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THE WATER REPORT

POLICY | REGULATION | COMPETITION

Final thoughts

Ofwat's Sonia Brown reflects on the delivery of PR14 final determinations and lessons for Water 2020

COMPETITION WATCH

- Ready to wholesale? Scottish Water on building wholesale capability
- Breakthrough on private central systems procurement for retail market
- Exit: industry feeds back to DEFRA on December plan

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THE WATER REPORT COMPETITION WATCH

Editor: Karma Ockenden e: karma@thewaterreport.co.uk t: 07880 550945
Art Editor: Numa Randell e: numa@randell-family.org.uk t:07754269168
Subscriptions: subs@thewaterreport.co.uk Single annual subscription £699; corporate annual subscription (10 copies plus unlimited e-copies) £1,999.
Website: www.thewaterreport.co.uk
Address: The Water Report, 68 Church Street, Brighton BN1 1RL
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EDITOR'S COMMENT

You can't hurry reform

They say it ain't what you do, it's the way that you do it. In reforming the water market over the coming years, the "when" is going to be crucial too.

While retail market opening is nailed to April 2017 – and now central systems will be procured through private means, we can have more confidence in that date (see Competition Watch, p21) – the pace at which wholesale reform is progressed is going to be almost as important as the form that reform takes.

Ofwat's leadership team is embracing the agenda, as its strategy and forward work programme show (see report, p10). Its top strategic priority is delivering the reforms provided for in the Water Act 2014. This will involve implementing retail market opening; supporting the development of abstraction reform; and designing policy upstream.

The regulator is ambitious, looking to have a clear idea of how the wholesale market will change before it conducts PR19. Indeed, it aims to publish a market assessment by early next year setting out the upstream services over which it will facilitate competition in the short and medium term. There may be those within Ofwat's walls that prefer the day job of economic regulation or even the night shift of implementing the retail market, but the public face is certainly one that has its eyes and ears open to new ideas.

While the government clearly supports upstream reform too – it has, after all, legislated for it – DEFRA is thought to be in no particular hurry to rush it through. It has rather a lot on its plate making a go of retail competition and setting up a new abstraction regime. Again there may be enthusiastic wholesale reformers within the department, but the overarching approach seems to be to proceed with caution.

As for the companies, their appetite varies. Some argue the Water White Paper interpretation of upstream reform – essentially, catchment management activity and contestability in wholesale markets – is too narrow; others have barely started working up a position.

It is admirable of Ofwat to take the bull by the horns in this inherently thorny area. It has been astute in learning from its hurried PR14 experience to get started early on Water 2020. But the regulator would be short sighted to hurry reform that will have to stand the test of time and could really invigorate upstream outcomes if done well, mainly to fit in with the five yearly cycle. Particularly if it doesn't want to unduly spook debt investors who will inevitably panic about the RCV in the process.

The Water Report is to carry a new series on upstream reform, starting this month with a focus on upstream services. See p12-17.

Karma Ockenden, editor, The Water Report

Feedback, comments and suggestions very welcome.

Contact me on karma@thewaterreport.co.uk or 07880 550945.

BRISTOL: FDS ARE NOT IN CUSTOMER BEST INTERESTS

Bristol Water argues Ofwat's cost model is flawed; all other firms accept final determinations; Dee Valley assurance prescribed

A bridge too far: Bristol rejects Ofwat's suggestion to plug it's totex gap through efficiencies and scope reduction

Ofwat has worked hard to put customers at the heart of the price review process and to embed in companies' mentalities that their raison d'être is to serve their customers. In rejecting Ofwat's final determination (FD), Bristol Water is running with that philosophy, arguing that its customers would not be well served by it accepting the settlement.

The FD in December cemented in a 32% gap between the company's proposed totex of £541m and the regulator's number of £409m. With the notable exception of funding for the initial construction phase of the Cheddar Reservoir Two scheme which Bristol factored in but Ofwat excluded, the gap didn't stem from a different view of desirable outcomes but from a different view of efficient costs.

> **In practice, accepting the determination would mean we'd have to reduce our maintenance expenditure by a third.**

Ofwat argued then, and chief regulation officer Sonia Brown repeated in our interview in January (see p6-9), that the gap could be bridged through further efficiency savings and/or by Bristol reconsidering the scope of its programme. Bristol rejects both suggestions as untenable.

Regulatory director Mike King said: "A substantial reduction is scope is not in our customers' interests. In practice, accepting the determination would mean we'd have to reduce our maintenance expenditure by a third." The company does not consider the £409m figure sufficient to maintain its levels of service and investment: "Our investment plans are essential for us to be able to carry out sufficient maintenance to ensure the reliability of our local water infrastructure, to meet the needs of a growing population in our region and to add greater resilience and security of supply. If we cannot invest locally, the infrastructure will deteriorate more quickly and customers may experience greater or more frequent water supply problems as a result."

On the Cheddar reservoir specifically, Bristol argues the scheme has local support and is "the most economic and environmentally sound solution, satisfying future demand for water arising from population growth and additional commercial activity". It adds: "Delaying the building work could add cost and stretch our water resource capacity."

On further efficiencies, King asserted that the gap is simply too large to be plugged that way. "For example, the determination assumes our operating costs fall by 21% beyond the costs set out in our plan," he said.

Cost shortcomings

In explaining the gaping chasm between its and the regulator's totex calculations, Bristol argues Ofwat's cost model is flawed: built with a one-size-fits-all approach, and unable to account for different company situations. Pertinent issues in Bristol's case are that it has a very old network and the amount of water it needs to apply sophisticated treatment to is the second highest in the industry. Calling Ofwat's model "very complex and over-specified", King commented: "Our cost should be above average, but Ofwat's model predicts we are very low cost." According to Bristol, independent assessors agree the model does not accurately predict company costs.

King acknowledged Ofwat had given his company a fair hearing, including making special provisions for engagement to continue beyond the 3 October cut off point imposed on the rest of the industry. "They did try to listen," he said, "but they were just too wedded to their models."

Ofwat will now refer the case to the Competition and Markets Authority (CMA), which will reopen the entire determination and make a ruling – a process expected to take about six months. Aside from the cost model issue, King confirmed the company will take the opportunity to raise other grievances and restate its case for a company specific weighted average cost of capital uplift. Ofwat rejected its business plan claim for a 70 basis point increase. King said: "Our reasons for that [requesting a small company premium] are drawn from the Competition Commission's (CC) judgement five years ago [when Bristol appealed its PR09 determination]. Ofwat has departed from the CC's approach, not us."

Among other factors the company is likely to draw attention to in the appeal are:

- Material revenue reduction: the final determination imposes a 21% cut on the average Bristol Water bill over five years, down from £202 in 2014/15 to £160 in 2019/20. This is the greatest percentage reduction in the sector, and over four times the industry average five year bill cut of 5%. This is a product both of Ofwat's much tighter totex number and the fall in allowed returns.
- Customer support: Bristol said a whopping 92% of customers considered its business plan acceptable.
- Solid wider performance: including below average cost to serve; low average bills for the region; fifth place Service Incentive Mechanism ranking; and a good quality compliance record.

CMA prospects

Precedent from its 2010 CC appeal suggests Bristol could walk away from the CMA with a more favourable settlement than the current FD offers, though it is unlikely to achieve as good a deal as its business plan proposed. Ratings agency Moody's expected Bristol to maintain near term credit quality on the back of its sufficient liquidity and gearing headroom, but said the outlook was negative, "reflecting the very challenging price determination from Ofwat, and the fact that unless the CMA price redetermination is significantly more favourable, Bristol Water's financial metrics will weaken in AMP6 and the company will likely fail to maintain a financial profile in line with Moody's guidance for the Baa1 rating."

Ofwat will obviously defend its cost model and other decisions before the CMA and can point to the fact that all 17 other water companies have accepted its cost model and their FDs. Company attention will now be turning to delivering the deal they have signed up to – in particular, living with lower returns (3.6% wholesale WACC plus retail margins), chasing operational outperformance in pursuit of Outcome Delivery Incentive payments/penalty avoidance, operating within their four discrete price caps; and delivering challenging totex programmes.

Inevitably some companies will find it all more comfortable than others, with the highly geared under particular pressure from lower allowed returns.

Listed companies

Of the listed companies, South West Water enjoys privileged enhanced status. Moderately geared United Utilities (at c60% of net debt to RCV) is aiming to stick within its current gearing range of 55-65%, maintain its existing credit ratings (A3 with Moody's) and target dividend growth in line with RPI inflation. According to Moody's: " Given (1) the group's prudent financial policy, evidenced by the recently confirmed gearing target and updated dividend policy; (2) a relatively high proportion of inflation-linked debt within its capital structure; and (3) low interest costs, UU is in a stronger position than its peers to face ongoing pressures of challenging efficiency targets for the next five-year regulatory period and low near-term inflation, as well as expected longer term developments of the industry, such as Ofwat's reform to promote competition in the upstream segment of the industry."

Severn Trent has announced it will move towards a net debt/RCV gearing ratio of around 62.5% which is in line with Ofwat's notional assumption, as part of which it will start a £100m share buyback programme. It will also cut its year one dividend payout by 5% compared to the full dividend for the year 2014/15 and allow for dividend growth of no less than RPI in subsequent years. This replaces the current dividend policy of RPI+3%.

The company said: "The board believes that this financing plan and new dividend policy are commensurate with a sustainable investment grade credit rating." Moody's, however, was less confident, dropping its outlook on Severn Trent's ratings from stable to negative.

"The change in outlook reflects the risk that Severn Trent's dividend cut may not be enough to maintain credit quality in line with the current ratings," said Paul Marty, Moody's lead analyst for Severn Trent. "Absent outperformance against regulatory assumptions and at least moderate inflation, the group's credit metrics could fall short of Moody's guidance for the current A3/Baa1 ratings during AMP6."

Perhaps the industry should be grateful the FDs weren't even more challenging. According to Agency Partners utilities analyst Lakis Athanasiou, excess returns remain part of the picture – but it need not be thus: "The reason that both Ofwat and Ofgem give too high returns is that they have sleepwalked into assuming too high gearing, and are consequently forced to allow high returns to maintain debt financeability.

"It is not difficult to cut returns. In the current review Ofwat assumed 62.5% gearing, increasing from 57.5% from the last review, and allowed return of 3.8%, and struggled to maintain financeability. A 52.5% gearing assumption would have allowed returns to drop to 3%, debt financeability would improve, excess returns would be cut, and customer bills drop by a further 5%." TWR

ASSURANCE RANKINGS AND REGULATORY REPORTING

Ofwat this month published IN15/01, confirming its initial water company assurance categories (see table). Companies were assessed against past performance.

It continues to consult on final proposals for setting specific additional assurance requirements and how companies move between categories over time. Its consultation on the future assurance framework runs to 10 April, with conclusions and guidance due by the end of May.

In IN15/01, Ofwat also set out arrangements for regulatory reporting in 2015/16. Each company is to prepare (and make available to all stakeholders) a single annual performance report. This will contain common content and assurance so stakeholders can compare companies against each other. Each company will be required to present detailed information on revenue and costs for each part of the business subject to price controls: wholesale water; wholesale wastewater; retail household; and non-household retail.

OFWAT'S INITIAL ASSESSMENT OF COMPANY ASSURANCE CATEGORIES

Assurance category	Companies
Self assurance: subject only to minimum industry-wide assurance requirements; discretion over additional assurance requirements	South West Water; Affinity Water
Targeted assurance: some assurance requirements above minimum levels will be prescribed	Anglian; Dwr Cymru; Northumbrian; Severn Trent; Southern; Thames; United Utilities; Wessex; Yorkshire; Bristol; Portsmouth; Sembcorp Bournemouth; South East; South Staffs; Sutton & East Surrey
Prescribed assurance: all assurance requirements above minimum levels will be prescribed	Dee Valley Water

FINAL THOUGHTS

Hard-to-predict and time-constrained: Sonia Brown reflects on delivering PR14 final determinations in challenging circumstances and is keen to get going on design work for Water 2020.

They say the early bird catches the worm, and that seems to be one of the key learnings Ofwat is taking away from its experience of delivering PR14. Chief regulation officer Sonia Brown assumed responsibility for implementing price review policy in summer 2013. Reviewing her experience since, Brown identifies that the regulator was able to tread a far smoother path when it flagged up its intentions early and factored in time for industry dialogue than when it sprang what were perceived to be surprises on companies or when time was particularly constrained.

