a higher priority, not surprisingly. They see that issue around helping customers pay for this fundamental product—water—so that everybody can afford it as actually quite a high priority. The issue around resolving that for all customers, wherever they live, is I think probably one of the outstanding gaps in the Water White Paper.

Q145 Neil Parish: This is slightly off the question but you talked earlier on about the £2 or £3 people would be prepared to pay, but I think in the south-west I am right in saying that bad payers or not being able to pay is something like £15 on each bill—

Tony Smith: That is right.

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Q146 Neil Parish: So it is a significant gap?

Tony Smith: Absolutely. I think the advantage of trying to address the affordability problem, either with social tariffs or a Government-funded scheme, is, if you can help those customers who genuinely have got a problem paying, then arguably the water companies can be a little tougher with those customers who are not paying and, therefore, imposing some of that £15 on other customers. I think that is the other argument in favour of trying to address the affordability problem. It means that the people who could pay but are not paying could be helped more strongly by the water companies to do that, and that is in every customer's interests.

Q147 George Eustice: I know you said it should be extended to businesses, but given that the Water White Paper itself and the Bill that has come from it are intended to increase competition within the business sector, is that not the way to deliver the result for businesses rather than diluting the fund that the Government has identified for consumers?

Tony Smith: Competition for business customers will help them reduce their bills modestly, potentially, and it will help them get, hopefully, a better service from their supplier. What it will not do is fundamentally address a big bill gap for, say, business customers in the south-west, because, at the moment, all that is being talked about in terms of business competition is the retail component, which, at the very most, is probably about 15% of the bill. The unfairness issue in the south-west is probably bigger than that. Competition can help business customers but it will not necessarily go all the way to resolving those issues around the overall scale of the bill in the south-west.

Q148 George Eustice: Do you think as well that £50 to a large restaurant that is metered and uses huge amounts of water in a year does not make a great deal of difference?

Tony Smith: No, I agree. It is a relatively modest amount.

Q149 George Eustice: I wanted to ask you about water efficiency as well, because I know there is quite a bit in the Bill that aims to encourage consumers to think more carefully about how much water they use and to have kitemarks on dishwashers—things like that to encourage people to buy appliances which are water-efficient. To what extent do you think perceptions about leakage in the water system deter consumers from thinking themselves about their water, if, basically, all this water is just leaking through the pipework? They have got a point, haven't they? Why should they have only one bath every other day or something, when the water companies have got leaks they are not fixing?

Tony Smith: The good news is that customers—most customers anyway—are quite receptive to playing their part in using water wisely. As long as we as CCWater, water companies and others make it easy for them—in other words, tell them what to do to actually save water, they are very receptive. Certainly, our tracking survey, where we track water customers' views, is showing that around 70% of customers now

are doing something active to save water. That is starting to affect a number of companies that are now reporting, particularly in the south-east, a reduction in demand for the first time over the last two or three years.

These things are working, but you are right that the biggest barrier—and we know this from customer research—to customers playing their part is the perception that others are not, particularly the water companies, and the biggest issue there by far is leakage. The water companies really need to play their part in that regard in achieving their leakage targets. We think the regulatory system probably needs to take account of leakage, which is a very large issue in the customer's mind. At the moment, the sustainable level of leakage that Ofwat uses to set companies' leakage targets does not really do that. It does not really address the perception issue that customers have. Obviously, the perception issue becomes that much more acute during times of drought, because they are being asked to save water and if their perception is that companies are not doing the same then obviously that can affect their appetite to actually play their part. It is a very important point and one we should not underestimate.

Q150 George Eustice: Do you think the companies are doing enough?

Tony Smith: Most of them, although not all of them at the moment, are achieving their leakage targets, but, as I say, I think there is a question about the regulatory system that does not really take account of that perception issue. The perception issue is really important not just in the overall question, "Are they achieving their leakage targets?" but also in the speed with which they address leakage reports. It causes customers concern if they report a leak to a water company and it apparently takes days for the company to come and resolve that problem. The smarter companies realise that and are much more proactive in resolving those problems. We think, particularly in times of drought, that is very, very important from the customer's perception.

Q151 George Eustice: Which are the best performing companies and the worst performing ones?

Tony Smith: In that regard, we know that Southern Water, for example, in the past has been very active in terms of resolving visible leaks. But on the other hand some of the companies, I think, failed their leakage targets last year. That does not look very good as far as the customers are concerned when now we start to talk about drought.

Q152 George Eustice: Do you know which ones missed?

Tony Smith: I think that Yorkshire failed its leakage targets.

Q153 Chair: May I interject a cautionary note here? I hope this is something that the regulatory system does allow for. Last year, we had temperatures of minus 17 for four or five consecutive nights. I challenge any pipe to prevent leakages in those

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conditions. I think we have to have a reality check here before we fire off. Are we saying that there is enough slack in the system to recognise that there are extreme conditions sometimes that will throw the leakage off course?

Tony Smith: Absolutely. Do not get me wrong—I am not saying that we should be criticising the companies who necessarily did have that problem with cold weather. I absolutely agree with you. The problem here is one of customer perception, which is the thing I am flagging up. If you get the combination of companies failing their leakage target and then a drought, it is an unfortunate mix in the customer's mind. You are right that there are circumstances where a company might, in a particular year, fail its leakage targets—

Q154 Chair: It was two years running.

Tony Smith: But the customers will not necessarily recognise that.

Q155 Amber Rudd: Do you accept that this country is going to need near-universal metering at some stage in order to meet the increasing pressures on our water supply from climate change and population growth?

Tony Smith: We think that Government have got this right in terms of their approach of addressing metering through local requirements, because the need for metering varies across the country. The implementation of metering needs to be very sensitively done because, although some customers will benefit a lot from having a water meter, some customers will have an instant hit on their bill, sometimes in excess of £200.

The transitional arrangements that companies put in place to address that problem and the protection for those customers who ultimately, when they have a higher bill, need affordability help, are very, very important. What we would not want is for metering to become a reason for customers to be alienated by the water companies and the regulated system. We have been working very closely with the companies who are now putting in metering programmes, particularly the compulsory ones, like Southern, South East Water, to make sure that they do it very sensitively, that they have got the right protections in place, and we think that is the way to try and minimise the risk of metering programmes. Our view is that, over the long term, metering is the right solution.

Q156 Amber Rudd: 100%?

Tony Smith: Yes.

Q157 Amber Rudd: 100% metering?

Tony Smith: Ultimately, but you need—

Q158 Amber Rudd: Sensitively done.

Tony Smith: It needs to be sensitively done and it needs to be done at a pace that makes sense for the local region, so we think Government have got the approach to metering right in the White Paper.

Q159 Neil Parish: Ofwat told us it was confident that abolishing the cost principle would not leave the household customers subsidising big business. Do you

share that confidence and, if not, what safeguards would you like to put in there?

Tony Smith: We are in favour of the cost principle being replaced, because it has been a major constraint on competition for business customers. The issue around making sure that what replaces it does not allow a disadvantage to fall on ineligible customers—obviously particularly domestic customers—is absolutely crucial. We are pretty confident that Ofwat can do that. It is a key part of its regulatory role but we will be keeping a very close eye on it to make sure that customers get the benefit of the elimination of the cost principle but that ineligible customers do not suffer disbenefit as a result of it. We will be working very closely with Ofwat to make sure that happens.

Q160 Neil Parish: That is right. In Scotland, Scottish Water is a publicly owned company and then there are retail companies that can then sell. You can get competition but within the business sector, not within the household sector. Would you ultimately like to see competition introduced to household consumers throughout England and Wales?

Tony Smith: We have done quite a lot of customer research around this issue, and business customers are very keen on competition—particularly the larger ones but even small business customers are very pro-competition. Domestic customers are much more ambivalent. Domestic customers, when they understand how competition might work, roughly fall into groups of about 30% who want it, about 30% who do not want it, and about 30% who do not know or have not quite decided. They are very ambivalent. When you explore why that is, it is largely to do with their experience in energy, which has been very mixed in terms of mis-selling, price volatility and tariff complexity. Those are the issues that customers have not necessarily viewed as beneficial to them.

Q161 Neil Parish: The message is loud and clear that, if we were to introduce any sort of competition like that, it would have to be accessible for people and they would have to understand it, otherwise, they are not really interested.

Tony Smith: Yes. I think the first thing to do is to make sure it works for business customers because business customers do want it. Again, we are positive about what the White Paper is proposing to do, which is to do a stepwise approach and make sure it works, because the worst thing we can have is a competition regime that is introduced prematurely, that does not work and that causes customers to lose faith in that regime.

Q162 George Eustice: What, in your view, are the main risks that could make this experiment go wrong?

Tony Smith: Competition?

Q163 George Eustice: Yes.

Tony Smith: We are quite positive about the concept of competition. The biggest risk to the move to retail competition is we try and move too fast and the system cannot cope. If we move to zero megalitres, basically all business customers—I think over a million customers—would then be open to

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competition. We have just got to make sure that the system could cope with that and that it does not cause what happened in the energy sector, where the switching system does not work and it caused customers big delays when they wanted to change suppliers. That is probably the biggest risk in the retail part.

Again, upstream competition could benefit all customers because it could cause water to be allocated more effectively than it is now. The risks there are that, if you start pricing very locally, some customers could get very big changes in their bills—some down but some up a long way—and that could cause some alienation. The second issue is making sure that the system can still have enough certainty in it to get the right investments at the right time to make sure that the long-term security of supply, which is a customer's high priority, gets addressed. There is a danger that, if you have a competitive regime, there will be so much uncertainty that people will defer investment for a long time and it means that, in the end, long-term security of supply could be jeopardised.

Q164 George Eustice: Don't you deal with that by separating the wholesale from the retail function? The wholesale is a protected monopoly—a regulated monopoly, in effect.

Tony Smith: Yes. That is the quite encouraging approach that Ofwat is proposing, which is the fundamentals of the regulated system around the upstream bit of the value chain get retained—so things like the regulated capital value and so on—which does give investors a degree of certainty about what is going to happen in the future. Those are all encouraging signs, but, obviously, there is some detail to be thought through on things like interconnection. We think, in the round, it could probably make sense. There is quite a lot of detail to make sure that either customers are not disadvantaged as a whole or customers in particular locations do not get disadvantaged by what is proposed, particularly for upstream competition.

Q165 Richard Drax: When should the competition in the retail market be open for business in your view?

Tony Smith: When it can cope is the short answer. I think we need to be ambitious but we need to be realistic, and we want a competition regime that, when it starts, works, broadly speaking. One of the biggest issues there is to just make sure that the system could cope with a very large number of customers, some of whom may choose to switch. I think we have just got to make sure that the regime is capable of coping with that.

Q166 Richard Drax: *Water UK* argues that an April 2015 market opening “would entail an unacceptable degree of operational risk”.

Tony Smith: That would be a concern to us. We do not have a particular view on when the right time is, but we just want to be reassured that the system that lies behind it would be fit for purpose. Those sorts of concerns would be a concern to us. The worst thing that can happen is that customers experience a system

that does not work for them, because then the competition regime would fall into disrepute.

Q167 Chair: Could I return to water efficiency and the Anna Walker recommendations? Do you have any preference? What would you favour as being the measures most capable of increasing water efficiency? Do you have any favourites?

Tony Smith: Our view is water metering can play a part but it is not a solution in itself. It can help customers play their part. The work that we have done on alternative tariffs—and the work that some companies have done on alternative tariffs—is not that positive in the sense of customers' receptiveness or, indeed, their behaviour change when they have alternative tariffs. There is quite a lot of work that needs to be done, not from a statutory point of view but to get customers thinking water efficiency is quite important for everyone. I think it is quite a long-term job but, as I was saying earlier, customers are receptive to playing their part.

We have got to make sure we do not blame customers and that we do not penalise customers for using water, but that we help them by giving them ideas on how to save water, backed up by sensitive implementation of metering. That is our preferred approach. Things like rising block tariffs and seasonal tariffs could potentially play a part over time, but customers' receptiveness and their likelihood of acting on those tariffs at the moment looks to be quite low. The danger is we could implement things that do not have a positive effect.

Q168 Chair: In terms of who the regulator should be, is it correct that, in Northern Ireland—or the Irish market—you actually have three regulators: a regulator for Northern Ireland, a regulator for southern Ireland, and then a third regulator for the Irish market? Do you have any thoughts about who the regulator should be moving forward? At the moment, we have obviously got the regulator for Scotland and the regulator for England. Who should be the regulator for the UK market?

Tony Smith: I think that is more of a political decision than it is a customer decision. I think there is a fairly high degree of consistency between the Scottish regulator, the Water Industry Commission, and Ofwat in terms of the way they regulate the regulated business. There is, obviously, a difference at the moment in the competition regimes, and we are encouraged by the White Paper saying that those two things should be looked at to come in line with each other. Who should regulate that, I think, is an open question. We do not have particularly strong views about it. There is a question for business customers, particularly multi-site customers, in that they, at the moment, face different regimes in Scotland and England and, obviously, it would be beneficial for them if it was the same regime so that they could get one service from one supplier, potentially, across those two countries.

Q169 Chair: In response to Richard Drax's question, the chief executive of the Water Industry Commission for Scotland told us on the record in his evidence that

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any market opening date earlier than April 2017 “would be really pushing it”. Obviously, there is a debate about where we are with the legislative process. Do you have any ideas about whether 2017 is being over-optimistic?

Tony Smith: As you say, it depends on the legislative timeframe, and it goes back to the question about, as well as the legislative timeframe, whether operationally the competition regime has got all the systems in place to make it work. I do not have a strong view about whether it is 2015 or 2017, but as I say what we will be doing is just making sure that both those elements—the legal framework but also the operational framework—are in place and are actually going to work. That is our main issue, I think, for customers.

Q170 George Eustice: In the evidence that we had from the Scottish industry, they talked about the separation that they had achieved between the wholesale and the retail side, and business streams were spun off. How much separation do you think is required for this to work between the wholesale businesses and the retail? I know Government, in the face of protest from the industry, backed off somewhat from where Scotland was heading.

Tony Smith: We would be concerned about legal separation at the moment, because we noticed that the White Paper’s impact assessment suggests that the costs of doing legal separation and the payback period are much longer and a much bigger cost than just doing accounting separation. Given that the costs of this are going to fall in part on ineligible domestic customers—and they may not benefit, ultimately, from this split—then, actually, for the moment, we need to minimise the cost of the change so that the impact on those customers is minimised. We are, at the moment, happy to see just accounting separation. I think, in Scotland, it is slightly different because the retail services for domestic customers are actually provided in large part by the local authorities, which is different to England, of course.

Q171 George Eustice: Are you not concerned, though, that, in terms of getting service from the

wholesaler, the incumbent wholesaler’s subsidiary company or retail division will have first call on those and it will be a barrier to new entrants?

Tony Smith: That is a concern. It is a concern that the regulator can probably keep an eye on, but it is less of a concern to us than the cost of doing legal separation will have for customers. I think step one is to do accounting separation and see if it works; if it does not, then clearly there is an option on doing something more radical later on.

Q172 Chair: You have been given a reprieve, under the Public Bodies Act, until 2014. Do you believe that Defra should commit to retaining the Consumer Council for Water in its current form until the forthcoming market reforms have been fully implemented? Do you see a future role, as did David Gray, after that time?

Tony Smith: Yes is the short answer because, as we have discussed, there are timing questions about the competition regime. There are issues today for business customers that we are trying to address, and many of these issues have been there since privatisation, particularly transparency of charges and transparency of things like back payments that companies make that affect customers now. As David Gray suggested, there will be issues around the implementation of business customer competition, as there were in energy.

If CCWater is not there, the alternative proposals for CCWater do not really address business customer issues; it is all around domestic customers. Business customers who, today, have got issues with the water industry and probably will have during the implementation of the competition regime, would be unprotected in that sense. It is quite important, as David Gray suggested, that business customers have somebody representing them, either to water companies individually or to the regulated system—to Ofwat—which is what we do today.

Chair: That is very helpful. Thank you very much for contributing and being so generous with your time today. I think we have benefited greatly.

Wednesday 7 March 2012

Members present:

Miss Anne McIntosh (Chair)

George Eustice
Barry GardinerNeil Parish
Amber Rudd**Examination of Witnesses**

Witnesses: **Pamela Taylor**, Chief Executive, Water UK, **Peter Simpson**, Managing Director, Anglian Water, and **Steve Mogford**, Managing Director, United Utilities, gave evidence.

Q173 Chair: Good afternoon and welcome. Thank you very much for being with us this afternoon and agreeing to participate in our inquiry on the Water White Paper. For the record, I invite you to introduce yourselves, starting with Pamela.

Pamela Taylor: I am Pamela Taylor and I am Chief Executive of Water UK.

Peter Simpson: I am Peter Simpson, Managing Director of Anglian Water.

Steve Mogford: I am Steve Mogford, Chief Executive of United Utilities.

Q174 Chair: You are all very welcome. Thank you very much for participating. To begin with, I am going to ask a couple of questions on drought, and then we will move to the White Paper, and possibly the draft Water Bill as well. Are you confident that the White Paper's package of measures to address water scarcity will secure England's water supply in the face of possibly severe and persistent droughts in the years ahead?

Pamela Taylor: The White Paper does exactly the right thing, which is to talk about resilience and the need to tackle climate change. There is no one simple solution to deal with long-term drought; we will probably need a package of measures. Certainly, in the first half of the White Paper, the co-operation, planning and so on is going in the right direction, but we will need to continue to work very carefully with the Environment Agency and all of the players, in the countryside in particular as well as urban areas, in order to ensure that we plan. One of the things we will need to look at is the ability to move water between boundaries of companies, which companies are doing increasingly. We will also need the ability to consider how all of us can look at our attitudes to how much water we use.

As to whether the White Paper will make a difference, it will. Say you are a manufacturer. You have an abstraction licence and some spare capacity, and you come along and pour it into Peter Simpson's pipes at Anglian Water. Will it be sufficient? That will depend on the nature of the drought we are facing. It will never make up in terms of what we are facing now, for example, but will it be part of a plan to help us face things? Yes, it will have a place.

Peter Simpson: I agree with all of that. One particular aspect that is usefully highlighted by the White Paper is the uncertainty associated with climate change. The Paper goes to great lengths to stress that we need to start planning, not on the basis of the worst drought we have had in living memory, but the probability

against the UK climate change scenarios of exceptional droughts in the future. Therefore, it makes more sense to have a strategy of resilience, which is a big centrepiece of the White Paper. Bringing in that uncertainty, as opposed to the historic ways we have planned for drought, which are based on the worst drought we have ever experienced, is particularly useful.

Steve Mogford: I support those views. The key thing the White Paper talks about in the early part is collaboration. The locations for drought are unpredictable. Eighteen months ago we had a drought in the north-west; now we are talking about the south, so this is something that can often be localised and requires a whole series of different solutions. The key thrust of resilience, sustainability and collaboration is a really important feature of the White Paper.

Q175 Chair: Mr Simpson, in the current drought do you have any concerns about the way Defra and the Environment Agency are handling the situation and the speed of the response?

Pamela Taylor: I think we have been very pleased.

Chair: Perhaps Mr Simpson will go first.

Pamela Taylor: I am so sorry. I did not hear. Forgive me, Chair.

Peter Simpson: Quite the contrary. The Secretary of State has shown very strong leadership. She has made it very clear through the drought summits that have been held—remember, there were a couple last year as well as one held relatively recently—that she is expecting companies to work together and collaborate, as Steve has suggested; and also that this affects not just the water sector but many others. That has been very positive, and there is very strong leadership there.

Equally, the Environment Agency has been very helpful. It has drawn the line in the sand very clearly about its environmental responsibilities in terms of protecting the environment, but it has been much more open to different ideas and suggestions as to how we might help ourselves during this period of drought. Overall, I think the message has been very strong from the Secretary of State, Defra and the Environment Agency.

Pamela Taylor: To put it in context, interestingly in the UK we supply 17.5 billion litres of water every day, so we will need to look at the scenarios of climate change. We will need to look at a suite—a menu—of things, such as increased storage, winter storage and so on. It will take quite a broad range of things for us all working collaboratively to tackle this longer term.

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Peter Simpson: I know that the Secretary of State and the Minister, Richard Benyon, were particularly pleased with the way the industry was collaborating in advance of the last summit. They were particularly pleased to see that we were already thinking about the summer of 2013, which in many ways is of greater concern, particularly if we have a third dry winter. That collaboration has been enabled by the way they have approached it, but they have been particularly pleased by what has actually been going on.

Q176 Chair: To put a general question on the White Paper, do you believe that the Government's expectations of water companies are realistic? What do you believe the timetable for implementation of any draft Bill should be?

Pamela Taylor: The timetable is a difficult one for us all, because in a way we have not got to the bit marked "start", and it depends on where you start from. We feel that the publication of the draft legislation would be a start. With this timetable we are also concerned that there should be adequate time to help to develop what I call the second part of the White Paper. That is the more difficult part—the upstream proposals. That is more difficult, unlike the first part, where in the Anglo-Scottish market we can call on the evidence and experience we have in Scotland. We are Water UK, not Water England, so we have a great deal of experience north of the border and can call on experience there.

In terms of the upstream part of the White Paper, we are in uncharted territory, so it is very important that we work collaboratively. We would very much like to see the draft legislation and this Committee being able to look at that, and for it to be done in such a way, as I know the Committee would want, that all the stakeholders including ourselves collaborate to make sure we make the most sensible decisions we can.

At the moment some thought has been given to time scales, but a route map does not exist at all. To be honest, the idea that you would do it all together—the Anglo-Scottish market, the upstream changes and the price review with additional consumer engagement—would, frankly, be madness.

Peter Simpson: I agree with that, particularly the focus on opening up the non-domestic retail market. We compete in the Scottish market through Osprey Water Services, and our experience is that it takes time to set up the market properly. It probably took about five years pre-2008 to get all the basic set-up for that particular market. Some of those things are not there yet, and effective governance of the whole process was particularly important. Alan Sutherland has been very proactive in making sure that all the people who will be involved in the market are brought into what the structure would look like in future. He was very keen to ensure that those affected by the market, i.e. non-domestic retail customers, were equally involved in helping to set it up.

Some of those things are terribly important, and it takes time to get them right. One of our feelings about the time scale is that it will take several years to do it, but it is much better to spend the time getting the set-up right to avoid potentially unintended consequences. Our experience from Scotland is that it

took probably five years up to 2008 to get that in place.

Steve Mogford: I would agree. One of the core themes in the White Paper is the potential for unintended consequences. To work through this against an evolutionary timetable, which I think is one of the themes in the White Paper, is extremely important. Some of the aspects of the White Paper are little more than concept. Some of the case for change is as yet unproven, and how we would implement those things has not been worked through. I see a need for a thoughtful timetable based on strong collaboration between the parties.

Chair: That is very helpful. Perhaps we can move to abstraction.

Q177 George Eustice: My questions are also about time scales but specifically in the context of the reform of the abstraction regime. I think it is fair to say the industry generally welcomes the focus on flexibility going forward and the ability to vary the volumes that can be abstracted, but some of the environmental groups have expressed disappointment that this is not going fast enough and we should commence these changes earlier. What are your concerns about starting it earlier? Do you agree with them on that?

Pamela Taylor: We have started, but again it is a question of defining "start". For a year or so we have been working successfully with Defra, the Environment Agency and Ofwat on abstraction licence reform. It is absolutely right that the process is properly thought through. It does not affect only water companies, but businesses and others. It is not just a conversation we can have and get on with it. We are also working in parallel with the Environment Agency, where we talk just about water companies' abstraction. We have already begun work in parallel with the EA on that to see whether, on a voluntary basis, we can bring forward any of the principles in the White Paper so we can make a difference already ahead of any legislation that is introduced.

Our present approach, which is the work we are doing with Defra, EA, Ofwat and other stakeholders, whom we must not forget, and the research programme, is something in which we have to play a part, but we cannot dictate the pace of it. What we can and are doing in parallel with that is to say that where it affects just water companies, we are already working with the Environment Agency to see what we can do, and obviously we also involve environmental NGOs.

Steve Mogford: To give some examples, for us in the north-west, we have about 350 licences, of which about 250 are under consultation in terms of modification of the abstraction regime. The sorts of things we are talking about involve areas of special scientific interest, but also areas where we have very fragile public supply lines. The types of thing in which we are engaged with the Environment Agency is how we achieve the abstraction change that is being sought but also maintain the public supply through alternative sources, which may be different boreholes, different storage arrangements or different pipelines. We come down to the very practical issues, which then require funding, planning and delivery. I think

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that overnight changes to abstraction can cause quite significant risk to continuity of supply.

The other issue for us in the north-west is that we are only a proportion of the total abstraction from the environment. An awful lot of businesses abstract. In today's environment, if you walk into a company and ask it to reduce abstraction over a very short time scale, there is very little it can do either to adjust its processes or, to be honest, fund them in the current environment. Part of it is how do we bring about the desired change without either threatening public supply or damaging businesses?

Q178 George Eustice: You have talked about the importance of getting it right, and we can all agree with that, but as I understand it, it is not really envisaging a change until the mid-2020s, which is quite a long way off. How much conversation do you need? You say you have started a conversation.

Pamela Taylor: Where it would be relatively easy for a company to work with the Environment Agency, we are beginning that work anyway; we are anticipating the legislation and so on because we appreciate the need and the interest, which we all share, to get that right and to get on with it.

Peter Simpson: To add some context, when we look at 2027 and that statement in the White Paper, that envisages where we might get to as the end point, for example maybe an open market for abstraction licences. That is quite significantly different from what we have had before. Therefore, it makes sense to do it over a decent time scale.

Q179 George Eustice: But do you imagine that the new types of licences could start to be introduced much earlier?

Peter Simpson: Potentially, because the piece Pamela is talking about is the current programme. There is already an Environment Agency programme for restoring sustainable abstractions. Steve and our company are looking at where the Environment Agency is saying that a stretch of river is under stress and, therefore, what can we do?

To give you a very practical example similar to Steve's, in the city of Norwich there is a potential reduction in the amount of water that we as a company may be able to take out of the public water supply of approximately the same amount of water that we supply to that city. If you take that to its extreme, it means no water for the public water supply. Clearly, that is not something where you can click your fingers and say, "Well, that's the answer; we've traded one off against the other." What you have to do is develop the evidence base to make absolutely sure you are talking about genuine amounts of water that if they are not there will adversely affect the environment, and then work out what the infrastructure solutions are to ensure you do not end up with a situation where a city does not have sufficient water supply. That takes time.

Steve Mogford: It would be wrong to assume that everything waits until 2027.

What we are seeing is that work has already begun and there is a progressive amendment of abstraction licences.

Q180 George Eustice: So you see 2027 as the end of the process, not the beginning.

Steve Mogford: Absolutely, and we have already begun.

Q181 George Eustice: That brings me to my other point on sustainable abstraction and the proposal to make use of section 27 of the Water Act 2003 to revoke a licence without compensation where it is causing serious damage. Do you have any concerns about the implementation of that power and its implications, given what you have just said about having to plan for these things? This power will be coming in next year. Is that something that concerns you?

Pamela Taylor: It would certainly be necessary for the Environment Agency to be transparent in the justification and evidence for its decisions, and obviously it will need to allow sufficient time for the changes in the assets to take place, as you have just heard from examples that there may be, particularly as we need to bear in mind that companies have been acting lawfully to date under the licences. We all share the responsibility of looking after the environment while placing that alongside a statutory obligation to supply water to people, because we are put on earth for public health reasons—to supply drinking water and sanitation. Obviously, companies are very used to that balance, which they always have to strike. We will continue to have to do that in the discussions with the Environment Agency.

Steve Mogford: In the current environment, where there are consequences of changing abstraction, that drives a particular behaviour. One is always concerned in any sphere of life if there are no consequences for your actions, but the evidence is that the progress we are making with the Environment Agency is very pragmatic; it is engaged. We are modelling and working through consequences, so at the moment we would not be concerned if we carry on the way we are in terms of working this through properly.

Q182 Chair: Just before we leave abstraction, can we have an assurance that growers and farmers, particularly in the eastern and south-eastern regions, will have access to water for livestock, vegetables and cereals?

Peter Simpson: A lot of the water that is used by farmers in the east of England is abstracted directly from the environment, in which case it is the relationship between the farming community and the Environment Agency that decides the appropriate level of abstraction, for example for irrigation. We have quite a constructive dialogue with all the various sectors in the east of England and the south-east around the challenges we face. In terms of assurances, I think that is a discussion for the Environment Agency and those particular groups in terms of what they are allowed to take out of the environment. It is not within our control.

Q183 Barry Gardiner: I want to talk to you about large-scale transfers, but before I do I want to pick up the issue of abstraction. As to the abstraction incentive mechanisms, looking at the hydromorphological

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changes to rivers—basically changing the structure and direction of the river flow at various points—how are you going to do that without seriously affecting biodiversity, species and habitat along those river catchment areas? Is there a commitment anywhere that this will be done only where it shows a biodiversity improvement? There are many historical examples where people have decided to straighten out river channels. Hurricane Katrina and the MR-GO channel in New Orleans are a very good example of that. It destroyed all the tupelo swamp that had protected the city for so many years. I see us getting into a position here of thinking, “We’ll increase the river flow here; we will straighten out the channel and do this, that and the next thing,” and our focus is so much on abstraction that we lose the wider picture. What commitments have been put in place here?

Peter Simpson: As to responsibility and accountability for looking at flows and biodiversity in rivers, ultimately that comes down to the Environment Agency. I think it is the Environment Agency that is being targeted in the White Paper with respect to potential changes to river flows, the creation of in-river channels and the like. That does not directly fall to water companies. If you like, it is not part of our accountability. We come into it in terms of discussions with the Environment Agency about what role we can play in abstraction, and increasingly what we can do in terms of work around catchment management, but when it comes to deciding what the rivers should look like—you have replayed the words a little—that is really a matter for the Environment Agency, not water companies.

Q184 Barry Gardiner: I have to say that does not reassure me greatly, but I leave that on the record and move on. Mr Mogford, I want to explore a discrepancy between United Utilities and Water UK on the issue of large-scale transfers. My understanding is that you have proposed a north-south pipeline to run alongside High Speed 2, which might cost about £2.6 billion but you think it is a once in a lifetime opportunity to have minimal local environmental impact but maximum effect. Of course, Water UK has set its face against these large-scale transfers. Perhaps you would play out before the Committee your fight, with one of you in the blue corner and the other in the red corner.

Steve Mogford: Why do you think Peter is sitting between us?

Barry Gardiner: You stay out of it!

Steve Mogford: I would like to put the HS2 pipeline idea in context. Peter mentioned earlier that one of the things water companies had been doing was working together to look at the opportunities to deal with both the current potential drought situations and also the longer term. Of course, we are sitting in the north-west with normal reservoir levels and a healthy position at this time of year. What we were doing essentially was looking at ideas that might contribute longer term to this issue. Clearly, HS2 is a very long-term project and would not make any contribution to the immediate issues. The thing that triggered the idea was a look at activity in China. China has put

pipelines over very long distances to feed its coastal cities. We have been looking at the cost of that. We also did some work on putting a pipeline between Manchester and Liverpool, so we had current experience of being able to do bulk transfer between cities.

To put this in context, the size of a pipeline of that nature is unlikely to make a massive difference. To give you an idea of scale, having talked to my colleagues in Thames Water, I think London consumes about 2,300 megalitres of water per day. A pipeline that supplies 30 megalitres of water is a very small contribution to that overall demand. The truth of this issue for us—I think there is no difference between ourselves and Water UK in this matter—is that the solution to long-term climate change will be a combination of issues. Some of the things that we are contemplating now are very much about trickle effect and moving relatively small quantities of water relatively short distances, but freeing water further across the geography to be able to move it across boundaries, with the assistance of small bulk trades between different companies.

I think the high-speed line affords us an opportunity to say: are there services that we wish to put with it? There are lots of engineering issues involved in putting a pipeline next to a high-speed line, which I am sure will be debated elsewhere. This was just putting ideas into the pot, but the more immediate challenge and solutions will be around trickle effect and also storage.

Q185 Barry Gardiner: Maybe we can come to storage later. I think you are being very nice to Water UK, but it is on record as saying that it would be economically and environmentally unsustainable to do what you suggest and have those long-range transfers. You say this is far into the future, but we are already talking about 2027 scenarios. I want to see HS2 used for all sorts of biodiversity improvements, migratory corridors and so on. When these opportunities arise, is it not absolutely essential that we do not just say, “We can think about that later,” as you have just done?

Steve Mogford: No. I think ideas of this nature need to be tabled, discussed and either adopted or discounted, and they are. When we looked at a drought in the north-west 18 months ago, we were thinking of laying a pipeline along the hard shoulder of the M62. It took us seven or eight years to lay the pipeline that we eventually did. These are long-range projects. They are also insurance policies simply because, if you look at future scenarios, the probability of water shortage is as high in the north-west as in the south. These are things that could well be localised. It does not mean it has to be in the south or the north; it could be all over the country. An infrastructure project of that nature would need to be properly considered, costed and looked at against the other options. It is a long-range decision, and an insurance policy.

