THE WATER REPORT

POLICY | REGULATION | COMPETITION

JULY/AUGUST 2015

DOUBLE SUMMER ISSUE

Bouncing back

How can water companies deliver more for less on resilience?

COMPETITION WATCH

- No room for error as Open Water responds to baseline review.
- Licence changes: retail readiness and the in-area trading ban.
- Is the price right? How suppliers should set open market prices.

DOUBLE SUMMER ISSUE

EDITOR'S COMMENT

Why are we waiting?

Since our last issue, a good many more pieces of the jigsaw that is the developing retail market in England have been put in place (see p36-40). Meanwhile in Scotland, the pin-up for water competition, there is still no news on the public sector procurement contract.

In early June, preferred bidder Anglian Water Business expected to seal the £350m deal to supply 200 public sector organisations in Scotland inside a couple of weeks. It had already been waiting four months longer than anticipated following an unspecified delay. But here we are some six weeks later with no progress, no information, and very little prospect of movement until at least after summer.

Early on, the accepted wisdom was the delay was the result of legitimate procedural or technical queries. But the longer it drags on, the harder it gets not to wonder whether the delay is politically motivated. Anything that can be classified as back door privatisation is a hot potato ahead of next year's elections in Scotland. Only recently ferry workers have been on strike after private sector Serco looked set to take an eight-year operating contract away from publicly owned CalMac after Scottish ministers put the deal out to tender under EU procurement rules.

Labour is thought to be rallying claims the SNP is privatising Scotland. On 9 July, Labour MSP Lewis Macdonald posed a series of parliamentary questions on why the public sector water deal has been delayed and when the contract award is expected. These questions may have been raised on an anti-privatisation ticket (never mind c90% of contract revenue will flow back to publicly owned Scottish Water), but ironically they look to be our best chance of getting more clarity on what is going on. Answers are due by 7 August.

So perhaps we are kept waiting while the Scottish Government wrestles with the choice of either awarding the contract to the preferred bidder and stirring up hostile anti-privatisation sentiment on a vital public service a year ahead of an election (let alone a possible legal challenge from Business Stream which it, awkwardly, owns); or overturning the procurement process. It should be aware that the latter would damage the credibility of the whole Scottish water market – a market it has proudly showcased to the world since 2008.

| NOTE: In view of a busy early summer for water and a likely quiet August given parliamentary recess and holidays, we have produced a double issue this edition, covering July and August. We will be back to usual monthly issues from September.

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CUSTOMERS NEED GREATER SAY AND A HELPING HAND

According to *The Water Report's* Expert Forum, customers should be better informed on water matters and then handed heavy influence over decision-making – on issues as diverse as price, service, resilience and upstream reform.

Customers' place at the centre of the water industry looks unshakeable, according to the second *The Water Report* Expert Forum survey, conducted late June/early July by Accent. The vast majority of Forum members – leaders and opinion formers from in and around the sector – said the level of influence customers had over price and service decisions for 2015-20 should be maintained or strengthened going forward. But equally, the customer mantra was not blindly followed. The Forum acknowledged there are plenty of difficulties to overcome before customers can make truly effective price and service decisions and that customer views would sometimes need to be balanced by input from other stakeholders.

TWR EXPERT FORUM

THE WATER REPORT

Accent

The Water Report, in partnership with market research company Accent, set up the Expert Forum to consult every other month on a key industry issue. Approximately half our Forum members are at board level and most of the remainder in other senior management positions. Many thanks to all those who have joined.

Group members are emailed surveys which should take no more than ten minutes to complete. Responses are treated as confidential. Findings will be reported in aggregate only and any comments used will be anonymised, unless members are happy to be identified.