This is common sense and no doubt an all-too-familiar lesson for the regulator; one which the PR14 experience hammered home rather than revealed. But it explains why Ofwat is resolved to start planning now for PR19 and beyond (see Ofwat strategy report page 10).

Brown inherited rather than created a tight schedule when she took PR14 on. The final methodology was published in July 2013, just five months before companies' business plans had to be submitted in December. Given this, as well as broader difficulties at Ofwat around that time including senior management departures and resource shortfalls, it is to Brown's credit that final determinations were delivered on time, to the satisfaction of most stakeholders and to a high standard.

But she is reluctant to take the credit. "I took responsibility for the implementation of the price review and I think the implementation of price reviews always looks and feels very different from the policy phase. The policy phase by its very nature has more twists and turns in it because it's asking searching questions. You end up at the end of that policy phase with a methodology. What I ended up with was a really strong methodological starting point."

She continues: "It's no secret that the overall timetable was tight and compressed and I think that was the key challenge. Looking to the future we will be looking to do the design work for Water 2020 earlier."

In fact, initial work to support PR19 features in Ofwat's forward programme for 2015-16, published last month. The plan is to work collaboratively with other stakeholders, presumably to stand a chance of delivering even some strands of upstream reform without a showdown. "We are going to try to work with the sector to make sure we are in a really strong position to start implementing, whether that's price controls or deregulation in some areas," explains Brown. "If we start all of that work earlier, it will be to mutual benefit."

She adds that it was only because companies got behind the PR14 process and worked collaboratively with the regulator that this price review was successfully delivered. "It's been delivered by the sector; it hasn't been delivered just by Ofwat and I think that's why it's been a successful process."

Responsive not predictable

Inherited challenges aside, Brown holds her hand up to not foreseeing and, more importantly, to not communicating as well as possible once she had realised, that Ofwat couldn't be as predictable as in previous price reviews this time around. "We set out an implementation timetable which we thought would work," she explains. "But as we started working our way through implementation, it became very clear to us that we needed to be much more responsive, more flexible to deal with challenges that emerged through the companies' plans.

"I believe it's a consequence of giving companies freedom and ownership of their own plans and that's really important because

it goes to the heart of companies owning the relationship with their customers. That is the heart of our new strategy for the sector – delivering trust and confidence for customers. So that's not going to go away. But having the conversation is something we could have done differently. One of the things for me that goes into that lessons learned bucket is, if I knew then what I know now, I would be telling people at the start of the implementation to watch out for the fact that we will need to be more flexible and responsive."

A good example here is Ofwat's introduction at the draft determination stage of horizontal checks on companies' Outcome Delivery Incentives (ODIs) in six common areas: supply interruptions; customer contacts on water quality; water quality compliance; sewage pollution; sewer flooding; and leakage. The regulator intervened in some companies' ODIs on the back of this, effectively to stretch them further in light of other companies' plans. This stretch factor dominated companies' representations on ODIs in October 2014, with some claiming the policy hadn't been signalled.

Brown comments: "We tried on several occasions to signal the idea that we only think the reward should be given in the event that they [performance commitments] were genuinely challenging, genuinely stretching for the companies to achieve. But I don't think we really understood until later in the process just how valuable the use of comparators could be in this space. When we did understand it, we obviously put in place the upper quartile challenge. So next time around, yes, we'd be looking for opportunities to do that earlier."

CCG value

In the last issue of *The Water Report*, some of the Customer Challenge Group chairs said they felt the customer voice had defined the shape and scale of company business plans, but that Ofwat had seized the agenda back in the last few months of the review. Brown says it was the regulator's job to apply a cost challenge. "To give you a really great example, I wouldn't have known as somebody on the CCG in Bristol what my relative cost efficiency was compared to, say, Sembcorp Bournemouth Water. That's where the regulator and the CCG process started to work more together and that has been really important."

But she concedes that once again the restricted timetable was responsible for hindering extensive re-engagement with CCGs, which would have been desirable all things being equal. "As an example, we gave three companies – Bristol, United Utilities and Thames – indications in early August around their totex – of there being still a very significant gap. We did have dialogue with the CCGs but we could have had much more if all of us had had more time. The reality was that the companies, CCGs and everybody had until 3 October to get back to us, so it was a very limited window in which to do lots of additional engagement."

She adds a qualification: "Right up until the end, I was meeting very regularly with the chairs of the CCGs. Their conversations with me helped shape my thinking in terms of how we were going to go through some of the issues."

In the round, Brown describes the work of CCGs at PR14 as "hugely valuable". She elaborates: "I don't think we would've ended up with anywhere near the quality of the plans we got last December if it hadn't have been for the hard work of all the people giving up their time, quite often for no payment. They really helped shape those companies' plans by challenging them." She adds: "They really helped to shine a light on some of the issues. If a CCG came to us for instance and said 'we've challenged A B and C really hard; we were convinced by X and Y but Z? We really couldn't get there' – that was immensely helpful for us because Z then became the thread that we picked at."

Capital ideas

In stark contrast to the difficult areas where time was tight and dialogue consequently limited, Brown views as key PR14 successes a number of areas where Ofwat engaged with companies openly and early. Taking care to qualify upfront that "it's important to say that PR14 is a package; it has to be viewed as a whole in order to make sense of it", she provides the example of that most sensitive of issues: cost of capital.

Traditionally this is revealed to companies at the draft determination stage. "But this time around we had a conversation that very deliberately started earlier; we took a very active decision to signal where we thought the market evidence was taking us. When companies' plans didn't match that market evidence, we intervened [first by issuing Risk and Reward guidance and then by reducing returns further at the FD stage]. That obviously led to a change in the process but one where I think it was really important for customers." In fact the regulator says its interventions on returns benefitted customers to the tune of £2bn.

Companies grumbled but there was no concerted opposition to the new, lower number. Brown is crystal clear that she believes companies can keep their credit ratings with the level of returns on the table – though the more highly leveraged players will have to think hard about whether they can remain so distant from Ofwat's notional balance sheet.

Brown comments: "Actually it's one of the things I've found really good as we've gone through this process. If I take myself back a year, I was having these constant conversations with companies who were saying 'we don't understand why you are so fixated on the difference between the notional and the actual balance sheet'. To me, it's been one of the really important learnings, not just for us but for the companies, to really focus on what are the risks shareholders are taking within those structures versus the customer side of that equation. I think that's really important.

"As to what any individual company chooses to do, it's really down to that company. Deleveraging is an option associated with it, but how that's achieved? – again there is a variety of different approaches."

Early engagement and dialogue has also been the saving grace in reaching agreement with companies on totex numbers. Says Brown: "We formed views on the efficiency of companies' costs and were very transparent very early about what our views were. Then we put the challenge back to the companies to say: 'This is our view. You need to persuade us that there are factors which need to be taken into account to change our view.' That process has been really very important and successful in some of the companies that had significant efficiency challenges, particularly being able to grapple with those issues themselves and then come back to us with some quite different proposals." (See box, Minding the gap)

Brown hopes companies will be able to outperform their challenging totex settlements: "I really hope that there are opportunities for outperformance because I think it's win-win. Investors gain and customers gain. They gain in the short term through the way in which the sharing mechanism works for totex outperformance and, really importantly, they gain in the longer term too because it will give us some really valuable information about where to set thresholds on costs for the future."

Incentives and partnering

PR14 was laden with regulatory innovation beyond the aspects already discussed. Brown confesses piling in so much change was "tricky" but she stands four square behind the benefits the changes will deliver.

The ODI policy is a good example here. She rejects the idea that Ofwat drove the policy through in the face of lukewarm support from companies and criticism (to financial incentives) from the Consumer Council for Water. "I'm not sure we've driven anything through because I think the whole process has been very much one of dialogue and mutual understanding as we've worked our way through."

Be that as it may, Brown is convinced of the value of the incentive instrument. "What we want to do is really shift the focus in water companies. For the last few years there has been a bit too much focus down the road in the City in finding financial ways of beating determinations. We want to make sure that the companies are really focusing hard on what the customers want them to deliver. ODIs are the way in which we joined up the promises that companies are making to their customers with the investor, and that will put additional pressure on the companies to really deliver what customers want."

Though perhaps borne of necessity – a hard deadline and insufficient internal resources – Brown also advocates the delivery partnering process Ofwat adopted for PR14. Alongside "a solid team of people" at Ofwat, the price review was delivered with three external organisations: PWC, which worked on overall delivery; Jacobs, an engineering specialist which assessed specific company proposals including Severn Trent's Birmingham resilience scheme; and CEPA, which worked on the totex models.

According to Brown: "Regulators – and I've worked for other regulators – always outsource things in a price review because it's a big event that comes along once every few years. It would be inefficient – and some of the skills are highly specialist – to have those skills not being fully utilised all the time. What was new at Ofwat was we put that all within one delivery contract rather than issuing individual pieces of work.

"It's far too early to say how we are going to implement all of the changes that are going to be coming through for 2020, but I think what we will be doing is looking into partnerships with other organisations. You can see this already on Open Water. We're saying that we want to work with WICS in partnership. So we can see ourselves working collaboratively with other bodies in the future. We are a small organisation."

Delivery and design

Going forward Brown says she will divide her time between a delivery role and a design role. In terms of delivery, she will both see PR14 through the next couple of months and, increasingly, work on the implementation arrangements for retail market opening in April 2017. This should pick up now the Open Water programme has been taken under Ofwat's wing and the coveted private central systems procurement route agreed.

Brown brushes aside a question about DEFRA's confidence levels in Ofwat's ability to deliver a non household retail market on time – and hence the team-up with WICS. "The important thing is it's [the retail market] not something Ofwat's going to deliver or DEFRA's going to deliver or WICS is going to deliver – it's an overall programme where all parties need to work together in partnership. We are going through the process at the moment of making sure that there is going to be a really detailed plan produced around the delivery of all of the aspects of it and all the interactions – across the work that DEFRA needs to do and the work that we need to do – to make sure that's all aligned; to make sure we deliver the best possible outcome associated with this.

"Everybody's focus is going to be on trying to make sure April 2017 becomes something that's realisable for business customers. They have been waiting a long time for real choice in the water sector. We are committed to making sure that happens."

On the design side, Brown will pick up the baton on the Water 2020 work. "We do want to get an early start on this design work for the future and really making sure we can have a great conversation with the industry. We don't think there's a single truth about how the future might be taken forward. We definitely don't have it and we suspect nobody else has it either."

How and how extensively the water market will have changed by 2020 depends on who you ask (see feature on upstream services, page 12-17). Brown says Ofwat doesn't have a blueprint but does expect companies "not to have challenging conversations with Ofwat but for them to be having challenging conversations themselves". She indicates a belief that reform could be extensive and could gather momentum this side of PR19. "We think there are new opportunities to potentially realise value in a different way between customers and investors in future, and we expect the companies to be exploring that. As an example, if I just can't deliver excellent customer service for business customers, am I going to keep on trying or am I going to actually exit? If I think I've got diseconomies of scale with regard to treatment facilities, is there any way I can partner or increase my ownership of that type of asset to increase my ability? Maybe I'd like to be running some wastewater networks as well as water networks?

"So there are big questions here that we think the sector needs to be considering for itself. Just like I described about PR14, our role isn't to drive it, it's to understand and then to challenge anything that comes forward to make sure customers' interests are being protected and that they're getting the best possible deal." TWR

NO, MINISTER

Since environment secretary Owen Paterson wrote to water company CEOs in November 2013 urging them to think carefully before implementing full price increases for 2014-15 given household affordability issues, there have been whispers in corners about how independent of politics water regulation really is. As lead on PR14, has Brown been politically pressured to keep bills down?

"Absolutely not. I think all of the political parties really respect and understand how important it is for the price setting process for us to be independent from government. After all, that's why independent economic regulators were set up. In this sector, it's particularly important because the cost of capital is set by the regulator that there isn't any perceived or any form of risk associated with that."

MINDING THE GAP

Three companies had significant totex gaps at the DD stage. Brown says closing these gaps by the time FDs were issued was simply a result of those companies presenting better evidence.

Thames: Ofwat accepted Thames' £405m costs relating to the Tideway Tunnel, but allowed a much narrower uncertainty mechanism than the company proposed. This kicks in only if the procurement process for the tunnel Infrastructure Provider is unsuccessful for a reason outside Thames' control.

UU: A £1bn DD gap shrank to £188m in the FDs. UU "came back with a very different totex plan" in response to the draft, says Brown. By its October representation, the company had dropped its support for average efficiency and accepted the regulator's upper quartile approach and the implications this had for aspects of its proposed plan including NEP5 work. UU officially accepted the FD last month.