Pamela Taylor: As the blue corner, if I may, our comments related in general to the generic idea of a national grid, which, if you began from the beginning and tried to set it up, would indeed be costly and carbon-intensive. Of course, one of the problems is

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that it costs megabucks to pump water around, but one thing we have said to Defra is that as an industry we would be very happy, should this become Government policy or should they want to explore it as a possibility, to look at what Steve has called insurance mega-structures. You might want to think further outside the box and ask what kind of projects and connections, in addition to bulk trade and interconnections that of course we are focused on in terms of resilience, would be a sensible idea or possibility, or how we might look at it. While we have not said that a national grid would be a good place to start, we have said to Defra that these insurance mega-structures would be a possibility and would need to be looked at, and if they were to be looked at, we certainly as an industry would be happy to do that.

Q186 Barry Gardiner: You are open-minded on HS2.

Pamela Taylor: Exactly.

Peter Simpson: In terms of the White Paper, in this area we very much agree that the immediate opportunities are to look at the strategic interconnections between companies and the ripple effect. With respect to the summer of next year, one of the pieces of work we are doing particularly with Yorkshire and Severn Trent is to look at opportunities to allow those companies to release some water to Anglian using existing interconnections. I think the White Paper is spot-on in that respect, and also spot-on in that it creates a role for the Environment Agency to take an overview across the country to look at these sorts of opportunities. That seems like a fairly sensible place to go.

Q187 Amber Rudd: I want to ask about water metering. Do you think that the White Paper should have contained more ambitious proposals to increase levels of water metering at a faster speed?

Pamela Taylor: We think the White Paper has got it just about right when it comes to metering. Obviously, metering is a fair way to charge for water services, and it makes it easier for customers to understand their water use and make informed choices about the way they use water. We would like all customers to use water wisely for as much of the time as they possibly can. It also helps with tariff structures, because meters could be used in terms of affordability, tariff structures and so on. That would be a contribution to the social challenges faced by people.

But the transition to metering needs to reflect local circumstances, which will vary from company to company. Companies will need to take account of their water resources, their current level of metering, the cost and benefits of going further with metering and also improvements in metering technology. We think that the White Paper has got it just about right, and it does not seek to impose and pretend that two companies, which may be experiencing very different circumstances, are the same because clearly they are not.

Q188 Amber Rudd: Mr Simpson and Mr Mogford, do you support the pace at which we are trying to get metering done?

Peter Simpson: For us, in the next three years Anglian Water will have 80% of its domestic customers metered. That has been terribly important for us in a water-scarce area. Having pursued this particular agenda for the best part of 20 years, we know that for every meter put in, we see a reduction in consumption of about 10%. That is an important part of our demand management strategy, but we also accept it is horses for courses; the same approach will not necessarily work across the country. We are convinced that it is right for us, but we also accept that different approaches will work in different areas.

Steve Mogford: From surveying customers, we have a high degree of scepticism about water metering. I think the White Paper got it right, in that we could have seen quite an adverse public reaction among our customers to imposed water metering. In the north-west area we have about 13% of the population but 52% of the most deprived wards. I think people are more comfortable with the certainty of the present billing arrangement, particularly when they see meter charges rising quite significantly in other utilities. There is nervousness and distrust of water metering, and in that sense you see a different picture in different parts of the country.

Q189 Amber Rudd: I would also like to ask you about the mistrust we sometimes see among customers regarding leakage and their confidence in the water companies themselves, with a slight emphasis on the water companies "allowing all this water to leak, so why should we try to conserve water?" Do you feel the message is getting over to people? Do you feel they have a point because not all leakage targets have been met?

Peter Simpson: There is always more we can do to educate the public on leakage, particularly the economic implications of it. As a business, since about 1992–93 we have virtually halved the leakage, going from 960 megalitres down to 464 megalitres, which is our target. We have met our leakage target over the last six years. We have been trying to engage the public in leakage through the use of things like free leak lines, particularly at periods of drought or freeze-thaw, when we have very high leakage levels, and through the way we publicise the opportunity to report and advise us on leaks.

All of us have an economic level of leakage set. If we were to look to drive out leakage to the absolute maximum, we would be doubling the water bill for our customers. There is a point at which you can only go so far on leakage for it to be an adequate economic approach and for it to be affordable for our customers. Perfection would cause a very expensive water bill.

Pamela Taylor: We understand where customers' attitudes come from in that regard. We also do not make excuses when companies miss the targets they have agreed with the economic regulator, so we are certainly not stepping away from that at all. One thing to bear in mind is that when the weather causes bursts, water companies have people out there round the clock, even checking empty workplaces for signs of bursts—for example, during the Christmas break. One thing people forget is that leakage on customers' and businesses' pipes count against water companies'

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leakage targets as well. This is something we all have to do in terms of safeguarding, minding and looking after the infrastructure, but this is customers' money we are using, so it is perhaps for us to continue to have that engagement with customers regarding what is appropriate in terms of the amount of their money we spend on leakage.

Peter Simpson: It is absolutely right that we are held to account, and customers look to us and say, "You must have your own house in order before you start making demands on us." We are very clear about that. Bear in mind that last year's winter was exceptional. For Anglian, around Christmas and New Year we were putting more water into supply than we would normally on a peak summer day. There was an exceptional level of leakage caused by that. It was minus 19 degrees consistently in parts of Lincolnshire and that area. These things had never been seen in living memory. We recovered the leakage that resulted from that in eight weeks, but there is no doubt that additional water was leaked in the year.

To set the context, as a company we are leaders in terms of leakage levels in the industry. We are right at the forefront, and we should be, because we are in the most water-scarce area. This is related to Steve's point about some of the economics. I spent quite a lot of my career working round the world in Asia, central Europe and North and South

America. It is also quite important to contextualise where we sit as a country. The International Water Association has recently done some work to try to regularise the reporting of leakage across lots of different countries and companies. It is all reported differently round the world. Having taken on that mantle, it has come up with something called the infrastructure leakage index, which is basically a common way of looking at it. That shows that the water companies in England and Wales are among the best in the world. When we say that Anglian as a company has a low level of leakage, that is true, but it is also true on a global scale.

When you look at countries like Australia, where you might anticipate a real focus on leakage, in that particular comparison it is in the same band—band A, according to the World Bank definitions—but slightly behind where we are. It is not easy to get all of that message across to customers, and one of the biggest challenges we face is how to communicate that. We all recognise that one visible leak that is not repaired undermines everything I have just said and all the messages we send out to customers as to what we want them to do in terms of water efficiency. That is a clear challenge we have to take on.

Q190 George Eustice: In some of your written evidence you have talked about a disconnect. You say half the White Paper talks about competition and the other half talks about having a holistic approach and collaborative working. Can you explain in a little more detail why you think the two are mutually exclusive?

Pamela Taylor: The first part of the White Paper describes the world rather as it is now, with water companies taking responsibility for ensuring that they safeguard water in its raw state in the catchment

through to treatment and the quality in customers' taps. A classic example of that would be catchment management, when the water company works long term over many years to improve the quality of raw water in that environment. That includes many stakeholders: local conservation groups, environmental groups, landowners, local government, farmers and so on—whoever is relevant in that catchment. We were way ahead of regulatory incentives in doing that. We did it because it was the right thing to do.

The second part of the White Paper opens up the world I have just described to competition, so we need to work together with others, as we set up this new way of working and the introduction of competition, to try to limit, with new contracts, people coming in and so on, and how complicated that might be and how expensive it might become. Take the example of XYZ water company. Would it be interested in joining in and spending money on local catchment management? Would that be part of its business plan? I am not ascribing to them unworthy business practice. What I am saying is that any new entrant would just be responding to the market incentives being offered at the time, so it is for all of us to ensure we safeguard that if we think it is important. Of course, we accept the principle of new entrants and competition, in which case the question is how do we work together to make sure we can bridge the gap?

Q191 George Eustice: Ofwat and the Environment Agency disagree with that argument for the reason that you are still separating the wholesale operation from retail competition, so all the upstream work about collaborating and managing water resources will still be handled by privatised regulated monopolies. The only competition is at the retail end, and even then it is only with businesses, not domestic customers.

Pamela Taylor: That is correct for one part of the White Paper and that is indeed our point, but for the other part it is envisaged that there will be competition at each stage. What we are saying is that we need to look at how it is introduced. It seems to us that the sensible way to do that is to ask what needs to be safeguarded. In that part of the White Paper where we are saying this works well with integrated companies, what do we need to safeguard? Once we have decided that, how do we go about introducing the competition that is being talked about in such a way that is not undermined?

At the moment the White Paper is very light on detail in that regard. That is not surprising because it is not being done, but it is up to us to play our part in making it happen. The point you are talking about is the retail part, which would not be the problem. What we are talking about is my being able to pitch up with a spare pint of water that I might have from my abstraction licence if I were a manufacturer, and pop it into the pipes of these two companies here, or XYZ Ltd's reservoirs. That is the point we are talking about. Of course, we accept that it will have to happen. It is a question of how we manage it in such a way that the work currently being done to integrate, protect and plan is safeguarded.

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Q192 George Eustice: But if there is a market incentive to supply that water, does it not encourage working together?

Pamela Taylor: Not necessarily. It depends on how those incentives are constructed. If the incentive encourages somebody to pitch up, forget the environment and just go for one or two jolly good interesting, easy business customers, and that's it—thank you and goodbye; but if the incentive is part of protecting the environment and catchment, it is a very different feel.

Peter Simpson: Internationally, if you think of comparable examples you might find a build, operate and transfer contract, so company A is incentivised to come in and build a treatment works and supply an amount of water to a city. The contract is all based on how much water they provide at what quality, and it is a take or pay contract. They are all over the world. The problem is that it ignores a lot of the things Pamela has been describing. It does not very easily allow that integrated approach to look at things. You have to think through those things very carefully. It is one of those areas where we are saying there is very little definition in the White Paper at this stage, and it needs a lot of careful thought; otherwise, there could be potentially unintended consequences, which nobody wants.

Q193 George Eustice: In your view what would it look like? What could the Government change in their current proposal that would reassure you?

Peter Simpson: In my view, it would probably be much more sensible to do this in a step-by-step fashion and focus on doing a few things really well first. I think the whole issue of setting up the non-domestic retail market is a big deal. It is a difficult thing to do and will take time. A lot of people talk about the experience in Scotland. The reality is that Scotland has 130,000 customers. If we apply that to England, that will go up to 1.3 million or 1.4 million, so it is a question of a scale-up from a pilot plant to a full-fledged operation. You go from a state-owned wholesaler, if you like, to 21 different wholesalers; in fact it is more than that, because insets are being granted all the time, so that number is ever increasing. So, a relatively simple set of tariffs organised in Scotland becomes at least 21 sets of different wholesale tariffs in England.

As part of the feedback, our suggestion is that we do a few of these things in order and sensibly, and let's start off with non-domestic retail competition. Let's think it through and work together and get something that works, not try to do all the bits at once. To think of the example I have just given, in Scotland there is not the wholesale piece—the upstream piece Pamela talked about. There is no model to follow there. Therefore, it is really uncharted territory. My view is that we should start with something where we have some experience. Work together and get it right, and then we can think about the next steps we want to take, not try to do it all at once.

Q194 George Eustice: Again, it is timing; you put it off. You seem to be saying that you do not want to

start the upstream competition yet. You want to do the inset stuff first.

Peter Simpson: My view is that you do not start it at the same time. Do these things in a logical order. Who is asking for competition the most? Non-domestic retail customers in particular are pushing very hard for it; that is their view. We need to put the effort into getting that bit right and to do that bit first. All I am saying is that is a big thing and it is not easy to do. I base that on our experience in Scotland—what it took to do it there, our role in that and where it has got to.

Q195 Barry Gardiner: Of the £600 million transferred through a charging system based on rateable value, at least a third of it was progressive, wasn't it? Therefore, doing away with it will mean that it is quite regressive in its effect. You will remember that the Walker review in 2009 suggested that of the £600 million transferred between customers, charging on a rateable value basis, £180 million—about one-third—was going from rich to poor people; the rest was transferred from people to people who were much the same, and in some cases it was going from poor people to rich people, but that was very much the minority, because you were charging on the basis of the value of the house.

Pamela Taylor: Yes.

Q196 Barry Gardiner: How are you going to make good that regressive change in charging? How will you ensure that you are meeting needs? Mr Mogford said that his own region in particular has a high concentration of very poor areas. Some people would say, "Isn't it stupid of your company to have chosen that particular area as a privatised company?" Some people would say this was just a problem of privatisation, but you are now not able to get the same public cross-fertilisation and subsidy going on.

Steve Mogford: The way we have looked at this is essentially in being able to deal with affordability. There are a number of elements to this. First, there is a continual pressure on efficiency. If you look at the drivers of efficient operation through our regulatory contracts, there is a lot of pressure continually to improve efficiency through comparators. Very much linked to the point you make about the demographics of the different communities we serve is the concept of a social tariff, which is contemplated in the White Paper. That concept is more acceptable in some areas than in others because of the proportion of wealthy to not wealthy, which is the point you are making. Because of those differences in demography, we have to take different approaches.

I will let Peter speak for himself, but I know from conversations we have had that social tariffs may find greater acceptance in his region than in mine, as served by United Utilities. In dealing with communities that have difficulty in meeting their bills, we have to use different tools and techniques, perhaps in the way we help people who are struggling to come back into payment, for example by way of the charitable trusts that we fund and are there to support people who have difficulty to get back into payment. These are areas where there is an element of horses

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for courses in the way we deal with the different demographics we serve.

Q197 Barry Gardiner: From the public's point of view—at the moment they do not have any real choice in this matter; unless they move house, they are not going to shift between you—what they want to know is that if they are a poor family in a poor area, they will not find that the cost of their water per year will go up by quite a bit. I saw the percentages in the papers: 23% of households pay more than 3% of their incomes, and 11% pay more than 5% of their incomes on water, and that is going to rise, isn't it?

Peter Simpson: I have a few observations. It is quite a complex question, and it has a number of different definitions.

Barry Gardiner: Absolutely. It is a complex thing.

Peter Simpson: Speaking for Anglian, first we think that metering is pretty important. Obviously, that takes out a lot of the things you are talking about.

Q198 Barry Gardiner: You are not talking about rising block tariffs on the back of metering, are you?

Peter Simpson: No, we are not.

Q199 Barry Gardiner: Why? From an environmental and water efficiency perspective and a poverty angle, it makes sense, but you are not promoting that.

Peter Simpson: Because we have done quite a lot of work, looking particularly at Australian companies, on what the signals are and what size the blocks need to be before there is an effective reduction in the amount of water used. We are not convinced that will lead to reduced water consumption. To return to your original question, from our point of view the answer is metering, because we think that is the fairest way to pay.

Q200 Barry Gardiner: If metering is not going to reduce consumption, remind me why we are doing it.

Peter Simpson: You were talking about rising block tariffs and their impact.

Q201 Barry Gardiner: So you think the meters will be a better indication to a household than the fact that they start paying a lot more money once they go over a certain usage per annum.

Pamela Taylor: It is the only way they would know.

Peter Simpson: We know from fitting meters generally that every one we fit means a reduction in consumption of about 10%. That is why we have been pursuing that quite intensively. Your question about rising block tariffs was an add-on to that. We are not convinced that approach makes that much difference over and above having a meter in the first place.

To go back to your original point about affordability more generally, there is a point about metering as opposed to basing it on rateable value (RV). Another particularly important point is that we offer a range of different tariffs to customers, which again helps in these situations.

Pamela Taylor: If they are on a meter.

Peter Simpson: Yes. To come to Steve's point about affordable tariffs, which is flagged in the White Paper,

we think water companies should be given the option, as is writ large in that paper, to implement affordable tariffs if they think they are right.

In our case, in 2005 and 2010 we tried to introduce our affordable tariff, which was called the Passport tariff, and that would have meant a 25% reduction in water bills for those customers in receipt of certain income-related benefits. We did more than that; we spoke to the wider customer base and surveyed them to ask essentially whether they would be prepared to have a 1% increase in their bill to enable that to happen. Two-thirds of our customers said they would. That is something we would like to be able to do, but in the past it has been vetoed particularly by Ofwat. As a result of this White Paper, we are particularly keen to see that water companies are given the ability to implement social tariffs if they think that is the right thing to do, and that it is not vetoed either by the Consumer Council for Water or Ofwat.

Pamela Taylor: We need to target in order to provide the assistance, so we need information as to who are the hard-pressed customers if a company wants to devise such a tariff. As we know, at the moment the Government, in particular the DWP, hold that information; we do not. Unless and until we get that information, we have our hands tied behind our backs.

Q202 Barry Gardiner: That is a pretty disingenuous response from all three of you, if I may say so.

Pamela Taylor: No, you may not!

Q203 Barry Gardiner: I tell you why. The summary of the report by the Department in October last year said that the consensus among the water companies was that increased support for customers facing affordability issues "could be best achieved by additional Government funding". Not one of you has mentioned that.

Pamela Taylor: We were talking with you in the context of the Water White Paper.

Q204 Barry Gardiner: But we are talking in the context of what you can do about affordability of water, and your response to the Defra proposals was that the Government should put in more funding. You have not said that to this Committee, nor have you said how likely you think that will be in the present financial plan. How likely do you think it will be that they do what you said in your response to that October report?

Pamela Taylor: I must apologise. I was answering, clearly wrongly, in the context of what we have in the White Paper now. Therefore, taking that as a given, how do we implement and move on? Social tariffs can help when it comes to the water bill customers are finding difficult to pay, but we cannot solve the broader affordability problems; only Government can do that. We have not moved away from that at all. I apologise that we were talking within the context of the White Paper.

Q205 Barry Gardiner: Let us go to likelihood and probability. This is your solution for affordability. The first thing to happen is that Government must put in more money. Can you quantify how much, and how

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likely you think that is in this spending round? If this is not a realistic proposition, we have to look at something else, and that puts the onus back on you, doesn't it?

Peter Simpson: We are talking about various submissions, and one that was made on behalf of the water industry. If I talk about what we have said as a company, we would like the ability to implement a social tariff. We have not said anything beyond that. We have researched it; we understand our customers' appetite for that and we are comfortable that the majority are with us. Given that approach, we would take it and move forward. We think that would make a very significant difference in our case. That is us and with our level of deprivation, if you want to use that word, in our part of the world. It is different for different companies, and I can speak in this case only on behalf of Anglian.

Q206 Chair: Do you operate your current tariff from a charitable trust?

Peter Simpson: We have an arrangement similar to Steve's for people who are in a very difficult position.

Steve Mogford: United Utilities is not at the moment seeking Government subsidy or support. I am conscious of the fact that for one particular region that is contemplated. The issue for us, as with Peter, is that for customer acceptability in our region, a social tariff does not have the same level of acceptance, but we want to be able to continue to explore the different schemes we have, whether it be charitable trusts, different tariff arrangements or a series of mechanisms. The key point, which Pamela made, is that it would be extremely helpful for us to understand the communities that we should be targeting. Therefore, the relationship with the DWP that energy companies, for example, are developing is something we would like to extend to water companies.

Chair: That is very helpful. Perhaps we can move on to bad debt.

Q207 Neil Parish: Basically, they reckon that about £15 goes on every bill in the country due to bad debt. Of course, water is always seen as very much part of life, so you cannot cut it off. We have been discussing that there are a lot of people who cannot pay, but there are also quite a lot of people out there who won't pay. So why should the good people who pay their bills turn round and pay for those who won't? What measures would you like to see to help encourage those people who can afford to pay but just won't pay?

Pamela Taylor: Take them out and thrash them. No, you are absolutely correct.

Neil Parish: I could not agree with you more.

Steve Mogford: I think one of the tangible measures that the Government could take is to proceed with the view that requires landlords to advise on tenant arrangements, because one of the irritants for us is being able to understand who is the tenant in a particular property and then to bill appropriately. Certainly within United Utilities, and I think it is the same industry-wide, we are very supportive of the move to place that obligation on landlords.

Pamela Taylor: The biggest problem is that 80% of people in water debt live in rented properties; that is Ofwat's figure. So asking landlords to provide the contact details of those tenants seems a very sensible, small and simple thing to do as they have the information. We are even going to the expense of setting up a national web portal in order to make that very simple for them because, as you say, why should families and pensioners be asked to pay an extra £15 for landlords avoiding a small administrative burden on what is, after all, a commercial undertaking? We are looking for Defra to come forward and stop delaying on the implementation of this measure, which in fact was passed in the last Parliament with cross-party support. We just need Defra, frankly, to get on with this so that we can get on with it.

Peter Simpson: In playing our part there, we recognise that the whole administration around this could be quite complex. As Pamela said, that is why we have come together to create this industry portal. For Anglian, just to put a number on it, 70% of our bad debt relates to people who are in tenanted property, so it is the lion's share.

Q208 Neil Parish: Does Scotland have a different policy? Is there anywhere in the United Kingdom that has a different policy towards getting these bad debts paid or not?

Pamela Taylor: Because of the way in which we are structured and because of the way in which we bill customers, we cannot borrow from the model either in Scotland or in Northern Ireland.

Q209 Chair: So we do not need any new legislation; the Government just needs to apply the 2010 Act?

Pamela Taylor: All it is doing at the moment is delaying implementation of the measure that the last Parliament passed, as I say, with cross-party support.

Q210 Chair: I remember it well. Do you know why?

Pamela Taylor: No. I can take a guess that this is a regulation and it is waiting in the queue for one to go out before one can go in. But really and truly, this is a situation that is not getting better; it is getting worse, and the idea that people who may well be hard-pressed or pensioners are picking up this bill is just not on.

Neil Parish: Surely, madam Chairman, we can press for this, can't we?

Chair: We do not need to. I will just do a question, but that is very helpful. If we could now turn to market reforms.

Q211 Barry Gardiner: What are the key risks that Defra and Ofwat should have in mind when introducing market reforms, and how can these best be managed?

Pamela Taylor: I think that the Government has already identified the biggest risk—which does not have to materialise; it is very important for us to say that—that needs to be managed, and that is ensuring the confidence of investors as we implement the recommendations in the White Paper. We are absolutely clear that there are three major parties when it comes to investor confidence: one is the

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Government, another is the regulator and the other is the regulated. Of course, we take that responsibility very seriously, as indeed does our regulator, and we are very pleased that the Government does, too.

What we do not want to see is that investors either walk or that they cost the additional risks if they perceive additional risks. As we know, what investors do, because that is their business, is cost risk. So if they were to think that the way in which we were carrying out the implementation of the White Paper, in their perception, was increasing risk, then they will either walk or they will increase costs. We do not want that, which is why we are so keen to implement this White Paper as constructively and co-operatively as we possibly can.

As we know, the industry is debt-financed, and we are going to need to invest as an industry over £22 billion over the next five years and, of course, if customers had to pay for that on a pay-as-you-go basis, the bills would not be worth thinking about; it would just not be possible. We have to make sure it is done in such a way that the cost of borrowing money for companies does not increase, because a one percentage point increase in the cost of capital results in a 5% increase in customer bills. We know the Government does not want to see that. That is not why they produced their White Paper. We know our regulator does not want to see that and we certainly do not, so there is a big responsibility on us to get this right.

Q212 Barry Gardiner: We have spoken before about the way in which if Ofwat were more relaxed about companies using green infrastructure, soft engineering rather than concrete and steel plant, the amount of capital that you need to invest could come down substantially. What representations are you and the industry making to them to allow that, which would achieve a benefit for you as a company, a benefit to your consumers in lower cost, but also a benefit to the environment in far more environmentally friendly soft green engineering?

Pamela Taylor: Absolutely, and as I mentioned earlier and, indeed, Chair, as we have discussed before, a classic example of this would be catchment management. We were ahead of the regulatory curve on that in terms of pushing, pushing, pushing for it. You can understand, I guess—well, I am kind enough to say that now that we are making progress, but I was not kind enough to say it at the time—the reluctance of an economic regulator when you are saying, as a company, “Please may we invest this amount money and we are not sure precisely what the outcome will be or when it will be and how you might be able to evaluate it, but we want to have a go at this.” Companies together and as individual companies did a lot of work to move Ofwat, and we have been pleased that we have seen that movement.

Q213 Barry Gardiner: Perhaps you could feed this in then, as a case example, to the Treasury’s Green Book task force?

Pamela Taylor: Yes, indeed.

Q214 Chair: On the regulatory aspects, do you have a view on who the regulator should be for the shared

market? At the moment we have WICS, who is the regulator for the Scottish market, and Ofwat for the English market. Should it be one of them? I do not want to put words into your mouth, Mrs Taylor.

Pamela Taylor: This is such a difficult thing for us all to grapple with. As we were exploring earlier, we are Water UK, so we know very well what has happened in Scotland, and there you were talking about a Scottish market, so it was highly appropriate that the Scottish Government said, “This is the policy direction of travel. You, dear Scottish regulator, the WICS, get on with it and deliver it.” When you are talking about an Anglo-Scottish market, you cannot say that completely, as a Westminster Government, to Ofwat, the English regulator, because we are talking about an Anglo-Scottish market. Obviously, as the person who runs Water UK, I have a great interest in terms of Scottish Water and the market there, and not undermining or damaging that by inappropriately introducing an Anglo-Scottish market.

Obviously, companies south of the border also have an interest in making sure that the market they are part of continues to function well as we expand it. So we do not know yet, and it is something we are all going to have to grapple with: how, in some way, we permit Defra Ministers and Scottish Government Ministers to hold the ring in a governance way—because obviously water is a devolved topic for Scotland—that permits the Water Industry Commissioner for Scotland to do what is right for Scottish Water and the scene there, for Ofwat to do what is right here and to ensure that where it is appropriate for setting up the Anglo-Scottish market, they work together.

We must not forget the companies themselves, because I was corrected recently by Alan Sutherland, the Water Industry Commissioner for Scotland, when I said 80% of the work will be carried out by the water companies. He said, “No, it is well over 90%.” So we have to come up with something. We do not yet know what it is, but if we at least agree that those are the principles, we are on the way.

Steve Mogford: Chair, I am not sure that the solution necessarily has to be one or the other. I think, as Pamela said, a good governance structure will ensure that we are doing things in the same way where we need to, and that we have consistent policies. I think we have very clear collaboration between both regulators, the Government and industry on both sides of the border, so I do not think it naturally necessarily leads you to a single regulator. It is about governance and collaboration.

Q215 Chair: In terms of the White Paper and the regulatory aspects more generally and looking ahead to the draft Bill, would you expect the Bill to look at aspects of the Pitt Review that require possibly further legislation, as well as the Walker, the Cave and potentially also the Gray Review on regulatory aspects?

Pamela Taylor: Well, Chair, as you know, we have history here in terms of it always being exciting and challenging and wonderful to have proposed new legislation, and we all work out how best that can be done. Hopefully, we get cross-party support, we make

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sensible recommendations, we get things passed and that is marvellous. But then we do not see them implemented. You are absolutely right, and we do not stop reminding our sponsoring Department that in fact there are still things that have not been carried forward from before, things that were worked through very carefully with the help of this Committee's predecessors and so on, and we really, really do need to see that carried forward.

It will be for Defra to say whether or not it includes that in a draft Bill, but of course we also have to bear in mind that were they to include it in a draft Bill, when they introduce something in terms of the Bill, as we know, things have a knack of dropping off. So that is something that we will not stop on, regardless of whether we see it as part of a draft Bill or whatever. We will still be pressing for that.

Chair: That is very good news.

Q216 Neil Parish: Just to go back to competition, I am quite wedded to private companies competing with one another, and I am not quite so convinced it is going to frighten off all your investors to have a little bit of competition between companies; it could actually bring down consumer prices in the end. I am just worried about private companies acting as monopolies.

Pamela Taylor: We can certainly understand where you are coming from. As I said, investors can either walk—which means they are just not up for it, and they will not stick around and argue, because they do not have to; they can take their money not just elsewhere but anywhere in the world—or they can cost that risk, because that is what they do; that is their business. We do not want them to do either of those things, because we do not want there to be increased risk.

Q217 Neil Parish: Other private companies have to do that. Why are you different?

Pamela Taylor: Only because—and you are absolutely right to challenge on that—it is then passed on to customers, because as I mentioned, for every one percentage point the companies pay in terms of an increase, that is 5% on customers' bills, and we are not looking for that. What we want is a perfect way forward, and we are not going to give up on this, which is that the competition is introduced in such a sensible, co-operative and collaborative way that the investors are not spooked, they do not walk and they do not increase.

Q218 Barry Gardiner: Despite the Cave recommendations, there is not going to be legal separation. In the absence of that, what steps will need to be taken by your companies to ensure that new entrants are treated fairly?

Peter Simpson: We have a fair bit of experience of this, not just through our experience in Scotland but also through the competition that already exists in the water industry.

Q219 Barry Gardiner: In Scotland, Business Stream said that legal separation was essential, didn't they?

Peter Simpson: Yes they did, and we have Osprey Water Services, which sits within Anglian Water and is a separate legal entity but a lot of communication goes on between the companies. Where we have learnt most lessons, though, is probably the inset regime in England. There, we have had to introduce, as a company, very strong equivalence processes to ensure that as a wholesaler, if you like, to new entrants, when we have competition of a retailer here and another retailer coming in here, the wholesaler is giving them the same approach and the same answer. So the company's own retailer, if you describe it like that, is not preferentially selected because of knowledge or information that it has otherwise.

As a company, what we have done is taken a lot of experience from British Telecom and the change in the telecoms market, and we have implemented a lot of the same equivalence processes to deal with the issue of inset competition to ensure that new water entrants who come into our area have the same approach from us as, if you like, the monopoly in the area that our own downstream company entity would have. It is building on that, so I think we have some relevant experience.

Steve Mogford: I think it is also important to recognise that there are many different views on legal separation. There are some that express a view that it is essential, and others that say it is not necessary. I have heard Martin Cave himself say that whilst preferable it is not essential to deliver the outcomes that we want. The industry, for a whole variety of reasons, has established very good practice in the way that transfer pricing occurs and the way that costs are allocated.

In many ways, what I would hope is that we go through this implementation and we create a level playing field for both the incumbents as well as the new entrants to compete in, rather than simply attracting new entrants. One of the core points there for me is the cost principle, which I think has been established as a law that Government has said is anti-competitive and that therefore it will repeal, but I think there are some very important principles in the cost principle that have to be retained. One is certainly that costs are allocated fairly, but also that domestic customers, through introducing attractive margins for retail competition, are not subsidising big business. So I think we are very interested, in setting this level playing field, in what is going to replace the cost principle rather than its repeal itself.

Barry Gardiner: Thank you, that is very helpful.

Q220 Amber Rudd: We have run over time, so please just one or two sentences for your answers. The final question that I wanted to ask is: when should the competitive retail market, do you think, open up for business?

Pamela Taylor: When it is ready.

Chair: How long is a piece of string?

Pamela Taylor: There is only one place that we can learn from, and that is Scotland. We are really keen to get on with this and to ensure that it is a credit to us all. We have suggested that what we should do is find a way—preferably Defra should lead on this but if not we are happy to work with all the stakeholders—and

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produce a route map with indicative times next to it: so, all the steps that need to be taken, the indicative times and let's get on with it.

Q221 Barry Gardiner: Chair, could we ask for the rising block tariff modelling to be made available to the Committee?

Chair: Indeed, that would be very helpful.

Peter Simpson: Yes.

Chair: Pamela Taylor, Peter Simpson, Steve Mogford, thank you very much indeed for being so generous with your time in contributing to our inquiry. We have learnt a lot.

Examination of Witnesses

Witnesses: **Dr Rose Timlett**, Freshwater Programme Manager (UK Rivers), WWF-UK, **Dr Geoffrey Findlay**, Chairman, Action for the River Kennet, and **John Lawson**, Technical Adviser, Action for the River Kennet, gave evidence.

Q222 Chair: I welcome you most warmly. Thank you very much indeed for being with us this afternoon and participating in our inquiry on the Water White Paper. Please state who you are and your position for the record, starting with Dr Timlett.

Dr Timlett: Thank you for inviting us here today. My name is Rose Timlett and I manage WWF's UK Freshwater Programme.

Dr Findlay: Dr Geoffrey Findlay, Chairman of Action for the River Kennet-ARK for short.

John Lawson: I am John Lawson. I am Technical Adviser to Action for the River Kennet, and by profession I am a civil engineer specialising in water engineering and associated environmental management.

Q223 Chair: We are all very grateful to have you here this afternoon. In the short term, do you think that the drought review that the Government conducted is having an impact in minimising the consequences of drought?

Dr Timlett: We are in the middle of quite a significant environmental drought, and we have been seeing the effects on the environment for some months now. At the moment, the latest Environment Agency reports show that pretty much every river in the south, the east and the midlands is either notably or exceptionally low, but most of them are exceptionally low. There are many impacts that are associated with low flows and dried rivers, which I am sure Action for the River Kennet will go into, but it is worth noting that although this is a short-term effect, the impacts on the environment will go on for a long time; it is going to take many years for the environment to recover. While we cannot control the weather, we can control how we use and manage water. The drought symptoms that we are seeing in rivers at the moment are a symptom of the unsustainable and outdated way that we are managing water, and it is with considerable urgency that we need to reform.

Dr Findlay: I absolutely agree with what Dr Timlett has said. What the drought has done is to draw attention to a problem that has been long in the knowing. Action for River Kennet was formed nearly 20 years ago now, and was drawing attention to the effects of abstraction and repeatedly making the point. We went through a public inquiry, in which the Environment Agency lost to Thames Water, because there was an inadequate value attached to the River Kennet.

Our frustration, therefore, is—it gives us no comfort to say it—that we have been warning about this. It is now a crisis. I do not like to use the word “disaster” too much, but it is an impending disaster, a potential one. My colleague, Charlotte Hitchmough, who directs ARK, described it recently, having been working on the River Kennet, as watching a car crash in slow motion. I would love to tell you a lot more about that.