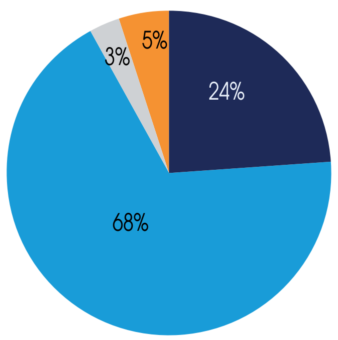
The next Forum will take place in September for the October issue of *The Water Report*. We would be delighted to welcome more members in senior positions. If you are interested, or if you have a topic suggestion for the Forum, please email karma@thewaterreport.co.uk

Customer voice 2015-20

First we asked the Forum for its views on the amount of say customers had in determining investment and service levels for 2015-20. Over two-thirds felt customers had the right amount of say, with most of the rest saying customers had too little say (see chart 1).

Reflecting this result, most verbatim comments were very supportive of the approach to customer engagement taken in the recent price reviews in England, Wales and Scotland. There were multiple positive references to both the work of the Customer Challenge Groups/Customer Forum, and the extensive amount of research companies did. This is perhaps best exemplified by this comment: "The industry carried out more customer engagement than ever before and the CCG approach ensured companies were thorough in their customer engagement. I think we can do more regular engagement throughout the five years, but think the level of input is about right."

Chart 1: In terms of determining the investment and service levels water companies will deliver in 2015-20, customers had:



Too little say **24%**
The right amount of say **68%**
Too much say **3%**
Don't know **5%**

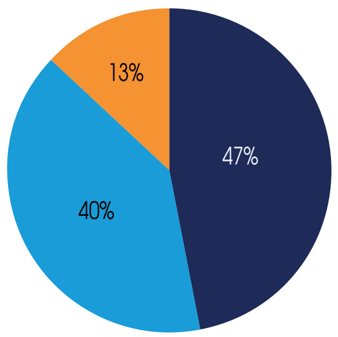
Those who felt customers had too little say offered a variety of reasons for their view. One for instance thought customer consultation could have been better publicised: "Whilst there was consultation it was not widely publicised and many businesses were unaware they could influence." Others cited interventions from both government and regulator that weighed against customer preferences:

- "They [customers] were consulted extensively, but in too many areas their views were over-ridden. For example, there was masses of evidence that customers wanted service improvements rather than bill reductions, but due to the political winds that were blowing their views were ignored."
- "Customers told companies what they wanted, companies listened and built business plans that reflected those views. And then Ofwat forced companies to introduce ODIs [Outcome Delivery Incentives] against customers' wishes."

PR14 comparative analysis

One particular brand of regulatory intervention at PR14 – Ofwat's late-on decision to compare company proposals across the industry in six common areas (supply interruptions, customer contacts on water quality, water quality compliance, sewage pollution, sewer flooding and leakage) and to intervene in some companies' ODIs on the back of this, effectively to require them to aim higher because of other companies' plans – completely split Forum opinion. We asked: should preferences expressed by the customers of individual companies be subject to adjustment on the back of such comparative analysis? Just under half (47%) said yes; 40% said no and the rest didn't know (see chart 2).

Chart 2: Should preferences expressed by the customers of individual companies be subject to adjustment on the back of such comparative analysis?



Yes **47%**
No **40%**
Don't know **13%**

Among the comments offered in support of Ofwat's comparative analysis approach were these:

- "Customers only have experience of one company and are unable to compare that experience with those of customers elsewhere in the country. It is right that, to some extent, the preferences of local customers should be adjusted by cross-sector analysis by the regulator, especially when this results in overall improvements in service over time."
- "There was great variation between companies in terms of commitments for supply interruptions. While customers wanted service to improve, they would not have been able to judge whether their company was offering a leading edge or poor service. It was appropriate that Ofwat tried to make sense of it, although there remains some variation between companies."