Bristol: The gap between Bristol Water's proposed totex of £541m versus Ofwat's FD allowances of £409m stands at 32%. Brown says the regulatory numbers are achievable: "I think that what Bristol would need to do is go back and think again about some aspects of their plan. Some of it might be changing some of the scope of what they intend to deliver. Some of it might be about changing how they intend to deliver things. But we do think we've made an allowance that allows them to operate as an efficient company. Obviously there is a risk, there is a significant difference, and if they weren't able to do those two things there would be a cost to their shareholders as a consequence of that. These are all issues for the company to work its way through." (Editor's note: this interview took place before Bristol declared its intention to seek a CMA referral - see Bristol report, page 3-4).

TRUST AND REFORM: AN UNEASY MIX

Ofwat bets on a "market for ideas" to build trust at a time of disruptive change. Will it work?

In launching its *Trust in water* strategy last month, Ofwat set the bar high for both itself and the wider water sector.

To borrow the regulator's own terminology, the "outcome" being pursued – a water sector that is trusted and that inspires confidence – at first glance seems eminently achievable. Customers already have confidence in basic service provision; financiers of various sorts have confidence to invest; and despite the best efforts of certain politicians, the public has failed to cry foul at the sector's corporate record.

To be truly trusted according to Ofwat's broad definition – to be resilient in the long term, to treat present and future generations fairly, to do right by suppliers and society – the industry would have to redouble its efforts. But it would be starting on a reasonably good footing.

The difficulty in securing trust arises because the sector is entering a period of reform that will be inherently disruptive. Of its strategic priorities going forward, announced last month (see box), Ofwat said number one was delivering reform. There is an inherent tension between a steady-as-she-goes sector and one that is being encouraged to look afresh at its structure and services and potentially to innovate, diversify, divest, partner, consolidate (see Upstream services feature, p12-17). Particularly as above all else customers want clean, safe, reliable supplies and investors want stability.

However, it is true that sticking to the knitting would offer no safe haven. Political pressure on the industry is likely to gather pace around the election and doing nothing to improve customers' lot could raise the risk of political intervention.

In putting trust on the strategic agenda at a time of change, Ofwat seems, sensibly, to be trying to get the industry to raise its game and hence head off potential political intervention. Its chosen delivery route, which builds on PR14 form, is to abandon prescription and instead open a "market for ideas" – essentially, it wants companies to propose ideas on matters such as what services to offer going forward, how best to structure themselves, and desirable incentives and regulatory arrangements for PR19.

Starting as it means to go on, the regulator kicked off the approach by announcing the formation of an independent resilience working group, charged with fleshing out how resilience might play out and how Ofwat should best carry out its new resilience duty.

It's easy to see why an open door policy of this sort is appealing. Ofwat had its fingers burnt when it last tried to impose significant (licence) changes on the industry and hopes the new route will encourage company buy-in upfront. There are also almost certainly financial upsides to be had from piggybacking on companies' work in these tricky reform areas – a practical benefit for a regulator that is having to pull an already-tight belt another notch in (see box, Forward programme).

However the approach also carries risk. Collaboration could make political intervention more likely, should it be perceived as regulatory weakening. (Ofwat counters this by saying it will use all the tools at its disposal including, when necessary, the blunt ones). Moreover, while the cooperative approach could work well while reform discussion is general, at some point it will get crunchy. Issues like contestability and RCV, whether returns are excessive and a possible move to CPI indexation won't be easily agreed. And while Ofwat indicated it would welcome less of an "industry" mentality and more individualism from companies, there will inevitably have to be commonality on some basic market rules and processes.

So Ofwat finds itself in a similar situation to companies looking towards AMP6: legitimate outcomes agreed, but everything to play for in delivery. TWR

OFWAT'S FOUR STRATEGIC PRIORITIES

- 1. Deliver the Water Act 2014 reforms: implement retail competition and support the development of abstraction and wholesale reform.
- 2. Maintain investor confidence through this period of change.
- 3. Develop the means to monitor companies' performance on trust and confidence, and develop a risk-based assurance framework.
- 4. Ensure Ofwat has the skills, experience, systems, processes and culture to support the new strategy.

2015/16 FORWARD PROGRAMME

Ofwat will publish its final 2015/16 forward programme by 31 March. Last month it consulted on a draft, designed to contribute to meeting its *Trust in water* strategy. Highlights for the year include:

- final approach to its resilience duty
- Water 2020 – retail: guidance on customer eligibility for switching; design of retail licensing arrangements; consult on exit arrangements (supplier of last resort, deemed contracts and new guaranteed service standards); consult on charging rules
- Water 2020 – wholesale: define wholesale services; set out which services will be contestable in the short and medium term; set out which services will be regulated differently at PR19
- assessment of sector compliance with Ofwat's governance principles
- set up licence review working group
- vulnerable customers – issues to take forward and regulatory change
- competition law guidance, particularly in light of retail competition
- a process for a third party to adjudicate on non-strategic casework
- consult on merger assessment approach
- Thames Tideway: award Infrastructure Provider licence; amend Thames Water's licence to accommodate
- internal: reduce office space, new website and implement improved casework management system, leadership programme and talent management.

From 2015/16, Ofwat will be part of the government's Comprehensive Spending Review and will have a significantly reduced budget. It has proposed a licence fee, recoverable from customer bills, of £20m for the year. This is 33% down on the c£30m it had in 2014/15. Separate ring fenced licence fees capped at £10.5m will fund Ofwat's Open Water work, and Thames Water will pay a special fee of £1.5m to cover the cost of Tideway regulation.

THINGS ARE LOOKING UP

Upstream reform is variously defined, understood and supported but decisions need to be taken on exactly what it will entail and when. Through a series of articles, *The Water Report* will explore the key issues, starting with a look at what upstream services are and could become.

Despite being on the cards since the government published its Water and Natural Environment White Papers in 2011, "upstream reform" remains something of an enigma. DEFRA's Water White Paper cited new entry in upstream markets as desirable, and encouraged incumbents to look beyond traditional capital projects in meeting future challenges. Perhaps because of their similar timetables and interrelated nature, upstream re-form has also become bound up with abstraction reform. Consequently it is these aspects – wholesale contestability, operating solutions, and abstraction reform – that have hitherto dominated our collective under-standing of what upstream reform might look like.

However, with PR14 done (CMA referral aside) and retail water competition for business customers – finally – gathering pace, the time has come for government and regulators to establish more firmly what upstream reform will entail, when it will happen, and how it should be directed and regulated.

As yet, there seems to be little consensus here. Few disagree with the need to shore up our increasingly uncertain water supplies in the face of climate and demographic change, and to manage our resources better. But already there seems to be tension between government and regulatory agendas on how and when this is done (see box Reform priorities and tensions).

All the while water companies – inevitably some more than others – have been beavering away exploring their preferred options for upstream re-form. Again there are divergent views about the challenges facing the sector, what reform might mean, what its benefits and costs will be and how it should be implemented.

In pursing this work, some of the more proactive companies have reached an interesting position: that upstream reform should be much more broadly defined than the Water White Paper indicated; that we should look beyond abstraction reform plus breaking up water companies into their regulated monopoly and regulated market components.

David Elliott, director of environment and assets at Wessex Water, makes this case. "We need to agree the policy perspective of what we are trying to reform," he says. "We suggest reform of the water market, not just the water utility."

He recalls that back in 1974 when the regional water authorities were formed, catchments were managed holistically. Water authorities were inadequately funded to deliver the full benefits of the approach but the concept was sound. At privatisation, the arrangements changed and while shareholder investment facilitated dramatic improvements in water quality and environmental performance, "25 years on, we still face some familiar challenges – flooding, water resources and river water quality, particularly in light of the Water Framework Directive," Elliott comments.

He continues: "These are not sole agency issues. Take flooding. Today, this issue involves the Environment Agency, local authorities, water companies, insurance companies, developers, businesses and others often working in silos. Our approach is to look at the benefits of catchment management from the water authority days but deliver it in a better way.

"Upstream reform creates a fantastic platform to do this. We need to start with the outcomes we want to achieve – for example to address flooding. Then look at the options for orchestrating activity in a better way; who is best to own, deliver and pay for the best solution. Then you can start to price the services to deliver the desired outcomes. In such an environment, water companies would be service providers, not utilities, operating in a market of alternative service providers. It would be much better than operating as a series of silos. It would change the landscape of water service provision."

This is upstream reform taken well beyond the traditional definition.

Upstream reform series

Given the diversity of opinion on upstream reform – the absence of easy questions let alone answers – management consultancy Indepen has been facilitating discussions between stakeholders on the subject. The intention is to foster better understanding of upstream issues with a view to informing policy development and implementation.

The Water Report will be producing a series of articles on upstream re-form, drawing on the key areas identified by Indepen's work. To kick off the series, the rest of this first article will focus on upstream services: what they are and how they might develop given the reform agenda. Future articles will look at other areas including upstream contestability, the costs and benefits of reform and implementation.

REFORM PRIORITIES AND TENSIONS

Ofwat's future strategy, unveiled last month, seems to wholeheartedly embrace the reform agenda. It talks of a "market for ideas" and beckons all to come and share their visions of what future companies might look like and what services might be offered. It makes no promises to wave proposals through, of course, but it has clearly opened its arms to the prospect of further reform. And it conveys a sense of urgency in the need to have far greater clarity on at least key issues before it sets prices again at PR19.

Some welcome this open-minded and innovative approach. Others are concerned that the regulator may have taken its eye off the practical implementation of the retail market in 2017 in favour of the more exciting work of developing policy for upstream reform. Were this to prove the case, it could jeopardise the delivery of on-the-table benefits for business customers, possibly with no realistic prospect of offsetting that detriment by delivering upstream benefits ahead of 2020. At least anything that will interfere with incumbents' RCV will no doubt need a long lead time – a decade at least.

DEFRA's agenda is understood to prioritise the effective delivery of retail market opening first and foremost. In fact, upstream reform – at least aspects that require policy intervention rather than the operational initiatives companies can pursue anyway – is thought to be of lower priority than even abstraction reform, which is currently slated for early 2020s implementation.

There could be a number of reasons for this apparent difference of focus between government and regulator. As an economic regulator, Ofwat rightly focuses on economic objectives and water customer interests. DEFRA meanwhile has a much broader remit and has to be mindful of sectoral interests beyond the water industry, including those of agriculture and finance.

The government is also thought to be mindful of its time and resource constraints; of not biting off more than it can chew. Given its recent experience of a time and resource constrained price review, Ofwat might be expected to have sympathy with this concern at least.

What are upstream services?

Water companies' upstream activities account for everything not classified as a retail activity. Water abstraction, treatment and distribution and wastewater collection, treatment and disposal form the core. Together these activities account for around 90% of customer bills.

The Indepen facilitated stakeholder group defines upstream services as those that deliver or contribute to an upstream outcome for customers, the environment or both – for instance, higher water quality or the delivery of a certain quantity of water to a treatment works. The services include conventional water and wastewater services and a wide range of less developed services such as those procured from farmers by water companies to protect water quality; water resource services such as water trading and abstraction licence trading; and capacity and resilience planning involving the water and other sectors – agriculture, energy, business and the environment. (For further

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Long and winding: managing water sources holistically at catchment level is complex and involves multiple stakeholders

CATCHMENT MANAGEMENT AT THREE COMPANIES

1. Upstream Thinking at South West Water
Upstream Thinking is South West Water's name for a series of industry-leading projects designed to restore raw water sources and protect their quality. The company's long term aim is "to reduce the chemicals, cost and energy needed to produce the top quality tap water on which we all depend". There are two main types of work.

Encouraging land management best practice: South West Water has worked collaboratively with over 2,000 farmers to inform and assist them to better protect the Upper Tamar, Upper Tamar Lakes, Roadford, Upper Fowey and Wimbleball catchments. Tailored one-to-one advice and farm plans have been supported by capital grants to fund activities such as the erection of new fencing or the building of slurry stores. The focus is on land areas most likely to affect water quality.

The company has worked in partnership with the Westcountry Rivers Trust, which brought established relationships with land managers to the table, and has assisted farmers in leveraging match funding from CAP-related schemes. Davy says individual farms have received funds of up to £50,000 from South West Water, and have achieved match funding of up to £7 for every £1 funded by the company.

Similar work is going on elsewhere in the area too. For instance, the company is working with the Cornwall Wildlife Trust to provide landowners across the Drift catchment on the Penwith peninsula advice, training and grants.