Chair: I am afraid we do have rather a lot to get through.

Dr Findlay: Understood.

Q224 Chair: Can we look at the future of drought management? Do you believe that the package of measures in the White Paper to address water scarcity will be enough to secure England's water supply in the face of severe and persistent drought?

Dr Findlay: As we said in our written evidence, in principle yes; our problem is with the time scale, at two levels. There is an immediate issue with our own particular river system, which we can talk about later: the abstraction of the River Kennet. But we are struck, I think, by the relatively leisurely timetable presented in the White Paper compared with the evidence given as part of the documentation, the Environment Agency's two papers under the *Case for Change*, which I find create a sense of urgency that I do not find in the White Paper.

Dr Timlett: We have heard a lot about resilience already this afternoon, and we completely agree with that, but to get better at managing drought, there are two things we really need to do. We need to develop resources and we need to cut waste in order to allow us to have sustainable levels of abstraction whilst meeting people's demands. So we need to invest in the system. In total, if everything in the Water White Paper was implemented quickly, we would be really, really happy. I guess the key concerns for us are around putting off some key decisions until the next Parliament, and whether that will cause a lack of momentum in the whole process; and the fact that we are not going to see changes or completely change to a sustainable abstraction system for 15–20 years. Also it is still really unclear to me how, without water metering and much greater effort on demand management, we are going to start to address the fact that a third of the water that we take out of the environment is currently wasted.

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Q225 Chair: Thank you. Just generally on the Water White Paper, are you pleased with its contents? Do you believe it is over-ambitious? Do you believe it is deliverable? Are there any omissions—something that is not in the White Paper you would have liked to see in it? I think, Dr Timlett, you addressed this, but Dr Findlay, Mr Lawson, would you like to give us an idea of what the legislative timetable for implementation of any draft Bill should be?

Dr Findlay: I am struck by the good intentions in paragraph 2.12, which sets out all the things we would like to achieve. I am then disappointed when I turn the page and find that Defra says, “We will consult on detailed proposals for reform in 2013.” It is not obvious to me why we have to wait another nine months to even start on consultation. This is the familiar theme, which we will all come on to, of urgency. There is an immediate urgency for us.

One of the areas where the White Paper is weakest—we might want to come back to this later—is on metering. Clearly, we were listening to the debate you were having just now with the water companies. I did note just now that, in terms of the pagination, two pages of the White Paper are taken up with water-saving hints like brushing your teeth and this sort of thing. There is one very short paragraph on metering, and even that is what I would call half-hearted to say the best. I contrast that with the evidence from a disinterested party such as the Chartered Institute of Water and Environmental Management (CIWEM) and Lord Krebs, who speak very strongly on metering. I do not know if you want me to say more about metering now or later.

Chair: We will come on to it.

Dr Findlay: Fine.

Q226 Chair: Dr Timlett, were there any omissions in the White Paper?

Dr Timlett: We have talked about metering and demand management, but just briefly, we are completely supportive of the principles for the change in abstraction reform that are set out in the White Paper. The thing that we keep coming back to is the timetable. In the White Paper it is split up: there is the current problem—the legacy of unsustainable abstraction, and then this future world, if you like, of abstraction reform. They have dealt with them separately. It is unclear at the moment how we are going to resolve that legacy issue in terms of improving and injecting some life into the current Restoring Sustainable Abstraction programme.

Chair: That brings us neatly to abstraction.

Q227 Neil Parish: Talking about abstraction, you are saying the time scale for the long-term reforms is too slow, but is there a risk that if we rush them we do not get them right? What else would you like to see? When you talk about metering, I know people do not like to pay a lot for their water. Take South West Water, where people pay an awful lot for their water; they are much keener to have meters and cut down the amount they pay.

Dr Timlett: We understand that you need time to plan a transition to the new licensing regime, and we are not calling for the changes to be brought in overnight,

but what we are worried about is if the delay is not spent wisely. The delay is meant to be for people to work hard, to think about how they plan their systems to either develop new or alternative resources, including getting things in the river basin management plans and the water resource management plans. What we are worried about is that without legislation in the draft Bill there is not enough of a signal in order to make people make the best use of that delay. We are worried that people will just sit on their hands waiting for something because they are not sure if it will ever happen. What we would like to see is framework legislation in this year’s draft Bill that gives powers for the reform of the abstraction regime, but making it clear that it will take time to plan the transition, setting out a timetable in the Bill for secondary legislation or the results of the consultation to be fed into guidelines, for example.

John Lawson: I would like to go back, if I might, to the drought of this year. Can I say one or two things about that, because I think it is highly relevant?

Chair: Very briefly, yes, of course.

John Lawson: The first thing is that it is going to get worse in 2012. We are now in March. The period of recharging aquifers will come to an end in three or four weeks. The rivers are already exceptionally low and the ones that are fed by groundwater are going to get much, much worse in the course of the summer, so we have a serious problem. You asked whether we are happy with the measures that the Government and others are pursuing for drought management, and I think the answer to that is no, because the drought plans that we are seeing pursued by the water companies are focusing on how to supply customers, which is fair enough, but there is no focus at all, as far as we are aware, on how we can reduce the impact on yet more low flows in rivers. There are a number of things in the case of the Kennet, for example, which could be done, practical measures that we have been making some suggestions for but falling on slightly deaf ears, I think. I think that there should be much more of a focus, particularly from the Environment Agency, not just on worrying about the customers, but worrying about the rivers: are there things that could be done during this summer to alleviate impacts on rivers that are going to be highly stressed?

Q228 Neil Parish: You talk about the Environment Agency; they have identified sustainable abstraction areas and restoring it, but have they not identified these sites or are they just not doing anything about it?

John Lawson: A bit of both. For example, the River Kennet, as I am sure you are aware, is dry above Marlborough and it is going to be staying dry the whole summer, basically. If Marlborough was to be supplied from the existing boreholes further down the river, that would relieve the pressure on the upper part of the river. That is probably physically possible to do and we have suggested that to Thames Water, but that is not something that is on anyone’s agenda; it is just not being thought about. There are other measures as well; for example, the lower part of the Kennet is very severely affected by interaction with the Kennet and Avon Canal. Well, I think there should be serious

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consideration right now of not operating the canal at all this summer. That is something which British Waterways are thinking of in terms of, "Well, if it gets really bad we might have to stop things." I think that the Environment Agency and British Waterways should be thinking about that right now, worrying about the environment and not just about customers and boat users.

Q229 Neil Parish: Naturally, you are worried about the habitats within the river and restoring it and retaining that habitat. Do you believe the Kennet is under real pressure at the moment?

John Lawson: Massive pressure. Yes, massive pressure.

Q230 Neil Parish: Can I ask you just one last slightly broader question? One of my pet subjects is that we do not make enough use of recycled water, not only for human consumption but also for growing crops. There is also pressure in many parts of the country, perhaps not necessarily the Kennet. Do you think we should be putting more pressure on water companies to recycle water and then use that for growing crops? What I rather fear is that we will import food from countries that are even more water-strapped than we are and we are taking their water.

John Lawson: I agree completely on the point about recycling. Although it is something which is being paid lip service to—for example, by Thames Water—I do not think that they are really pushing hard, because they would rather have a big new reservoir near Abingdon, which is better for their bottom line. But in the case of the over-abstraction issue, there is a big solution for the Kennet, which again we have put forward, which in effect would have Swindon being supplied further down the system. The more you push the abstraction down the system, the less pressure there is on the upper system. If you can supply Swindon from lower down the Thames near Goring, and the infrastructure is largely in place to do that already, you could then switch off the abstractions in the upper Kennet supplying Swindon completely. That would be a form of water recycling, because the water would all finish up back in the Thames and go on down to London.

Q231 Neil Parish: Right. Is that different water companies or not? Would that mean reacting between two different water companies?

John Lawson: No, it is all within Thames Water's ambit.

Neil Parish: I know the White Paper talks about sharing of water between companies.

Q232 Barry Gardiner: Can I just ask how important you think the White Paper's proposals are to incorporate restoring sustainable abstraction programmes within company water resource management plans?

Dr Timlett: This is something that we think is very important. What we were quite pleased to see in the Water White Paper was recognition that the RSA programme is not effective at the moment and is slow. For example, sometimes it has taken decades for the

Environment Agency just to agree that there is a problem and then change the licence. For example, the River Mimram in Hertfordshire, the National Rivers Authority recognised it as one of the worst cases of over-abstraction back in the early '90s; we have finally got to the stage where everyone is agreed that the licence needs to change, but we are still not in a situation where we know when it is going to be changed. This is a problem that has taken a long time, 20 years or more, and it is not just a couple of rivers: there are 260 abstractions that are affecting sites across the country where RSA has effectively stalled. We would like to see urgency injected into this, and we think that adding RSA schemes into water resource management plans and then funded under the price review is a really sensible way to do that.

Q233 Barry Gardiner: Why do you think under the proposals for the environmental improvement unit charge they are saying that the funding has to be put in first from the companies, and they are not setting a time scale for that to be put in place? If there is a problem with getting that from the companies why is the Government not doing it and then recouping those funds from the companies?

Dr Timlett: The problem with the RSA scheme is that it is pretty much the only water company scheme that is funded on a pay-as-you-go basis, whereas everything else, as you heard from Pamela, is funded on a debt basis. That is why it has taken so long. It just seems crazy that you have Ofwat and the price review to deal with everything in a water company's plans, from pollution and sewage to developing new resources, and yet RSA schemes are dealt with separately. That is what is taking so much time. Unfortunately, we have not yet heard from Ofwat that they are going to allow RSA to be included in the price review. It was suggested in the White Paper but it was not a clear commitment, and we are just a bit worried that the companies are drawing up their plans now, and if Ofwat leave it too late to tell them, it will just cause more delay.

John Lawson: We are delighted to see that replacing supplies that have been lost through licence abstraction reductions can possibly be funded through the price review. That is great, although, as Rose has said, we would love to see that as a commitment for the next round. But there is a secondary issue there, and that is that one of the ways of reducing the impact of abstraction is to reduce the abstraction, but another is the so-called hydromorphological changes that you refer to in your Paper. First of all, hydromorphological changes are absolutely a second best; for example, if the river is dry, making it narrower does not help a great deal. We have a superb photograph we would like to show you of exactly that situation right now.

Chair: Unfortunately we cannot write that into the record, I am afraid, but we can receive it as written evidence.

John Lawson: Okay. In your proposals, the hydromorphological changes, if they are deemed to be the better solution, would not be paid for through the price review; they would be paid for through the EIUC, but why? There is no logical sense in that. We know that the EIUC is not working. It is a disaster. It

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has taken more than a decade for the Kennet solution, which has been agreed, to come to fruition, so why not just handle the whole lot through water company customers' bills?

Q234 Barry Gardiner: Thank you for that. By the way, they are not our proposals—we are the Select Committee; they are the Government's proposals. I wonder if you want to add something on the question that I put to the previous witnesses about the effect on habitat and biodiversity from changes in hydromorphology.

John Lawson: Yes, they do have some effect. If you have water in the river and it is not enough, if you narrow the river then the flow velocity will improve and there will be an environmental improvement associated with it. But that is a very simplistic approach, because it rather assumes that you have a constant flow in the river all the time, which you do not have, of course. Coming back to the point of *reductio ad absurdum*, if the river is dry it does not help you at all. So it is second best and if a solution can be obtained by reducing the abstraction or stopping it altogether, that really should be the top priority.

Q235 Barry Gardiner: Just to challenge you on one thing, obviously you are absolutely right that if you narrow the river, the flow of that river is improved, but you have no more water. If there is any gain in water it is simply through loss of evaporation and draining into the surrounding area, and that then does have an impact on the environment, does it not, and the habitat?

John Lawson: Yes it does. Improving the velocity of flow does have quite a big improvement, to be fair, but as I say it is still no good if the river is dry.

Dr Timlett: I understand the argument. If you have a concrete trapezoid channel, as much flow as you put down that it is not going to be good for wildlife. On a case by case basis, what needs to be done is work out what is the best solution, not necessarily the cheapest solution but the most effective. There are places where that could be valuable, but—

Q236 Barry Gardiner: But effective for what? Effective for abstractions or effective for the environment as a whole?

Dr Timlett: Effective, for example, for meeting the requirements of the water framework directive. We want to see good ecological status. We want to see thriving fish populations, thriving invertebrate populations and plants. There are places where habitat restoration alone will do that, and there are places where it will not—on the Kennet is a good example. There is also the risk that you could, potentially, normalise the over-abstraction problem. By making these rivers smaller, you are saying it is okay, and if you take that to the worst example with all the water scarcity pressures we are facing, you will have rivers pinched out of the landscape completely.

Q237 George Eustice: I want to come back to the point about abstraction. I do not know if you heard the previous witnesses who talked about the time

scale, saying that they have started already in that they have started the conversation at least, and that they envisage starting to switch to the new regime much earlier. They were aiming to complete it by 2025, not start it. Is that your reading of the current plan? What comment have you got on that?

Dr Timlett: It is great to hear that from the water companies, but just going on the RSA example of how long it is taking companies to start thinking about these problems and implement them, it is worth saying that the Kennet and many of these other rivers have not had a solution timetabled yet; we are still waiting. It is great that they are talking about it, but we are just worried that there will be lots of talking and the action will be in the last five years. The real worry about that is that as well as the impacts on the environment, it is going to be expensive, because if you wait and you need to bring alternative supplies online within a five-year period, you are only talking about expensive things like desalination. The ideal solution is for everyone to start working towards it now, realising that it is going to happen and that they need to implement it.

Q238 George Eustice: They claim they are doing that, but given your experience, what is a realistic time scale? If they pulled their finger out, got their act together and said, "We are serious about doing this", what is your view? Having seen the situation of the Kennet, how quickly could it be done realistically?

Dr Timlett: We see what is possible in terms of the five-year planning cycle—just how much water companies are able to bring online in five years. What we would like to see is the next round of river basin plans and water resource plans including these kinds of changes, so it is not just left to some distant round of plans; it starts to be done in the next round.

Q239 George Eustice: If there was a clear commitment to get the management plans reflecting the change with immediate effect, that would be a step forward, would you all agree?

John Lawson: Yes I would, provided the solutions could be funded through the price review. By and large, the solutions to over-abstraction tend to be quite small schemes that can be implemented fairly quickly once you get round to it. All the delay in these schemes arises from the process that you have to go through before you can have an agreed solution rather than just getting on and doing it. Once you have agreed it and have the funding, it just goes ahead.

Q240 George Eustice: The other thing the Government is talking about is obviously using section 27 of the 2003 Water Act to be able to revoke licences in the most extreme situations, which presumably might even include something like the Kennet if it is running dry. How confident are you that that will be a solution to this problem?

Dr Timlett: In principle, I think it is an effective solution. Originally, when it was part of the Water Act in 2003, the idea was to have it come into effect 10 years hence in order to give people time to plan and transition. However, the problem is that they have only just brought the consultation out—a few weeks

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ago—so all of this time no one has been able to plan because no one really knew what “serious damage” was.

We have serious concerns about whether what’s proposed in the consultation is actually going to be effective. Section 27 says, “Protect from serious damage” and the way the consultation was written almost ignores the “protect from” bit; it is “wait until we have had serious damage”, which is defined as “local extinction of species and destruction of valuable habitats”, and then take action, which is completely the wrong way round as we see it. We would like this to be a precautionary approach rather than waiting until the damage has occurred.

John Lawson: I have some concerns about the phrase “without compensation”, because I think if you take something away without compensation you are immediately heading towards a confrontation, and that means delay. If you want to get the problem sorted quickly, it is much better for people just to be able to be paid fairly, probably through customers’ bills, for whatever is needed, and then get on with it. So I do not really understand “without compensation”. It sounds dramatic—“we will teach these people a lesson”—but what purpose does it serve?

Q241 George Eustice: Probably the Treasury insisted on it; there is no money for compensation. They are consulting on the principles at the moment. What should those principles be? You make a very good point, Dr Timlett, that it should be preventing damage rather than just after the event action. What other principles would you include? At what point does it trigger this section 27 action?

Dr Timlett: It is a really subjective thing, and even when you read the consultation you are still not necessarily wiser. I think it needs to be done on a local basis as part of, potentially, a local catchment approach where people could say, “Is this serious?” For example, I am sure that the Kennet guys would argue that it is serious on the Kennet if the river is dry, but I am not sure if that would pass the criteria in the consultation document. So we would like to see more emphasis on a precautionary approach, but also we would like to see recognition of what is possible in terms of the monitoring systems that we have. We do not want to see “We need this amount of evidence, but we are only collecting that amount.” Nothing will ever pass the tests.

John Lawson: I think the two key words that Rose has used there are “subjective” and “precautionary”. I think the precautionary principle does need to be applied, and so does judgment. The danger in all this is that if you try to define in very numeric terms that if the phosphate level is only above this can you deem it to be seriously damaged, you will never reach agreement on what serious damage is. If you just allow expert judgment to be used and a consensus is reached that “this is a problem”, and that judgment is then allowed to be used to drive a solution, it would be a much better approach than trying to rigorously define “serious”.

Q242 Amber Rudd: Could we turn to the issue of metering? Could you let me know how important you

think it is, and whether the White Paper has got the timing right in terms of the proposals?

Dr Timlett: Yes. To be honest, we are completely disappointed with the metering policy in the Water White Paper. Given all of the evidence from the Walker Review, recommendations from this Committee and others, and support from NGOs, from WWF to Age UK, about the fact that metering is the fairest and most sustainable way to pay for water, we would have liked to see more—at the very least, some real, clear, positive statements that metering is needed and that it has benefits.

It is not clear to me how we are going to address the issue of affordability without a widespread metering strategy, because we have this mixed system and, as you said before, we have this system where the RV is not progressive. It is also not clear how we are going to address demand management and wastage without metering, because we know that not only does metering really make sure that water efficiency works, it also helps companies find and fix leaks.

The other point that I think is missed is that by 2015 half of England and Wales will have a water meter, so we are already getting there, and just with business as usual opt-ins we will get there in the next 15 years. The evidence suggests that we could get there much more cheaply and in a more strategic, rolled-out approach with greater public communication if we did it in a joined-up way.

Q243 Amber Rudd: I did not understand that last bit. What do you mean by a joined-up way? The message that we have been getting from the Environment Agency and the water companies is that everybody is committed to metering; everybody understands the benefit for efficiency and for clarity and for transparency, but it can only go so fast because it is a big job.

Dr Timlett: It is a big job, but one of the problems, we think, at the moment, which the Water White Paper did not really address, is the cost benefit argument for metering. At the moment, you have a real capex bias, which has not been addressed, and the fact that we just place so little value on the water we abstract. Abstractors are only paying an admin fee to take water out; they are not paying the cost to the environment. All the time that you are not factoring in that cost, it is always going to be cheaper to take more water or leak more water than it is to put in demand management measures.

Q244 Amber Rudd: What other steps should the Government, the regulators and the water companies be taking to improve efficiency and reduce demand, apart from the metering?

Dr Timlett: This whole issue about the value of water is key, because it is going to change the whole ballgame on all sorts of demand management if we get that right. The abstraction incentive mechanism that was in the Water White Paper, which is about valuing water in operations, so a company able to abstract water from a place where water is more available rather than a place where water is scarce, is a start. But that kind of shadow price, or mechanism,

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also needs to be part of the planning and investment process as well as the day-to-day operations.

John Lawson: I would also like to put in a plug for smart meters and rising block tariffs. I know there was some evidence earlier suggesting that it does not always work, but there are other places in other parts of the world where they say completely the opposite. I think the Government should be seriously pursuing that idea and getting to the bottom of what the best way is. That can be linked to the concept of water having a higher value during times of drought as well.

Q245 Barry Gardiner: Yes. I am just nodding in agreement with that last sentiment. That is why I asked for the modelling that had been done, because I suspect that the modelling that has been done was pretty particular in the way that they had managed it. I want to turn to catchment management and the White Paper's proposals to increase competition in the sector. Do you think that they are going to have any negative implications for catchment management and for the environment?

Dr Timlett: In terms of the market reforms and competition, we see them as a means to an end and not the end in itself. The end should be sustainable, affordable water. Anything that encourages resilience, or companies to take water from where it is available and less water from where it is scarce, is a good thing, but as well as the nuts and bolts of that, you also need the management systems to allow companies to do that.

Barry Gardiner: My question was about competition in particular.

Dr Timlett: The point on competition would be that we need to make sure that we have safeguards in place if you are looking at wholesale competition, so that you do not end up exporting more water from over-abstracted or over-licensed catchments into other places.

John Lawson: I think Rose has just touched on the point that I wanted to make: there are many licences at the moment that are not fully used. For example—this is a good example—in the little River Og, which is a tributary of the Kennet, there is a licence for 8 megalitres per day, but they are only currently taking about 3 megalitres per day. That 5 megalitres per day could be traded, and Thames Water would be perfectly entitled to trade it, presumably, under the proposals that you have in mind, but that would be quite disastrous for the river. So I think there is a potential for licences that could be damaging at the moment, but actually are not, suddenly becoming damaging because someone sells them on to someone else who will use them, so that really needs to be watched.

Q246 Barry Gardiner: Excellent point, thank you. What are the benefits of catchment management? I want to give you the opportunity to set that out to the Committee. How far do you think that they rely on voluntary organisations such as ARK?

John Lawson: We absolutely welcome the catchment management approach. I think it is terrific. The river basin management plans that were produced in 2009 were verging on a disaster, because there was nothing concrete coming out of them, and getting it down to

a catchment-based approach is marvellous. I am sure that is the way ahead. Getting voluntary organisations or organisations that have an interest in individual rivers is the key to making it happen. I am thrilled that ARK is involved in that process, but we do have some reservations about how well it might work. We are very happy to see that you have a proposal that in 2013 there should be a review of these pilot catchments. What I would really urge is that that review should be independent—when I say independent, I mean independent of the Environment Agency—and that the criteria against which the success of these catchment management plans are judged are all to do with action and timetables and commitment. One of the big weaknesses of the river basin management plans is that they are very light on timetable and commitment.

Q247 Barry Gardiner: The catchment walking proposal to identify misconnections and so on is a hugely labour-intensive operation, is it not?

John Lawson: Just the kind of thing that volunteers could do.

Q248 Barry Gardiner: Indeed, and you would see that very much as a role for ARK?

John Lawson: Yes.

Q249 Barry Gardiner: I have a similar catchment area that I have been looking at for years in my own constituency, so I am very familiar with all the missing connections there and so on, but do you have a concern that if your volunteers were to be used in that way, to go to householders and say “We have been doing our catchment walking and we have identified that your foul sewer has been misconnected here rather than your surface sewer and you should get that fixed and put right”, some volunteers might get into a spot of bother? What are the risks here for volunteers doing that catchment walking?

John Lawson: I would see the catchment walking as being a broader thing than just simply looking for misconnections, and I would share your concerns about whether lay people can identify some of these things that are, at the very least, proper plumbing and probably water company issues. But there are many other problems in the river basin that, by doing catchment walkovers, you can identify and set the wheels turning for doing something about them. If one is using volunteers, there would need to be careful management around it with appropriate levels of professional input as well, so that you are not entirely volunteers, which is what we do, to be honest.

Dr Timlett: To follow on from that, I think it is incredibly important that we do not take advantage too much of the millions of people and the time, effort and energy that they are going to put into this. They must have the right support and backup from the Environment Agency and Defra. Catchment walking, in particular, is a good example of where you need really clear roles and responsibilities. For example, if you walked over a catchment and you found a pollution discharge from a business park, it would be the Environment Agency's job to follow that up, not

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necessarily a volunteer, because that is a regulatory role. That is really important.

Chair: I thank you very warmly indeed for being so generous with your time. If we can take the photographs we will write them into the record. You have been an enormous help and we are very grateful to you. Thank you very much indeed.

Dr Findlay: Thank you, and we would love to invite you to come and see the river some time, if you can, any of you.

Chair: Thank you very much. That is very kind.

Tuesday 27 March 2012

Members present:

Miss Anne McIntosh (Chair)

George Eustice
Barry Gardiner
Neil Parish

Ms Margaret Ritchie
Amber Rudd

Examination of Witnesses

Witnesses: **Richard Benyon**, Parliamentary Under-Secretary for the Natural Environment and Fisheries, and **John Bourne** and **Gabrielle Edwards**, Deputy Directors, Water Availability and Quality Programme, Department for Environment, Food and Rural Affairs, gave evidence.

Q250 Chair: Good afternoon and welcome, Minister. Thank you very much indeed for being with us and giving evidence on the Water White Paper. Please introduce your team for the record.

Richard Benyon: On my right I am flanked by Gabrielle Edwards and on my left by John Bourne, both of whom are Deputy Directors in the Water Availability and Quality Programme in Defra.

Q251 Chair: Minister, I would have expected the White Paper to contain more about water efficiency, given the present backdrop of the drought, which must have been in people's minds.

Richard Benyon: The drought is a very serious problem, and we are tackling it in a whole range of ways. We can use it to put out some very serious messages on water efficiency. We think that there is a lot of potential to develop innovation and resilience in various elements of industry. The theme that underpins the White Paper is resilience. I think there is enough in it to address the fact that water is a declining resource, that we are facing extremes of climate change and that we need to be resilient to weather patterns such as the present one. I think there is a lot in the Water White Paper that addresses that.

Q252 Chair: We will come to metering in a moment. One looks at the Anna Walker report and the Pitt report to a certain extent. Anna Walker made quite a large number of recommendations on water efficiency that might have worked their way into the White Paper. Was the decision taken not to do that, and might we expect them in the draft Bill?

Richard Benyon: Specifically on metering?

Q253 Chair: Not metering, but water efficiency measures such as those set out by Anna Walker.

Richard Benyon: Which ones in particular?

Q254 Chair: Water butts, and educating householders and businesses to take more water efficiency measures.

Richard Benyon: Tomorrow I am launching a scheme that we are very keen on, which is connecting people with water. That theme is also evident in the Natural Environment White Paper. When we flick a light switch, we do not relate that—I am guilty of it myself—right through to the effect it has on the environment. With water, when people see their rivers running dry and the impacts of over-abstraction, there

can be that connection right through to the water coming out of their taps. Water is a fantastic medium for teaching, and there is a whole range of ways in which we can connect people more closely to the need to conserve water. The Water White Paper deals with the sorts of things on which the Committee and, I hope, Defra are great experts.

Chair: It is a very nice answer but it does not address the question.

Richard Benyon: But it also deals with things at the other end of the pipe, which are the incentives for households to use less water. We think this is equally important. There are many different buttons we can press that address that, and the plan that I am launching tomorrow will be fundamental to this.

Q255 Chair: Was there a particular reason it was not in the White Paper, given the fact that it is meant to wrap up a lot of the issues in the Anna Walker report?

Richard Benyon: Water conservation was in the White Paper. It said that everyone had a role to play in encouraging efficient water use. We are working through organisations such as WRAP to promote water efficiency. We are leading by example. Defra is using 21% less water. These are important things. Of course, the hot water scheme is part of the Green Deal and is fundamental to that. The central theme of the Water White Paper was one of resilience to the kind of weather we are facing right now, so it is at the heart of what the Paper is seeking to do.

Q256 Chair: What is the proposed legislative timetable for the draft Water Bill?

Richard Benyon: The Water Bill is being drafted as we speak. As was said to you by the Prime Minister in reply to your question, it will be available to your Committee for full pre-legislative scrutiny. What is or is not in the Queen's Speech is above my pay grade, but I very much hope you feel it is a Bill that sets out clearly what we are trying to achieve in terms of retail competition, complementary changes to Ofwat's regulatory regime and all the other environmental permitting regulations and suchlike. I think it will deal with a lot of the stuff that was not in the Flood and Water Management Act. Then there are the abstraction reforms, which we will come on to.

Q257 Chair: We are coming to that. Given the fact that you are not in charge of the legislative programme, what is the legislative timetable? What

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do you see as the end date for when it might be implemented?

Richard Benyon: Gabrielle has been working closely with the parliamentary draftsman.

Gabrielle Edwards: We will publish the draft Water Bill in the coming months. Clearly, we will need to talk to the Committee about the timetable for pre-legislative scrutiny after that, but I am assuming that will take a number of months. We would then need to take account of your report, so that will take us into next year.

Q258 Neil Parish: On abstraction, Anglian Water are very keen to say that the end date for reforms of licensing is 2027. Environmental groups are concerned about this lengthy timescale for abstraction reform. What progress to date has been made to ensure that the momentum to reform is there? Is that timescale realistic in drought situations?

Richard Benyon: That is the date by which we want to have concluded the reforms of the abstraction regime. That is not to say that is the date when a button will be pressed and everything will be changed. There is a long process of addressing some 30,000 abstractions on which many businesses have grown to depend. They have borrowed money to invest in those businesses on the basis of having that amount of water. These are very complex matters to resolve. We will need legislative changes, which we think will be introduced in the early part of the next Parliament, but there is a lot of work that we are doing now, and that can be done in parallel, to address that. We are taking short-term measures right now, for which we do not need legislation, to resolve some of the issues about over-abstraction. We will be working closely with the abstractors to make sure we manage the change to a system which goes back to the 1960s and is simply not fit for purpose today.

Q259 Neil Parish: Naturally, environmental groups are quite right to be worried about the rivers but, if you move into a situation where water is in short supply and you need that water for human consumption, how will you deal with those competing forces?

Richard Benyon: There are a number of tools one can use. You are absolutely right. We have to make sure that we can address the problems of over-abstraction and damage to the environment, with important rivers that are the lifeblood of communities just disappearing, but the taps still have to flow. That is why we need to work through it in a balanced way. The Government have a very powerful tool to operate this year. I refer to the provisions of the Water Act 2003 that allow us to remove without compensation an abstraction licence that is causing serious damage to the environment. These are measures one could use in that sense from July. There are other short-term measures we can be using, but the longer-term reform requires close working with the Environment Agency and abstractors. Over that period we may well find abstractions that are either being underused or could be used better, or are being used in a very damaging way that need to be addressed more urgently.

Q260 Neil Parish: Many of these licences naturally do have value, as you say. Will you commit to incorporating restoring sustainable abstraction programmes within the resource management plans in time for them to be funded by the 2014 price review? Basically, we will have to try to buy out some of these licences and it could be quite expensive.

Richard Benyon: It could be very expensive, and that is another reason we need to get this right. It is important to have a robust evidence base; that is something we are absolutely determined to have in developing any new regime. Over the next 18 months we will be working on this to enable us to develop policy options. I will not be specific about any particular abstractors we can think of in our constituencies who, rightly, will be worried about the possibility of losing something they value very highly for their business, but it has been clearly set out in the White Paper that we can find solutions and we will take this forward in a timely manner.

Gabrielle Edwards: On the question about whether or not the RSA schemes for the water companies should move into the 2014 price review, the White Paper said that is where all the parties wanted it to end up. We have made good progress with Ofwat and the Environment Agency and have talked to the water companies about how practically that could be delivered. While we have not sorted out all the details, I am very hopeful that will be in Ofwat's draft methodology for the price review later this year.

Q261 Neil Parish: In the long term are you looking at ways in which more recycled water could be used for crop production, which is a pet subject of mine?

Richard Benyon: Some of the upstream reforms we have announced in the White Paper allow new entrants to come in and offer recycling solutions. I have been impressed by some of the water recycling I have seen in the growing industry, and I think there is much that can be done to share water between neighbouring abstractors, in particular in the case of the farming community. A startling statistic that is always in my mind is that agriculture in the basic form of water abstraction is only a little over 1% of the total compared with energy and household use. Nevertheless, it has a big impact in certain areas, and food security is at the centre of our thinking in Defra. We need to get this balance right.

People have easy and quick solutions to these matters; they ask why we do not do this or that. They come up with binding binary solutions; you stop doing it this way and do it that way. That has an impact. We want to make sure we can continue producing good quality food in this country, that water continues to flow out of taps but that we can repair the environment. That is a very difficult thing to get right, but we think we have the means.

John Bourne: As to recycling water, the upstream reforms will help people come up with solutions. It seems to me more likely you will find that reuse of water will be used in factories and so on because they are close to sewers. The cost to agriculture of piping reused water from treatment for a long distance will be prohibitive. That does not mean it does not benefit agriculture, because the less water is being used by

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factories, etc, the less water is taken out of the environment and the more there will be in the environment near to farming to use. Reuse can be useful to farming, but it is less likely to be direct and more likely to be indirect. Horticulture might be slightly different.

Q262 George Eustice: I want to return to the point about the concern of environmental groups about lengthy timescales. We all know that in politics time is a powerful enemy. They made the very striking point that, when the 2003 Act was introduced, the changes to the then abstraction regime would take place in 10 years' time, for precisely the reason that it would give companies time to reorganise themselves, prepare investors for change and all of those things. Now they have not prepared at all; they have squandered those 10 years and done nothing. When you press them on it, the message is, "Don't rush it; we need more time." Is there a case for having key objectives along the 10-year route that you want to see delivered and achieved in order to get to the end point? Otherwise, there is a danger that all of it will just get lost.

Richard Benyon: I am sure this Committee will be a very good body to hold Government to its timeline on this. Let me set out what we propose to do. We are consulting in 2013 and will introduce legislation to reform the regime early in the next Parliament. By the mid to late 2020s, the new regime will be implemented, so it will not be like the Water Act 2003, which had provisions that kicked in 10 years afterwards. That is the timeline by which we want to see the new abstraction regime implemented and up and running. Would we like a system where we could wave a wand and change it tomorrow? Yes, but you cannot do that without damaging the interests of some key groups that we want to carry with us. I think that most green groups with whom I have been working would agree with that, frustrated though they may be with the time it takes to bring about these changes.