Moorland restoration: Under the Exmoor Mires Project, South West Water is blocking drainage ditches on Exmoor using local materials and contractors. The aim is to "re-wet" the bog after generations of peat cutting and drainage schemes have caused it to dry out. This has reduced the water-holding capacity of the moor, hindering it in absorbing water during heavy rainfall and hence reducing the protection it offers against flooding. In addition, this drying action causes oxidation of exposed peat bogs which releases large quantities of carbon into the atmosphere. Davy says the project has been very successful and 2000 hectares have been treated already. A trial has begun for a similar project on Dartmoor.

2. Wessex Water and catchment management
Since 2005, Wessex has worked with land managers in its region to ar-rest nitrate, pesticide and metaldehyde pollution of its ground and surface water sources. The company directly employs a team of catchment managers to target agriculture in priority catchments.

Among the services the team offers are: advice on amounts and timing of chemical applications, fertiliser spreader calibration, the provision of locally derived data to improve management plans, assisting farmers in-to agri-environment schemes and financial contributions.

Elliot explains Wessex has offered both one-off support for capital projects and ongoing payments to farmers who change their practices or even how they use their land – for instance, in converting to organic farming. He comments: "Policy has always been anchored to a belief in polluter pays. It's laudable, and yes, Wessex has invested not to pollute. But it hasn't worked in the case of diffuse pollution. As a company, we believe in a beneficiary payment model."

He adds that Wessex now aims to progress beyond payments to individual land managers to create a market for water quality improvements, nutrient removal and water management to prevent flooding. "We are identifying potential buyers and sellers in a catchment and want to orchestrate them around a trading platform." Sellers bid in to perform nutrient removal or to provide storage, or both. "Sometimes it can be a straight competition – who can deliver for the best price."

Elliott adds: "After ten years of doing catchment management, there is clear evidence these things work…By the end of this AMP, our catchment activities will have saved the customer around £200m. In some of our examples, catchment management has delivered benefits for 16 times cheaper for us than building a water treatment works. In the case of re-moving some pesticides, we have not yet found a practical end of pipe solution."

3. Anglian to target trouble spots
To date, Anglian Water's catchment activities aimed at improving protection of water sources have been focused on raising awareness, providing advice to land managers on good agricultural practice and most importantly getting a thorough handle on the science – for example, on understanding the passage of nitrates and pesticides through the water system. In the coming AMP period, it will set about, where appropriate, putting this learning to practice in the field.

For a number of reasons, its activities on the ground will be different to those of Wessex or South West Water. Anglian's river catchments are extensive with, for example, a significant part of the water supply originating from the Trent (outside its area), and so the company does not so easily have direct influence over source supplies. Its catchments are also very large and agriculture in East Anglia is dominated by big or industrial scale arable farming. Its work to understand the passage of nitrates and pesticides has therefore been important to effectively target activity and resources.

Moreover, strategy and policy analyst Alice Piure explains customer engagement conducted for PR14 showed customer support for the polluter pays principle and some concern over water customers funding farmers to behave differently.

So Anglian's AMP6 catchment activities aimed at protecting water sources "will operate under a very targeted risk-based approach" says Piure. Catchment managers have been recruited, and key areas of focus will be "hotspots, where both nitrate and metaldehyde problems overlap". The company will also explore where phosphorous in wastewater originates with a view to possibly limiting pollutants at source.

Anglian is also taking the lead in sponsoring the Cam and Ely Ouse catchment partnership (http://www.cameopartnership.org/), as well as working at a catchment level, through the Water Resources East Anglia project, on multi-sector water resource planning.

More on the moor: South West Water is re-wetting bogs on Exmoor to hold water upstream

reading, Deloitte compiled a comprehensive list of upstream services for Ofwat in 2011 in the report *Accounting separation, definition of services in the water and sewerage industry*).

Aside from the bread and butter upstream services water companies have always delivered, most "fringe" services explored to date – those that are loosely slung under the banner of "reform" – have typically involved working with land managers to protect water quality and/or quantity. Such approaches tend to be based on either the land manager making some kind of saving from performing a service the water company desires, or on the water company providing a financial incentive – a Payment for an Eco-system Service or PES (see box – PES in brief p16). This could a one-off payment for the land manager to perform a particular task, or a more regular payment which requires the landowner to behave in a particular way on an ongoing basis.

Some examples of this kind of activity are set out in the box, Catchment management at three companies. It is important to note though that the industry is not as one on the subject. The companies described in the box are, for one reason or another, progressive; others have barely started to explore catchment management yet.

According to a 2014 report for Severn Trent, South West and Wessex Water, though, they would be wise to start thinking about it. It found catchment services involving changes in land use offered dynamic efficiency savings. The report said catchment services are capable of delivering benefits of £300m-£1bn over the next 15 years for water companies and customers through avoided costs and better outcomes. These figures exclude wider societal benefits.

Susan Davy, finance and regulatory director at South West Water until her recent promotion to group director of finance at parent company Pennon, says part of the reason South West was motivated to explore catchment activity was the desire to save money for customers. "We looked ahead and saw investment levels could be similar to those of the last 25 years, which for South West Water has caused affordability and bill pressure issues."

For Wessex, Elliott says catchment activity was motivated by recognising land management had a major affect on water quality over which his company had little control. "We can't achieve WFD demands without dealing with diffuse pollution, which is largely an agricultural issue," he says. "We can't build our way out."

Lessons from the land

From companies' experiences of delivering upstream services through land and catchment management activities to date, a number of important lessons emerge.

- Catchments vary – and what works in one area is unlikely to be directly replicable in others. Even comparing the two largely agricultural areas occupied by South West Water and Anglian Water, major differences in catchment size, farming type and scale, and water supply origin render a straightforward application of lessons learned in the South West un-tenable. Anglian Water regulation director Jean Spencer adds that whereas South West has successfully worked through river and wildlife trusts to access and gain the trust of landowners, "we simply don't have river trusts to the same extent in our region".
- Catchment management is not always the right choice. Piure notes that Anglian's research shows water treatment to remove nitrates is actually cheaper in some instances than conducting catchment management activity, when catchments are large and big populations are being served.
- Stakeholder management is complex. By its very nature, working at catchment level involves collaborating and negotiating with a tangled web of interests, some of which will inevitably be more engaged and supportive than others. Frequently it will involve working on land owned by a third party. As an example of this complexity, South West Water's Dartmoor bog restoration work involves Dartmoor National Park Authority, the Environment Agency, the Duchy of Cornwall, Natu-ral England, the Dartmoor Commoners Council, the MOD, RSPB, English Heritage, the Dartmoor Access Forum and the University of Exeter, aside from individual land owners and managers. Davy says South West Water uses technical agreements with stakeholders to set down its rights over the benefits to water quality resulting from catchment activity and to protect its customers' investment.
- Other beneficiaries could get involved. Water company work to improve water quality and quantity could benefit others – for instance, local businesses (see Adnams feature, page 28-30). These other beneficiaries could shoulder a share of the cost.
- Carrots and sticks. Stakeholders have to consider how best to balance financial incentives for farmers for good land practices with regulatory sticks. Spencer recalls that in recent months, Anglian has had to close ten intakes because of metaldehyde spikes. "This is a serious problem and the Environment Agency has a part to play in classifying these as pollution incidents even though they can't be pinned to anyone in particular. Catchment management isn't a soft option and needs to be complemented by regulatory and enforcement action where necessary."

> **We need to agree the policy perspective of what we are trying to reform. We suggest reform of the water market, not just the water utility – Wessex Water**

- Quality regulation may need to adjust. Catchment solutions offer less certain quality standards than treatment plants and take time to get off the ground. Spencer says that in an information letter issued last year, the Drinking Water Inspectorate "set a tight timescale to demonstrate the effectiveness of catchment management. If it's not clearly demonstrated by 2018, it will expect to see more robust operational measures put in place, in particular, treatment solutions."
- Investment in assets will still be needed. Operating solutions won't be able to take care of everything.

Future upstream services

Such catchment and land management activities show that the industry – some companies at least – are already straying out of traditional areas to explore new upstream service provision. The upstream reform agenda, be it fast or slow to take off, looks set to accelerate this diversification and create markets for new upstream services. >

Some of these services will supplement or replace existing water company activities, as catchment management is supplementing water and wastewater treatment. But others could be genuinely new services and grow up in spaces water companies do not currently occupy. Flood risk management and sustainable drainage services are good examples of new avenues that might well be explored.

According to Iain McGuffog, chief economist at South West Water, exactly what services develop and when will boil down to the simple matter of whether there are willing buyers and sellers. Wessex's Elliott agrees, arguing the key is to end traditional silo-style operation and instead bring buyers and sellers of services together.

Monetising the benefits of upstream services that go beyond offsetting water investment looks set to be a key area going forward – and one that has hitherto been barely touched.

This could lead to an active PES market, which hitherto has been in its infancy. Elliott says Wessex will continue its explorations in the PES area – for example, it will be pursuing work as a partner in a Bristol Avon catchment project to orchestrate buyers and sellers of water and wastewater services.

McGuffog confirms South West Water has been examining PES options since last year. "These are complex calculations," he explains. "We've been looking at how we incentivise the right behaviours. How do we come up with a value to pay on an ongoing basis? How do we monetise the benefits of investments we no longer have to make? How do we factor in wider benefits?"

In fact, monetising the benefits of upstream services that go beyond off-setting water investment and safeguarding water quality and quantity looks set to be a key area going forward – and one that has hitherto been barely touched. These benefits may relate to matters as diverse as recreation, amenity, flooding, biodiversity, carbon reduction, public health and the wider environment. McGuffog comments that carbon al-ready has a price in other markets, which could be referenced under PES arrangements.

And new upstream services need not be confined to rural areas. Markets could well grow up in urban catchments to prevent or mitigate flood risk, for example. It's early days but Elliott says Wessex is looking into incentives for customers to reduce the amount of surface water they dis-charge to sewer, to minimise sewer flooding risk and to offset the need to invest in storage and asset replacement. "In the past, customers have not had to consider the impact of paving their gardens or building extensions," he muses. "They have paid their bills and water companies have built more capacity to deal with the additional surface water. We want to offer alternative solutions through demand side incentives."

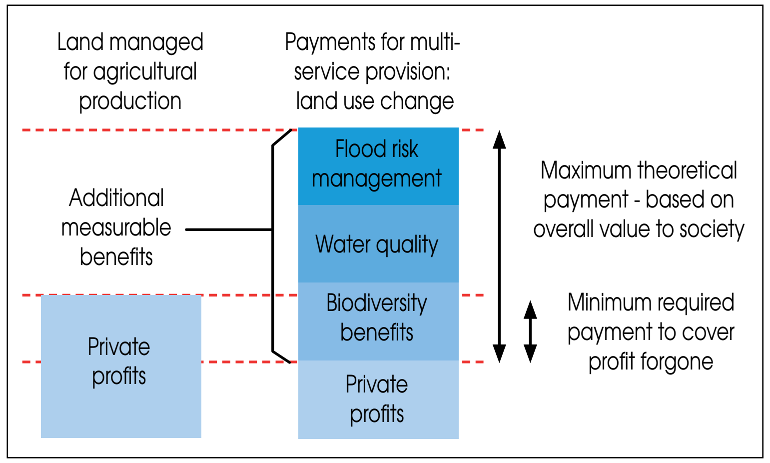
Wessex is collaborating with Dynamic Flow Technologies and Elster Water Metering to develop wastewater metering. "This could provide incentives to be more imaginative about grey water management within the property, water reuse and so on. It would takes us towards becoming a service based organisation, not a utility."

PES IN BRIEF

Payments for Ecosystem Services (PES) schemes are market-based instruments that connect sellers of ecosystem services with buyers. Typically the beneficiaries of ecosystem services provide payment to the stewards of those services, often via a continuing series of payments to land or other natural re-source managers in return for a guaranteed or anticipated flow of ecosystem services.

At present, farmers, who represent less than 1% of our society manage nearly 80% of our countryside and are largely responsible for the health of the ecosystems it supports. However, they are currently only paid for the provision of one ecosystem service: food production. The basic idea behind PES is that those who are responsible for the provision of ecosystem services should be rewarded for doing so, representing a mechanism to bring historically undervalued services into the economy.

The chart shows how PES funding works. The bar on the left shows the current situation, where land is managed exclusively for agricultural production and only the private profits from this activity are realised. The bar on the right shows how, by assessing services that may be provided and offering either a minimum payment to cover profit forgone or a maximum possible payment based on the overall value to society, the seller can change their land use. Funding could be available as an annual revenue payment (either for a fixed term contract or in perpetuity) or as a single lump sum payment.



There are five broad categories of ecosystem service provision, with potential buyers/sellers shown in brackets:

- Water quality: bathing water (local government); WFD good ecological status (national government); drinking water (water companies).
- Water resources: ensuring adequate supplies for drinking (water companies) and hydro-electric power (energy groups); attenuating localised flood peaks (national government, water companies, insurance companies).
- Climate regulation: carbon offset and land use change schemes (general public, private companies).
- Habitats for wildlife: habitat protection, habitat management, ecological net-works, biodiversity offsetting (government, NGOs, developers).
- Recreation and culture: for tourism, culture, wellbeing (National Parks, local community groups, leisure groups - e.g. anglers).

Note: This is drawn from a PES guide produced by the Westcountry Riv-ers Trust. Full report available at: http://bit.ly/176aO86

Opening the floodgates? How quickly upstream markets are developed is a source of contention.

Anglian Water is involved in investigating another innovative upstream service – a multi-stakeholder reservoir. The Water Resources East Anglia project brings together Anglian Water with Essex and Suffolk Water, local agricultural interests, businesses, developers and others to holistically consider the water resources and storage needs of the area. Spencer explains: "Over the next 25 years, there is the potential, as a result of restoring unsustainable abstractions, population growth, new development and climate change, that up to half the water we currently put into supply could be lost [up to 500Ml/d of the total 1100Ml/d currently sup-plied]. So we are looking to add new storage. But there's no point looking at that from a public water supply point of view only."

The company expects to have material ready to publish on this within the next 12 months, which could include a multi-stakeholder financing model which taps into the low cost of finance accessible by Anglian as a regulated water company. It will also include proposals on how such an asset could be regulated and managed and how water resources might be allocated highlighting the need for a more holistic reform of the water market and resource planning.

Pace of development

As for which upstream services should be developed and when, Elliott believes the market should decide. We should start with the outcomes we want to achieve, he explains, and then "look at whether creating a water market for a service is feasible, viable and desirable; whether better outcomes could be achieved if someone other than the local water company provided the solution". This turns on its head the approach which starts with a desire to introduce contestability into the wholesale value chain, suggesting instead contestability should only be introduced where it will add benefit. It is, as Elliott advocated at the outset, reform of the water market, not just the water utility.

He continues: "Which areas we chip off sooner rather than later should depend on the extent of market development today." He provides some examples. Generating renewable energy from sludge is already a mature market so could readily be more widely opened. A market for nutrient removal and water quality protection is emerging via catchment management and PES initiatives, so could be progressed. The relatively new area of sustainable drainage could also be delivered by many types of organisation. However markets for flood and surface water management have yet to be created – flooding for instance is still managed by different organisations in silos – so markets for these services will naturally take longer to develop, but could perhaps offer much wider societal benefits.

Water companies are showing leadership in exploring the fascinating and complex area of upstream service development. Indeed they are exhibiting exactly the sort of behaviour Ofwat said it wanted to encourage when it launched its sector vision last month (see report p10).

However it will of course be down to the government to decide on the type, extent and pace of change and for regulators to decide how regulation evolves to keep up.

How much can realistically be achieved ahead of PR19? Anglian's Spencer says she would like to see "clear priorities set, not everything thrown up in the air". She adds: "We have benefitted from a stable RCV for years now, it has proved a solid basis for investment. We recognise the need to look at that in future but we must not destabilise investment." On her priority wish list are sorting access pricing out – "that's been in the too difficult box for 20 years"; intelligent abstraction reform; and identifying which other upstream areas are ripe for reform going for-ward.

Elliott advocates extensive exploratory work. "This is such a fast moving area. Our thinking has transformed quite quickly from when we put our business plan together to the time we got the final determination. We need to avoid cementing too much in. If we fix the way the market will work in three years time, that will stand for seven years. That's an awful long time in market creation terms."

He adds: "Some markets could potentially be unregulated, too." TWR

Companies grapple with new planning route for SUDS

Anglian Water has set out a list of priority issues it wants to see resolved before it can progress with the adoption of Sustainable Urban Drainage Systems (SUDS).

Speaking at an All Party Parliamentary Water Group (APPWG) meeting last month, flood risk manager Jonathan Glerum said Anglian was minded to adopt SUDS and take on their maintenance "to give certainty to investors to develop in our region". But wanted:

- system design approval – ideally, via pre-application involvement with the developer
- statutory consultee status in the planning process
- the automatic right to connect to a public sewer removed
- the legal basis for SUDS adoption (which surrounds the definition of a sewer) clarified.

Glerum noted that none of these would come easily. He said the company often did not learn of developers' SUDS intentions until they were in the planning process; that it had to work with lead local authorities on developments because the industry's bid for statutory consultee status had been turned down; that there was no clarity yet on the legal issue; and that the removal of the automatic right to connect to a public sewer was one of the things that went down with Schedule 3 of the Flood and Water Management Act.

This schedule had provided for SUDS implementation but the government has now opted to consult on an alternative approach, under which sustainable drainage will be delivered via the planning system. According to Richard Ashley, emeritus professor at the University of Sheffield: the Department of Communities and Local Government "effectively crippled this [Schedule 3]; they were more interested in bleating developers who said it would be too expensive".

While there is widespread disappointment at the demise of Schedule 3, the water industry is trying to find a workable solution under the new planning-led route. According to Water UK: "Members consider that this would, in principle, be a suitable way to proceed, but there are concerns."

Beyond the issues highlighted by Glerum, Water UK said these include:

- the planning system is affected by a range of priorities, which could lead to the desirability of SUDS being outweighed by other considerations.
- Expertise in the technical aspects of SuDS will inevitably impose a cost on planning authorities.

This point was echoed at the APPWG meeting by Bronwyn Buntine, a sustainable drainage engineer at Kent County Council. She welcomed the planning role on SUDS, but said there were "capacity and time" issues in play. "Most authorities are already under pressure from funding" she noted, adding there has been no discussion of finance in the consultations.

Water UK added: "SUDS represent an integrated approach to surface water drainage issues but Water UK does not consider that this approach is currently reflected in the legislation, which could lead to a patchwork of ownership of different elements of the SUDS system." It said it would continue to work with stakeholders to reach a solution.

Welsh Government takes the lead on enforcing landlord liability

Providing further indication of its desire to take more control of water policy, the Welsh Government last month put landlord liability regulations into force.

The Water Industry Regulations 2014 place a duty on all residential owners who let properties out to provide basic information on occupiers to their local water company – Dwr Cymru or Dee Valley – within 21 days. Specifically, they have to supply: property address, tenancy start date, and the title, name and date of birth of all adult residents. If they fail to do so, they become jointly and severally liable with the occupier for water and sewerage charges.

The Welsh Government's agenda is one of reducing the number of people who get into debt and consequently making water more affordable for everyone.

Minister for natural resources Carl Sargeant said: "The cost of trying to recover outstanding charges is believed to add between £15 and £20 to the average customer's bill. This is not right and our Tackling Poverty Action Plan makes it clear that the introduction of a fairer and more streamlined system for recovering outstanding charges is one of our priorities for the sector."

He added: "Occupiers will benefit from the new approach, as they will be made aware of charges earlier, helping them to budget accordingly and ensuring they receive information about support for paying their bills, such as social tariffs, assistance funds or payment plans.

"This will, in turn, mean a reduction in the number of people who get into debt with their water supplier in Wales and provide a more streamlined system for the water companies to recover outstanding bills, cutting costs and making it more affordable for everyone in the process."

Welsh Water said landlords could contact it direct online or use www.landlordtap.co.uk – the web portal developed by the wider water industry. This enables landlords to submit all of their tenancy changes via one system without having to notify different water companies about various tenancy changes or without landlords needing to know which water company to contact.

The portal has been designed to issue notifications to the relevant water company for action and it will provide the landlord with a confirmation receipt for each notification as proof that they have made the notification within the required timescale.

Welsh Water's managing director of customer services Julia Cherrett said: "We are currently working to ensure landlords are aware of this new duty. We want to make the process as easy as possible for new landlords. Due to the short notice of the new legislation, landlords are being given three month 'grace period' by Welsh Water to help them prepare for the legislation and share the necessary details. This means that we will not take any action to enforce the regulations until 31 March 2015."

Calls from English Water companies to force landlords to provide tenant information have hitherto fallen on deaf ears.

NEWS IN BRIEF

WFD review: the EC is to start a review of the implementation of the Water Framework Directive. Water UK said: "We are concerned that a forthcoming review of the WFD may be taken as an opportunity to seek ever tighter restrictions on water quality, without supporting evidence."

Need a drink? the EC is also considering whether to carry out a full review of the Drinking Water Directive. Water UK said there is a risk standards might be set for new and emerging pollutants, even if this increases price.

Infrastructure Act: The Infrastructure Act became law on 12 February. Among other things, it seeks to cut red tape for Nationally Significant Infrastructure Projects, and specifies water companies must be consulted by planners on shale fracking.

Lean deals: Affinity Water and Anglian Water have each formed separate partnerships to provide water efficiency advice to customers, working with Save Water Save Money.

Coming on Stream: Business Stream has confirmed its appointment of Johanna Dow as permanent chief. Dow has been interim chief executive since October 2014.

Hello and goodbye: CC Water has appointed Bristol Water's director of customer services Phil Marshall as deputy chief executive. Meanwhile, Water UK founding chief executive Pamela Taylor has confirmed her long rumoured exit. She will leave at the end of the year.

UKRN to explore common approach to affordability

The UK Regulators Network (UKRN) is to explore how to align strategies for addressing customer financial vulnerability more closely across regulated sectors.

The multi-regulator group said this year it planned to: look into developing a more common approach to affordability indicators; consider joint reporting of data findings which could help flag up issues that regulators could jointly address; share best practice; and consider coordinating approaches among regulators when developing policies which address financial vulnerability. The intention is to establish whether a more joined up approach would benefit consumers – for instance, by common signposting to third party financial advice and assistance.

The move followed the UKRN's publication of a report *Understanding affordability pressures in essential services*. This found that different approaches are taken to affordability in the water, energy and telecoms sectors. For instance, affordability is defined in fuel poverty terms in energy, while in water and communications, no single measure is employed by the government. Moreover, Ofwat, Ofgem and Ofcom have different levels of influence over affordability in the sectors they regulate, and have taken different kinds of action to help those who struggle to pay.

While these differences make it hard to directly compare the extent of affordability problems across the three sectors, the report noted about 2.3 million households in England (10%) were in fuel poverty (2012); 4% of UK households experienced problems affording communications services (2014); and 11% were spending more than 5% of their income on water in 2009-10.

The UKRN research found that on average, 5% of household spend goes on energy; 4% on communications and 1.4% on water and sewerage services.

The UKRN added that it would also examine the factors likely to affect bills over the next ten years.

Under water company charges schemes published this month for the 2015/16 year, average water and sewerage bills in England and Wales will fall by 2%, or £9. Water UK confirmed that by April, 14 of 18 companies will also have social tariffs available.

FORECAST AVERAGE HOUSEHOLD BILLS FOR 2015/16 (INCLUDING 2% RATE OF INFLATION)

Company	Average combined bill 2015/16	Average change in combined bill
Anglian	402	-7%
Dwr Cymru	435	-1%
Northumbrian	371	1%
Severn Trent	329	-1%
South West	482	-3%
Southern	410	-6%
Thames	367	-1%
United Utilities	411	-1%
Wessex	460	-5%
Yorkshire	360	-3%

Source: Water UK

Casework: dispute decisions for Affinity, Wessex, Thames and Anglian

Ofwat has released decisions on separate complaints against three companies relating to connection costs and network reinforcement charges.

Following a complaint against Affinity Water about the reasonableness of connection costs for providing a new water supply to a household property, the regulator concluded charges were reasonable but the administrative fees and overheads were excessive.

Following a complaint by a self-lay organisation (SLO) against Wessex Water about charges it has recovered for network reinforcement needed for self-laid works, Ofwat concluded Wessex's calculation of the asset value payment to the SLO was correct and could be recovered.

Millwood Homes issued a complaint against Thames Water about the reasonableness of water main requisition and connection costs. Ofwat determined that Thames' charges were too high and the company should refund Millwood.

Ofwat has concluded in a bulk pricing dispute determination that Anglian Water's Large User Tariff as charged to Independent Water Networks for the bulk supply of water and the bulk discharge of wastewater was appropriate. Ofwat concluded that the infrastructure used to supply the site was broadly common and not discrete and did not give rise to competition or efficiency concerns.