Q263 Chair: To return to abstraction before we move on, is there an assurance that livestock farmers will have access to water should the drought persist and worsen?

Richard Benyon: The new abstraction scheme will have to be equitable and fair. We are working closely with farming groups to make sure that there is adequate water. Can I make the statement now that in 2027 every livestock farmer will have the same amount of water? Livestock areas are predominantly, but not exclusively, those where there is plenty of water.

Q264 Chair: Is it the same amount as now, or the same amount as each other?

Gabrielle Edwards: We have put into the White Paper some principles for transition from one scheme to the other. We have said we would expect licences under the new system to be based in some way on licences under the old system, so we are not talking about taking licences away and going through a complete reallocation process. The licence may be different; it

may have different sorts of controls over it, but the historic licenced volume will be reflected in some way in the new regime.

Q265 George Eustice: I was also interested in the idea of transfers of water between regions. You might recall that earlier this year there was some speculation started by United Utilities about a north-south national grid for water that could be put alongside high-speed rail. I note that the Paper emphasises local connectivity and moving water resources around locally, but do you think there is scope for more national schemes along the lines they proposed?

Richard Benyon: United Utilities are a good case in point. They have just opened a very large connector with north Wales. It seems extraordinary that the year before last the north-west was in drought, but it is not this year. There can and should be greater connectivity. I am frequently written to, as no doubt you are, by constituents who say that a blindingly obvious solution to the problem is to run a vast pipe from Cumbria to East Anglia. It is not that simple. Looking at the case very carefully and the economics of moving water great distances—it is very heavy and energy and carbon intensive—the secret to it is greater connectivity between water company areas. Nature does this pretty well for us. The water we drink in London comes in part from the Cotswolds. We must not forget the value of nature in providing that ecosystem service. That is another impetus to find solutions to times of low rainfall like this. But the bulk trading incentives we want to see in the next price review and the incentives to greater connectivity will make it likely that we will see more movement of water from areas where there is plenty to areas where there is not. I am told that at the moment it is physically possible to move water from Kielder to East Anglia in a convoluted system of different drainage ditches and pipes. There is already that degree of connectivity.

The really good news is that a lot of water companies, building on experiences in the past—Yorkshire Water is one in particular—have developed a good way of balancing the system within their areas. We have to encourage them to connect with one another. I am impressed by what Water UK are telling me about how advanced their thinking is, and we want to work closely to make sure more of that happens.

Q266 Chair: Are you aware of the cost to Yorkshire of setting up their grid? It was millions of pounds.

Richard Benyon: Yes, it was; I remember that it was a huge amount of money. I also remember the problem. At the time I think it was the largest peacetime convoy ever seen. Water tankers took water to fill an empty reservoir. That resolution is part of the £90 billion invested by water companies in infrastructure, and it is a huge success story. Is there more that can and should be done to minimise the risks of low rainfall periods or just increase resilience in our system? Yes. The investment incentive is one of the real drivers of the vision in the White Paper.

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Q267 Barry Gardiner: What is the most significant measure we can take with householders to promote water efficiency?

Richard Benyon: Do you mean behavioural change?

Q268 Barry Gardiner: Let me come clean. I am quoting Wessex Water, who said that the most significant measure to take would be metering. What is singularly lacking in the White Paper is any real aspiration on metering. It has been heavily criticised by environmental organisations and even by some of the companies themselves. The ones who have not criticised it are those who are achieving 80% metering in the next three years anyway and are therefore quite happy to see their competitors not do as well. Walker said it should be 80% by 2020. You have not done that. Why?

Richard Benyon: We do not think that metering is the total solution some people seem to suggest. It is an important part of making people more aware of the water they use, and there are undoubtedly some benefits when households move. But there are also some very significant costs for certain households, many of which are at the lower income end. We want to see a continued drive towards greater levels of metering and a clear understanding of the impacts of universal metering projects, such as the one Southern are introducing. We note that the highest level of metering thus far has been in South West Water; it is 83%. We all know the reason for that.

Q269 Barry Gardiner: I think it is 72% for South West Water.

Richard Benyon: Or it may be moving to 83% over the price review period. With apologies to Members from the south-west, the fact is that on average water costs £1 a day. That is, if you like, the greatest disincentive for people to change their behaviour. I want it firmly on the record that I am not suggesting we should increase the cost of water, because there are quite enough people who are defined as being in water poverty at the moment. We also touch on that in the White Paper, but the key point about metering is that it can have a dramatic effect initially. It drops back to about half that benefit fairly quickly. There are many other tools in the box, and one should not look just at metering as the solution, as some people suggest.

Q270 Barry Gardiner: I accept it is not a magic bullet but, given that it can have the effects with which you have just agreed, surely we can all say that we do not rely on it too much. It is not the only tool in the box, but it should be one of the key tools we use, and that is why the lack of aspiration in the White Paper on this is so striking and why people had expected you to go with Walker and say you wanted to set targets, even for 2020. It is the lack of direction here that is so surprising. It is not that you have to justify that there is not another set of tools; there are other ways of doing this, but this is a tool that you seem singularly reluctant to use, and people just want to know why.

Richard Benyon: Water companies can move towards universal metering, and in water stressed areas it is

very much open to them to do that. I have seen the roll-out of the scheme in Southern Water; I have seen the high level of management it requires and the impact it can have both to the benefit but also in some cases to the cost of households.

Q271 Barry Gardiner: You have mentioned twice that for some households it will mean additional cost, and we all understand that.

Richard Benyon: That can be mitigated.

Q272 Barry Gardiner: Does that mean that the decision not to pursue metering with alacrity is a political one? Is it a fear of the political backlash that will come from perhaps larger families and larger users of water, and that makes it just too difficult to go down that road?

Richard Benyon: Not entirely. There are certain parts of this country where water companies have told me they would like metering as a way of better managing their water. They would be able to tell when there are leaks and look at peculiar levels of demand by certain communities at different times and manage and balance their water better. In other parts that are more stressed it is a direct tool available to them to be able to reduce water consumption. In discussion with Ofwat through the price review process, they will develop increased metering, or universal metering in some cases, with our support and clear determination that water companies should do more actively to promote metering for those who would benefit.

We decided not to promote a universal metering scheme. You say I have said it twice, so I will not repeat it, but the impact it has on certain households, initially anyway, can be damaging. I think the impact of metering on those on lowest incomes can be minimised by good working with organisations like Citizens Advice Bureaux and others and having what are called water doctors going into the homes of people on benefits and saying, "With these fittings, which the water company will provide free, and advice about how to do various household activities, not only can you use less water and pay lower bills but you will also be able to monitor it." I suspect that in 15 or 20 years' time we will be wondering slightly why we are having this conversation, because we will be networked into our energy and utility usage in a much more electronic way. We will be able to tell remotely from our home exactly how much water and electricity we are using and manage our lives accordingly. I think knowledge is power. I would like to see more metering, but it needs to be done sensitively in areas where it is effective.

Q273 Amber Rudd: I understand that the sustainable economic level of leakage is the level at which it is no longer economic to correct those that exist, and Defra is now conducting a review of that. Are you concerned that leaving some leakages, however economic it may be to do that, will impact on the public's willingness to engage in water efficiency measures?

Richard Benyon: The Environment Agency are carrying out this bit of work just to see whether the modelling of what is currently a sustainable economic

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level of leakage is right. The good news is that we have a nearly 40% improvement in the level of leakage, but if we have more problems such as we are facing at the moment, the economics can change. You can start to say there is a much more economically efficient basis for requiring more work to be done on the levels of leakage. It would be possible for Ofwat to say they want water companies to concentrate on this to the exclusion of all other priorities, but there are 335,000 kilometres of pipes and about 23 million properties. As we know from our constituencies, some of them are Edwardian or even older. I think we owe it to the payers of water bills to get this calculation absolutely right, and that is why we are asking the Environment Agency to review how we get to it.

Q274 Amber Rudd: What about the fact that if we leave leaks the public might say that clearly there is no need to save water after all? How do we get the message across?

Richard Benyon: It is a difficulty and it clouds the message at a time like this. For instance, we see posters all round London and the south of England about the drought. It is an easy hit for newspapers to say, "Well, it is all down to the water companies," and they will produce a figure to show how many Olympic swimming pools could be filled with the water lost every day. We have to say that we are on top of the problem in that water companies have improved their leakage rates by 40%. We recognise that occasionally there will be certain spikes, as there were last year due to the cold winter, but we want to make sure that pressure is being put on water companies so they do everything they can to reduce this figure because, as you rightly say, it makes it more difficult to get over our messages about water resilience.

John Bourne: In terms of this particular period of drought, which is when people start to take the approach you are talking about, asking why they should save water when they see it running down the road, water companies as part of their drought plans spend more time, effort and money on mending leaks and reducing leakage. They are also very much aware that, while the most important leaks are usually those that cannot be seen—they are underground—it is really important that the public see a quick response to visible leaks, even if they are not the ones that make the big difference.

Amber Rudd: That is very interesting.

Q275 Chair: I know you will be disappointed if I do not question you on sustainable drainage systems. Where are we with SuDS at the moment?

Richard Benyon: We will be announcing the end of the automatic right to connect, which was a recommendation of the Pitt review. Once commenced, the provisions in the Flood and Water Management Act relating to SuDS will amend this right. It has taken a long time, but we want to make sure we get the policy right. We think it is important that it is done in conjunction with the new national planning policy framework announced an hour or so ago in Parliament.

We completed consultation on 13 March. We are analysing the results, and we will be taking those

forward in consultation. We want to make sure that the SuDS approvals body has the capacity. Many of the local authorities that will be taking on this role have told us that they are up for it and ready for it; some not so. There are questions about who will take responsibility for existing sustainable drainage systems. It is easier to plan for newer ones, but as far as concerns an exact date, I look to John to see whether we can be more specific.

John Bourne: My team has just done nine workshops with about 1,000 people attending from local authorities and elsewhere, so there is quite a lot to collect on the basis of that consultation. One consistent theme that came out of that—plainly, there is more than one view on this—is that it is really important we get enough time and certainty on dates to upskill and make sure we have the capacity we need; and that is on behalf of both the developers designing the SuDS and putting the proposal forward and the approval bodies who need to take that from the developers and have the right commercial skills to understand what has been said. It is more likely that we are looking at April 2013 than October 2012, but no decision has been made on that yet.

Q276 Chair: I am delighted that we are ending the automatic right to connect. It has taken us five or six years to achieve it. To go further, might you consider that water companies should be responsible for maintaining SuDS and have the statutory right to be consulted on the same basis that the Environment Agency is on new connections?

Richard Benyon: To deal with the last point first, some water companies are very keen to be statutory consultees; others see a huge burden in this. The problem is that these matters are dealt with at the wrong end of the process. We want a planning-led system, so connections, sustainable drainage systems and the whole profile of dealing with such matters in a development are dealt with at a much earlier stage. That is what the NPPF seeks to do across a whole range of things, and that is why we want to hardwire policies around such things as sustainable drainage systems to that end. What was your first point?

Q277 Chair: It fits in entirely with what you are saying. The question is whether water companies could be statutory consultees and whether eventually not all of them but those who wished to and were in a position to could be responsible for maintaining SuDS.

Richard Benyon: I will ask John to provide more detail. One thing we are very conscious of is that SAB, the sustainable drainage approval body, is the planning authority and therefore is in the best position to act in a regulatory capacity to make sure that the thing is built right and it is maintained correctly way into the future. There may be some exceptions. The local authority may also own the bit of land on which the SuD is located; it may be in a park or bit of green open space. There may be some where the water company can treat it in a rather similar way to the way it treats its assets in other ways. I do not know whether John wants to go into details about how we will manage that.

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John Bourne: There are two parts to that question, one of which is that there is a facility in the Flood and Water Management Act, as I am sure you are aware, that an order can be made so that the SAB is no longer the default tier 1 local authority and can be any other body. We have no intention of making use of that order at the moment, but plainly if at any point there was a really good case to be made, we would look at it. But we think that generically it makes more sense for the tier 1 body to be the approving body, and that is why it is in the Act.

The other way it could happen is that there is nothing to stop an approving body from delegating some or all of its activities in a contractual way to a water company where that water company is willing and they can come to such an agreement. The local authority under that would retain the overall legal responsibility, but plainly it could subcontract activities—you can think of a number, including maintenance—that it wishes to, so there are various ways it could be done if there is a need.

Q278 Chair: I do not want to belabour the point. I just leave you with the thought that going forward some water companies may be in a better position to maintain existing SuDS than local authorities, and the Minister's point that water companies are best placed to see whether there is the capacity in the waste water system to connect. I will leave you with that thought. On retrofitting where appropriate, has there been any further development?

Richard Benyon: We are working closely with industry, for example the paving industry on technology changes and the development of sustainable hard surfaces. There is adequate provision in local authority planning policies to ensure that people do not concrete over their front drives in a way that will lead to greater run-off. That is not to say the problem will go away; we need constant engagement with the industry, but retrofitting larger sustainable drainage schemes is more complicated, though not impossible. We had this debate around the whole issue of the Thames Tideway. We know that the cost of retrofitting and separating out rain water and grey water is complicated and very expensive, but that is not to say we should not be looking at it, encouraging and incentivising it. Therefore, retrofitting is a key part of our policy moving forward.

John Bourne: But the two are linked, in that if we are looking particularly at larger-scale retrofitting again it raises the question of who will maintain those SuDS going forward. If you have a large community or block of flats with a lot of shared ownership, you do not want to repeat the experiences we have had with private sewers and so on where there has been very poor maintenance because no one can decide who is responsible. Therefore, when we solve the maintenance issue through new build, we have that process in place and there is a clear mechanism whereby people pay for and have their SuDS maintained, it will make it much easier to encourage retrofitting because there will be a process by which you can bolt it on.

Q279 Chair: In the 2007 floods 55,000 properties were damaged because water did not connect and pipes overflowed, so the water companies have a definite role to play in connections.

Richard Benyon: That is absolutely true. When my constituency had a lot of flooding in 2007 a lot of people blamed the local authority and those responsible for drainage for not having cleaned out the drains. With the quantity of water that was coming down, it would not have made any difference if they had been cleaned out 20 minutes before, but you are absolutely right that we have to think of our surface water management plans, and understanding of the impacts of different weather patterns on communities and streetscapes is now hugely improved. Technology that can put in a multitude of different weather patterns and the impact that can have down to household level is now available, so that can start informing the retrofitting of sustainable drainage systems, or where there is a bottleneck that causes back flooding of culverts and how you can improve that. These are dramatically improving, and I think we will see a lot more houses protected by such means in the future.

Q280 George Eustice: It will not surprise you that I want to turn to water affordability. Can you explain why the White Paper backs away from the idea of a national social tariff? It was mooted in the original Walker review and has been discussed, but in the end you concluded not to go down that route. Is there a reason for that?

Richard Benyon: Dealing with affordability, we thought that water companies were best placed to know at local level how they can best tackle those issues, and having a national scheme would be a blunt tool in many areas. We want to incentivise water companies to use a variety of different methods. People look at a social tariff as if it is the only show in town; it is one of many at the disposal of water companies, with legislative back-up in certain circumstances by Government. I do not think a national scheme like that would have been the right approach, and it certainly would not have addressed some of the anomalies we have seen through this process.

Q281 George Eustice: There is a corresponding problem with company social tariffs. Those areas with lots of poverty and problems of affordability and relatively high bills are quite limited in what they can deliver in terms of a company social tariff. Demand for it is very high but the ability to win broad support from the rest of the customers is more difficult.

Richard Benyon: We have one water company that serves about 2,000 properties, and at the other end of the spectrum there are companies that serve millions. It is harder in some areas to get that level of cross subsidisation that you want to achieve, but the proof will be in terms of how we can address the needs of those in water poverty. We will shortly be announcing the company social tariff guidance. Where are we on that?

Gabrielle Edwards: We have consulted on draft guidance.

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Richard Benyon: It will be clear to companies what measures they can take, in addition to the range of other options they can provide to address the specifics of affordability issues. We think that is the right approach.

Q282 George Eustice: Was the national social tariff not deliverable in your view? Was it too complicated to administer, or did you think it would not be fair?

Gabrielle Edwards: It was a combination of facts. As the Minister said, is it the right tool? It could be a very blunt instrument. From water company area to water company area there is a big variation of circumstances and income mix, and how much cross-subsidy there is within the system and how it is unwinding. There is a huge amount of cross-subsidy in the water charging system at the moment. The extent to which it is becoming more regressive over time as the cross-subsidy unwinds depends a bit on the pace of metering. You have very different situations in different areas.

The other issue we had to bear in mind was the question that a nationally mandated social tariff would be counted by the Treasury as a tax, and Defra's spending settlement would be debited accordingly. We are talking of quite substantial sums of money.

Richard Benyon: It is the ONS that make this burdensome calculation which the Treasury then impart across Government.

Q283 George Eustice: Therefore, they would take it off your budget.

Richard Benyon: Under the tax and spend definition, yes.

Q284 George Eustice: I understand. On the related pointed of bad debt, which is a real problem for some companies because it is difficult for them to cut off water supply and things like that, is there a reason you have not implemented the Flood and Water Management Act provisions which would basically make landlords liable for the bill so it would be easier for water companies to get landlords to pass on the details of tenants?

Richard Benyon: We are consulting on this at the moment. There are two schools of thought. Some large registered social landlords are perfectly capable of putting into their systems methods of imparting this knowledge to water companies. For smaller landlords and people who have gone abroad and let their houses to somebody through an agency it is more complicated and burdensome, and we are a Government that seeks not to burden legitimate businesses. It is a question of getting this right, so we are consulting at the moment. One of the options is to implement that provision in full and create a regulatory framework whereby all landlords will have to inform the water company of a change of tenancy. I think of my children at university who share accommodation with other students. Some go, some appear and some go off on a sandwich course elsewhere for a year. The burdensome nature of a system that one could impose on certain landlords makes me wonder whether a dirigiste route is the right way to go, but I am very conscious of the £15 being

imposed on bill payers up and down this country to pay for bad debt. If we could claw back half of that it would be a major achievement; it would be money in the pocket of people who do pay their bills, some on very low incomes. I think we can do much better than half if we get this right. Perhaps we can be reminded of where we are on the consultation.

Gabrielle Edwards: The consultation went out in January, so we are fairly close to completing it.

Q285 Amber Rudd: Regarding social tariffs and the need for water companies to have information from Government about which customers might be in need and are not, there is some discussion going on about when that will be triggered and become relevant. In what circumstances do you believe it would be legal and feasible to provide water companies with Government-held data on which customers are in need?

Richard Benyon: Data protection laws mean that simply passing on the details of those who are on benefits to water companies without appropriate consent is illegal, and for good reason. Ofwat's evidence shows us that 60% of households at risk of water affordability problems do not receive means-tested benefits, so we are talking about considerably over half. We know that many customers on benefits are at high risk of not being able to afford their bills. We will continue to work with the water industry in the development of social tariffs, including by making available or verifying information, where it is legal or feasible. However, across Government we take the security of sensitive data like benefits data extremely seriously, and the circumstances in which any individual's personal data can be shared are totally controlled by law. Therefore, if we were to go down that route it would require a legislative change and not one by my Department.

Q286 Neil Parish: I refer to Scottish Water and the Anglo-Scottish retail market. As you know, Minister, I am quite interested in how competition is going to work, especially on the Anglo-Scottish border. Basically, you have two different beasts: you have Scotland with one wholesale water market that is a state-owned company, and you have retail companies competing with each other. How do you envisage the Anglo-Scottish market working, because on the English side you have private companies which up until now have not really had to face much competition?

Richard Benyon: We were keen to work with Scotland to develop a proper Anglo-Scottish model. There are benefits to be had for customers and market players on both sides of the border. We need to start working now with the Scottish Government and regulators to make clear to customers what the market might look like and how we are going to work together to create it. There are different regimes, but I do not think any of this will be a disincentive to making these changes. We work closely with WICS and Ofwat. I believe that some of the reforms that have been introduced north of the border are precisely what we are seeking to achieve here for non-domestic users. It is not just businesses who are benefiting; it is

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also the public sector. An LEA can buy its water for all its schools in a much more competitive way and we want to see that, but there are some anomalies between the two regimes either side of the border that need to be ironed out before this is truly up and running and effective.

Q287 Neil Parish: Therefore, will a consumer in Carlisle be able to get the benefits of greater competition—these are small retail businesses, and what have you—than, say, the same business in Devon in the future?

Richard Benyon: The idea is that all businesses will be able to look at alternative means for the retailing of their water, and that is not just buying it, but also whether it will come with a package of assistance for how they can improve the service they get, using less water and water efficiency measures. Gabrielle and others have spent a lot of time with Business Stream in Edinburgh making sure that we understand how things work up there, and how change could impact on businesses in England. There is nothing to stop businesses in Devon buying water services through a company that may be based quite a long way away.

Q288 Neil Parish: What I am trying to tease out of you is whether or not you are keen on getting competition between companies in the water industry.

Richard Benyon: Absolutely; retail competition is a key element of our market reforms.

Gabrielle Edwards: We want to get to a situation where, as you say, a company in Cumbria or Devon can decide from whom it would like to take its water services. There is a lot of work to be done in trying to work out how we deal with that in a cross-border market, but that is certainly the endpoint we are looking for.

Q289 Neil Parish: On the Anglo-Scottish market, one worry the companies have is that they do not want to have complications with the licensing authority. They foresee that on the English side of the border it will be Defra who issue the licences and it will be the Scots doing it on the other side, and each will mutually recognise the other's licences rather than try to do a combination of both. Is that how you envisage it working?

Richard Benyon: If a company in Carlisle was buying its water through, say, Business Stream in Scotland and had a complaint about the way Business Stream was operating, that would be a matter for the Scottish regulator. If there was a problem with supply and somehow that could be levelled at the local provider it would be a matter for Ofwat, and vice versa.

Gabrielle Edwards: The White Paper sets out where we want to go in policy terms, but there is a huge amount of detail that needs to be worked out. Some of the things, such as dispute procedures, would have to be set out in market codes. Having an agreed market code between England and Scotland is almost certainly where we will want to be, but that level of detail is very much what the work will be over the next few years.

Q290 Neil Parish: Scottish Water said that it took them about four years to achieve this. Do you foresee taking that length of time, or can you learn from the Scottish experience?

Richard Benyon: I think you have asked this question of both WICS and Ofwat. I was interested by their replies. Ofwat said that it would be 2015; WICS doubted it could be done before 2017. We would like to be near the former, but we must accept the experience that it may take a year or two longer. We are seriously engaged in making sure we understand this and are now doing a lot of work to ensure that we can move forward on whatever legislative timetable we work to, that preparatory work is done in parallel to legislation and that we can get the codes Gabrielle mentioned developed with the industry. It is not just a techie matter for regulators; it is really important that the customer understands the benefits. That is what we are trying to achieve, and I think that will be of benefit.

Gabrielle Edwards: We very deliberately did not set a start date in the White Paper, because we wanted to go through the process of thinking through with the regulators, customers and water companies what would be practical as well as move forward with as challenging a timetable as we could.

Q291 George Eustice: On a related point, the industry also expressed concern about trying to do upstream competition simultaneously with the introduction of competition in the retail market. It suggested that it would be difficult enough to introduce competition in the retail market without having upstream competition alongside it. Have you given any thought to staggering the two so you prioritise retail competition and leave upstream competition to later, or do you think their concerns are ill founded?

Richard Benyon: It is a classic position in which Government finds itself. Some people are purist about this and want us to do a big bang full legal separation. For a variety of reasons, which we thought were the right ones, we decided not to go down that route, but we thought that more competition could be provided at both a retail level and upstream. I do not think it is impossible to work on both in parallel. Industry is in entirely the right place. The water companies, to whom I speak regularly, recognise this and get the direction in which we are going. For the record, the nicest letter I have received in my time in the Department was one from Professor Cave who thought that what was in the White Paper was precisely the direction in which Government should be going and congratulated us on it. If he thinks we can do it, we must do it and alongside each other.

Gabrielle Edwards: As to the timetable, we would want to work on them together, but the question is whether they are implemented and introduced on the same time scale. That is one of the practical issues we will want to talk to people about. We have a good model in terms of retail competition. Although with upstream we are evolving from what is already there, it is a much bigger change, and it may well take longer to do the work. The start dates may not be exactly the same.

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Q292 George Eustice: I am very conscious that whenever we have had evidence from the water companies they keep coming back to the fact that basically they are in debt up to their eyeballs and a big element of their cost is the servicing of debt. Therefore, maintaining investor confidence is crucial to them. Is there a danger that doing it alongside the Ofwat price review as well could spook the markets? What seems to underlie all their concerns is that they will not be able to borrow money as cheaply and it will destroy their business model.

Richard Benyon: For them to be licensed they have to achieve a certain credit rating, which they will do, but you are right that there are differing levels of debt. What the investor has been looking for is a clear direction from Government about how we view this industry. You will have heard from Moody's; if not in person, you will have seen their recent report. That sets out concerns from the investor community, but we have framed these reforms particularly with a view to de-spooking the investor, if such a word exists, and to give an assurance that we recognise we have a really successful model with the water industry. We think it can be improved for the day in which we live; there can be new incentives to address issues that are more prevalent today and were not around 22 years ago, but that framework, moving forward, is something we value and want to secure. I hope that over the next few months you will see reports such as Moody's starting to say that this is the right direction. We have already seen a sovereign wealth fund buying 9% of Thames Water, and I welcome that kind of confidence in this sector and want to see more of it.

Q293 George Eustice: Another area of concern is the removal of the cost principle in terms of pricing water and having to set up instead a new wholesale charging scheme. As I understand it, the retail impact assessment that accompanied the White Paper did not include any potential impact for removing the cost principle. Was there a reason for that?

Richard Benyon: I might require notice of that question to give you the fullest answer that you deserve. I may have to drop you a line, Chairman, to address the details. The fact is that the cost principle is a real barrier to effective competition, so we plan to remove it from primary legislation and replace it with a mechanism that allows Ofwat to set fair access prices that encourage competition and protect consumers, whether they wish to switch supply or remain with their incumbent supplier. We simply cannot get the reforms we want with the cost principle, because it would not allow new entrants to operate on the same level playing field. I understand why that causes concerns to certain incumbents, but I do not see it as being a measure that should worry them to any great degree.

Gabrielle Edwards: My understanding is that the removal of the cost principle is absolutely integral to the package of reforms, and I certainly would have expected it to be reflected in the impact assessments.

Q294 George Eustice: That is interesting, because several water companies did not think it was.

Gabrielle Edwards: If it is not we will clarify it, but I think it is.

Q295 Chair: How would you respond to the Consumer Council for Water who accept what you are doing but are worried that whatever replaces the cost principle might disadvantage household customers?

Richard Benyon: I do not think it will have any impact on household customers because Ofwat have told me so, and I believe them. They will make sure that these measures will not be discriminatory in a way that would increase the cost for households. I think they gave evidence to you that, although there might be complications for them to overcome, that was something they could very much deliver.

Q296 Neil Parish: The retail arm of Scottish Water was forced to separate into a new subsidiary company, Business Stream, with the introduction of retail competition. I also think it was in Professor Cave's recommendation. Yet you have decided not to require companies legally to separate, despite knowledge that that is the only way to guarantee non-discrimination. How will you deal with this?

Richard Benyon: We think that what we are proposing is the right balance. It addresses the concerns of investors and offers the lowest risks, lowest costs and shortest payback period. Legal separation is not essential for making markets work effectively. It is absolutely clear that it would reduce discrimination but it would not eliminate it, and we think we can provide a better way forward without requiring legal separation.

Q297 Neil Parish: What about new entrants?

Richard Benyon: We think we can offer a framework where new entrants can get a fair look into the market and which acts as a direct incentive to innovate, find new sources of water and provide a better way of dealing with some of the issues we are dealing with in terms of climate. I think this kind of balance is the right way forward.

Gabrielle Edwards: In the end, the only secure way to prevent any discrimination is divestment, not just separation. We have spent a lot of time talking to Ofwat and others about this. Ofwat are confident that they can police discrimination. They may have to try a little harder; there will be other things they have to do on the non-price front, but it is perfectly possible to do it in a non-separated market.

Q298 Neil Parish: Do you think Ofwat has enough teeth for that and they will use them?

Richard Benyon: I think David Gray's report set out very clearly the future direction of Ofwat. Later this year we are producing the strategic policy statement for Ofwat.

Chair: We are just coming to Ofwat.

Q299 Amber Rudd: What is your view of Ofwat's proposal that incumbent companies should be given the opportunity to have separate licences for retail and wholesale which they say would allow less efficient companies to exit the retail market?

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Richard Benyon: I have no problem with Ofwat distinguishing between these two key areas. With an independent economic regulator you have to allow it to do this in an open way with companies. No doubt there is a free flow of information to and fro, but it is their position to do that kind of thing. Just as it would concern me if a regulator tried to drive policy, it would be quite wrong for Government to try to interfere in too onerous a way in how a regulator operates.

Gabrielle Edwards: Ofwat take the view that if there were separate licences and companies were able to exit that would be one way to go. Considering the approach of the White Paper, Ministers took a judgment that they would like to go down a different route. If we were to allow exits we think there are some risks, and it potentially removes from Ministers the right to make a decision about separation or not within the market. If there was a decision to allow an exit route, it would seem proper for that to come back to Ministers and for Parliament to decide.

Richard Benyon: If you were to allow exits you could see competition authorities at some point being able to push, for example, towards a more legally separated route, and that is one we have firmly rejected for a variety of reasons, the principal one being that we want to secure continued investment. That is something Ministers should do for which they should be accountable to Parliament. Therefore, that is one of the reasons we have not permitted exits as part of this.

Q300 Chair: Minister, perhaps I may take you back to your answer about access to customer information. You very neatly referred to what was in the White Paper about whether it was legal and feasible. To be clear, have you taken a philosophical decision against allowing it? I realise it will be a matter for a different Department, but in what circumstances would access to that information be legal and feasible?

Richard Benyon: What people are asking is whether water companies can have access to data that are currently held by the Benefits Agency and the Department for Work and Pensions about those who are on benefits. As things stand, that is illegal. We would have to discuss it across Government with a view to changing data protection legislation, and there is not an appetite for that. I am happy to look at any recommendations you might make through this process as to whether we can. I am desperately keen to reduce the £15 that we are imposing on people. If we can do that within the current legislative framework, you will find no one keener than me to do that. Sometimes I get exasperated by data protection; all of us as MPs have it thrown at us when we are trying to do case work, but I do not see an easy way round this.

Gabrielle Edwards: As I understand it, under the legislation you have to be able to guarantee that the person will receive a benefit from their data being shared. Because of the support being provided and the variety of people's bills and circumstances—whether or not they are on a meter and what their usage is—it is extremely hard to be able to guarantee that in every single case someone will receive a benefit. If you look at WaterSure, for example, because of where average

bills are, some people's bills will go up if they are put on to that tariff. That is the real complication, which is why it is quite different from the situation with energy where pensioners' details are shared because in every single case you can guarantee that there will be a benefit.

Richard Benyon: We also want to see water companies doing more win-win schemes, for example, with long-term debtors. They can say, "You will owe less money if you can pay back this amount", or provide payment terms that are of benefit to the customer but also the water company and other customers in the area because they are reducing their bad debt. There are some really innovative ideas in these win-win schemes, and we want to see more of them. That is one of the tools they have at hand to deal with bad debt.

Q301 Chair: Perhaps you have given us a challenge to which we might rise. I turn to the suggestion that the White Paper is in two halves and they do not necessarily join together. You have the collaborative approach which the Department are asking for particularly in catchment management schemes and water companies collaborating for the greater good, but then you have competition and possibly the dreaded word "profit" being raised. How do you respond to that charge?

Richard Benyon: If you will forgive me, I make no apologies for trying to make it a balanced document and one that addresses the need for greater competition and is focused on customer and on affordability, but also wants to see continued investment. As to the breadth of the document, we have not talked about water quality issues, although we touched on rivers. There is a lot in the White Paper that looks at that side as well. It is broad. It was hard to keep it to a short document, which is what we try to do in Government, but in terms of the question we are trying to make sure we get that balance right. We are addressing very clear recommendations that came out of three important pieces of work, some under the previous Government and some under this. We are addressing the needs of customers but also want to see continued large-scale investment in this sector, because we need it now more than ever.

Q302 Chair: Not to disappoint, on water quality does the Department have an estimate of the cost of implementing the Water Framework Directive?

Richard Benyon: I am sure we do. I know that we have thrown a lot of resources at this. We found £92 million which we are rolling out through our catchment approach and are focusing on really good partnership work. We are now seeing this around the country. The Environment Agency are taking the lead in some catchments; in others it is being led by third-sector organisations like rivers trusts, wildlife trusts and angling groups. In other cases we are providing support for local people who are starting to feel their way.

Government can still throw money, but there are huge resources out there of incredibly dedicated, expert people with whom we have to work. I do not have my finger on the figure, but the Water Framework

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Directive is something with which we must comply. If we do not, we are fined, but, actually, we want to do what the Water Framework Directive asks us to do. We want our rivers to be in a favourable condition. Many of the measures we talk about in the White Paper are things we can do now to protect water quality and flows in rivers such as the Kennet in my constituency. The frustration is that this year we will

not be able to start to see the benefits of these. In many cases the matter is complex, but there are things we can do now without legislation and any more parliamentary activity, but it would be a great help if we had some rain.

Chair: Minister, on that note we thank you and your team very much for being with us and being so patient. We wish you a very peaceful Easter.

Written evidence

Written evidence submitted by Business Stream

EXECUTIVE SUMMARY

- Customers will welcome the Government's intentions to establish an Anglo-Scottish market for retail water and sewerage services in partnership with the Scottish Government.
- Our experience in Scotland leads us to believe the Water White Paper sets out the right principles for customers and the water and sewerage industry for taking forward reform of the market.
- To retain customer confidence it is vital that the Government meets its commitment to publish a draft Water Bill in early 2012 and that it is included in this year's Queen's Speech.
- Evidence shows a genuinely competitive retail water market for all non-household customers will help reduce costs, increase innovation and bring environmental benefits to England, as has already been the case in Scotland.
- In the absence of legal separation the success of the market will rely on a robust compliance regime to create a level playing field for competition. The strength of this regime will be critical to giving new entrants confidence to enter the market.
- Based on experience of other markets, consolidation will be required to maximise efficiency, economies of scale and customer benefits. Consideration should be given to how this can be achieved given existing license conditions for integrated water companies.

INTRODUCTION

1. This evidence is submitted by Business Stream, the leading water retailer in Scotland. Business Stream was created in 2006 in response to the Water Services etc (Scotland) Act 2005. It is a wholly owned subsidiary of the Scottish Water Group, a public corporation. At the time of market opening Business Stream was separately financed, governed, operated and managed, this remains the case.

2. Customers will welcome the Government's intentions to introduce retail water competition as set out in the Water White Paper. Customers will also welcome a Water Bill being brought forward as a legislative priority thus ensuring they benefit from retail competition as soon as possible.

BENEFITS OF COMPETITION IN SCOTLAND

3. Evidence shows customers have benefited from improved and tailored service, keener pricing and new product innovation.

4. Since 1 April 2008 over 60% of customers are benefiting from lower prices and are better off now than they would have been without competition.

5. Around 40% of the market has gone out to competitive tender. The largest single contract tender will deliver the public sector savings of over £20 million. Customers in England now have an opportunity to reap similar benefits.

6. Total savings in the market are predicted to reach £110 million over the next decade.

7. We have developed propositions to generate environmental benefits via water efficiency initiatives. To date customers have realised £19 million in consumption savings, equivalent to 8,200 tonnes of CO₂ emissions.

8. Through separation and focus on delivering what the customer wants, we have achieved savings of £25 million (18%) against our inherited cost base, this has enabled us to reinvest to improve our customer offerings.

9. A greater focus on customers will generate benefits for both non-household and household customers.

RETAIL COMPETITION HAS WORKED IN SCOTLAND

10. Legal separation was fundamental for our success. Separation allowed us to create our own identity, brand and culture befitting of a customer focused and performance driven retailer. It also enables us to challenge our wholesaler to provide a consistently high quality of service.

11. Transparency, simplicity and certainty in the market have created an environment which has allowed retailers to deliver for customers and the wholesaler to focus on their network.

12. Fairness and customer protection has been a cornerstone of the market, in particular default tariffs and services have given customers certainty and a benchmark for comparison.

THE RIGHT PRINCIPLES

13. The proposals set out in the White Paper contain the appropriate building blocks that will allow high performing retailers to deliver benefits for customers. Critical proposals are:

- (a) inclusion of water, sewerage and trade effluent billing meaning retailers can provide a complete service, to minimise customer confusion and the risk of discrimination;
- (b) creation of a level playing field for new entrants;
- (c) removal of the cost principle and regulated wholesale prices;
- (d) an automated switching and registration system supported by common codes and market documents;
- (e) a market which is visible to all participants with clear eligibility rules for who is in the market;
- (f) an Anglo-Scottish market where regulators recognise the need to work together for customers; and
- (g) customer protection including default tariffs, standards and codes of practice.

While the proposals for retail competition are positive there are issues which will require careful consideration.

ENSURING A LEVEL PLAYING FIELD

14. We understand that legal separation was excluded from the White Paper to retain the confidence of the investor community. In the absence of legal separation new entrants and customers will need confidence that a level playing field can be created and that there is no discrimination in the market.

15. A robust compliance regime will have to ensure staff, data and knowledge are not passed between incumbents wholesale and retail businesses. Transparency in determining wholesale and retail charges, and how incumbents interact with customers will also be crucial.

16. The market should be an easy place to do business. Discrimination can facilitate itself in making business transactions difficult to undertake. It is important that new entrants find wholesalers fair and efficient for all interactions.

DEFINING THE MARKET

17. Customers and new entrants need a clear understanding of what “retail” is. This definition may evolve but must be simple and not create barriers to entry. Initially retail activities should be where a retailer:

- (a) adds value as a customer champion rather than a policeman;
- (b) does not impact on the network;
- (c) does not need to become an asset owner; and
- (d) does not need significant historic knowledge of the network to succeed.

MAKING THE MARKET WORK

18. Retailers will be keen to realise efficiencies and economies of scale. Inefficient incumbents may want to exit the market, thus also ensuring customers in areas with inefficient incumbents are not detrimentally impacted. Consideration should be given to how this can be achieved given the current licence obligation to provide retail services.

19. The registration, switching and settlement system will be critical to the efficient operation of the market. The system must be independently administered and data monitored in a transparent manner. Maintaining a high level of data quality will be critical to the orderly functioning of the market.

20. A clear set of market data should be presented and transferred in a consistent manner across regions. Separation in Scotland facilitated the sharing of market data enabling new entrants to search market data by customer and postcode.

21. The market must place the right incentives on participants to meet their market obligations. The market in Scotland has a mix of incentives and these are critical to ensure that the market is performance driven and customer focused.

DELIVERY OF A MARKET

22. Strong leadership in Scotland meant unnecessary delays to market opening were avoided. Achieving progress with multiple incumbents will be a challenge but will be critical to create certainty and confidence.

23. A simple Anglo-Scottish market which works for customers will require regulators to work closely together. Desirable outcomes will include common standards for customers and common protocols and procedures for market participants.

24. In Scotland Licensed Providers are required to make advanced payment of wholesale charges or provide other financial guarantees. In England under the existing Water Supply License regime wholesale charges are payable in arrears.

- (a) any form of advanced payment will protect both the “core business” and investor confidence
- (b) payment in arrears will reduce barriers to entry and arguably create a more competitive market

It may be desirable to allow both options to new entrants thus encouraging wholesalers to consider the relative benefits of each option to their business, this would then be reflected in wholesale charges. There are also variants within these options including daily or weekly settlements or reduced periods of advanced payments. Whatever approach is taken transparency, fairness and simplicity should be key principles.

25. Larger customers have an expectation that a competitive retail market, including site aggregation for multi-site customers (ie including where a customer uses five megalitres in total across their sites) can be introduced by April 2015.

26. To retain the confidence of the remaining non-domestic customers an automated market solution should be in place by April 2017.

27. We would encourage those developing the market to continue to listen to customers. Customer groups such as FSB and MEUC, customers, retailers, and experts such as the Policy Exchange have already provided valuable contributions.

20 January 2012

Written evidence submitted by WWF-UK

1. INTRODUCTION

WWF welcomes the Water White Paper and the vision it sets out for a sustainable water industry that can deliver affordable water for people and protect our precious rivers and wildlife. With climate change posing a very real threat, WWF believes the move by the Government to resolve future water-management issues and introduce stronger protection for the environment when and where water is scarce is vitally important. However, to address the damage caused by the legacy of historical over-licensing—which has already led to the taking of too much water from many of our rivers—we would urge the Government to ensure that the measures proposed in the White Paper are implemented as a matter of urgency.

2. A SUSTAINABLE ABSTRACTION REGIME

We are very supportive of the focus placed on dealing with over abstraction, which has been inadequately addressed by successive Governments, and of the vision of a future, sustainable abstraction regime. We fully support the case for change made by the Government and the principles set out (the need for abstraction licences to signal availability, reflect value including environmental scarcity, protect the environment and drive efficient use of water), which we think will act as cornerstones of an effective abstraction regime. Of course, the detail is yet to come and we welcome the opportunity to inform the development of this; WWF will be participating in the National Advisory Group. While we are pleased to see a clear timetable for the reforms, we are concerned about the intention that it will be the late 2020s before the reformed regime is in place. This is too late and we would like to see reforms beginning to be implemented to a much faster timescale. We are also concerned that legislation is to be put off until the next Parliament (most likely in 2016). A delay of this length risks greater uncertainty on the issue, which in itself could lead to a more expensive transition for water companies in particular. The longer action takes the longer water environments are exposed to the risk of damage. To reduce the potential costs of reforms to customers, companies must be able to start planning for changes now—if left to the last minute, it may be that expensive and otherwise inappropriate solutions (such as desalination plants) may be the only viable solutions in the reduced timescale. *The forthcoming Water Bill should grant powers to reform the abstraction regime at a future date, in order to give abstractors clear notice that the Government intends to do so.*

3. ADDRESSING CURRENT UNSUSTAINABLE ABSTRACTION

While the water scarcity situation will get worse as a result of rising demand, a growing population and climate change, unsustainable abstraction is very much a here and now issue. Drought over this last year has shown just what a devastating effect unsustainable levels of abstraction can have on our rivers and their wildlife. We agree with the Government that the current approach does not encourage change quickly at least cost, and that immediate action is needed to speed up and amend problematic licences. There are rivers all over the country that have waited over 10 years for changes to licences, largely related to inefficiencies, bureaucracy and lack of available funds in the Environment Agency's Restoring Sustainable Abstraction (RSA) programme. The Water White Paper provides some very welcome ideas about how to add momentum, including: the proposal to include water company RSA schemes in the price review, the development of an Abstraction Incentive Mechanism to encourage companies to take less water from vulnerable sources during low flows and give greater consideration to environmental impacts when managing water supplies, and clear intention to start using the power in the Water Act 2003 to revoke or vary abstraction licences that are causing serious damage to freshwater systems. It is essential that these proposals are implemented quickly. *Guidance to water companies (due in Spring 2012) must include instructions for the inclusion of all RSA sites in company Water Resource Management Plans and in Ofwat's PR14 determinations. The consultation on Water Act 2003 section 27 powers (which has been expected for over 10 months) must now be published, and Government policy must be set out before the provisions are enabled in July 2012.*

4. METERING

Widespread metering is essential to ensuring sustainable, reliable and cost-effective water supplies. With tariffs to protect the vulnerable and to encourage water efficiency, metering can help address affordability and keep water prices reasonable over the longer term. Significant reduction in per capita consumption is unlikely without widespread metering. We are extremely disappointed that measures to support significant increases in the level of metering are conspicuously missing from the White Paper, despite clear evidence of the benefits to customers and the water environment.¹ Ofwat's role is crucial, to drive companies to ensure that customers get the best deal over the medium to long term. *The Government must emphasise the clear role that meters play in reducing demand, addressing affordability and keeping bills low in the medium to long term. In its guidance to Ofwat, Government should encourage an increase in household metering from 50% to 80% by 2020, over the next price review period (in line with Walker's recommendation).*

5. WATER EFFICIENCY

WWF welcomes the emphasis on linking water use with rivers and plans for an awareness campaign. However, the measures are not enough to drive water efficiency on the scale that's needed. We are concerned that the expectation that companies will “*produce a plan that will deliver overall demand reductions in the first five years [and looking ahead] demonstrate that the trend is significantly downward*” (pp 51) is too vague to provide a real measure of success, and is not supported by policy instruments (such as incentives via the price review²) to deliver real savings. We feel that it is crucial that Ofwat takes a leading role in driving companies to promote water efficiency and to deliver sustainable water services. *It is essential that Government's guidance to Ofwat (and subsequent Ofwat and Environment Agency guidance to companies) includes emphasis on expectations on demand management, including leakage, metering and water efficiency, to significantly reduce water consumption.*

6. GREEN DEAL

Despite intentions in the White Paper to link water efficiency to the Green Deal, we are concerned that this could be lost across Government (eg the DECC consultation on eligible measures does not include hot water efficiency measures, even though such measures deliver clear water and energy savings for the householder).

7. WATER TRANSFERS

We understand the potential benefits of large-scale water transfers and trading in maintaining affordable security of supply and, potentially, in addressing over abstraction. Transfers via canals and rivers must be considered carefully, with publically available impact assessment and consultation with local stakeholders being imperative parts of the process, in order to ensure there are no adverse impacts on water chemistry or spread of invasive species and that any schemes do not prevent the UK from meeting the requirements of the Water Framework Directive.

23 January 2012

Written evidence submitted by the United Utilities Group PLC

1. *Does the White Paper set out the right principles for customers and the water and sewerage industry for taking forward reform of the market for water supply?*

1.1 The White Paper recognises that the current industry model has been successful and delivered multiple benefits to customers and the environment. We agree with the evolutionary approach to changes to this model outlined in the White Paper. A step-by-step approach to increasing competition within the water sector is sensible, as is the decision not to introduce fundamental structural change.

1.2 We agree that vertically integrated company structures are the most effective in securing a resilient water industry able to plan and deliver for the future. United Utilities agrees that there is no case in the foreseeable future for opening up the household market to competition.

1.3 The White Paper proposes repeal of the “costs principle” which currently governs access prices. That principle seeks to achieve competition which neither increases the overall costs of supply, nor implies cross-subsidy from customers not eligible for the competitive market to customers who are eligible. In any replacement access pricing regime it is essential that this underlying principle is maintained. This is particularly the case for the proposed competitive market in England which, unlike that in Scotland, extends to upstream markets (this form of competition is prohibited in Scotland). Defra should publish guidance for Ofwat on a new access pricing regime and we would expect its contents to be the subject of widespread consultation with stakeholders. We would ask that the Committee endorse the intent behind the costs principle.

¹ Walker, 2009. *The Independent Review of Charging for Household Water and Sewerage Services: final report* and www.fairnessontap.org.uk

² Ofwat's Future Price Limits consultation includes incentives for water trading to address perceived and actual bias to operational expenditure.

1.4 Delivering the expansion of competition set out in the White Paper will represent a huge change project for the industry, including its regulators. Developing market codes and the IT systems to register and switch customers will add further to the industry's costs. If poorly implemented, those costs will outweigh benefits to customers. Ensuring sufficient time and effort goes into preparation for the expansion of the competitive market is essential. The costs of establishing the new market should be recognised as a "relevant change of circumstance" and funded within price limits.

2. Are the proposals to protect and enhance water resources, for example on abstraction regime reform, likely to be fully effective?

2.1 The long term considered approach set out within the White Paper for abstraction regime reform is sensible and welcome. We support the development of a more flexible abstraction regime, reflecting the complex interaction between abstraction and the environment and permitting trading between abstractors in response to their changing needs. That said, the ability of United Utilities to plan and deliver secure supplies of water rests fundamentally on having security in the ability to abstract to meet essential customer demand and having sufficient capacity in reserve to cater for plant outages, drought and other contingencies.

2.2 The White Paper's proposals are embryonic, with much design work still to do but we welcome the recognition of the value of discharges to the aquatic environment. We also welcome the focus on diffuse pollution sources (whether urban or agricultural) and on catchments as a whole. Successful catchment solutions require regulation that reflects the softer nature of the controls being employed, the level of certainty of achieving outcomes, and the timescales over which effects may be realised.

3. How best can the White Paper's aims to promote water efficiency and the use of sustainable drainage be implemented?

3.1 We believe action beyond that recommended on water efficient product labelling should be taken. This could, for example, include allowing water companies to promote products that bear clear labels and allowing such promotion to count towards achievement of water efficiency targets. More generally, the regulatory regime should move towards a positive incentive for companies to help their customers save water.

3.2 We agree with the emphasis on retrofitting water efficiency devices in existing premises and the use of water footprinting. We also need a more joined-up approach between the water and energy sectors. Hot water saving measures that also save energy should be eligible for finance through the green deal. Even if not universally available, this should be part of the measures available to companies that operate in areas of severe water stress.

3.3 Whilst the sentiments on sustainable drainage are welcome, arguments of disproportionate costs may mean that most developments continue to connect to the sewerage system. The White Paper also refers to "*working with the water industry and retailers to provide better information at point of sale to explain the benefits of SuDS and promote their use*". Whilst we would agree with the sentiment, there has been little progress to date.

4. Do you support the White Paper's proposals on affordability of water bills for householders?

4.1 Affordability is an acute issue in the north west of England. United Utilities' water bills are close to the national average but income deprivation is worse than in any other region: more than half of the nation's most deprived communities are in the north west, which has only 13% of England's population. Based on analysis by Ofwat, we estimate that once households in South West Water's region receive their proposed £50 billion reduction, affordability will be more severe in the north west than in the south west.

4.2 In these circumstances we are not convinced that company social tariffs will help address affordability for our customers—too many are in need to make the cross-subsidy required acceptable and those remaining customers expected to provide the cross-subsidy are themselves likely, in the current economic environment, to be hard-pressed. Affordability issues will be made only more acute if domestic customers are made to bear the costs of introducing competition, a far greater risk with abolition of the costs principle.

5. Does the White Paper omit any key issues where further policy action is required to ensure sustainable, reliable and cost-effective water supplies?

5.1 National problems of water scarcity and resilience will in time need national solutions. We would like to see a greater emphasis on the scope for schemes that cross company boundaries, where possible leveraging other major infrastructure developments. The white paper identifies an enhanced role for the Environment Agency identifying such opportunities and we would support the EA taking an active approach to this new role.

5.2 More needs to be done to tackle bad debt to maintain the legitimacy of water bills. We look forward to the government enacting the provisions on landlord liability in the Flood & Water Management Act.

Written evidence submitted by the Water Industry Commission for Scotland (WICS)

EXECUTIVE SUMMARY

- The Water Industry Commission for Scotland (WICS) welcomes the UK Government's White Paper and looks forward to working with the Scottish Government, Defra and Ofwat to establish an effective Anglo-Scottish retail market.
- Such a market would reduce costs, generate innovation and bring environmental benefits. It will also add to the benefits already being realised in Scotland.
- We introduced retail competition in Scotland in 2008. This experience suggests that successful implementation of retail competition in England requires:
 - companies, entrants and regulator to work together closely;
 - an agreed date for and work-plan towards market opening;
 - no customer to be worse-off as a result of market opening;
 - a level playing field for the incumbent and potential new entrants; and
 - sufficient time to be allowed for all the tasks necessary for market opening.

RESPONSE

1. WICS welcomes the opportunity to respond to the Committee's call for evidence on the UK Government's White Paper (WP) on the future of the water and sewerage industry.

2. We consider that the WP sets out a realistic and balanced strategy for the water industry, focusing on resilience, improved resource management and the introduction of competition. It balances the need to continue to attract investment, safeguard the environment and respond to more uncertain weather patterns with the customer's ability to pay for and perception of the legitimacy of charges.

3. This response focuses on the WP's proposals for retail competition as we have already successfully designed and implemented such a framework in Scotland.

4. In line with the Water Services etc. (Scotland) Act 2005, WICS licenses retailers that buy wholesale water and sewerage services then sell to businesses and public sector customers. Every non-household customer (irrespective of size or location) can choose the supplier that offers the best price and services.

5. It took more than four years (over three after the 2005 Act) to implement the framework. The market opened in April 2008.

6. The results have been very positive. More than 50% of non-households have renegotiated the terms of their supplies. There is a new emphasis on providing additional, tailored services that result in lower bills, lower consumption and reduced environmental footprints.

7. Household customers also benefit as retailers pressure Scottish Water to improve efficiency. In addition, contracts have been tendered for the whole Scottish public sector, saving taxpayers an estimated £20 million.

8. The WP's proposals for a retail market should bring similar benefits to customers in England. They will also benefit customers in Scotland—we would expect new English retailers to enter the Scottish market and existing participants to increase further their activity, improving the service and price benefits available in Scotland. More tailored services would also bring further environmental benefits.

9. The biggest beneficiaries may be customers with sites throughout England and Scotland who would be able to select one nationwide supplier.

10. We welcome the proposals that a Scottish retail licence should be recognised in England and vice versa. We look forward to working with Defra, the Scottish Government and Ofwat in establishing an effective Anglo-Scottish retail market.

11. Experience suggests that there are five factors that are likely to be important to successful implementation. These are outlined below.

12. First, it will be essential to success for the incumbent water companies, new entrants and regulator to work together closely and collaboratively. Most elements of a retail framework require at least two parties (from the incumbents, entrants and regulator) to work together. An example is the Operational Code. The wholesale business should be responsible (as it has to reflect how it provides water and wastewater services to customers) but must also consider the needs of entrants.

13. Second, Government, companies, entrants and regulator should agree and commit to a date for and work-plan towards market opening. This would be an important discipline, allowing each party to hold others to account for delivering aspects of the framework for which they are responsible. It also allows new entrants to plan and creates clarity for customers on when they will have a choice.

14. Third, no non-household customer should be worse-off as a result of market opening. Price and service level incidence effects of the new retail framework will have to be managed. Avoiding incidence effects is

important: planned changes resulting from periodic price setting must be separate from changes in tariff that might result from retailer activity. In Scotland we ensured that the “default” retail tariffs were no different from the regulator-set charges that would otherwise have applied.

15. Fourth, the framework should ensure, and be seen to ensure, a level playing field for both the incumbent and the potential new entrant. Dealing with legacy agreements, in particular, is not straightforward. A level playing field gives confidence to customers and entrants that the market will reward innovation, efficiency and high-quality service. Experience in Scotland is that tenders have resulted in step function changes in retailer performance.

16. Finally, preparatory work is complex and time-consuming. Particularly complex issues include:

- Competitive retail tariffs will have to be developed, reflecting appropriate retail cost drivers and scope for savings (for example, bad debt charges for different classes of customer).
- Wholesale charges will need to be designed. The definition of wholesale activities and the results of the next periodic review of charges will need to be taken into account, as will the appropriate retail margin for each customer class.
- Any data accuracy issues (around definition of premises and information on customers, particularly with regard to connection type) will need to be improved before market opening—otherwise the effectiveness of the market is reduced. With hindsight, WICS and other stakeholders in Scotland could have paid more attention to this issue.
- Registration and settlement processes are fundamental to a smoothly functioning market, allowing wholesale charges to be calculated and retailers to transfer customers. Transparent governance rules are also key to efficient market entry, exit and alteration of market codes.

23 January 2012

Supplementary written evidence submitted by the Water Industry Commission for Scotland (WICS)

UPSTREAM ACTIVITIES AND THE APPROACH IN SCOTLAND

BACKGROUND

As requested by the EFRA Select Committee, this document provides further information on the regulation of wholesale (upstream) water and sewerage services in Scotland.

The Water Services (Scotland) Act 2005 (2005 Act) includes three provisions of particular relevance to wholesale services.

The first is that it is a criminal offence to put water into Scottish Water’s pipes if this has not been agreed with either Scottish Water or the Scottish Government. This provision is often referred to as a ban on “common carriage”. The 2005 Act does, however, allow Scottish Water to share (or “trade”) water resources with its neighbours if it so chooses.

Secondly, the 2005 Act requires us to facilitate entry to the retail market but, at the same time, to ensure that such entry does no detriment to Scottish Water’s core (wholesale) business. Under this provision any initiative by the retailers that has a negative and unavoidable impact on Scottish Water’s unit costs will be made good (on a NPV basis) at the next Strategic Review of Charges. As a result Scottish Water has no reason to be anything other than supportive of such initiatives.

This provision has been critical to the success with which retailers have provided water efficiency, water recycling and alternative waste water management solutions to customers. These initiatives reduce environmental impacts and the level of investment that has to be paid for by customers.

Finally, the 2005 Act introduced an incentive for customers (working with their retailers) to do, or agree to do, something which reduces Scottish Water’s costs. The benefits of any such initiative are shared between Scottish Water, retailer and customer. Our approach is to ring-fence the savings from any such initiative in our price determination; this aligns incentives across all market participants and improves value for money in the Scottish industry. A number of these opportunities are currently being explored.

HOW WE PLAN TO ENSURE BETTER UPSTREAM OUTCOMES

We have learned a number of lessons from our experience in introducing retail competition in Scotland. This experience has allowed us to identify a number of principles, which we are following to ensure that our regulatory framework encourages better outcomes.

REMOVE PERVERSE INCENTIVES

We adopted the regulatory framework that Ofwat established in the period after privatisation. This framework has worked well in Scotland, just as it had done previously south of the border. But there are perverse incentives inherent within the framework, which we are now addressing.

These include:

- a bias towards capital expenditure;
- a limit on the time horizons of improvement initiatives; and
- how a company earns its return.

A BIAS TOWARDS CAPITAL EXPENDITURE

There appear to be many opportunities to achieve better outcomes for customers by taking a more revenue (and less capital expenditure) oriented approach. These could involve, in Scotland, transporting water further, working with farmers to improve river quality, and improving waste water management.

So, for example, had Scottish Water identified a catchment management as an alternative to the construction of a new asset, it would have had to forego not only the return it would have earned by building the new asset, but also to accept an additional operating cost efficiency challenge at its next price review. We have moved to ensure that future price determinations contain no such bias.

A LIMIT ON THE TIME HORIZONS OF IMPROVEMENT INITIATIVES

Sharing operating cost reductions with customers after five years is a block on any improvement initiative that would pay back in more than five years. Given the long-term nature of the industry, many potential improvements that could be made by Scottish Water would not have been progressed under our previous regulatory framework. We now make it clear that we would allow Scottish Water to achieve pay-back on its investment.

HOW A COMPANY EARNS ITS RETURN

Another perverse incentive that is built into the current regulatory framework is that Scottish Water has no incentive to extend the life of a well-functioning asset. If the asset has already been fully depreciated, Scottish Water earns no return, even though it still has to operate the asset to provide the required level of service. Scottish Water's maintenance charges are compared to its actual spending. As such, there is a potential incentive for Scottish Water to replace assets earlier than is absolutely necessary.

We are adopting a cash monitoring framework, ensuring the maintenance of an appropriate degree of financial strength. This new framework will ensure that any operational decisions are taken on their merits—not in response to a potential regulatory incentive favouring one particular approach.

ALIGN INCENTIVES

The interests of customers, other stakeholders and the industry are aligned as far as possible. If retail competition is to develop successfully, retailers should be empowered to meet customers' needs.

One area where the alignment of incentives needs to be carefully considered is the pricing or valuing of resources. If currently licensed abstractions are to be traded or auctioned, then there is the potential for customers' bills to be adversely affected. For example, it would not be in customers' (or shareholders') interests for a company that has built assets to turn an abstraction right in one area into drinking water for its customers to abandon those assets just because the price of that abstraction goes up (at least until it becomes advisable to start again, notwithstanding any remaining asset life). There may be an environmental benefit but there would be substantial costs to either (or both) investors and customers. This would impact on customers' willingness to pay for future environmental initiatives and/or on the willingness of investors to finance such improvements.

There could, however, be value in setting new resource or discharge prices. Such prices would incorporate both the cash costs and the costs of any environmental impact. This could ensure that the most sustainable solution is pursued. The price determination would, however, include only the cash costs element of the best value solution—ensuring that customers were not paying any more than they needed to and were not exposed to the potential excesses of any auction-based system. This is the approach we are using to assess the worth of proposed innovations allowed for under the 2005 Act.

ENCOURAGE COLLABORATION

The water industry is exposed to the vagaries of our weather. Availability of raw water may depend on rainfall in preceding months. Effective drainage solutions have to be able to respond to intense rainfall. Moreover water is fully recyclable and expensive to transport. As a commodity to be traded, it is, therefore, quite different to gas, oil or other natural resources.

Should trading be the result of a collaborative process between neighbouring companies working out how best, and on what terms, to share available resources? Or should it be the result of bidding for resources and caveat emptor? The opportunity to abstract can vary over time and exceptional events can and do occur. This suggests that the positive benefits would be more sustainable if the approach to identifying trading opportunities is collaborative.

If water trading is competition, then competition existed in the water sector before economic regulation. In the period since economic regulation was introduced, it has actually become less common to agree new water trading arrangements.

Water trading in the Central Belt of Scotland was quite common in the days of the Regional Councils and the three public authorities. Collaboration between the different organisations responsible was assisted by the Central Scotland Water Development Board. Since the merger of the three authorities to create Scottish Water all decisions about how best to use water resources (or manage waste water) are focused on the best outcomes for customers across Scotland and for our environment.

If the aim is, as it should be, to encourage the transfer of water between regions when there is scope to do so then the question is how best to achieve this. Clearly removing a capital bias (transporting water is expensive) and allowing for a longer term pay-back would help.

EMPOWER CUSTOMERS

Experience from Scotland suggests that empowered end customers opt for different levels of service/price combinations from those allowed for in our price determinations. Customers have tended to be more keen on tailored services and improving water efficiency (and, consequently, saving money) than on simple reductions in their tariffs. Retailers, whose interests are aligned with those of end customers, also put more focused and targeted pressure on the wholesaler to improve the levels of service offered.

The retailers play an important role in the newly established Customer Forum, which will agree Scottish Water's proposed business plan. This harnesses the commercial pressure of the retailer/wholesaler relationship to the advantage of all customers.

ENSURE THAT THE WHOLESALE BUSINESS IS ACCOUNTABLE TO ITS CUSTOMERS

There should also be a responsibility on the water company to identify the cheapest approach available and allow it to share in the resulting benefit. Our revised regulatory approach will allow Scottish Water to choose a more risky solution (and require a better return) provided that the whole life cost on an NPV basis of the chosen solution (including any additional return) is lower than the alternative. This will benefit both customers and the environment. Our approach ensures that the wholesale company is responsible for the effective management of its business. It is also likely to be more effective than if we were to define the extent of the rewards available and, in doing so, potentially constrain the options available.

CONCLUSION

It is often suggested that our focus has been on retail competition alone, and not on encouraging better upstream outcomes. This is inaccurate on two counts.

We regard retail competition as a principal means of empowering customers and ensuring that they get the service they want at a price they can afford. It also helps make the wholesale business much more directly accountable for both what and how it delivers for its customers.

We are adapting our regulation of Scottish Water to provide further benefits to customers and to the environment. We are encouraging more efficient and more environmentally sustainable options in the wholesale business. Any lower cost, revenue-based approaches to delivering outcomes should, as a consequence, now be pursued—such as, for example, catchment management. Besides the empowerment of customers and greater accountability of Scottish Water to its customers the steps we have taken to facilitate this include: removing perverse incentives from the regulatory framework; encouraging collaboration by ensuring that the right incentives exist for customers (and their retailers) to reduce costs across the industry; and aligning incentives between Scottish Water, its customers and other stakeholders.

Further supplementary written evidence submitted by the Water Industry Commission for Scotland (WICS)

Thank you for your letter to Sophia Goring, requesting further information from the Water Industry Commission for Scotland on behalf of the Efra Select Committee. Before turning to your specific questions, I would like to provide some contextual information in relation to the issues raised.

My understanding from the Water White Paper is that the Government does not propose to mandate water and sewerage companies (or the water only companies) to separate their retail activities.

On balance, I consider that this approach represents the most appropriate course of action. It is in customers' interests to ensure that the supplier who is best capable of meeting their needs is able to supply them. In other words, and as I said in evidence to the Committee, it is important that there is a genuinely level playing field so that all existing and potential entrants can enter and operate in the market on the same terms. This means that the retail operation of say, Thames Water, should have to offer a customer in London a level of service and value for money that is every bit as good as that offered by a new entrant if it is to retain the business of that customer.

The Government should have the same interest if it is to achieve its aim of a sustainable and efficient water industry. Such a level playing field could be achieved through:

- separating the *ownership* of the retail and wholesale activities;
- *legal* separation of the retail and wholesale activities (mandated by Government or opted for by the regulated water company); or
- *functional separation*—under this option legal separation is not required; instead, a relatively restrictive Governance Code ensures a level playing field for new retailers and protects the interests of customers.

This Governance Code would reassure new entrants that they could be successful if they offer better services than those of the incumbent's retail operation.

In practice, even if there is legal separation some form of Governance Code is likely to be required to ensure that the wholesaler does not discriminate in favour of the retailer it owns (although the Code would be less restrictive than in cases where there is no legal separation). Such discrimination could potentially still be possible in matters such as the priority with which the wholesaler responds to a problem raised by an end customer.³

The Water Services etc. (Scotland) Act 2005 required Scottish Water to establish a separate retail entity, but gave it a wide degree of discretion as to how to achieve this.⁴ Scottish Water opted for legal separation. In doing so, it was no doubt mindful of our view that there should be a level playing field for both Scottish Water and any new entrants.

If the UK Government were to require legal separation in England, there is the possibility that, in certain circumstances, some highly leveraged water companies with very restrictive covenants on their debt could potentially incur financial penalties. (Although in our view this possibility would be relatively remote if the new framework is broadly similar to that which has been tried and tested in Scotland.)

It could be argued that it is the owners of these companies (the equity holders)—and not customers⁵—who have gained from such arrangements in the form of lower debt costs. As such, it could follow that the Government should not worry about imposing an obligation to separate. However, the Government should be keen to avoid any action which could be seen by infrastructure investors as increasing the political risk of investing in the UK.

I agree that the benefits of lower debt costs in securitised companies flow principally to the equity holders. However, I would still consider that the Government should be wary about mandating legal separation. In my view it is likely that investors would regard such an approach as increasing political risk in the water industry and other infrastructure projects that the Government may want investors to finance.