THE WATER REPORT

COMPETITION WATCH

CENTRAL SYSTEMS GO PRIVATE

In news critical for the timely development of the competitive water retail market, it has been confirmed that a private central systems procurement route, not a public one, will be followed.

Government, regulators and industry are understood to have reached agreement on this long running issue, meaning central systems procurement will be able to proceed more smoothly, quickly and cheaply than if public rules had to be followed. The procurement process is expected to be open and transparent in common with public arrangements, but won't require government approval for changes.

Ongoing delays to decisions on how the market operator would be classified and structured and consequently on the nature of central systems procurement had raised the risk that market opening might be pushed back. In December, when Open Water published its second Market Architecture Plan, it was still pursuing a twin track approach to the MO: working with DEFRA so it was covered should a public route prove necessary; while hoping to procure privately through MOSL, a new private entity set up by water companies. The twin track has now been dropped.

Open Water is understood to have been conducting behind the scenes work on central systems, so should now be able to firm up and progress these plans as a matter of urgency. It is expected that engagement with potential vendors will commence this month with the aim of system build commencing in summer. The plan is to have a working system available by April 2016, which would allow time for testing and data transfer.

Securing the private procurement route removes one of the key risks to on-time market opening, though that remains far from a done deal. There are other risks to the programme including completely external ones. Moreover, water companies as well as Open Water have a burgeoning work programme ahead, including: scrutinising the wholesale retail code; deciding on and enacting corporate structural change; designing wholesale tariffs; and perhaps most significant of all, ensuring their business customer data is clean, of good quality and formatted to interact with central systems. TWR

INDUSTRY COMMENT

LABOUR'S WATER POLICY WOULD HAMSTRING SERVICE INVESTMENT AND COMPETITIVE RETAIL

David Brown is vice president for Europe at specialist utility software provider Gentrack.

At a speech made in Salford during the first Labour party rally of 2015, leader Ed Miliband promised to reform the energy market to ensure companies operate in a competitive way. Miliband vowed that a Labour government would ensure suppliers "play by the rules" and that there would be "no more broken markets".

All well and good, but what is entirely neglected is any mention of the water sector that Miliband and his colleague shadow environment secretary Maria Eagle set their sights on so vehemently towards the end of last year. The focus in November, as it always is when a political campaign gets utilities in its crosshairs, was the impact of the sector on the cost of living, profits and tax. Little detail was given as to how a Labour government would fulfil its promises to lower consumer water bills and reduce the alleged profiteering and tax avoidance practices of the industry.

There was however a resurgence of social tariffs as Eagle mentioned the introduction of a national affordability scheme and powers to allow regulators to modify water utilities' operating licenses.

The combined effect is to force water providers to supply cheap water to those who can't afford normal rates and prevent utility companies from compensating for the shortfall elsewhere. It's a move that would send shivers down the spine of many CEOs and one that has been strongly rebuffed in the past.

It is absolutely necessary to ensure that everyone can afford water and the industry is fully behind any reasonable proposal to this end. However, hauling water utilities over the coals is a poorly conceived short-term solution to a situation that requires long-term strategic thinking.

In light of the impending transition to a retail market in 2017, competition and the ability to be flexible with pricing is an absolute must for the sector. Attacking profitability will do nothing but hamstring competition and reduce investment in new and better facilities and services.

Whichever party ends up holding the reins post-May needs to focus on developing a progressive approach that allows utilities to improve facilities and services in a competitive retail environment.

WHOLE NEW BALL GAME

Being a good wholesaler in a competitive market will need a new game plan. Scottish Water wholesale experts Jessie McLeman, Belinda Oldfield and Alan Scott urge English incumbents to get ready for wholesaling regardless of their retail strategy.

Efficient wholesaling has received scant attention since the Water Act 2014 made the prospect of business retail competition in England real. Perhaps because the retail space seems more dynamic and interesting? Perhaps because there are pressing choices to make on the supply side – to compete, retain or exit. Perhaps because companies feel they are dab hands at wholesale operations after all these years?

Whatever the reason, companies must not neglect wholesale preparations ahead of market opening in 2017. All incumbents in England, regardless of their chosen retail strategy, will be required to provide wholesale services. These must be effective and efficiently delivered or the market will fail. And supplying retail licensees will be a whole new – and different – ballgame from performing wholesale operations within an integrated company.

There are three key elements for companies to consider in this space:

- how to separate their retail from their wholesale operations
- how to establish a dedicated wholesale capability
- how to operate efficiently as a wholesaler on an ongoing basis.

The only water company in the country to have been through the process is Scottish Water, which has been operating as a wholesaler in the business market since 2008. *The Water Report* has spoken to three wholesale experts at Scottish Water about their experiences: Belinda Oldfield, revenue general manager; finance director Alan Scott; and Jessie McLeman, who established Scottish Water's wholesale capability ahead of market opening and was responsible for managing wholesale services until recently. She is now seconded to Open Water as codes and processes workstream lead.

Scottish Water does not profess to have all the answers but hopes water companies in England will be able to draw some insight from its experience.

Retail/wholesale separation

The legislation that provided for the Scottish business retail market to be opened to competition on 1 April 2008 allowed for Scottish Water to create a separate legal undertaking to supply business customers. Regulator the Water Industry Commission for Scotland (WICS) soon made it clear that it would look for this option to be taken up, with a view to creating a truly level playing field for new entrants.

Oldfield recalls that legal separation was a difficult concept for Scottish Water initially, largely because of corporate history. The company had been formed in 2002 from three predecessor authorities: North of Scotland Water; East of Scotland Water; and West of Scotland Water. It had spent years forging a cohesive identity and then had to stare down the barrel of a new split. "Initially, I think it's fair to say that having spent a long time bringing the company together from 2002 from three predecessor companies, it was culturally coming as quite a shock to then have to separate out retail," she says. "But the regulator required separation. Initially it was very challenging but after a period of time we embraced it."

McLeman describes how Business Stream was separated off in three main phases:

- **Pre-1 November 2006:** Business Stream became an independent legal entity on this date. In the period leading up to it, Scottish Water undertook work to develop a transfer agreement and all the supporting arrangements. The agreement governed the transfer of physical assets, contracts and, crucially, people. Before the relevant retail staff were transferred, Scottish Water undertook an extensive employee consultation and engagement programme to explain what was happening and why, and to answer any staff questions or concerns. Service level agreements (SLAs) were also drawn up to enable Scottish Water to undertake specified activities on behalf of Business Stream – for instance, certain IT activities and operational processes.

- **1 November 2006-1 April 2008:** From its formation as a separate legal entity to the opening of the market, Business Stream, working with Scottish Water and WICS, set about becoming more and more independent. Its brand emerged in 2007. It recruited staff, settled a business strategy, established its own business processes and so on. McLeman says: "As Business Stream's capability grew, the SLAs with Scottish Water started to fall away. When the market opened, there were still some SLAs – for instance on some aspects of trade effluent, use of accommodation

in Scottish Water and of the IT platform – but they were much diminished compared to November 2006."

- **Post 1 April 2008:** Separation levels continued to grow after market opening. Within a year or so, Business Stream had moved into its own premises and had created its own IT architecture. IT now operates independently of Scottish Water.

McLeman observes that, though a difficult choice at the outset, full legal separation has been valuable in giving clarity of management responsibility and crystalising focus. "We have a single focus on the wholesale role, not a split wholesale/retail focus and clarity of responsibilities. It has also made it easier to develop a wholesale culture in the company."

Incumbent water companies in England are free to choose how far to separate their business retail from their wholesale operations. Scottish Water's experience seems to suggest fuller separation is hard at the outset but proves itself down the line.

Establishing wholesale

McLeman points out that establishing a wholesale capability is a distinct activity from separating off retail; it is not a matter of carving off the customer facing elements of the business and the wholesale capability is what is left. A wholesale operation, capable of serving multiple licensed providers (LPs), has to be created.

People are the first crucial ingredient. "Get the people in," McLeman says. "We set up a wholesale services team. The team included a programme manager to keep business process changes and systems development on track and to oversee compliance with the technical requirements of the market; a contract manager to set up and manage contracts with LPs and account management; and a product manager with responsibility for billing, wholesale service performance and revenues. Separately a wholesale service desk was established to take service requests from and respond to retailers. In the period leading up to market opening, Scottish Water also worked with potential retailers, WICS and market operator the Central Market Agency on the market arrangements.

These wholesale staff were recruited both internally and externally, and were supplemented by contractors with specialised skills where necessary. McLeman adds that the need for people with these skill sets "does not stop on opening day – the same skill sets are needed on an ongoing basis".

She emphasises to English companies in the process of creating a wholesale capability that it is vital to have different people dedicated to the wholesale and retail parts of the business: "One person can't be head of both. You need someone to think as a wholesaler, and someone to think as a retailer."

In terms of which specific wholesale services to offer, McLeman says the Scottish market's operating code specified exactly what was expected of Scottish Water in all its interactions with LPs – on new connections, metering and so on. "It was a big programme of work," she recalls, involving, among other things, business process re-engineering and systems development. "Good will was very important for delivery, so along with the planning and technical work, there was also a very extensive programme of employee engagement, communication and training."

Open Water published its second Market Architecture Plan in December. This includes the wholesale retail code which sets out the draft rules for England. McLeman urges English companies: "There's not much time and these changes take time. Companies should be making plans now and many or most are."

Oldfield echoes the point. She recalls of Scotland: "It's not that any aspect was particularly problematic, it was the amount there was to do in a short space of time. We had 17 months so it's very similar [to the timetable for England, given the planned soft launch in October 2016] and it was very, very challenging – and Scotland only had one wholesaler. We were concerned that we weren't going to achieve market opening in time but we did manage it. It's part of the Scottish Water DNA, actually: to outperform our targets."

Having spent a long time bringing the company together from 2002 from three predecessor companies, it was culturally coming as quite a shock to then have to separate out retail

She stresses as a particular priority "getting the systems in place for the market operator – that will have the longest lead time". There have been a number of challenges on this issue in England, relating to whether the market operator would be classified as a private or public entity. However, with this issue now all but resolved and a private procurement route to be followed, all is not lost.

Scott observes: "There is a sequence to events. You need to define the market code and the fundamentals before you procure. So they [Open Water] are doing things in the right sequence. But these things are always time-consuming. Anything to do with computer systems and data – you have to go into so much detail to get it right, to make it work."

Establishment challenges

Aside from the tight timescale, Oldfield highlights three areas relating to establishing a wholesale capability that were particularly challenging for Scottish Water; three areas English incumbents should carefully consider.

People – culture and compliance: "When you convert an integrated business, you start to think 'I can't talk to my retailer anymore'. We were very aware of the relationship issues – people in Business Stream were former colleagues of the people in Scottish Water. Now we are six years down the line and there's been quite a significant churn in Business Stream and in Scottish Water, so we don't have that issue any more. But at the time it was an issue and it's hard to control from a compliance point of view. You have to work hard on the compliance messages to make sure that people are very clear that they are in the wholesale business; that they have to treat each individual LP equally; that they can't give any preference to their subsidiary company.

It was a big programme of work... Goodwill was very important for delivery, so along with the planning and technical work, there was also a very extensive programme of employee engagement, communication and training.

"Reinforcing those messages was very important. We did general awareness training for 1100 staff. We had compliance workshops for over 100 staff involved in the day-to-day processes. We had customer experience training given to about 600 frontline staff – people that would come into contact with customers or LPs on a day-to-day basis. We had briefings provided to our delivery partners – around 30 different companies. And we had detailed process and IT training for 150 staff directly impacted by the market processes."

Perhaps just to hammer home how seriously Scottish Water took compliance requirements, it added a personal touch. Oldfield adds: "We also have a compliance officer…It is part of the governance code that we have one. He wrote to everyone personally at the time about the dos and don'ts of working with retail competition."

Data: Preparing market data – not just ensuring the quality of data was good, but also that it was in the right format to interact with central systems and had been checked – was incredibly time consuming and remains an issue. Oldfield urges English incumbents: "It's important to make sure you start any data cleansing activities that are needed, now. You need to know your business customers; you need to understand where your assets are; and what your services are. That is something we are still working on six years down the line".

Scott observes: "You just can't understate the importance of the quality of the data you've got. Your business has been billing business customers directly and suddenly you've got to chop into the business and place all that data on business customers with a central agency. So suddenly a spotlight is shone on that and it takes on a whole new importance. And you have to create all the processes and systems to bill through that agency and serve customers through the LP, so it's very different from the way it has worked traditionally."

Charging: In the same way that companies' business customer data will be exposed to market scrutiny, so will their charging practices. Oldfield says: "We didn't anticipate the spotlight that goes on charging – and in our situation it was only Scottish Water and its Scheme of Charges. But having a retail market shines a light on to how you charge, your charging policies, why you charge what you do. I can only imagine it's going to be more challenging in England if there are quite a lot of different methods of charging, different local arrangements, different charging policies. So that will be an area that needs focus sooner rather than later."

Oldfield expects both retail licensees and customers (particularly multi-site customers who can compare and contrast different water companies' charging practices) to ask "very reasonable questions" about why charges are the way they are. English incumbents be prepared.

Wholesale operation

Once it had established the fundamentals of its wholesale operation and the arrangements to support LPs, Scottish Water's attention became and remains focused on delivering wholesale services efficiently and effectively.

Scott explains this situation is complicated by the fact that LPs come in all shapes and sizes. While on the technical side this hasn't caused problems because market and company systems factor in the different sizes and capabilities of retailers, "what is required in the account management team are relationship management skills and relationship building skills. Having people that can adapt fairly readily to the different types of individual they're working with and how they're delivering their service to their customers – that's one of the core elements of the people skills needed in building account management."

There will be an additional complication in England for companies that opt to compete in the market and under a structure of minimal wholesale/retail separation. Licensed retailers will be both customers to the wholesale part of the company and competitors to the retail part. This is a dual dimension Scottish Water never had to grapple with, because Business Stream was legally separated 18 months before competition kicked off.

Another consideration in delivering effective wholesale services is that it is important to look beyond the LP to the end customer. Scott says: "Going through all of this, you can lose sight of the end customer and what they want. You can become inward focused with all these changes you need to make within your business. But at the end of the day there are still customers consuming your services and paying for your services and they need to get a top quality product."

On a related note, Oldfield says six years of the wholesale business being under LP pressure has had trickle-down benefits for domestic customers. "When there is pressure put on the wholesale business, that drives that business to become more effective and more efficient which will deliver better service out for the household customers as well. That's probably one dynamic the regulator was looking for."

Performance measurement

Scottish Water monitors its wholesale performance in a number of ways, including monthly assessment against KPIs (the results of which are fed back to LPs), quarterly customer experience surveys and regular account meetings with individual retailers. According to Oldfield: "Our performance is generally good in terms of compliance with all the timescales in the processes and the operational code".

Scottish Water does not believe business customers have suffered from having an indirect relationship with their wholesaler. Says Scott: "You would think that you are putting in an extra step in the process to get a request through, but in fact the LP is an expert acting on the customer behalf. They know how to translate their requests into our standard format. And then the request comes under the KPI and performance standards and our business gets measured on that."

The company is currently undertaking a review of its entire wholesale service "with a view to being able to go back to the market if we need to propose any changes to the operating code or market code," Oldfield explains. She adds: "We may not; this may be within our gift as a wholesaler to say 'here are ways we can do this more effectively or more efficiently."

The review has a staggered implementation timetable, with design work due to be complete in two to three months; initial changes around six months out; and any alternations that require system changes timetabled for 12-18 months' time.

In addition, an incoming customer experience measure for Scottish Water overall will factor in business customer experience. Two LPs – Anglian Water Business and Business Stream – sat on the Customer Forum that worked with Scottish Water to agree a business plan for 2015-21. Oldfield says they "brought business customer pressure to bear" on the Forum, raising as important issues charging levels and meter replacement needs. Fifty-thousand meters are now due to be replaced under Scottish Water's 2015-21 capital maintenance programme.

Finally, being an efficient, effective wholesaler means moving with the times. Oldfield explains: "The market code and the operating code were absolutely appropriate at the time the market opened when there were three LPs in the market. We now have 18 – although only 16 of them are operational at this point – and that has been a big step up. But as issues arise in the market, changes are made in the codes to resolve them. That's one of the benefits of the governance structure that's in place; the change process works very well and did so right from the start. That's driving the market to optimise itself."

A growing number of LPs has put increased demand on Scottish Water's wholesale capacity as well as on market arrangements. The company has already responded by scaling up staff numbers and may be now looking to step this up again.

Harmonisation

With preparations underway for the English market to follow Scotland in giving all business customers the right to switch supplier, Scottish Water is keeping a watchful eye on developments south of the border. Scott confirms: "We do gap analysis on a continual basis with a view to understanding how the English market is developing."

There is a growing realisation from involved parties on both sides of the border that harmonisation levels on day one won't be 100%. The hope is that the English market will have developed sufficiently to open in April 2017 with broad alignment with Scottish arrangements, offering business customers a seamless experience across the two jurisdictions. In specific areas that aren't customer facing, the English market is in fact being built with different design features.

Suddenly you've got to chop into the business and place all that data on business customers with a central agency. So suddenly a spotlight is shone on that and it takes on a whole new importance.

One key difference between the two markets that has already surfaced and looks set to stay concerns how licensed retailers pay wholesalers for service. Scottish Water is pre-paid by LPs while in England, the proposal is that wholesalers will be paid in arrears with escrows providing some credit security. Scott comments: "Our arrangements were deliberately set up to protect us and Scottish customers from financial exposure. We have zero appetite for risk in that area."

The overriding message from Scottish Water's wholesale experts to English water companies: subordinate wholesale capability to retail capability at your peril. TWR

INDUSTRY EXIT CONCERNS SURFACE

Companies tell DEFRA customer price protection arrangements and the tight timetable are top of mind on retail exit

Consultation closed last week on DEFRA's initial retail exit proposals, published in December. At a workshop held at the beginning of February, water companies and other interested parties gathered to chew over the detail.

The general sentiment was that the overarching policy was well balanced and proportionate, and DEFRA's light touch approach was welcomed. In an encouraging sign for customers, incumbent companies as much as consumer groups endorsed the guiding "principle of equivalence": that non-household customers should have access to the same safeguards regardless of whether their undertaker quits or stays. Moreover, there was a spirit of cooperation in the room; a sense of everyone trying to reach the best possible outcome and an acceptance that the debate was now about how rather than whether to shape the exit arrangements.

Needless to say a number of areas of contention surfaced in the debate. Because exit provisions were added very late to the Water Act 2014, there has been little time hitherto to explore the detail or how exit policy will interact with other aspects of market reform. DEFRA indicated it would listen and revisit concerns raised.

The key issues that emerged at the workshop – those that will need further attention and could indicate where future policy movements might come – are set out below.

> Ofwat is to consult in May on licence changes...This will be a soft consultation, not a Section 13 notice.

Price protection: Incumbents were divided over whether DEFRA's preference on deemed contract price protection for customers whose undertaker exits was the right choice. The government department considered two options: requiring licensees to set default tariffs using an equivalent process to that used by the exiting undertaker; or price terms in deemed contracts identical to those the customer received from its undertaker at the time of exit, for two years following market opening. In its December document, it proposed adopting the second option (unless undertaker prices were found to be unsustainably low) on the grounds of simplicity and because this would protect customers from licensees reapportioning costs between customer groups and hence some facing price rises after an exit.

While some water companies supported the government's chosen position, others argued all licensees should have to offer default tariffs, as is the case in the Scottish market, as this would guarantee customers could obtain the same prices as if their undertaker hadn't quit.

There was also lack of consensus on whether price protection should extend beyond 2020. The government has charged Ofwat with reviewing this, in light of how the market develops. At the moment DEFRA seems minded to favour retaining some kind of protection, at least for some categories of customer.

Two year switchback right: DEFRA proposes limiting customers' right to switch back to deemed contract terms with a previous supplier to two years. It argues customers switching to a licensee have always had the right to return to the incumbent if they wish, so it follows under the principle of equivalence that customers should be able to switch back to an acquiring licensee on deemed contract terms should they at any point switch away from it. It concedes, however, that if customers had this right in perpetuity it would be highly complex to implement – for instance, if the customer had undergone multiple transfers and switches. The two-year protection is something of a compromise.

The proposal was generally unpopular at the workshop, with participants raising everything from practical problems - for instance, could a customer who had actively switched away from the incumbent "return" to a licensee that had subsequently acquired the incumbent's customer base even if it had never been a customer of that licensee? – to fears that licensees might be inclined to jiggery pokery with customer terms and conditions at the two year break point. The point was made that if all licensees had to offer default tariffs, the need to switch back would be removed.

Timetable: There was concern around the tight timetable of the exit work programme, and in particular around the range of dependencies that are assumed. For instance, for an undertaker to apply to exit, it will need to have an acquiring licensee(s) lined up, which in turn will need to have secured a licence to trade ahead of this. Moreover a desire for earlier certainty on exit was expressed; final decisions from the secretary of state are currently slated for December 2016. A question was raised: could the process be de-risked by allowing the exiting incumbent to outsource its business retail operations to the acquiring licensee ahead of official exit?

Customer confusion: DEFRA proposes that all companies that apply to exit must publish notice of this on their websites. Nevertheless, with exit decisions only coming in December 2016, it is likely that the first proactive communication customers will have from departing incumbents will be December 2016/January 2017 at the earliest. This leaves them only three to four months to organise a active switch if they don't want to be transferred to the acquiring licensee.

Some participants felt the whole period could be a confusing and difficult time for customers, and that more attention needed to be paid to customer communications and engagement. TWR

On the case: DEFRA is listening to feed-back on its retail departure plans

OFWAT TO CONSULT ON LICENCE CHANGE PACKAGE

Ofwat is to consult in May on the package of licence changes that will be necessary to accommodate the new retail water market. This will be a soft consultation not a Section 13 notice, with the regulator attempting to build consensus where possible. It is timed to coincide with the expected publication of the Open Water's third Market Architecture Plan, so stakeholders can see how market arrangements are shaping up in the round.

Everyone operating in the retail market will need to have a licence and licensing will be a key part of the exit process, particularly given the light touch approach DEFRA is adopting. In making exit decisions, the secretary of state will rely on assurances from companies that they meet certain criteria, while the licensing system will provide assurance that acquiring licensees are fit and proper.

Ofwat's consultation will consider possible licence changes for both appointees and Water Supply Licensees – both new and those that need to be converted to updated arrangements. Among the changes to be examined will be those to accommodate transition arrangements, market operation and consumer protection, as well as changes to the licence applications process.

According to DEFRA's December exit consultation, Ofwat should develop a flexible licensing system capable of catering for all types of retailer – from those looking for large scale customer transfers to niche players and self-supply licensees.

RETAIL EXIT AND THE OPEN WATER PROGRAMME

The Open Water programme interacts with, and has to take account of, the emerging retail exit regulations in multiple areas. Some of the key issues are:

- MAP2 envisages companies' retail operations will provide market data to central systems. Will exiting companies have to be incentivised to do this to a high standard?
- The market operator will have to take account of exit activity – for instance, overseeing the allocation or reallocation of Service Point Identification numbers (unique reference numbers per supply point); reconciling transactions that are incomplete at the point of exit; and managing the process by which an exiting incumbent resigns from the MO company.
- There will need to be sufficient gross retail margin for each class of customer to ensure that some retailers are keen to acquire customers that become available.
- Supplier of last resort arrangements will have to take account of exits.
- Will exiting companies be required to comply with the full range of market testing and assurance procedures?

PULLING PINTS

Adnams already leads the brewing industry on water efficiency. It is now on the hunt for price and volume risk protection and further efficiencies upstream.

Adnams is looking for “the next big thing in water,” says Richard Carter, who is responsible for finance and sustainability at the Suffolk brewer and distiller. Something to protect it from future volume and price risk. Ideally, something that would have as much wow factor as its anaerobic digestion plant had on its carbon emissions. This facility converts brewery and local food waste into some of the cleanest biogas around which is fed direct to the grid. It saves around 7,000 tonnes of carbon by diverting 12,500 tonnes of waste from landfill.

However, finding a step change improvement in water looks set to be a real challenge. Adnams is incredibly environmentally aware and all the low hanging fruit has already gone. Perhaps in part because of its long history (see box page 30) and its deep roots in its home town of Southwold in water-stressed East Anglia, the company takes a long term view of environmental issues and has a corporate value that it will “make great products without costing the earth”.

Aside from Carter, whose job title indicates environmental reporting has board level attention, Adnams also employs environmental manager Ben Orchard. Orchard makes it his business to chase down opportunities to reduce energy consumption, carbon production, water use, and waste generation, and more recently to safeguard biodiversity.