It would be preferable if Government made clear its commitment to a level playing field and to customers being able to choose the supplier that best meets their needs. It should also signal both the importance of a level playing field and the fact that legal separation is likely to require a less restrictive Governance Code. Wessex Water separated its billing operation into a new joint venture company with Bristol Water some ten years ago. The company reports that, in all that time, debt investors and rating agencies have never raised any questions about the implications of this separate legal entity.

³ What economists would term non-price discrimination.

⁴ Section 13 of the Water Services etc. (Scotland) Act 2005.

⁵ Ofwat uses the same cost of capital for all water and sewerage companies and water only companies (except for a small company premium). As such it is the equity holders rather than customers who benefit from any lower cost of financing achieved by the regulated company.

THE EXPERIENCE IN SCOTLAND

As noted earlier, Scottish Water opted to create a separate subsidiary company to fulfil its retail responsibilities. However, it was not straightforward, even then, to ensure a level playing field. There were issues associated with ensuring that costs were properly allocated, that no informational advantage was available to Business Stream, and that Business Stream's responsibility would be to its customers not to its parent company, Scottish Water.

Getting this separation between the former retail and wholesale arms of Scottish Water's non-household business was central to successful implementation of the competitive retail market.

In October 2006 we required Business Stream to produce a Business Plan explaining how it intended to operate within the new framework. In response we granted Business Stream provisional water and sewerage licences. This allowed us to use our statutory licensing powers but restricted Business Stream's activities.

We also specified three tests that Business Stream had to pass before it could be granted permanent licences:

1. Business Stream's activities and assets were demonstrably separate from those of Scottish Water.
2. Business Stream's governance was demonstrably separate.
3. Business Stream was financially viable and independent of Scottish Water.

Only when Business Stream had passed these three tests in January 2008 did we grant it permanent water and sewerage licences and allow it to operate freely within the market. Until it met these tests, new licensed providers were able to sign up customers for transfer at market opening and Business Stream was unable to respond.

Since market opening we have had to look carefully at some of Business Stream's activities to assure ourselves that it was not misusing its incumbency to its advantage.

LEGAL AND FUNCTIONAL SEPARATION

The process that we followed contrasts with "functional" separation. Under this approach, the regulator has to seek undertakings that require certain behaviour. These undertakings would cover the same issues that were of concern to us in monitoring Scottish Water's decision to separate its retail activities legally. With functional separation the economic regulator has to be much more "hands-on" in ensuring that new entrants can see that the playing field is level.

In comparing the costs of these two options, it is perhaps useful to explain the nature of the different costs incurred.

Set-up costs are the costs the economic regulator, the regulated company and the market settlement and registration system operator incur. These costs occur once (although perhaps over two-three years) in establishing the initial retail framework.

On-going costs are the costs that the economic regulator, the regulated company and the market settlement and registration system operator will incur each year that the framework is in place. These costs are incurred in ensuring that the playing field continues to be seen as level and that settlement and registration systems function effectively.

Functional separation may have lower set-up costs for the regulated company. But set-up costs for the economic regulator and the registration and settlement system operator are likely to be higher. Overall set-up costs may well be lower. However, because there is not the same transparency as exists under legal separation, more concerns are likely to be raised by other market participants about whether or not the playing field is genuinely level. There are also likely to be more regulatory concerns surrounding the allocation of costs. These issues are likely to increase the costs for the regulator and the registration and settlement system operator on an on-going basis. The regulated company is also likely to incur higher compliance costs on an on-going basis.

It may be appropriate to characterise legal separation as ensuring that the company takes responsibility and is fully accountable for how it interacts with other market participants. In contrast, functional separation requires the regulator to take the lead.

In my view, this explains why the Government should make it clear that it wants to see a level playing field and that the Governance Code arrangements are likely to be more restrictive if a company opts not to separate its retail activities legally. This is not the same as the Government mandating legal separation, as it allows investors to make their own assessment of the costs and benefits of different governance possibilities.

THE COSTS OF LEGAL SEPARATION—CCWATER EVIDENCE

On a separate, but related issue, I have noted the oral evidence that the Consumer Council for Water provided on the costs of legal separation.

While I cannot comment on the views of Defra or Ofwat, I would be surprised if the costs of establishing a non-household retail framework would be allowed to have an adverse impact on household customers. Indeed, I believe it should not.

As I indicated above, the Consumer Council for Water is correct in highlighting that the initial costs of a framework based on optional legal separation would be higher than the costs for functional separation. However, as I set out above, it is important to consider the set-up and on-going costs for the regulated company, the economic regulator and the operator of the settlement and registration systems. In Scotland additional savings were realised from the legal separation of Scottish Water's retail and wholesale activities—in my view, similar savings could well be achieved in England.

The questions in your letter ask me to quantify the costs of frameworks based on legal and, alternatively, on functional separation. You also ask me to quantify the benefits of both options.

The information provided in this letter is based on our best estimates of the potential costs and savings in England and Wales, based on the experience gained in Scotland. We have included Wales in our assessment because we were unable to separate out the costs and benefits attributable to one company. Where we are less confident about the estimates (because they are not based on experience) we have made this clear. We have, however, included them in order to be helpful to the Committee.

What is WICS' estimation of the costs to (a) Ofwat and (b) water companies (including any financing costs) were there a requirement for legal separation of water companies' retail and wholesale functions to be completed within three years of a Water Bill receiving Royal Assent?

Our response

It is not possible to generalise about any additional financing costs that may be incurred by water companies as a result of a Government requirement to separate legally. The companies that are highly leveraged would be the most vulnerable to additional claims from investors for extra financing costs given the increased risk of a breach of that company's covenants. Equally, there would, almost certainly, be some companies that would incur no additional financing costs as a result of a requirement to separate. Clearly, the longer the period, the less debt would be affected (assuming refinanced debt would not carry restrictive covenants).

I have also noted the comments of some witnesses to the Committee that the industry's overall cost of capital could be increased by the proposals in the White Paper. The proposals to offer non-household customers a choice may entail an increase in the costs of capital that are allowed to the retail activities of a water company. However, in Scotland this has been immaterial relative to the reductions in costs that have been achieved by Scottish Water's retail subsidiary, Business Stream.

In our view, it should be possible to ensure that, other than this small adjustment to the retail component of the current vertically-integrated companies, the impact of the Government's retail proposals would not increase the cost of capital. Indeed, the proposals may actually lead to a reduction, as this single reform should reduce the risk of the wholesale business materially. For example, the fact that retailers pre-pay in Scotland, and bear the risk of non-payment, has removed the bad debt risk to Scottish Water's wholesale business.

The Committee may want to consider that some companies may be unsuccessful in any retail market and would incur additional financing costs if they are unable to exit the market. In our view, a company should be free to exit the retail market.

It is also possible that the financing costs of the wholesale business could be reduced once investors have had time to understand the new framework. This could happen, for instance, if there was a working capital benefit to the wholesale business (ie retailers pre-paid wholesalers, as happens in Scotland) and all bad debt risk was borne by retailers (again, as happens in Scotland).

In our view, companies will respond pro-actively to the regulatory framework within which they have to operate. If a company can ensure that it faces a substantially less restrictive Governance Code by legally separating its retail activities, it is likely to pursue such an option. It would be in the interests of its investors to do so because the costs of complying with the Code would be much reduced.

We have a clear understanding of the costs that were incurred in Scotland from introducing a retail competition framework that also involved legal separation of Scottish Water's non-household retail activities. These are set out in Appendix 1. These costs are presented in both cash and net present cost terms.⁶

On the basis of our experience in Scotland, we have estimated the costs that could result in England and Wales if a broadly similar approach were adopted.⁷ These estimates are set out in Appendix 2. For the reasons set out above, we have not included any estimate of the additional financing costs that may be incurred by some companies with a highly leveraged financing structure.

In our view the deadline will only impact on the costs of separating activities if it is unreasonably short. In Scotland, full legal separation was achieved well within three years after Royal Assent.

Table 1 summarises our estimate of the present value of the costs of introducing a retail framework with legal separation in England and Wales.

⁶ Using a discount rate of 3.5% real.

⁷ Our estimates include an adjustment based on the number of non-household customers in England.

Table 1**ESTIMATED PRESENT VALUE OF THE COSTS OF INTRODUCING A RETAIL FRAMEWORK WITH LEGAL SEPARATION IN ENGLAND AND WALES**

<i>Cost item</i>	<i>PV over 10 years</i>	<i>PV over 30 years</i>
Set up costs (one-off)	£182m	£182m
On-going costs	£166m	£360m
Total costs	£348m	£542m

What is WICS' estimation of the costs to (a) Ofwat and (b) water companies (including any additional financing costs) were there a requirement for functional separation to be completed within three years of a Water Bill receiving Royal Assent?

Our response

We cannot be as confident about the costs that would be incurred if the requirement were for functional separation only. This is because the framework we implemented involved legal separation of Scottish Water's retail activities.

We would not expect any additional financing costs to be incurred as a result of a requirement for functional separation. This assumes that a company could choose to exit its retail activities should that be the right commercial decision.

In terms of the set up costs, our view is that the costs regulator would incur higher costs in establishing the framework (specifically in relation to ensuring a level playing field, assessing the appropriate level of wholesale revenue, and agreeing an appropriate set of wholesale tariffs with the company). It is also likely that establishing the central registration and settlement systems would involve higher costs. However, the set up costs for the incumbent company may be materially lower.

As to on-going costs, we would expect regulatory (market supervision) costs to be much higher (given the greater potential for disputes between market participants. Similarly, the more restrictive Governance Code that would be required to ensure a level playing field would cost both the retailer and the wholesaler more.

In order to make an estimate for the Committee of the costs of functional separation, we have assumed:

- a 10–20% increase in the regulator's costs of establishing the market;
- a 10–20% increase in the incremental costs of establishing the settlement and registration systems;
- a 25%-40% reduction in the water company's initial set-up costs;
- a 10%-20% increase in the on-going running costs of the settlement and registration systems;
- a 40%-60% increase in the incremental costs to Ofwat of managing the framework; and
- additional compliance costs of between £3 million and £4 million a year.

Appendix 2 sets out the rationale for the assumptions we made.

Table 2 summarises our estimate of the present value of the costs of introducing a retail framework with functional separation in England and Wales.

Table 2**ESTIMATED PRESENT VALUE OF THE COSTS OF INTRODUCING A RETAIL FRAMEWORK WITH FUNCTIONAL SEPARATION IN ENGLAND AND WALES**

<i>Cost item</i>	<i>PV over 10 years</i>	<i>PV over 30 years</i>
Set up costs	£119m to £145m	£119m to £145m
On-going costs	£209m to £231m	£454m to £501m
Total costs	£328m to £376m	£573m to £646m

More detailed information on these costs is set out in Appendix 3.

What is WICS' estimation of the savings to water customers over the first decade of a reformed regime (assuming that the White Paper proposals are implemented)? Can it provide comparative figures for estimated savings over the first decade of a reformed regime in which water companies were required to (a) legally and (b) functionally separate their retail arms?

Our response

Appendix 4 sets out the savings that have been achieved in Scotland and the present value of these savings on the assumption that the existing level of costs is maintained in real terms. It should be noted that, in this analysis, we have not sought to quantify the benefits of:

- the improvements in service levels now being provided to customers;
- the environmental and carbon benefits of the water efficiency achieved; or
- the cost savings that Scottish Water has achieved through identifying redundant activities when it separated its retail and wholesale activities or from the company's greater clarity and focus on service level outcomes.

In Appendix 5 we also calculate the net present value of the changes over a 30—year horizon and over a 10—year horizon (excluding any benefits accruing after the 10—year time horizon).

On the basis of our experience in Scotland, we have estimated the savings that could result if a broadly similar approach were adopted in England. These estimates are set out in Appendix 6 to Appendix 11. The potential for these cost reductions is based on two different approaches⁸ and uses published information⁹ that the water companies provided to Ofwat.

In the functional separation scenario we assume that the savings that could be achieved as a result of the new framework may be up to 10% lower than under legal separation.

Table 3 summarises our estimate of the present value of the savings from introducing a retail framework with legal or functional separation in England and Wales.

Table 3

ESTIMATED PRESENT VALUE OF SAVINGS FROM INTRODUCING A RETAIL FRAMEWORK WITH LEGAL OR FUNCTIONAL SEPARATION IN ENGLAND AND WALES

	<i>PV over 10 years</i>	<i>PV over 30 years</i>
Legal separation	£463m to £606m	£1,850m to £2,171m
Functional separation	£417m to £546m	£1,665m to £1,953m

Table 4 summarises our estimate of the net present value (NPV=total savings less total costs) of introducing a retail framework with legal or functional separation in England and Wales.

Table 4

ESTIMATED NET PRESENT VALUE OF INTRODUCING A RETAIL FRAMEWORK WITH LEGAL OR FUNCTIONAL SEPARATION IN ENGLAND AND WALES

	<i>NPV over 10 years</i>	<i>NPV over 30 years</i>
Legal separation	£115m to £259m	£1,309m to £1,629m
Functional separation	£40m to £218m	£1,019m to £1,381m

CONCLUSION

In our view it is important to distinguish between a requirement in legislation for companies to separate and a decision by a company voluntarily to separate its retail and wholesale activities.

We agree that the Government should not require companies to undertake legal separation of their retail activities. However, we do consider that the Government should emphasise its determination to ensure a level playing field for new entrants to the area of any appointed company. It should also be clear that the Government would expect the Governance Code to be more restrictive where a company chooses not to separate legally its retail activities but does specifically want companies to be allowed to pursue only functional separation. Such an approach would mean that additional financing costs (that are not more than offset by other cost reductions) are avoided.

We have a detailed understanding of the costs and savings that have been achieved in Scotland. As such, we consider this allows us to make relatively robust estimates of the potential costs and savings that would occur if all companies were to opt to separate legally and avoid additional financing costs. We have estimated the costs that would result if companies were to implement only functional separation.

Our analysis suggests that the 10—year cost of establishing a retail framework is broadly similar under both the legal separation and functional separation only options. The 30—year costs are much lower for the legal separation option.

Our analysis suggests that the 10—and 30—year savings from establishing a retail framework are higher for the legal separation option than for the functional separation only option.

⁸ The first approach was based on adjusting non-household retail costs based on revenue, while the second approach was based on adjusting non-household retail costs by non-household customers.

⁹ Ofwat's June return 2009–10 information for the revenue-based comparison (first approach), and Ofwat's June return 2010–11 information for the non-household customer comparison (second approach).

Our analysis suggests that the 10—and 30—year NPV (benefits less costs) of establishing a retail framework are higher for the legal separation option than for the functional separation only option.

I hope that these answers to your questions are helpful. I would, of course, be happy to provide further evidence if this would be useful to the Committee.

May 2012

Further supplementary written evidence submitted by the Water Industry Commission for Scotland (WICS)

I have been reflecting further both on the questions that the EFRA Select Committee raised in its letter to me and my response (dated 4 May).

Given the quite technical nature of the subject matter, perhaps it would be helpful to highlight what I see as four critical issues that I raised in explaining the background to the costs and savings associated with both legal and functional separation.

These are as follows:

1. Without some form of separation there is unlikely to be a level playing field that allows retailers to win customers from the incumbent supplier in any particular area. The level playing field is fundamental to a successful water and sewerage retail market and to achieving the innovation, improvements to customer service and lower charges that the Government seeks. The Water Services etc. (Scotland) Act 2005 required Scottish Water to establish a separate entity but allowed it full discretion to achieve this in whichever way it considered most conducive to meeting its statutory obligations. (In other words legal separation was one possible option; ownership or functional separation—appropriately policed—could equally have been possibilities.)

I do not think that the UK Government should mandate legal separation; however it should make it clear that a level playing field is essential. As such, it should also be clear that companies that opt for limited separation of their activities should expect to be policed rather more rigorously than those that choose voluntarily to separate their retail activities.

2. In any market, it is important for a participant to get the right balance between its revenues and its costs. This may be challenging for some of the new retail arms of the incumbent companies who lose a substantial proportion of their customers. Some of them may decide that it would be better to exit the market. It would clearly be better for these retailers to realise some value from disposing of their remaining customers than to continue to incur losses in their retail activities. There is no consideration in the Government's White Paper as to how a company could exit the retail market. Not to allow this could lead to higher bills for all those customers (including householders) who continue to be served by the unsuccessful retailer.

3. It is essential to allow sufficient time to implement the framework. To design and implement the new retail arrangements may require up to three years after Royal Assent. The setting of wholesale charges by Ofwat (currently scheduled for November 2014) is also critical. In my view, it will take around two years to complete design and implementation after this date. This makes April 2017 the most feasible date for the opening of the retail market.

4. It will be important for all parties (the two Governments, customers, the companies, new entrants, Ofwat and ourselves) to work collaboratively to achieve the vision set out by the Government in its White Paper. We stand ready to play our part.

I attach a copy of a speech that I gave at the Institute of Water's Annual Conference today. I hope this provides you with further useful background information. As I said earlier, I understand that many of the issues that the Committee is considering are quite technical—if you would find it helpful to meet up or discuss any of these further, please do not hesitate to contact me.

May 2012

Written evidence submitted by Ofwat

INTRODUCTION

1. Ofwat is the economic regulator of the water and sewerage sectors in England and Wales. Our primary duties are to:

- protect the interests of consumers, wherever appropriate by promoting effective competition; and
- enable efficient water and sewerage companies to carry out and finance their functions.

2. We also have a range of secondary duties. These include:

- contributing to sustainable development;
- promoting economy and efficiency;

- ensuring there is no undue discrimination against particular customers; and
- to have regard to the principles of best regulatory practice.

3. Since privatisation, our regulation has helped the water and sewerage sectors to deliver major improvements to customers and the environment while keeping bills lower than they otherwise would have been.

4. But as the Water White Paper—“Water for Life”—recognises, the sectors now face a new set of challenges that require a different response from Government, regulators and the companies.

5. We welcome the Water White Paper (WWP) as a significant step forward. It proposes a package of necessary reforms to help to tackle the challenges facing the sectors and help deliver sustainable water and sewerage services, now and for future generations. We support the introduction of legislation to implement the proposals in the WWP. We also believe there are some areas where those proposals can be improved to deliver the Government’s aims.

6. In particular, we welcome the Government’s focus on:

- ensuring more sustainable water use, by reforming the abstraction framework, and introducing measures to encourage more water trading between companies and other water users;
- delivering more customer-focused sectors, including measures to help address affordability and giving choice to all non-household customers; and
- introducing competition so that market forces drive innovation and improvements in the way that companies deliver water and sewerage services.

7. Ofwat is already taking forward proposals to reform the regulatory framework in a way that both aligns with and is complimentary to the reforms set out in the WWP.¹⁰ But to deliver fully on the Government’s vision we need legislation to bring about a number of the changes—for example, to change water supply licences to allow a fully functioning retail market. We look forward to working with Defra on the forthcoming Water Bill.

8. Ofwat’s duty to contribute to sustainable development is a vital part of our work. This means delivering social, environmental and financial sustainability. It also means ensuring sectors serve customers now and in the future.¹¹ The proposals in the WWP will help us continue to do this. But any unnecessary amendments to our duties could create uncertainty around the regulatory framework and undermine confidence in the sectors.

9. We encourage the Government to identify any particular concerns about how Ofwat’s decisions contribute to sustainability and reflect those concerns in targeted guidance it issues to us.¹²

ENVIRONMENTAL SUSTAINABILITY

10. We welcome the commitment in the WWP to secure sustainable and resilient water resources. As the WWP recognises, the following proposals in our future price limits (FPL) framework will also help achieve this.

- Incentives for water trading and interconnections.
- An abstraction incentive mechanism (AIM).
- Measures to address any perceived or real bias to capital, carbon-intensive solutions.
- A planning framework that encourages effective demand management.

11. Long-term sustainability requires measures to tackle the lack of value on water from source to tap. Proposals set out in the WWP to reform the abstraction framework are essential and we look forward to working with Government and the Environment Agency to ensure changes happen soon.¹³

12. We consider that the ability of the sector to deliver more efficient use of this scarce resource will be further enhanced by allowing incumbent companies to purchase water not only from each other, but also from new licensees. Those new licensees could have access to water sources that are less environmentally damaging than those of incumbent companies. Restricting the ability of incumbent companies to choose the best source of water—environmentally and economically—is likely to reduce the effectiveness of the WWP reforms.

13. We welcome the Government’s commitment to dealing with diffuse pollution through innovative means. We look to the companies to put in place catchment management schemes where these deliver best value for money for customers.

¹⁰ Ofwat’s consultation on the future price limits framework (2011) http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf1104fpl_customer.pdf

¹¹ Delivering Sustainable Water—Ofwat’s Strategy (2010) http://www.ofwat.gov.uk/aboutofwat/reports/forwardprogrammes/rpt_fwd_20100303ofwatstrategy.pdf

¹² See: Statutory Social and Environmental Guidance to the Water Services Regulation Authority (Ofwat) (2008) <http://archive.defra.gov.uk/environment/quality/water/industry/review/documents/ofwat-guidance080922.pdf>. The Water White Paper also proposes to introduce a further “Strategic Policy Statement” for Ofwat.

¹³ Environment Agency/Ofwat—Case for change: Reforming water abstraction management in England (2011) <http://www.environment-agency.gov.uk/research/planning/135501.aspx>

SOCIAL SUSTAINABILITY

14. We welcome the WWP's central commitment to create more customer-focused water and sewerage sectors for both non-household and household consumers.

15. We have taken steps to change our own regulatory processes to improve the sectors' accountability and engagement with customers. These include:

- changing the way that companies set targets and report performance so they deliver for—and are accountable to—customers rather than the regulator;¹⁴ and
- ensuring that companies engage with—and are challenged by—their customers in the plans they bring forward the next time we set price limits.¹⁵

16. Choice and competition can also create a powerful incentive to improve customer service. Evidence from Scotland and other sectors shows how market forces can both drive down prices and encourage customers to use water more efficiently through the more effective provision of added value services, such as water efficiency advice.¹⁶

17. Affordability is a growing problem for some customers. If customers are unable to pay their bills, there is a risk that bad debt will increase, which can have an impact on investor confidence.

18. The companies should take responsibility for identifying and supporting those customers who are at risk of not being able to pay their bills. To make this effective, and to keep the administrative burden and cost to a minimum, it is important that:

- Government guidance sets a clear policy framework for how the companies develop social tariffs; and
- the assistance to be provided to South West Water customers is delivered in a way that ensures transparency without unnecessary regulatory burden.

FINANCIAL SUSTAINABILITY

19. We welcome the WWP's recognition of the need for continued investment in water and sewerage infrastructure. Our own proposals are also designed to ensure this—for example, by protecting the regulatory capital value (RCV) of the wholesale business.¹⁷

20. We consider that financial sustainability would be further served by ensuring that regulation and restrictions on businesses are kept to a minimum, consistent with our primary duties of protecting customers and ensuring financeability. This could be achieved by allowing incumbent companies to choose to have separate wholesale and retail licences. This would enable the companies and their investors to choose the most efficient structures for their businesses. This, in turn, would create more opportunities for companies to deliver the most efficient and lowest-cost services to customers and sustainable investment in infrastructure.

21. Separate licences would give a company the power to choose to exit from one part of its licence and focus on, for example, wholesale activities only. This would leave retail services to those better able to deliver them and provide scope for new entrants to innovate in this area. It would also allow customers to gain from the clear economies of scale in retail activities through mergers.¹⁸

DELIVERING “WATER FOR LIFE”

22. Meeting all of the objectives set out in the WWP will require new legislation.

23. There has been no significant reform of the water and sewerage sectors since privatisation in 1989. There is an opportunity now for new legislation to:

- reduce regulatory burdens, and promote innovation and investment;
- promote choice and better service for customers; and

¹⁴ Ofwat's consultation on Regulatory Compliance (2011) http://www.ofwat.gov.uk/consultations/pap_con111006regcompliance.pdf?download=Download#

¹⁵ Ofwat's consultation on the future price limits framework (2011) http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf1104fpl_customer.pdf

¹⁶ There are a range of studies cited in the UK Government's retail impact assessment which demonstrate the incremental gains of competition over regulation see table 5, p41, Introducing retail competition in the water sector (2011) <http://archive.defra.gov.uk/environment/quality/water/documents/wwp-ia-retail-1346.pdf>. There have also been a number of studies that suggest the total efficiency benefits of reform may be in the range of £200 million to £2.5 billion (NPV over 30 years) see: *ibid*, p6. Water efficiency benefits from retail competition have also been a headline benefit from the experience in Scotland see: *ibid*, pp54–55.

¹⁷ Ofwat's consultation on the future price limits framework (2011) http://www.ofwat.gov.uk/consultations/pap_con201111fpl.pdf

¹⁸ There are more than 21 retailers currently operating in the water and sewerage sectors and by way of example, in the energy sector some studies suggest that the minimum efficient scale of suppliers is at least between 100,000 to 1,000,000 customers—Littlechild, *Smaller Suppliers in the UK Domestic Electricity Market: Experience, Concerns and Policy Recommendations*, Electricity Policy Research Group 2005, p19 <http://www.eprg.group.cam.ac.uk/wp-content/uploads/2008/11/littlechildsuppliers.pdf>. This suggests that between 7–11 water companies have a customer base so small that it is extremely unlikely that they are operating at minimum efficient scale. Ofwat's econometric analysis suggests that allowing retail mergers could lead to consolidation in the sector and generate between £60 million to £210 million of benefits for customers (NPV over 30 years).

-
- enable more efficient use of scarce water resources.

January 2012

Supplementary written evidence submitted by Ofwat

Thank you for sending further questions following our formal evidence session. We have responded to them in turn below.

Would Ofwat support a staged market opening with the introduction of competition in the upstream (as described in paras 5.46—5.50 of the White Paper) delayed until the retail market charges have been implemented?

We are committed to working with customers, the sector and other stakeholders to develop an overall timetable to deliver choice to business customers as well as greater efficiency in the way that companies (and others) manage water resources. As the Government has set out in its White Paper, these reforms are likely to take place over a number of years and it is therefore not the case that all aspects of upstream and retail market changes will be implemented simultaneously.

Defra published three impact assessments alongside the Water White Paper. These showed that the net benefits of retail market reforms were £190 million, of upstream market reforms were £1,952 million and of abstraction reform were £65.7 million. The benefits of upstream market reforms are considerable and suggest that it would not be sensible to delay obtaining those benefits beyond what is necessary to allow successful implementation. The current drought situation also underlines the importance of upstream market reforms which will help address the significant resilience/supply constraints we currently face.

We will be issuing a statement of principles shortly on the changes that we propose to introduce for the next price review. These changes are proposed to cover aspects of both upstream and retail development. The statement will be followed by consultations on various aspects of our proposed changes such as water trading, sustainable abstraction incentives and our approach to regulating retail. We will listen carefully to the responses to these consultations before taking any overall decision on the scale and pace of change in our methodology paper in autumn 2012.

Since Ofwat gave evidence, the rating agency Moody's has issued a special comment, warning that the combination of changes to the Price Review process and the White Paper's proposals on market reform have the potential to increase credit risk in the UK water sector. What is Ofwat's reaction to this analysis?

It is crucial that the sector is financially sustainable and able to attract the right amount of inward investment at the right financing cost. Our proposals are an “evolution” of our approach rather than “revolution”, not least as a reassurance to investors that the stability and transparency of the regulatory process remain high priorities for us. The elements of our regulatory regime that have helped deliver £98 billion of investment since privatisation will remain. Examples include the regulatory capital value approach, including indexation by RPI, and many of our risk mitigants, such as reopeners in the case of new obligations being put on the companies. We also continue to adhere to our primary duty of making sure companies can finance their functions. Our proposals alongside the Government policy direction will not impact on this.

The Moody's analysis shows that there may be greater differentiation in performance between companies and this may impact the credit quality of poorer performers. However, this is what might be expected from properly designed incentives.

We aim to keep and build on the parts of the approach we expect to continue to work well, and to adapt other areas by taking appropriate steps. We will continue to maintain an open and constructive relationship with the major credit rating agencies and the investment community more widely and welcome their input.

The White Paper proposes that Restoring Sustainable Abstraction programmes should be included within a company's water resource management plans so that they can be funded through the price review. What steps is Ofwat taking to prepare for this and are you confident that these changes could be implemented in time for the next Price Review in 2014?

We have established a process under which we would be able to make allowance for restoring sustainable abstractions schemes as part of the water resource management planning and price review processes. We are working with Defra, the Environment Agency and others to make sure that customers continue to be protected under any new system. We are confident that we will be able to implement the changes for the 2014 price review provided that those conditions are satisfied.

In oral evidence, Regina Finn suggested that any differences between the English and Scottish regulator with regard to the issuing or revocation of licences in a joint Anglo-Scottish market would be dealt with according to a protocol which should be agreed before such a situation could arise. Please could you clarify whether you believe that such a protocol should be agreed before the opening of the Anglo-Scottish market; and are you able to provide further details of how such a protocol might work?

We are committed to working with WICS to establish an overall framework for regulation that can support the development of choice for business customers across England and Scotland. As part of these arrangements we would envisage putting a protocol or a memorandum of understanding in place to explain how the regulators would work together on all relevant matters including the revocation of licences. The precise details of these arrangements are still being developed and we would expect to consult with all interested parties before putting the arrangements in place. We will aim to get the protocol or memorandum of understanding in place well before the opening of the Anglo-Scottish market.

May 2012

Further supplementary written evidence submitted by Ofwat

Notwithstanding Ofwat's commitment in oral evidence to using the tools at its disposal to police discrimination against new entrants, does Ofwat remain of the view that legal separation of water companies' retail and wholesale functions would be its preferred option for the structure of the market?

It is very important as greater choice is introduced for non-household customers that there is a level playing field, so that existing companies are not afforded an unfair advantage over new entrants. Without a level playing field choice is unlikely to be effective and we will not realise the expected gains for customers. We will be consulting later this year on options for achieving a level playing field.

Legal separation will not be included as the government has determined that this is a route it does not wish to pursue. Instead we will be concentrating on the licence conditions and other requirements to ensure that choice can operate effectively for all non-household customers.

What is your estimate of the costs to (a) the regulator and (b) water companies (including any additional financing costs) were there a requirement for legal separation to be completed within three years of a Water Bill receiving Royal Assent?

When the Water White Paper was published, Defra published accompanying impact assessments. These estimate the costs of legal separation over a time horizon of 30 years. The Defra retail impact assessment includes:

- costs the regulator will incur to establish and administer the market arrangements;
- costs the regulator will incur to design and manage the market settlement and switching infrastructure;
- costs companies will incur to set up and maintain legally separate retail businesses; and
- financing costs companies will incur if they breach covenants and other financing arrangements.

To understand how the costs of legal separation look over time, it may be useful to consider the present value (PV) of the costs of legal separation over 30, 10 and three year time horizons, as follows:

Table 1

		30 year PV	Legal 10 year PV	3 year PV
Regulatory market arrangements	Setup and on-going costs	46	29	18
Market settlement	Setup and on-going costs	79	44	20
Company	Setup and on-going costs	721	459	279
	Finance costs	529	409	308
		1,249	868	587
TOTAL COSTS (£m)		1,374	942	625

It should be noted that the Defra impact assessment also considered the benefits associated with legal separation and estimated their present value to be as follows:

Table 2

	<i>Legal</i>		
	<i>30 year PV</i>	<i>10 year PV</i>	<i>3 year PV</i>
TOTAL BENEFITS (£m)	1,669	619	202

Defra's impact assessment assumed that, while a large proportion of the costs of legal separation would be incurred early on, the benefits would accrue later. This explains why the costs are higher than the benefits over a three- year horizon, but the benefits are greater than the costs over a 30 year horizon.

What is your estimate of the costs to (a) the regulator and (b) water companies (including any additional financing costs) were there a requirement for functional separation to be completed within three years of a Water Bill receiving Royal Assent?

Again to understand how the costs of functional separation look over time, the present value (PV) of the costs of functional separation over 30, 10 and three year time horizons are considered as follows in Defra's impact assessment:

Table 3

			<i>Functional</i>		
			<i>30 year PV</i>	<i>10 year PV</i>	<i>3 year PV</i>
Costs	Regulatory market arrangements	Setup and on-going costs	63	38	21
	Market settlement	Setup and on-going costs	79	44	20
	Company	Setup and on-going costs	721	460	280
	TOTAL COSTS (£m)		864	542	321

However, the impact assessments prepared by Defra also considered the benefits associated with functional separation and estimated their present value to be as follows:

Table 4

	<i>Functional</i>		
	<i>30 year PV</i>	<i>10 year PV</i>	<i>3 year PV</i>
TOTAL BENEFITS (£m)	1,264	466	152

As with the previous question Defra's impact assessment assumed that while a large proportion of the costs of functional separation would be incurred early on, the benefits would accrue later. This explains why the costs are higher than the benefits over a three year horizon, but the benefits are greater than the costs over a 30 year horizon.

What was the cost to the regulator and companies of implementing accounting separation?

Ofwat first commenced working on accounting separation in 2008. Water companies started work on providing accounting separation data in 2009, with the first data provided in mid-2010. Ofwat has not asked companies to provide details of the actual costs of reporting accounting separation information. The accounting separation information currently collected is only cost allocation, rather than detailed accounting separation, and for several companies the costs are negligible (as they already have systems in place to carry out such cost allocation).