Best foot forward

On the energy/carbon side, apart from the big win of the AD plant, there are examples of energy efficiency and carbon minimisation at work throughout the business – from low energy lightbulbs in shops to the reuse of waste process heat wherever feasible. Specific initiatives include switching its Spindrift beer out of blue and into brown bottles when it found it could save 18 tonnes of carbon a year just from that, and the company has made more of its best selling brands available in cans rather than bottles to save over 140 tonnes of carbon per year.

But Carter comments that it isn’t as simple as reducing carbon: “Recycling cans is essential to avoid depleting the earth’s scarce supply of bauxite and to minimise land scarring, eutrophication, smog and acid rain. So Adnams has one of the highest ratios of recycled metal in their cans. We’re also removing the plastic rings holding can packs together to reduce any risk to wildlife.”

These are just some of the initiatives that flowed out of an industry-first project delivered with the University of East Anglia to carbon footprint all its beers. This followed a “grain to glass” philosophy and has measured Adnams’ core range of beers in all their forms – bottled, canned and cask. Adnams is encouraging other breweries to follow and invites the opportunity to collaborate. Adnams is also able to claim production of the UK’s first carbon neutral beer, East Green, in 2008 and generally, that pint for pint, its beer production is less carbon intensive than milk production.

The company’s reportable emissions under the Greenhouse Gas Protocol have already been reduced to around 3,500 tonnes, but Carter’s internal calculations suggest that the company’s wider considerations such as the AD plant offset that to within the equivalent emissions of around two homes.

Three-to-one

Unlike in lots of other businesses where water is energy’s poor relation, Adnams has also paid attention to water efficiency. The company as a whole uses around 60,000m3 of water a year, 53,000m3 of which is consumed by the brewery and distillery. Since saline intrusion put its borehole out of action some 20 years ago, all Adnams’ water has come from mains supplies.

Since the early 2000s, the company has used around 3.2 pints of water to produce a pint of product (the distillery is far more water intensive than the brewery). This is well below of the industry average, which for beer alone was 8:1 back in the early 2000s and now stands at 4-5:1.

The industry-leading performance stems from a number of roots.

Scale of output plays its part, says Orchard. “The thing to look at is where the water that doesn’t end up as beer is going. Mostly it’s on cleaning, where daily and weekly routines operate. Those routines

don’t change regardless of how much you produce, so the more you produce, the less water used per unit.”

However much larger breweries can have higher water consumption ratios, so other factors must also be at play. Orchard says he “can’t get enough” data and has made significant consumption savings from detailed study and adjustment of production processes. He gives an example: “We’ve done lots of work to improve the cleaning cycles. We’ve managed to remove two 4-minute cycles by using a different detergent, which when you think of the 15 litres per second pressure, is well worth having.”

There is reuse too, which exploits synergies between the brewery and distillery. “For the distillery alone it’s 20-30:1 [water use to spirit output] ratio, primarily because of cooling,” Orchard explains. “But we use the waste hot water from cooling to clean the casks in the brewery.”

The company’s commitment even goes so far as to harvest rainwater from the green roof of its distribution centre for use in toilet flushing. Carter comments: “This makes only a minor impact on our consumption, but sends a clear message.” Orchard adds that over the Christmas period, the company had sub meters fitted so from now on will be able to generate data of even greater granularity.

Desal and upstream

Despite its high level of water efficiency, there is to be no resting on laurels in Southwold. Carter remarks: “You can’t move a business forward by looking back.” For a carrot, there’s what some seriously water constrained Australian brewers have achieved – water to beer ratios of 1-2:1 – albeit in very different circumstances.

For a stick there is risk of supply constraint and price shock. Orchard says: “Water is such a local problem. We are very aware of the pressures in our area from climate change, population growth, development, intensive agriculture and so on. If we had a plant somewhere else it might be different, but we don’t. Water supply risk is very much on the company’s risk matrix.” Carter adds: “We are convinced the cost of water will go up when its true value is appreciated.”

The company takes these risks so seriously in fact that in pursuit of “the next big thing”, it has conducted an extensive study into the feasibility of desalination – scrutinising all relevant factors including planning issues, costs, process issues, siting issues and the environmental cost-benefit. The latter was a key sticking point. The plant would require grid power, so any gains made on the water side would be wiped out by increased power use and the resulting carbon emissions. The case illustrates well the company’s mature strategy of considering environmental gain and loss holistically, rather than in traditional energy/carbon/water silos.

Carter notes that desalination has been “deferred for now, but not ruled out” and would be reconsidered should – for example – technological development cut plant energy use, renewable power become feasible, or water availability decline or prices spike.

In the meantime, other avenues are being explored for water. Adnams is examining how to follow up its carbon footprinting work by calculating the water footprint of its beers. It hopes this will reveal where further savings can be made. Given the existing efficiency of water use in its brewing and distilling processes, Orchard comments that to make further gains, the company is going to have to look “beyond its four walls”.

This means working with its supply chain to help them improve their water management practices. Particular focus, Orchard explains, is likely to fall on encouraging best practice farming among its 16 local barley producers, both to limit any water wastage and to safeguard water quality. Upstream reformers take note (see feature page 12-17).

Retail competition

Adnams does not think its "next big thing" box will be ticked by the opening of the retail market in 2017; its concerns are wholesale concerns that won't go away by switching supplier. Moreover it is reasonably content with its current suppliers Essex & Suffolk Water (water) and Anglian Water (wastewater). Orchard says: "They are both good, both helpful, and Anglian Water Business is very proactive."

But nevertheless competition is on Adnams' radar. "I think customers should make a deliberate choice," says Orchard, "and we are actively looking at our options." No decisions have been made, he adds, but for administrative simplicity and to take advantage of end-to-end benefits, he sees merit in selecting a single supplier for all company water interests. It also clearly has a vision of the sort of retailer it will choose.

My worry about competition is that in the short term, prices might go down – undervaluing water by an even greater amount than currently.

Beside the seaside: Adnams has explored desalination to secure its water supply

Carter elaborates: "We don't always go for the cheapest when we are choosing who to work with. We want good advice and good service. We do like working with local businesses." He provides a couple of examples of recent switches away from national providers to local ones, including for security alarms. "We want to know that if an alarm is going off in the middle on the night, we can call a real person who will fix it quickly and sensibly while minimising any impact on our neighbours and our operations." Moreover the company will look for a supplier that is credible and experienced, and one that shares its green agenda and is willing to work collaboratively – "not Joe Bloggs Water", Orchard muses.

Of the various options that will be available to Adnams, Anglian Water Business is clearly building its brand identity around efficient water management and environmental responsibility. At first glance at least, it appears it might tick all of Adnams' boxes.

But clearly it's not a done deal. The company would welcome help "knowing how to make the decision" on choosing its supplier. The customer only knows so much, says Carter, quoting Henry Ford: "If I had asked people what they wanted, they would have said faster horses." He urges water companies to fill this void before the multitude of phone calls he already gets from green consultants and carbon advisors offering to work wonders on Adnams' energy bills is swelled by similar offers for water.

Quite simply, Carter wants clear, honest information from a trustworthy source. "I'd welcome more information, more visibility – for example about when the cost of water is likely to go up and by how much." Perhaps betraying how deeply ingrained environmental concerns are in Adnams' psyche, Orchard comments: "My worry about competition is that in the short term, prices might go down – undervaluing water by an even greater amount than currently." TWR

ADNAMS OF SOUTHWOLD

Adnams is a household name as a fine quality brewer. Its core range of beers includes the best selling Broadside, Bitter and Ghost Ship brands but the company also produces many special, seasonal and bespoke brews. In total it produces 100,000 brewers' barrels a year – which is equivalent to around 27 million pints, half a pint for every UK adult.

Nearly five years ago it diversified and its Copper House Distillery now produces around 50,000 litres a year of high end spirits and liqueurs. Its Longshore Vodka last year beat off global competition to be voted "worlds's best" at the International Wine and Spirits Competition, following the same accolade for its gin the year before.

Based in and synonymous with Southwold on the Suffolk coast, Adnams operates its state of the art modern brewery and distillery from the Victorian premises it has occupied since the company was founded in 1872. This nestles unobtrusively in the heart of the town. Southwold also hosts two Adnams hotels and some of its 50-odd pubs and dozen shops which are spread throughout East Anglia. There is also an online and mail order operation.

The company employs around 420 people and turns over £60-70 million a year. It is a public limited company but the founding Adnams family retains a major shareholding and is represented at executive level by chairman Jonathan Adnams. Most staff hold shares, as do many local families.

Despite the UK-wide brewing industry being in the doldrums, particularly beer sales in pubs as opposed to home consumption, Carter says Adnams is thriving in both segments.

WATER TASKFORCE FOR BUSINESS

Business In The Community is collaborating with the water industry and others to galvanise firms across the country to put water on the corporate agenda.

Of the many risks the world faces – including war, economic collapse and disease –water crisis has been among the lead global concerns for some years (see box). But it is increasingly becoming a threat not just to regions where shortage and drought are characteristics of their geography but to some of the wealthiest regions. Parts of the US are battling drought. And while much of the UK sees itself as part of the time-honoured green and pleasant land, the reality is not so pleasant and likely to become less so.

A growing number of the UK's industrial and commercial water consumers are being rudely awakened to the true value of water as its scarcity in some areas of the country is threatening their businesses. Some are responding well and making progress with improved efficiency in their water management. Others are not.

Recognising this, a taskforce of major players from the water, energy, construction, retail and food sectors along with government agencies is looking to address the disparate levels of engagement with water issues among businesses and to "press home the crucial part water has in the prosperity of all industries".

The Water Taskforce – established by the corporate social responsibility promotion charity, Business in the Community – highlights in a recent report, *Water: securing resources for future prosperity*, how businesses in those areas of the UK where water is scarce including East Anglia and the South East, have made headway in their efforts to accommodate shrinking water resources.

Meanwhile their counterparts in other parts of the UK are less motivated, with lack of cost pressure part of the reason. According to Water Taskforce: "Water is simply not as expensive as other inputs such as energy, and until an emergency arises in the form of a flood or drought, the risks of inaction are not fully appreciated."

And naturally those industries such as the food and drink sector with a direct and substantial dependency on water have, according to the Taskforce report, done "quite a lot" to manage their water use while others "have yet to begin".

The Taskforce points out that water costs can be 1-2% of a company's turnover and cost savings of 30 - 50% were readily achievable. And it highlights encouraging signs of engagement in addressing water-related challenges.

In 2014, 83% of the global 500 companies based in the UK invited by non-profit organisation the Carbon Disclosure Project to report on their water management did so. A huge majority (89%) said that they had evaluated how water quality and quantity could impact business growth. Water issues created direct risk to operations or supply chains for 74% of respondents with 32% having experienced water-related adverse impacts in the year. And 84% had identified water-related opportunities while just over half had a water policy.

The Taskforce urges companies to take measures to address forthcoming water challenges. These include, naturally, the management of direct water use but there is an emphasis on the need to rein in indirect water use through collaboration with suppliers and customers.

The reasons for taking action in water management are clear: at the same time as it reduces costs, it cuts emissions and rescues the environment from flooding and harmful impacts from over abstraction. For these reasons investors as well as government and regulators expect to see businesses up their game in water management.

The Business in the Community Water Taskforce is sorely needed. And smaller businesses as well as the big players need to engage. Small firms lost more than £830 million because of the 2013/14 floods in the UK. Without concerted action from businesses on water management there will, in the long run, be a substantive cost to those businesses in meeting their water needs. Early action is inevitably cheaper than calling the emergency plumber. While incentives through pricing remain restrained politically, the price will not give the right signals. It's down to businesses to take the initiative. TWR

WATER RISK: LIKELIHOOD AND IMPACT

The World Economic Forum this year published its tenth Global Risks report – an analysis of perceived threats derived from polls of some 900 members of the forum. While water crises do not rank highly on likelihood, they top the 2015 list of risks on impact and have been in the top five since 2012. However only 4.2% of respondents considered water crises to be among the top three global risks in which the most progress has been made over the past decade.

Top 10 global risks in terms of
LIKELIHOOD

1. Interstate conflict
2. Extreme weather events
3. Failure of national governance
4. State collapse or crisis
5. Unemployment or underemployment
6. Natural catastrophes
7. Failure of climate-change adaptation
8. Water crises
9. Data fraud or theft
10. Cyber attacks

Top 10 global risks in terms of
IMPACT

1. Water crises
2. Spread of infectious diseases
3. Weapons of mass destruction
4. Interstate conflict
5. Failure of climate-change adaptation
6. Energy price shock
7. Critical information infrastructure
8. Fiscal crisis
9. Unemployment or underemployment
10. Biodiversity loss and ecosystem collapse

Economic Environmental Geopolitical Societal Technological

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