Ofwat therefore does not have actual costs of implementing accounting separation, only estimates from an accounting separation impact assessment prepared in 2009. This impact assessment gives a cost of £22.9 million present value over five years from 2009. These estimates drew from information provided by some of the water companies.

There are also figures Water UK provided to the Gray review of Ofwat. These show that the incremental costs of compliance with the June return process (a broader set of activities than those relating just to accounting separation) were £6.5 million in 2009–10. Initially, companies reported to Ofwat that providing commentaries alongside the June return data, was a significant burden. Anecdotal evidence from a stakeholder workshop held by Ofwat in June 2011 suggests that the burden for the June Return 2011 (JR11)—without commentaries—was reduced compared to that of the previous year's JR10—with commentaries—but not significantly. However there was also a recognition that this was the first step, and it may take time for changes to embed in the companies.

What is your estimate of the savings to water customers over the first decade of a reformed regime (assuming that the White Paper proposals are implemented)? Are you able to provide comparative figures for projected savings over the first decade of a reformed regime in which water companies were required to (a) legally and (b) functionally separate their retail arms?

Defra's impact assessment estimated the costs and benefits over a time horizon of 30 years. The Defra retail impact assessment shows that the net benefits over time horizons of 30, 10 and three years and can be seen in table 5.

Please note that table 5 only refers to retail savings. Defra's impact assessments also estimated that upstream reforms would generate net benefits of £492 million over 10 years, which should be added to the retail savings to give an estimate of the total savings to customers.

Therefore the estimate of the savings to water customers over the first decade of a reformed regime (assuming that the White Paper proposals are implemented) is £521 million. Comparative figures for projected savings over the first decade of a reformed regime in which water companies were required to legally separate their retail arms is £198 million. In contrast the projected savings over the first decade of a reformed regime in which water companies were required to functionally separate their retail arms is £416 million.

Whilst the above assessment attempts to capture some of the fundamental costs and benefits that derive from offering choice to retail, non-household customers, it is worth noting that not all the benefits can be readily quantified.

In particular, customers benefit from a choice of supplier and service package they prefer. These benefits are hard to quantify. Experiences in the Scottish water and sewerage sector, shows that choice has facilitated better information to customers from their retailer and has help customers manage their own consumption better.

The Cave Review that informed the Defra Water White Paper considered the potential efficiencies to be gained from innovation in the water and sewerage section. They used a range of sources including the experience in Scotland and a number of academic studies.

The review highlighted the potential improvements that introducing retail choice could drive. In particular, companies are more likely to innovate to reduce their cost where they will provide wholesale inputs to multiple retailers in terms of more efficient resource and network management. Given the challenges we face in terms of dealing with the effects of climate change and demographic change, such innovation should be encouraged as much as possible.

May 2012

Table 5

		<i>Legal</i>			<i>Functional</i>			<i>WSL</i>		
		30 year PV	10 year PV	3 year PV	30 year PV	10 year PV	3 year PV	30 year PV	10 year PV	3 year PV
Costs	Regulatory market arrangements									
	Setup and ongoing costs	46	29	18	63	38	21	75	42	19
	Market settlement									
	Setup and ongoing costs	79	44	20	79	44	20	79	44	20
Company										
	Setup and ongoing costs	721	459	279	721	460	280	86	41	14
	Finance costs	529	409	308						
TOTAL COSTS		1,249	868	587	721	460	280	86	41	14
TOTAL BENEFITS		1,374	942	625	864	542	321	240	127	53
NET benefits		1,669	619	202	1,264	466	152	430	157	51
		295	-323	-423	401	-76	-169	190	29	-2

Written evidence submitted by Consumer Council for Water

1. INTRODUCTION

1.1 The Consumer Council for Water (CCWater) is the independent, non-departmental public body representing the interests of water and sewerage consumers across England and Wales. We have four local committees in England and a committee for Wales.

1.2 We have worked with the water industry and its regulators since 2005 to get the best results for consumers. In that time we have:

- been central to achieving the customer focused outcome from the 2009 price review, which was over £1 billion better for water customers than the 2004 price review when CCWater did not exist;
- convinced water companies to return over £135 million to customers through either additional investment or bill reductions;
- dealt with over 90,000 complaints;
- helped customers get over £13 million in compensation from water companies; and
- cost 21p per annum for each water bill payer.

1.3 We welcome the opportunity to submit evidence to the Environment, Food and Rural Affairs (EFRA) Committee inquiry into the Water White Paper—“Water for Life”.

1.4 Our evidence is provided from the perspective of water consumers, both domestic and business, and is based on our wide ranging consumer research undertaken over the past six years, as well as our experience in helping customers with their complaints and enquiries.

2. SECTION ONE—OVERALL RESPONSE

Are the White Paper’s aims supported and what is the likelihood of these objectives being effectively fulfilled by the approaches it proposes?

2.1 *Are the White Paper’s aims supported?*

2.1.1 CCWater broadly welcomes the White Paper’s aims as it addresses issues that CCWater has been working for on behalf of water customers, such as:

- a considered, paced approach to compulsory metering that is tied to what local customers find acceptable;
- extended competition for business customers in England;
- Government funding to mitigate high bills for household customers of South West Water;
- protecting more properties from sewer flooding by removing the automatic right to connect surface water drains to existing sewers;
- improved customer awareness on the need to use water wisely and water resource issues; and
- a commitment to retain CCWater’s expertise and to improve outcomes for customers in the event of any changes to consumer representation. However we would be concerned if disruption to CCWater affected customers negatively, particularly during the lead up to the Price Review in 2014.

2.2 *What is the likelihood of these objectives being effectively fulfilled by the approaches it proposes?*

2.2.1 Generally the approaches will fulfil the objectives effectively, but there are some issues where we have concerns. These concerns are addressed in the responses to other questions.

AFFORDABILITY

2.2.2 The Government’s objective for everybody to have access to an affordable water supply will not be fulfilled by customer-funded social tariffs alone.

2.2.3 The scale of the affordability problem is significant. Over half of lower income households spend more than 3% of their income on water charges, and one in seven households feel their bills are unaffordable. Estimates of the annual cost to effectively address the problem range from £162 million to £447 million.¹⁹ The Walker Review estimated £340 million.

2.2.4 While customer-funded social tariffs would help they would not be sufficient to deliver a widespread and meaningful solution to the problem facing low-income households. Water customers are not willing to pay much more through bills to fund social tariffs. Our research²⁰ suggests this could be limited to about £2

¹⁹ In work commissioned by CCWater in 2009 the University of York identified a range of possible interventions to address, to varying degrees, the water affordability problem. The cost of these options ranged from around £162 million to £447 million per annum. Link here The Walker report. Link here.

²⁰ CCWater’s 2010 customer research found customers might only be willing to contribute up to an additional £2 per annum through bills to help low income customers with their water charges. Increasing all non-eligible customers’ bills (including non-household) by £2 would realise around £36 million per annum. Link here to research

which, across England and Wales, would only realise about £36 million a year. This is significantly short of what is needed to address affordability.

2.2.5 Discretionary local customer-funded social tariffs could also lead to large disparities in the help available to customers depending on where they live. In some areas help may not be offered at all.

2.2.6 The evidence suggests the Government should play a greater role in supporting social tariffs:

- the Walker Review highlighted Government’s responsibility to address poverty;
- customers agree that there is a strong case for Government to fund a single industry-wide social tariff as the costs can be shared widely and in line with ability to pay; and²¹
- customers would be more willing to help fund social tariffs if Government also contributed.

2.2.6 In the absence of a universal Government funded social tariff, local social tariffs would be much more likely to succeed where they are funded by Government as well as customers.

2.2.7 In order to ensure it fulfils its objectives Government should consider whether its strategy to give everybody access to an affordable water supply will work.

REFORMING THE MARKET FOR BUSINESS CUSTOMERS

2.2.8 We generally welcome the package of reforms and believe it will meet the Government’s objective to build on the strengths of the existing regime, introduce evolutionary reforms and improve the deal for customers.

2.2.9 We believe Government must be cautious that the cost of implementation does not outweigh the benefits to business customers and that safeguards are in place to protect customers who cannot switch supplier.

ASSISTANCE TO HOUSEHOLD CUSTOMERS OF SOUTH WEST WATER

2.2.10 We welcome the Government’s move to reduce high household bills, but feel help should also be extended to non-household customers of South West Water. The exceptional circumstances acknowledged by Government also apply to non-householders.

2.2.11 Customers across England and Wales feel it is fair to address this issue.²² Providing a tax-payer funded subsidy to non-household as well as household customers would enable Government to achieve its objective and fully and fairly address the historical legacy of high bills.

3. SECTION TWO—RESPONSES TO THE QUESTIONS

3.1 *Does the White Paper set out the right principles for customers and the water and sewerage industry for taking forward reform of the market for water supply?*

3.1.1 The Government has highlighted the key issues on which business customers want reform. We welcome this as business customers are frustrated by the lack of progress on water competition.

3.1.2 We generally welcome:

- reducing the competition threshold to zero. However, the systems and framework must be able to cope with this level of activity and suitable protection must be in place for ineligible customers;
- removing the cost principles and creating a transparent wholesale access pricing regime, as long as this minimises any unwinding of cross-subsidies and protects ineligible customers;
- extending the Water Supply Licensing regime to include sewerage services to offer greater choice and possible savings; and
- the development and introduction of statutory market codes and a mandatory “cooling off” period, to provide protection for business customers.

3.1.3 *We would like further clarity* on plans to establish a new England/Scotland retail market. However, the idea is welcome as it would enable customers to use one licensee to provide retail services across England and Scotland. This would help multi-site customers with sites in England and Scotland, though not Wales and Northern Ireland.

3.1.4 *We are concerned* that introducing water sources through “upstream competition” could affect water quality. Customers will need to be assured that appropriate safeguards will be put in place. As customers value the safety and quality of their drinking water,²³ we support increasing the role of the relevant regulators.

²¹ CCWater’s Research into cross-subsidies and social tariffs 2010—[link here](#)

²² CCWater’s Research into cross-subsidies and social tariffs 2010—[link here](#).

²³ Understanding Customers’ Views —joint research to inform the 2009 Price Review — Section 4.2—[link here](#)

3.2 Are the proposals to protect and enhance water resources, for example on abstraction regime reform, likely to be fully effective?

3.2.1 We believe the proposal could be effective in protecting and enhancing water resources, however in areas where water is scarce, increasing charges for water could significantly impact on customers' bills.

3.2.2 To get customers' acceptance and buy-in to the process, they should be involved in local debates on water resources. This could help manage tensions that may arise in seeking to balance the needs of consumers and the environment.

3.2.3 We support the steady pacing of schemes to help water resources management. This will ensure a sustainable approach to protecting and enhancing water resources where, costs and benefits can be identified and decisions based on what is acceptable to customers.

3.3 How best can the White Paper's aims to promote water efficiency and the use of sustainable drainage be implemented?

Water Efficiency

3.3.1 Consumers want practical advice and support to help them be more water efficient at home and in their businesses. This needs:

- to build on the successful work of CCWater, jointly with others, to inform and educate customers on using water wisely, such as in the South East, where a sustained information campaign has helped to reduced demand; and
- long-term government commitment to raise awareness and encourage consumers to understand their local water resource situation and to use water wisely, not only during droughts.

3.3.2 With the help of Government and regulators and CCWater (which has credibility with customers due to its independence), water companies can help consumers be water efficient by:

- providing targeted advice and practical assistance to different customer groups²⁴ and by working with other interested parties and partners.
- combining advice and practical support when introducing tariffs to encourage water efficiency or switching to meters. This is more likely to change habits than relying on price signals alone.²⁵
- having easily understood tariffs so customers can make the right choices, and ensuring those less equipped to compare tariff options are helped to make the right choices.²⁶
- addressing customers' negative perceptions surrounding leakage by working with customers so they understand how decisions to fix leaks are made by balancing the cost of the repair against the local water resource situation.

Sustainable Drainage

3.3.3 White Paper aims on sustainable drainage could be aided by giving water companies incentives to opt for more sustainable and cost-effective drainage solutions. We are working with Ofwat to explore this further.

3.4 Do you support the White Paper's proposals on affordability of water bills for householders?

3.4.1 Please see our response at 2.2.2 to 2.2.6.

²⁴ CCWater's "Using Water Wisely" Demographic factors, particularly age and family status affect willingness and ability to act in using water more wisely. Link here—page 4.

²⁵ CCWater's "Using Water Wisely"—Link here—section 3.1.2.

²⁶ Energy sector experience has found the more numerous and complex tariffs become, the more customers are confused and unwilling to engage. It also risks leaving vulnerable customers or those less well equipped to compare tariff options on less favourable charging arrangements; a point also highlighted in research carried out by Ofwat last year.

²⁷ CCWater's Research—Living with Poverty —link here—Page 12 (m) and UKWIR Customer Targeted Debt Management (07/CU/04/5)

3.5 Does the White Paper omit any key issues where further policy action is required to ensure sustainable, reliable and cost-effective water supplies?

Low-income customers who are in receipt of government benefits

3.5.1 Some low-income customers who are struggling to pay but not in debt to the company would welcome paying their bills direct from their benefit.²⁸ We would welcome Government's direction to its agencies to allow this to occur where it currently does not.

January 2012

Written evidence submitted by Anglian Water Services Ltd

1 Does the White Paper set out the right principles for customers and the water and sewerage industry for taking forward reform of the market for water supply?

1.1 In general we welcome the principles as set out in the White Paper for taking forward reform. However we raise concern about whether, in implementing the principles, enough consideration has been made of the potential consequences, and the potential complexity of the process.

1.2 Since 2008 Osprey, part of the Anglian Water Group, has been offering water and waste water services to any non-domestic customer in Scotland. Anglian Water therefore has experience of the process of liberalisation in a utilities market and is familiar with the complexities and potential pitfalls.

Impact on investor confidence

1.3 In light of the sector's success in securing £95 Billion finance for infrastructure investment since 1989 we are pleased that the Government recognises the need to avoid taking risks which might undermine investor confidence.

1.4 However, the White Paper's proposals sit amongst a range of regulatory changes that affect the water industry. These include proposed changes to water company licences, the changes proposed in Ofwat's Future Price Limits consultation, and a new approach to monitoring compliance. Whilst many of the changes are welcome, taken together, they add up to the most radical change to the water industry since privatisation and the scale of the proposed changes adds a significant amount of potential uncertainty to the way we do business.

1.5 Both the changes themselves and the uncertainty surrounding them have the potential to increase the perception of risks to the sectors current or future investors. Some financiers are already looking carefully at the potential implications. It would be unfortunate if the net result of the proposed changes were to be an increase in financing costs which ultimately is borne by the customer.

1.6 We would therefore urge the government to urgently consider the potential impact on consumers of regulatory and legislative uncertainty. Including a range of unintended consequences if enough time is not given to assessing the risks and opportunities. We strongly emphasise the combined impact of legislative and regulatory change needs to be fully considered rather than the narrower consideration of the proposals set out in the White Paper.

The potential for de-averaging of prices

1.7 There are potential issues over the interaction between competition law and regulation specifically on how Ofwat prices third party access to services. A very strong basis in law and regulation for the maintenance of regional average pricing for wholesale or network services is needed. Without this, wider competitive entry in the market will increase the risk of water companies being open to accusations of anti-competitive behaviour from new entrants due to the current system of cross subsidy. This may in turn produce costly legal challenges.

1.8 Companies will seek to minimise such risk, as well as looking to price competitively in contestable markets. One predictable response will be to bring charges to customers in line with the actual cost of supplying water to business customers. In areas which are remote or hard to supply this could lead to significantly higher charges. The impact on small businesses as a result of this could be particularly severe. Water companies may be forced to implement price rises amounting to two or three times the current level of bills so for some SME customers there could be significant winners and losers. There are sound economic arguments for pricing to reflect costs of supply, but we would like to see further evidence of the potential impacts on customers before any changes are made.

Implementation complexity

1.9 Anglian Water's experience of liberalisation in other utility markets and indeed from the implementation of the business retail water market in Scotland reveals the potential complexity of implementing such changes. Visibility throughout the process is essential as are the agreement of robust plans and governance arrangements.

²⁸ CCWater's Research—Living with Poverty —link here—Page 12 (m) and UKWIR Customer Targeted Debt Management (07/CU/04/5)

Currently a high-level timeline for retail market implementation has been drawn up by Ofwat without the participation of the potential market participants. Successful market implementation requires the commitment and involvement of the participants themselves, not least because of the cost and resources likely to be required.

1.10 Changes must be considered and consulted on in detail at Draft Bill stage to ensure that the impacts and risks of the changes are fully understood by all participants. We would also urge government to make clear what powers it should retain in relation to the implementation and regulation of the retail market.

2. Are the proposals to protect and enhance water resources, for example on abstraction regime reform, likely to be fully effective?

2.1 Anglian Water has advocated strongly for reform of the abstraction regime, recognising the severe pressures on water resources that we already face and which may well be exacerbated by climate change. We have been fully involved in the discussions that have led to the proposals and intent to develop policy set out in the White Paper.¹

2.2 We are pleased that the Government's thoughtful proposals on Abstraction Reform, as they stand in the White Paper, give the industry time to plan for the changes. This will allow for the investment required to research how best to implement the plans.

3. How best can the White Paper's aims to promote water efficiency and the use of sustainable drainage be implemented?

3.1 The proposals go some way to help promote the use of SuDS. Though we are concerned that the "affordability" clause within the Standards may dilute the principles of sustainable drainage.

4. Do you support the White Paper's proposals on affordability of water bills for householders?

4.1 Anglian Water is keen to address issues of affordability and since 2005 has consistently advocated changes that could provide a comprehensive approach to the issue of affordability. However, Ofwat have used their powers of approval to block our tariff proposals and in their view the government direction was not clear enough.

4.2 The Floods and Water Management Act includes a section on "social tariffs" allowing companies to introduce initiatives to address affordability. However, this section of the Act has not yet received a Commencement Order, because ministerial guidance needs to be developed. The guidance is currently drafted and is out for consultation.

4.3 The guidance is unclear about the role and powers afforded to both Ofwat and the Consumer Council for Water, but it implies that both bodies will retain the power to veto company proposals. If this is the case, it will be even easier for Ofwat to continue to hold back attempts to deliver affordable water to vulnerable customers. It is essential that final guidance is clarified in order that we might be encouraged to put forward proposals with a reasonable expectation that they would be capable of being implemented.

4.4 We would recommend that Ofwat's powers on "social tariffs" be removed.

5. Does the White Paper omit any key issues where further policy action is required to ensure sustainable, reliable and cost-effective water supplies?

5.1 We welcome the recognition that new water resources need to be considered and planned for and appreciate the leadership the government is showing by initiating the discussion in which we want to fully participate.

5.2 We would urge the Government to consider further the environmental safeguards that would need to be applied to new entrants to the market. Without safeguards there is the potential for a "free rider" problem to emerge if the environmental custodianship carried out by the asset owning companies is not catered for in pricing.

FOOTNOTES

1. We have published two papers: (i) "A right to water?" a joint report by Anglian Water and Frontier Economics (published 10.02.11) which sets out concrete recommendations for moving towards a more sustainable allocation regime; (ii) "Trading Theory for Practice" a joint report by Anglian Water, Essex and Suffolk Water and Cambridge Water (published October 2010) which provided evidence of the potential benefits of water trading between water companies in East Anglia and recommended changes to make trading easier. Both reports are available at http://www.anglianwater.co.uk/_assets/media/a-right-to-water-abstraction-report.pdf

Supplementary written evidence submitted by Anglian Water Services Ltd**RISING BLOCK TARIFFS IN ENGLAND AND WALES**

1. At present, measured domestic tariffs in England and Wales are generally structured on the traditional “two-part” basis, with a fixed component and a variable component.

2. As household metering has developed, alternative tariff structures have been considered from time to time, prominent amongst which is the “rising block tariff”. In general, such a tariff would entail a small or zero fixed charge, a lower volumetric rate for consumption up to a certain level (which could vary according to specific customer characteristics such as household occupancy), and a higher volumetric rate for demands above that level.

3. The case for the rising block tariff is usually put forward on the basis of one of two arguments (or both):

- that a rising block tariff has re-distributive properties, because better-off households use more water than less well-off households; and
- that it has positive water efficiency and environmental properties, because it confronts households with a lower price signal for their “basic needs” non-discretionary use (toilet-flushing, drinking, etc), and a higher price signal for their discretionary use (garden watering, use of pressure washers, etc), and can therefore make a positive contribution to “demand management”.

4. Neither argument can be refuted from a theoretical point of view. They therefore stand or fall on consideration of the empirical evidence.

5. For example, in some countries the correlation between income or wealth, and water use, is very strong, especially in warmer climates where better-off households tend to have gardens and swimming pools, and in areas where the access to water supplies of the less well-off is attenuated (eg where communities are served by communal standpipes).

6. In England and Wales, however, the correlation between income and consumption is both flat and weak. The main reasons for this are that, after occupancy, the principal determinant of water use is age and type of water appliance, which is inversely correlated with income: that is, better off households tend to have, for example, newer toilet cisterns and modern water efficient white goods, whereas the less well-off households are more likely to have older cisterns (which use at least twice as much water) and older white goods. It is possible that, in the long term, the relationship between income and consumption will have altered, as older cisterns are replaced and the scope for achieving yet further efficiencies (without significant technological changes) is exhausted.

7. Similarly, the second argument is not supported by empirical evidence. For one, whilst it is possible to define “basic needs”, it cannot be estimated with any degree of reliability for any given household. In principle, it might be possible to set the “lower block” on the basis of “occupancy”, but even that can be difficult to pin down. A new-born baby, for example, “uses” a very different amount of water as compared with a teenager. In addition, as noted above, two households with identical “occupancy” may use very different volumes for reasons to do with the types of appliance they have.

8. Further, there is no strong evidence that the price elasticity of demand, even for “non-discretionary” water use, is very high in England and Wales. The net effect of a stronger price signal for higher volumes, coupled with a weaker price signal for lower volumes, may therefore be very limited.

9. Indeed, the evidence of the past 20–30 years suggests that factors other than price signals have a more promising role to play in achieving water efficiency objectives. Government policies (eg on cistern capacities) have achieved significant reductions in water use in the home and will continue to do so as older devices are replaced with modern ones. In addition, it is probably fair to say that centrally-developed and mandated policies on issues such as grey water recycling in new properties offer a more promising route to the achievement of greater water efficiency than relatively modest changes in price signals to households, the majority of whom find their water bills modest and manageable in comparison with other demands on the household budget.

10. At the hearing of the Select Committee Peter Simpson also commented on experience in Australia. In Melbourne, a rising block tariff was introduced in 2004. The tariff was in three parts with an increasing price for each additional block of water in each three month period. No account was taken of the number of people in a household. An independent reviewer²⁹ concluded that the tariff ensures that water will be used inefficiently in an economic sense; that it creates incentives for trade in water between households; and it discriminates between households in a way that is inequitable, especially in relation to the number of people in a household.

²⁹ “Whose Values Count? Demand Management for Melbourne’s Water”, Geoff Edwards, Department of Economics and Finance, School of Business, La Trobe University, Victoria, Australia; The Economic Record, Vol 82< September 2006

Written evidence submitted by Action for the River Kennet

SUMMARY OF KEY POINTS

There is an urgent need for more effective action in dealing with over-abstraction—in light of the current situation on rivers such the Kennet. The solution to over-abstraction from the Kennet at Axford was agreed in 2008, but there is still no commitment to funding its implementation.

The current “Restoring Sustainable Abstraction” (RSA) programme is drawn out and ineffective, but there is no commitment to finding a solution. We strongly urge DEFRA and Ofwat to bring RSA into the 2014 price review. Customers should pay for rectifying over-abstraction, just as they pay for rectifying sewage pollution through their water bills.

There should be a commitment to RSA schemes like Axford, which were identified in Thames Water’s 2009 Water Resource management Plan, being funded by variations to water companies’ current business plans, ie by 2014.

1. Action for the River Kennet (ARK) is a local action group formed twenty years ago, to campaign against excessive consumptive abstraction from the Kennet aquifer which damages the flow and ecology of the River Kennet. It now has over 600 members. ARK has been highly successful in raising local awareness, through information campaigns, schools work, wide use of volunteers in river restoration work, and managing cost-effective restoration work funded by non-governmental grant giving bodies as well as the Environment Agency (EA) and the Rivers Trust. With support from the WWF-UK Freshwater Programme, with whom we have worked closely, ARK is hosting the Kennet Catchment Management Plan, in conjunction with the EA. We are working with Thames Water on a local water-saving campaign which they are using as a pilot for a potentially much wider campaign.

2. At national level we worked with BBC’s Panorama programme “Drinking our Rivers Dry?” broadcast in September 2011, and achieved good local and national press coverage with features on BBC and ITN news and articles in The Times, The Guardian, The Independent and local press. Our local MP Claire Perry is highly supportive of our cause. Last autumn we invited the DEFRA minister Richard Benyon MP to see the dry bed of the river in Marlborough. Most recently, thanks to Claire Perry, we hosted a visit by the Chairman of the All Party Parliamentary Angling Group, Charles Walker MP, and Martin Salter, former MP for Reading West and now Campaigns Director for the Angling Trust. All were shocked at the complete lack of water upstream of Marlborough—the first time in living memory at this time of year. For more information, please see our website—address below. We will also send by post a copy of our Annual Report, to show how much can be achieved by a small local organisation, and would be happy to send multiple copies if members wish.

3. ARK’s overall response to the White Paper is positive. It addresses the objectives which ARK has been promoting, and if and when fully implemented should make a substantial contribution to putting a truer value on the price of water, and protecting Britain’s rivers—particularly our unique chalk streams. Our concern is with the slow pace of progress envisaged, and the lack of firm commitments to the actions proposed. More specifically:

- (a) *The need for action is incredibly urgent—particularly in light of the current situation on rivers such the Kennet. There is effectively no flow upstream of Marlborough, as we have shown MPs.*
- (b) The policy dealing with the legacy of over abstraction is most relevant for the Kennet. The current “Restoring Sustainable Abstraction” (RSA) programme is drawn out and ineffective. We are therefore concerned that legacy issues will continue to be dealt with this way, acknowledged to be slow and cumbersome. There should be clearer commitments on how the RSA will be made to work better.
- (c) We are pleased with DEFRA’s commitment to work with Ofwat to bring RSA into the price review. We think this will be the fastest way to implement changes to existing licences.
- (d) We welcome DEFRA’s intention to use powers in the Water Act 2003 where no compensation is payable, if there is serious damage to habitat, which could be key to resolving quickly the problems on the Kennet.
- (e) The policy for long term reform of the abstraction regime has good principles, but the timescale is too slow.
- (f) There should be stronger incentives for water companies to do more demand management. We would hope to see more concrete proposals and timetabled actions.

4. We draw attention to the EA’s 2008 study “International Comparisons of Domestic per capita Consumption of Water”. This shows the UK in a poor light both for the UK’s high level of per capita consumption and low level of household metering, with evidence of a linkage between the two. The Committee should examine and make these findings more widely known.

5. The current price of water does not reflect its true cost. For a large majority of the population the price of water does not influence how much water they use. While there must of course be protection for vulnerable groups, we urge Ofwat and Government to introduce universal water metering, and we support the concept of a charging regime which recognises the impact of water consumption on the environment.

6. The influence of abstraction on river flows; the consequent impact on ecology, and the means to minimise resultant damage must be approached on a catchment-wide basis. We therefore welcome the EA's new Catchment Based approach to river management and are pleased to be working with the EA on our local plan.

We would be happy to expand on any point above. We would be pleased to give Oral Evidence if there is an opportunity. We believe it would be helpful for the Committee to hear at first-hand a case study of a particular river, as an example of the wider picture. We would be happy to host a visit to the Kennet for members to see for themselves its present parlous state.

January 2012

Supplementary written evidence submitted by Action for the River Kennet (ARK)

Following its session of Oral Evidence on Wednesday 7 March 2012, Action for the River Kennet (ARK) is grateful for the opportunity to submit the following supplementary written evidence:

1. The Drought, the Present State of the River and a proposal to mitigate it

The river above Marlborough is in the worst state in living memory—for *this time of year* when it should be at its highest. It was in a similar state only in the summer of 1976. Above Marlborough, there have been periods when the river has been completely dry; now there are just disconnected and increasingly polluted puddles. ARK assisted the Environment Agency in locating and where possible helping to move hundreds of suffocating fish. This is particularly serious at this time of year when trout should be spawning, requiring clean clear and well oxygenated flowing water. Below Marlborough the flow is now significantly augmented by sewage effluent. Thousands of young trout have died of suffocation through lack of adequate flow. ARK is submitting to the Environment Agency and Thames Water a proposal to alleviate the effects by an alternative usage of the boreholes in the catchment. See *Annex A*

2. The 1998 Inquiry, Valuing the Environment, and Time Line

The Inspector ruled in favour of Thames Water's appeal against its abstraction licence reduction, over-ruling the Environment Agency, in the 1998 Inquiry because an inadequate method of assessing the "value" of the Kennet had been used by the Agency, which set its value at only around £300,000; which was dwarfed by Thames Water's estimate of the cost to them of finding alternative sources, of over £10 million. (See ENDS Report 278, March 1998). At the time this was a serious blow to the Environment Agency. Attached at *Annex B* now is the timeline of events since then. The present Government's new policy of putting a value on the natural environment was set out in the UK's National Ecosystem Assessment (UK NEA), and in the June White Paper "The Natural Choice: Securing the Value of Nature" (Cm 8082) following the Lawton Review. This policy should help resolve future conflicts over resources more equitably in favour of the environment, particularly when in the context of the Environment Agency's reports on water "The Case for Change—current and future water availability" supporting the Water White Paper.

3. The Case for Bringing the RSA into the WRMP, and the need for a more urgent timetable for reform of abstraction regime

Chapter 3 of the White Paper acknowledges the weaknesses and delays in the present system for addressing unsustainable abstraction through the RSA process. It states that DEFRA is working with Ofwat and the Environment Agency to identify ways to incorporate company solutions for restoring sustainable abstractions into the price review mechanism. We strongly support this move and would urge Government to address it with urgency, with RSA schemes funded in water companies' 2014 water resource management plans funded through the next price review. Equally, referring to Chapter 2 of the White Paper we are disappointed that the Department does not intend even to start consulting on proposals for reform before 2013, and legislation is not proposed before the next Parliament (para 2.18). ARK would urge Government to address the long term reform of the abstraction with a greater degree of urgency, commensurate with the pressing need for reform spelt out in the previous chapter and in the supporting Environment Agency and UK NEA reports cited.

4. Hydromorphological Measures

Para 3.37 of the White Paper refers to hydromorphological measures as an option for addressing unsustainable abstraction. Our oral evidence set out why we believe such measures to be of limited value, compared to cutting abstraction, particular in rivers that dry out completely. We referred to photographs illustrating an example of this in the River Kennet at Manton. These photographs are attached as *Annex C*

5. The Case for Metering

National and international evidence shows clearly the benefits that water metering brings both in reducing consumption and lowering customers' bills. See the Environment Agency's 2008 Report "International comparisons of domestic per capita consumption". This shows how far the UK lags behind other comparable European countries such as Belgium, Germany and Denmark in the introduction of metering and the

concomitant reduction in consumption. It also shows (Table 2, page 9) for the UK the significantly lower consumption of water in metered households than in unmetered ones for all water companies. For Thames Water the figures from Ofwat for 2006–7 are 142.7 l/h/d and 156.8 l/h/d respectively. The disinterested written evidence submitted to the Committee by the Chartered Institute of Water and Environmental Management (CIWEM) (WWP 29), and Lord Krebs (WWP 41) both strongly support metering. Given this strength of evidence and independent advice, it is surprising and disappointing to find the White Paper so weak on metering in paragraph 6.14. We urge the Committee to include a strong recommendation on metering in its Report to Government.

6. Clarification of position on 2003 Act “no compensation” Section 27

In our written evidence paragraph 3 (d) said we welcomed DEFRA’s intention to use these powers. We would like to clarify this to explain that, while we recognise that water companies would legitimately need to find the costs of losing abstraction rights if a licence is withdrawn, we believe that this should come from the consumer via water bills (ie as part of the Price Review process). It should not come in the form of “compensation” from the tax-payer via the Government.

Annex A

ACTION FOR THE RIVER KENNET

PROPOSAL FOR MANAGEMENT OF ABSTRACTION TO MINIMISE THE IMPACT OF THE 2012 DROUGHT

1. INTRODUCTION

Regardless of rainfall from mid-March onwards, the drought of 2012 will have a severe impact on the river Kennet. This paper sets out:

- Why the flows in the Kennet will be similar to flows in the great drought of 1976, regardless of rainfall.
- Why the impact of the drought on the river’s ecology will probably be worse than 1976.
- How the impact could be reduced by management of abstraction, without impairment of essential water supplies.

The paper is intended for discussion with Thames Water and the Environment Agency, as part of the process of overall planning for management of drought in 2012. ARK’s aim is to ensure that the needs of the River Kennet are fully taken into account in the plans for managing the drought, not just the needs of abstractors and Thames Water’s customers.

2. LIKELY FLOWS IN THE KENNET IN 2012

Figure 1 compares the hydrological features of 2011–12 so far, with the two worst Kennet droughts since flow records started in the 1960s—1975–76 and 1996–97.

The upper part of Figure 1 compares effective rainfall in the droughts (effective rainfall is the amount percolating to the ground water table). Effective rainfall in the Berkshire Downs since October 2011 has been lower even than 1976, according to the data in EA’s West Thames water situation report. However, the slight rise in groundwater levels and river flows in February 2012 suggests that the effective rainfall in January and February has been more than shown by EA’s data. Nevertheless, the dryness of the winter of 2011–12 has been similar to 1975–76.

The second part of Figure 1 shows recorded groundwater levels at Rockley and a prediction of water levels up to autumn 2012. The predicted groundwater levels are based on an assumption that there will be some effective rainfall before mid-April, but minimal effective rainfall and declining groundwater levels thereafter. The groundwater levels are predicted to be similar to 1976 and lower than 1997, when groundwater levels and river flows were boosted by significant rainfall in February.

Abstraction in 2011 was much more than in 1976, although less than licensed:

<i>Year</i>	<i>Axford</i>	<i>Average daily abstraction (Ml/d)</i>			<i>Ramsbury</i>
		<i>Ogbourne</i>	<i>Clatford</i>	<i>Marlborough</i>	
1976	2.0	0.3	Not known	Not known	Not known
2011	10.19	2.65	0.80	1.96	0.80
Now licensed	13.7	8.1	1.2	2.5	1.2

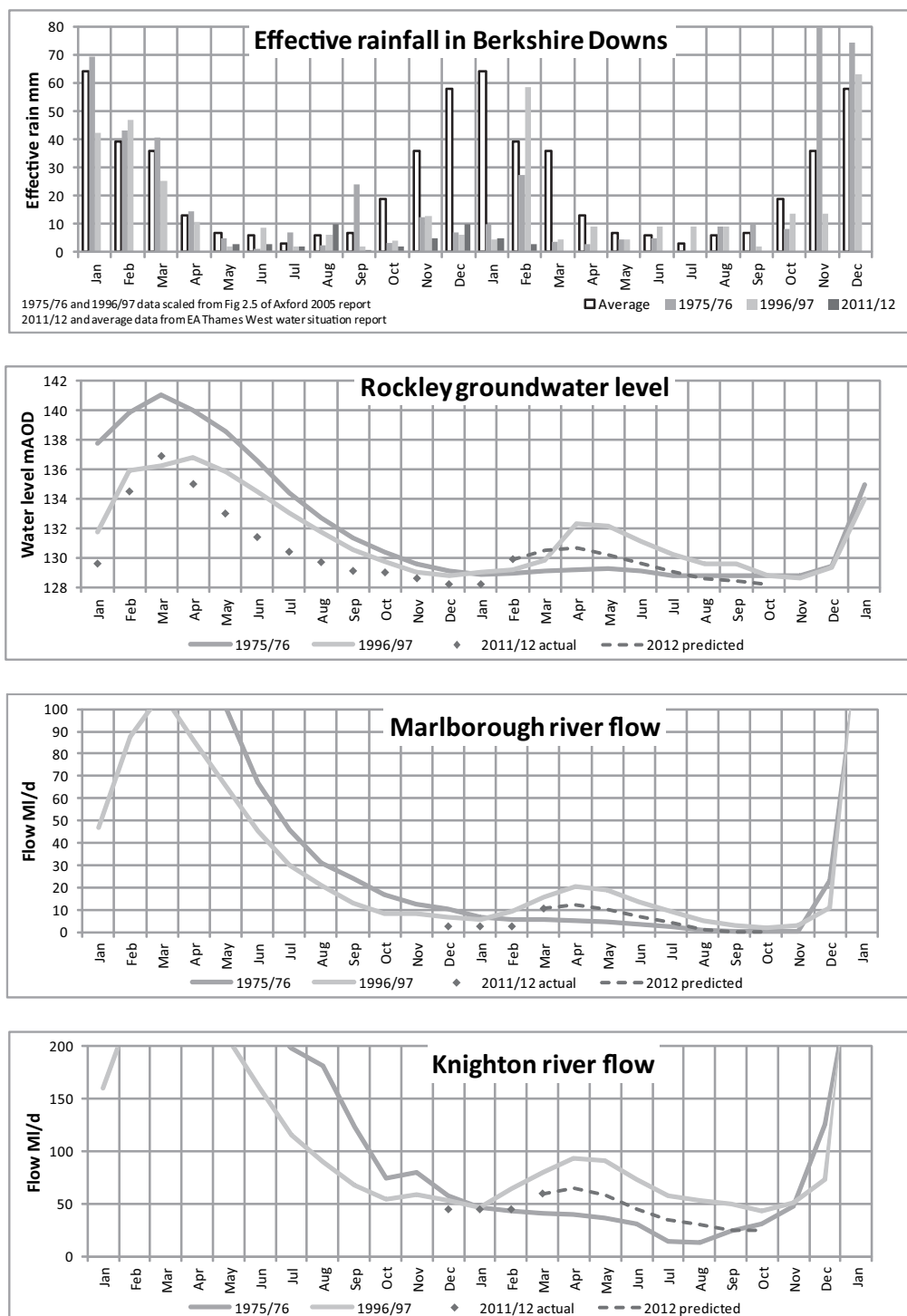


Figure 1—Comparison of droughts of 1975–76, 1996–97 and 2011–12

The lower two graphs in Figure 1 show recorded Kennet flows at Marlborough and Knighton, and predicted flows to autumn 2012, assuming abstraction remains similar to 2011 levels. The predicted flows are simply sketched in by eye, based on the rates of flow recession recorded in 1976 and 1997. Regardless of rainfall, the flows are likely to be almost as low as 1976 and significantly lower than 1997.

Assuming abstraction similar to 2011, the flows in the Kennet in the summer of 2012 can be expected to be lower than experienced in the autumn of 2011. The river will probably be dry at the Marlborough gauging station and through the town from about August onwards. By May, the flow at Knighton can be expected to be lower than in autumn 2011, falling to about half the autumn 2011 flow by the end of the summer, although not quite as low as 1976.

3. LIKELY IMPACT OF DROUGHT IN 2012, COMPARED TO 1976

The impact of the drought in 2012 on the ecology of the river is likely to be worse than 1976, because:

- Total abstraction above Hungerford has risen from about 4 MI/d in 1976 to about 17 MI/d now.
- The normal condition of the river is markedly worse than 1976 because of inferior water quality and algal growth.
- The decline in ranunculus has caused lower water levels, slower flow velocities and less cover for fish.
- The reopening of the Kennet & Avon canal in the early 1990s has caused a major deterioration downstream of Hungerford.

Therefore, every effort should be made to reduce abstraction in 2012, whilst still fulfilling Thames Water’s duty to supply its customers.

4. ALLEVIATION OF DROUGHT IMPACT BY MANAGING ABSTRACTION

The first priority in managing abstraction in 2012 is to reduce the demand for water. ARK fully supports Thames Water’s plans for water saving and proposals for temporary use bans, as announced on 12 March.

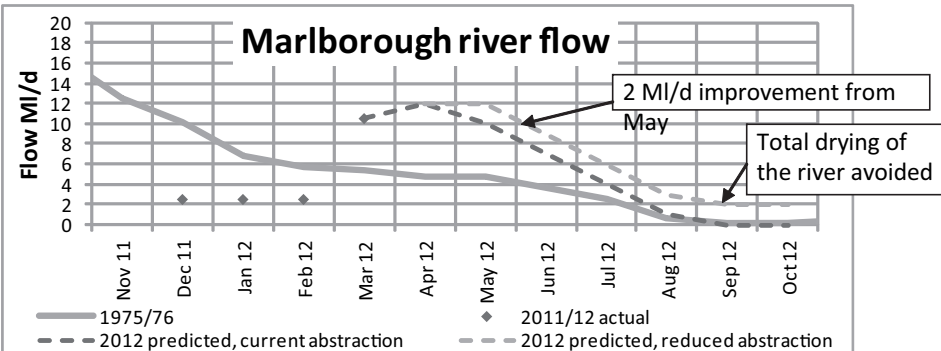
However, ARK believes these bans will be more effective locally if they are accompanied by announcements of drought measures to change abstraction for the benefit of the river. The changes proposed are:

- (i) Switching off the Marlborough and Clatford boreholes and supplying Marlborough and surrounding villages from Axford. The total abstraction from the upper Kennet would remain the same, but the location of abstraction would be shifted down the river, improving flows at all points upstream of Axford.
- (ii) Supplying Swindon as far as possible from Farmoor and Gatehampton, reducing abstraction at Axford and Ogbourne to the minimum possible. This option could only be followed if rainfall in April and May is close to normal and Farmoor reservoir is nearly full, ie in Reservoir Level R₀ in the Farmoor Control Diagram, as described in Thames Water’s draft drought plan. It should be noted that Farmoor reservoir is currently in level R₀ (ie almost full) and normal rainfall in the summer of 2012 is the most likely scenario. However, even with normal rainfall, flows in the Kennet will drop to close to 1976 levels.

These measures would significantly improve flows in the Kennet. The EA’s CAMS modelling has shown that fully licensed abstraction reduces drought flows approximately as follows:

<i>Reduction in flow due to abstraction</i>	
Marlborough	2.5 MI/d
Knighton	15 MI/d

The proposed measures would not reduce the impact of abstraction completely, but could lead to increases in flow of about 2 MI/d at Marlborough and 10 MI/d at Knighton. The potential benefit is illustrated in Figure 2.



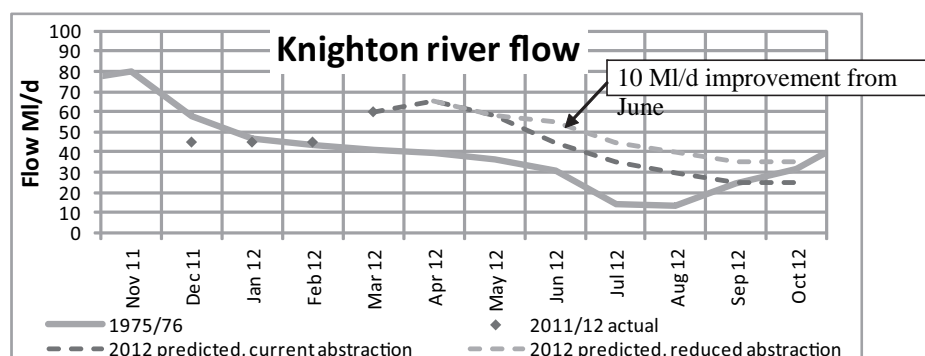


Figure 2—Impact of proposed drought measures on flows at Marlborough and Knighton

There would be similar benefits to flows in the Og if the Ogbourne abstraction is reduced or cut altogether, with south Swindon supplied from Axford only.

Annex B

TIMELINE FOR ARK AND AXFORD ABSTRACTION LICENCE

1990	Residents form “ARK” to protest about the state of the river
1994	Thames Water apply to vary the terms of the abstraction licence at Axford.
1998	Thames Water appeal against the Environment Agency’s ruling which leads to a Public inquiry into the impacts of abstraction at Axford. ARK gives detailed evidence. Secretary of State rules in favour of Thames Water, but recognises the ecological impacts of the previous licence arrangements, particularly on Ranunculus. The new license includes a flow constraint when flows are less than 90 MI/d to be applied from January 2000. The license must be reviewed in 2007 and any further evidence of environmental harm could be reviewed as part of any application to renew the variation.
2001–2004	Ecological studies to inform the Low Flow investigations (Atkins)
2004	Environment Agency Catchment Abstraction Management Strategy shows the Kennet to be “over-abtracted”.
2005	Low Flow Investigation is published (Atkins) and concludes that there is a negative environmental impact of abstraction from Axford.
2005	Jenny Covey (EA) attends ARK AGM and states that the EA will contest the variation on the license in 2007, but not the base license itself. ARK argues that the base license should be reduced.
2007	Thames Water apply to renew the variation on the Axford licence.
2007	Fiona Holmes (EA) attends ARK AGM and states that EA and Natural England are aiming to reduce abstraction at Axford to 6MI/d with 3MI/d to be used locally, and 3MI/d to go to Swindon with a target date of 2014.
2008	EA grant a temporary extension to the Axford licence with a reduction from 13.7MI/d to 11.1MI/d (average) until 2011. ARK argue this does not go far enough, and EA argue it is part of a process moving towards the target of 6MI/d.
2010	ARK give evidence at TW public inquiry into water resource management plan, stating that the cost of the Axford alternative should fall within the price review system.
2011	Thames Water apply to renew the temporary variation in the license because no work on the Axford alternative has begun. EA grant the extension.

March 2012

Written evidence submitted by Water UK

WATER UK REPRESENTS UK WATER AND WASTEWATER SERVICE SUPPLIERS AT NATIONAL AND EUROPEAN LEVEL.

1. THE CONTINUING ROLE OF GOVERNMENT IN DELIVERING MARKET REFORMS

1.1 The White Paper “Water for Life” sets out the Government’s proposals for market reform in the water sector. Successfully delivering the Government’s objectives will require all those involved to work collaboratively. Stakeholders will approach the issues from a number of different positions and only the Government is in a position to reconcile those positions to achieve the best outcome.

1.2 The Government also has a continuing role in guiding the development of the market over the longer term, even where certain elements of the market are subject to normal competitive forces. The absence of power to secure overarching strategic objectives for the sector could lead to the types of problems experienced

in other sectors where market reforms have been introduced. This would risk undermining the sector's current reputation for delivering the highest quality of water and waste water services.

1.3 The implementing legislation will therefore need to reserve a role for the Secretary of State if Defra is to retain the necessary authority to achieve its policy objectives.

2. RETAIL COMPETITION

2.1 Water companies are committed to delivering more and better services to business customers. This includes businesses choosing their supplier, in line with Government policy set out in the Water White Paper. Once the appropriate framework is in place, water companies will be in competition with each other in order to win market share, differentiating themselves through features such as quality of service and lowering prices to business customers.

2.2 The industry agrees with the Government's analysis that there is no case for introducing competition into the household market and we share the Government's conclusion that there is no need to force legal separation of the existing water companies.

3. TIMESCALE

3.1 We support the Government's decision to work with the Scottish Government to help deliver a cross-border retail market. It is important for Water UK's members both in Scotland and in England that new market arrangements are appropriate, proportionate and robust.

3.2 The Scottish experience has demonstrated that the path to market opening entails detailed, collaborative working to ensure that arrangements are fit for purpose. The industry both sides of the border will want to play a full part in this process to ensure that it is implemented as quickly as reasonably possible. A market opening in 2015, as announced by Ofwat without consultation, would entail an unacceptable degree of operational risk due to resource constraints at companies and in Government and its agencies. Water companies will bear by far the greatest burden of setting up the market and they have significant concerns about the achievability of Ofwat's timescale.

3.3 Attempting to introduce retail competition reforms, upstream reform and significant changes to the price review process affecting all customers, all at the same time, does not make sense. The DWI and Environment Agency will also need time to make sure that both drinking water quality and the environment continue to be protected.

3.4 It is also unclear whether the Government sees upstream reforms as being simultaneous with, or subsequent to, the proposed retail market reform. Implementing retail reforms first would have obvious advantages. This is because, unlike the retail market reforms, there is no experience of upstream reforms to draw upon from Scotland, where competition in such areas is illegal.

3.5 We believe a more structured and methodical approach to building the necessary market infrastructure is required.

3.6 A step by step approach should be taken with the most straightforward changes—which may yield the most obvious sources of benefit—introduced first. Further refinements or more fundamental measures should be implemented only when the Government has made a full assessment of the benefits and risks associated with upstream reform and following the successful establishment of the retail market arrangements. This emphasises the importance of continued Government involvement in the implementation of market reforms.

4. CONTRIBUTION TO THE LOCAL ECONOMY

4.1 Water companies don't just pump water into the regions in which they operate—they pump millions of pounds into their local economies. Water companies are regionally focused, and most investment stays in the region, supporting thousands of local businesses and tens of thousands of jobs at all skill levels. This provides a crucial boost to the local economies of all parts of the country, even in difficult economic times.

4.2 Water and sewerage services are a vital part of the infrastructure needed for new development, especially in areas of high population growth, and we plan decades ahead to ensure that future demands can be met.

4.3 We support local tourism and fragile seaside town economies through our real-time information on water quality and our work on cleaning up rivers and beaches. We work closely with local shopkeepers and local authorities to ensure that water quality messages are accurate and supportive of those whose jobs depend on tourism.

4.4 Water companies are integrated into the regions in which we operate, and are formed, and informed, by the communities in which we live. We can demonstrate to people living within each region that the environmental work we do has direct benefit to them.

4.5 If in the future—as implied in the Water White Paper—the geographical link between water company and customer were broken environmental projects would be less attractive to companies. It would also be far

harder to make the case for a company investing in environmental improvements and there would be less certainty that companies would deliver benefits to customers over the long term as a result.

5. INTEGRATORS

5.1 As Defra's Natural Environment White Paper points out: "Government alone cannot create a greener economy. Markets that trade sustainably in natural goods and services are essential." Water companies, in their catchment management work, have created unique and sometimes counter-intuitive coalitions, working with conservation groups, community groups, local government and crop protection companies. The engagement work with farmers and customers, undertaken collaboratively has not only benefitted the agricultural community but has also provided benefit for water bill payers, the environment and biodiversity alike.

5.2 It is, however, difficult to map a philosophical arc that links the first part of this Water White Paper, which envisages a holistic and sustainable industry by definition rooted in its communities, and the increased competition plotted out in the later sections of the document. Catchment management projects requiring many hours and days of one-to-one engagement and education will not seem attractive if profit takes centre stage, especially when hard engineered solutions such as treatment works provide solutions with predictably measurable results.

5.3 The twin drivers of demographic and climate change will mean that, in many parts of the country, a gap could begin to develop between the amount of water available, and the many sectors that have need of it—households, the environment and wildlife, agriculture and industry amongst them. Few sectors encourage their customers to use less of their product; however, water companies have been instrumental in both raising awareness of the precious nature of this finite resource, and supporting the view amongst the customer base that reducing water use is a social justice issue, that it behoves everyone in a community to use water wisely when there is not a lot of it to go around.

6. PUBLIC SERVICE OBLIGATIONS

6.1 The water industry is proud to provide an essential public service. At present we provide services to the entire communities in which we operate, on a regionally averaged basis. This means rural communities receive the same high quality drinking water as urban ones, but are not faced with an unaffordable cost.

6.2 We deliver Government social policy objectives such as ensuring that no household customer is disconnected because they are unable to pay and operating the WaterSure scheme to protect metered customers with unavoidably high water use from unaffordable bills. We will look to meet the Government's expectation in Water for Life of the early introduction of social tariffs.

6.3 This will add to the many things that companies already do to help customers who have difficulty in paying their bills—such as offering flexible payment plans, assistance through charitable trusts and restart plans, and funding support via debt advice agencies.

6.4 The Government needs to play its part too.

6.5 Social tariffs should be targeted to provide assistance to those in need—but much of the information on who is in need is held by Government. Government must help by allowing water companies to make use of this information.

6.6 To stop the burden of bad debt rising ever higher—it already adds £15 to every customer's bill—we need the Government to implement the requirement for landlords to tell water companies who their tenants are.

6.7 And as the Government implements its other policy objectives, it will wish to guard against unintended consequences.

6.8 For example, the Government has said that the "costs principle" for access pricing is anti-competitive and gives incumbent water companies little incentive to become more efficient. Parliament implemented the costs principle in order to ensure that households do not subsidise business customers.

6.9 Unless the underlying purpose of avoiding hard-pressed families and pensioners subsidising big businesses like supermarkets is maintained, the legitimacy of Government's reform programme would be undermined.

6.10 Given how significant the costs principle is in protecting household customers, and maintaining investor confidence, we find it surprising that Defra's extensive impact assessment of their retail reforms does not include an assessment of the risks of replacing the costs principle. The Government must remedy this.

7. INVESTORS

7.1 The water industry needs to invest £22 billion over the next five years in order to safeguard the high quality of service to customers and the environment, now and in the future. There are only three sources of finance: tax-payers, bill-payers and investors.

7.2 If customers had to pay for this investment on a pay-as-you-go basis, bills would rise to unacceptable levels. Ensuring that the water sector remains a good place for investors to do business is therefore crucial. Since privatisation, the sector has delivered £98 billion of infrastructure investment at no cost to the public purse. At present, water companies are able to raise debt financing at rates which are lower than many European sovereign states, helping to keep down water charges in England and Wales.

7.3 Returns on capital make up around a quarter of customer bills. An increase in the cost of capital of just 1% would translate to around a 5% increase in customer bills.

7.4 Both Defra and Ofwat have produced impact assessments of the profound changes they propose to make—to the industry structure and to the price review arrangements respectively—which show that just a small increase in the cost of finance would be enough to wipe out all the benefits. Ofwat's own calculations show that the radical changes it proposes to make to its price review arrangements are, at the high end, expected to yield savings of £2.5 billion over a thirty year period. Ofwat has also calculated that an increase in the cost of capital of just 0.2% would be enough to more than wipe out these benefits.

7.5 The Government and Ofwat must therefore take great care to ensure that its actions do not inflate financing costs through investors' perceptions of sectoral risk. If this were to happen, the adverse impact on customers' bills and company investment programmes would be significant.

8. PUBLIC HEALTH

8.1 The White Paper makes no explicit reference to the vital role that water companies play in protecting and promoting public health. The provision of water and sanitation services is essential in maintaining the health of the nation.

8.2 The Water White Paper should have considered how the changes and reforms proposed will be managed to ensure that this overarching responsibility to public health is not compromised.

January 2012

Supplementary written evidence submitted by Water UK

I write further to the recent Efra Select Committee evidence session on the Water White Paper, at which I appeared with Peter Simpson, Managing Director of Anglian Water, and Steve Mogford, Chief Executive of United Utilities.

We found the session very valuable and the Committee receptive to many of the points we made. The depth of understanding and, indeed, strength of feeling that many Members showed during the session was encouraging. That policy makers are so engaged with the debate surrounding the future of the water industry is vitally important and the Committee's role in that is a crucial one.

Time pressures meant that, unfortunately, we were not able to expand on the theme of investor confidence, which is fundamental to financing continued service improvement in the sector. Given the importance of this issue I thought it would be helpful to follow-up this point.

In recent weeks a number of worrying overtures have been made by members of the investment community. HSBC's Verity Mitchell is on record as saying that Ofwat's Future Price Limits and licence modification proposals increase the uncertainties in the UK water industry. She suggests that although the Water White Paper does not recommend fundamental structural change those measures emanating from Ofwat represent a medium-term agenda for quite considerable structural change, with the possibility of an adverse impact on bond covenants for some companies.

Recently, JP Morgan Cazenove suggested that the market had been complacent on structural reform reflecting that it had not fully understood the ramifications of many of the proposals *"Indeed, there are other changes which could have material negative implications for the companies such as removing the cost principle from legislation and replacing it with a yet to be defined wholesale access regime"*.

As I mentioned in the evidence I gave, for every one percentage point increase in the cost of capital there is a five% increase in customer bills. Moody's, the ratings agency, stated at Water UK's City Conference two weeks ago that *"Uncertainty as to the continued predictability and stability of the regulatory environment, together with changes that are expected to increase operational risk and earnings volatility for the sector, could lead lenders to require higher margins and so increase the cost of capital."*

The industry does not seek to be alarmist and it goes without saying that it is not in its interests to undermine market confidence, but unfortunately such statements represent a strengthening narrative that is now developing in some quarters of the investment community. For Moody's to suggest, as it has, that the sector's credit rating is at risk is extremely serious since the entire success of the sector is based on successful treasury activity within companies. This has allowed customers to benefit from extremely low financing costs despite the scale of the infrastructure challenge facing the industry—and in the UK we are the acknowledged world leaders in this area.

Indeed, yesterday, the Prime Minister has been talking about financing other forms of infrastructure based on the water and sewerage model, so it would be unfortunate to put the financing of water and sewerage infrastructure under a cloud just when the Government is seeking to use it as a template for other infrastructure investment.

Again, thank you for a very valuable session with the Committee and if I can be of any further assistance please let me know.

20 March 2012

Written evidence submitted by The Environment Agency

INTRODUCTION

In December 2011 the Environment Agency published two documents, one jointly with Ofwat, which provide supporting evidence to the Water White Paper, *Water for Life*. These documents set out the reasons why the measures in *Water for Life*, particularly those around reform of the abstraction management system, are needed now.

- The case for change: current and future water availability³⁰ sets out the Environment Agency's work to quantify water availability in the 2050s.
- The case for change: reforming water abstraction management in England and Wales³¹ (produced jointly with Ofwat) sets out the limitations of the current system.

WHAT WILL THE FUTURE LOOK LIKE FOR WATER RESOURCES?

Water is a precious resource that faces increasingly severe and often conflicting pressures. Clean, thriving water bodies are an integral part of the natural environment and the economy. Water is abstracted for many purposes, including public water supply, agriculture, industry and electricity generation. Water resources in England and Wales are already under pressure. Reliable supplies of additional water for abstraction are not available across much of England and Wales and, in some places, water bodies are already being damaged by abstraction.

In the future, climate change and population growth will increase the pressure on water availability. Current climate change projections for the UK suggest that by the 2050s, under the medium emissions scenario, summer temperatures may increase and summer rainfall may decrease. Short duration droughts (12–18 months) are likely to become more frequent, so that droughts like 1976 could be more common. Although society is better placed to deal with such events, due to increased resilience of public water supply and more winter storage, more frequent events would likely cause substantial difficulties.

The population is forecast to increase by 9.6 million people by the 2030s (9.2 million people in England and 0.4 million people in Wales). Population growth means that total demand for water is likely to increase even if per capita consumption goes down over time. Impacts will vary from place to place. However those areas already experiencing water stress will have a potentially increased population of over 40% (Thames and South East England) which will make the problem worse.

In *The case for change: current and future water availability*, the Environment Agency presents work to quantify water availability in the 2050s. The ground breaking research considers a number of scenarios that include a range of projected futures, taking climate change, population growth, demand changes and environmental requirements into account. The conclusions that can be drawn from this work are:

- Water resource availability in the future is uncertain.
- The water environment will be different from that of today. Some species will be better suited to future conditions than others. We will need to reconsider the requirements for future water ecosystems and the implications on the water available for abstraction.
- The combined impacts of climate change and increases in population show there could be less water available for people, businesses, agriculture and the environment than today.
- Future water resource availability pressures will not be limited to the south and east of England. Under many of the scenarios Wales, south west and northern England are likely to see significant unmet demand in the future.
- Over the longer term climate change could have a bigger impact on water resource availability than population growth. Unmet demand is more closely linked to the climate change scenarios than the demand scenarios.
- Demand management will have an important role in the future but increased demand and climate change could result in the need for significant new resources to be developed.

³⁰ <http://publications.environment-agency.gov.uk/PDF/GEHO1111BVEP-E-E.pdf>

³¹ <http://publications.environment-agency.gov.uk/PDF/GEHO1111BVEQ-E-E.pdf>

- The scale of the problem needs to be considered at a strategic and local level. Solutions also need to be considered at both scales. For example, trading would need to be assessed at a local level whereas the development of new resources would be more appropriate at a strategic level.

THE CURRENT SYSTEM FOR MANAGING ABSTRACTION

The current abstraction management system has been in place since the 1960s. It was designed for an England and Wales with a perceived surplus of water in most areas, with a considerably smaller population and with a very different attitude to environmental protection.

In The case for change: reforming water abstraction management in England and Wales, the Environment Agency, jointly with Ofwat, set out the limitations of the current system now and in the future. It highlights what needs to change and welcomes the Government's commitment to change the abstraction management system.

Under the current system, the way water abstraction is managed is not responsive or flexible enough to create market or regulatory signals. This means the system does not encourage or signal the need for actions to address the future challenges as set out above. The most obvious issues include:

- Many licences have a fixed water allocation. The volume of water permitted for abstraction is not dynamically linked to the actual volume of water available. Most licences have been issued without a time limit, making it difficult to review them. To change these licences, the Environment Agency has to follow a lengthy regulatory process. Where licences have a condition to reduce or stop abstraction, this condition is not flexible to a changing environment.
- Licences issued more recently have more restrictions compared with older historic licences, because of our improved understanding of the impact abstractions have on the environment. However there are still no mechanisms built in to licences to ensure that users respond to relative scarcity or abundance, and we still rely on regulatory intervention.
- There is no dynamic water abstraction market, with little trading or sharing of licences to abstract. This is because of real and perceived barriers, such as poor information about trading opportunities, a lengthy administrative process and uncertainty about trading outcomes. So abstractors who do not need to take their full water allocation do not hand back or sell-on licences as their needs change.
- Charges for licences are not linked to the volumes abstracted (with the exception of spray irrigators) so they do not reflect the availability of water or the competing demands and value that users place on it. Once water is allocated, there is no financial incentive to use it efficiently, or to consider its scarcity and other environmental impacts.

THE NEED FOR CHANGE

The combination of future pressures on water resources and the shortcomings of the existing system mean that the current system cannot just be left as it is.

The Environment Agency is working closely with Defra to further develop options for reform. The options clearly need to meet the criteria set out in Water for Life. The Government has committed to engaging with stakeholders throughout the process to ensure the implications of these options on abstractors are properly understood.

The two case for change documents outlined here were written to support Water for Life and in particular the abstraction reform elements, but they also have a more far reaching effect. Future pressures on the water environment will affect water quality, biodiversity and other aspects of environmental protection. We believe this supports the need for a broader approach to managing catchments, the need for efficient use of water and for sensible long term planning to ensure secure supplies across a range of sectors. We are pleased that such commitments are included in Water for Life and will work closely with Defra to deliver them.

May 2012

Written evidence submitted by the Department for Environment Food and Rural Affairs

WATER WHITE PAPER— FOLLOW UP INFORMATION

In your letter of 18 April you asked for further information on the legislative constraints to the sharing of data on benefits claimants with water companies. The sharing of data is controlled by the Data Protection Act 1998. Under the Act, data sharing may be lawful under certain circumstances, including where the subject has given their informed consent. This means, for example, that if a water customer was to apply for a social tariff and consent to that company confirming with DWP that the customer was in receipt of benefits that could be lawful. Similarly, DWP could ask all benefits recipients to consent to having their details shared with their water company.

Data sharing may also be lawful to enable an organisation to comply with a statutory function or legal obligation, for example, a mandated scheme.

The Committee may be aware of DECC's Warm Home Discount scheme. Government shares information about people in receipt of a subset of Pension Credit Guarantee with participating energy suppliers, in order that the energy company can provide those low income pensioners with a supplier-funded discount from their fuel bill. There is special legislative authority for this data sharing under section 142 of the Pensions Act 2008 and in regulations. This means that the pensioners' direct consent is not needed. The use of the information is strictly limited to the provision of the discount of their energy bill.

Article eight of the European Convention on Human Rights deals with the right to private life. Any new legislation which seeks legal authority for data sharing would have to be compatible with that Article. If we were to design a data sharing scheme for water we would have to consider how we could demonstrate this. In addition to showing Data Protection Act compliance, we might, for example, want to show that the people whose data was to be shared would automatically receive a corresponding benefit in order to show that any interference with the right to private life was proportionate.

Water companies are able to reduce the bills of those customers who would otherwise struggle to pay in full through company social tariffs. Many water companies have requested access to benefits data so that they can passport customers in receipt of benefits to a social tariff.

We would seek to ensure that such a scheme was able to provide a proportionate benefit to a suitable group of people (ie those actually struggling with water affordability). In their scheme, DECC were able to identify a clear group at risk of fuel poverty—older, poorer pensioners, who were well represented amongst the recipients of a subset of Pension Credit Guarantee. However, the profile of people at risk of water affordability problems is less clear. Ofwat found that the group most at risk is working-age adults living alone. Many of those customers would save money by paying for their water via a meter. Ofwat found that 60% of households at risk of affordability problems do not receive benefits. The picture of those most at risk of water affordability problems does not present a clear group of benefits recipients who could be automatically eligible for a discount via a data sharing scheme. Providing a guaranteed discount for all benefits recipients (or a subset group) would be very expensive for other water customers, who would fund this through cross-subsidy. Furthermore, the evidence suggests that it would not be an effective way to target those at risk of water affordability problems, the majority of whom are not on benefits.

On your second point, our affordability consultation stated that impact assessments would be prepared for policy proposals included in the White Paper. The key change which was being considered was a change to the WaterSure cap. Having carried out an assessment of the likely costs and benefits of this proposal the Government decided not to make any change. This decision reflected concern that the proposed change would not deliver support to many of those most at risk of affordability problems. Responses to the affordability consultation emphasised that many people at risk of affordability problems fall outside of the narrow WaterSure eligibility criteria. A decision to amend the cap would also have increased the cross-subsidy paid by bill payers across the country, with a disproportionate impact on bill payers in the South West. South West bill payers already make the greatest contribution to the costs of the WaterSure scheme and under the proposed change to the cap this would have increased to around eight pounds per household per year. Placing an additional burden on South West bill payers ran counter to the Government's objective of reducing the disproportionately high bills faced by households in that part of the country. Our analysis also showed that Government funding of WaterSure would not have been affordable, as the costs would have been completely open-ended as levels of metering increase. Having determined that a change to the WaterSure cap would not have represented good value for money we did not publish a formal impact assessment as there was no policy change.

We have prepared an impact assessment of the decision to issue guidance on company social tariffs, which will be published alongside the final guidance. We did not prepare an impact assessment on the payment to South West Water as this was a spending decision made by the Chancellor.

May 2012

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