Critics of the approach ranged from the sanguine to the downright angry, as these comments illustrate:

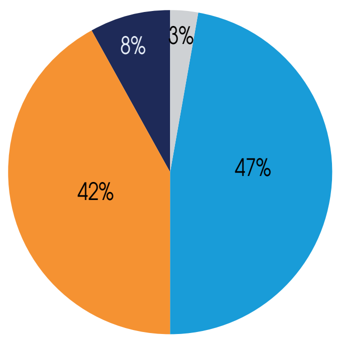
- "Customer priorities are different in different areas and [should] be reflected"
- "I do not agree that the horizontal audit was a good idea. It undermined the customer research approach"
- "This completely undermines the ownership of plans by companies and their customers. The move by the regulator back to a comparative regime has seriously undermined companies' future incentives to develop performance commitments in conjunction with their customers and stakeholders and will lead companies to second guess the regulator in future. Retrograde step."
- "Ofwat's imposed targets were not in line with the customer consultation carried out. To meet these targets we will have to divert investment from elsewhere in our plan. Our proposed investments were based on customer preferences – this is no longer the case. If Ofwat had made it clear what they wanted at the start of the process, we could have carried out the appropriate stated preference work. It would have been sensible for Ofwat to have actually tried to understand why companies were different and how much it would cost to get them to the same position before imposing revised targets on which customers had not been consulted. I'm still not sure if all companies will be measuring interruptions for example in the same way!"

An aggravating factor relating to the comparative analysis carried out by Ofwat was that it was introduced unexpectedly and late on in the price setting process. One respondent remarked: "Comparative information is important and it would be useful for customers or the customer group to have access to such comparisons when expressing preferences. However it is not ideal for the regulator to apply adjustments at the last stage." Going forward, if the regulator plans to set targets in line with benchmarking information, the Forum findings suggest it should both make its intentions clear as early as possible, and share the comparative information with all those involved with business planning, so they can factor relative performance into their plans from the earliest stage.

Future price setting

Next, we asked: going forward, when it comes to determining the investment and service levels water companies should deliver (beyond statutory requirements), would you like customers to have more, the same, or less influence than in price setting for 2015-20? Nearly half (47%) opted for the same amount of influence, while 42% said more influence and just 3% said less (see chart 3).

Chart 3: Going forward, when it comes to determining the investment and service levels water companies should deliver (beyond statutory requirements), would you like customers to have:



Less influence **3%**
The same amount of influence **47%**
More influence **42%**
Don't know **8%**

Clearly, many felt PR14 had hit the nail on the head in terms of customer influence and would be happy to see this set-up continue. One remarked: "Any more influence will detract from company… expertise and risks short-termism. Any less influence could result in [a] blinkered 'we know what's best' approach from companies."

Among those who wanted the customer to have more influence were those who opposed regulatory intervention after comparative analysis, as discussed above. One observed: "[Customer] views were often over-ridden at PR14. I would prefer to see this happen less at PR19."

Others sought more extensive customer engagement and research. For instance: "Companies should find ways through social media to get the opinions of customers going forward on what they pay for and what their priorities are for the environment." And this: "There is scope for companies to develop closer relationships with their customers and to conduct even more useful research. Also the Customer Challenge Group concept can be developed in the light of years of experience and lessons from Scotland and other sectors. We are all on a journey and there is further to go."

A couple of respondents advocated advancing the customer to the next level and moving towards a system where customers negotiate directly with their water and wastewater service providers. One respondent, for instance, said: "What would be worth considering is the Scottish approach to a negotiated settlement which gives more informed customer engagement." Another stated simply: "Customers should lead to the development of future plans."

Some curtailed their ambitions for customer influence on practical grounds. One advised: "It is important that customers have an input into companies' plans. However, customers cannot be expected to fully understand all aspects of water abstraction, treatment, distribution, and the economics of providing what is already a good standard of service. We would all like to deliver higher standards of service, >

at lower prices, with no damage to the environment, whilst allowing customers to use as much water as they like – but there has to be a balance. It is up to water companies, government and the regulators to explain that balance, and deliver the best balanced outcome for customers."

Practical difficulties

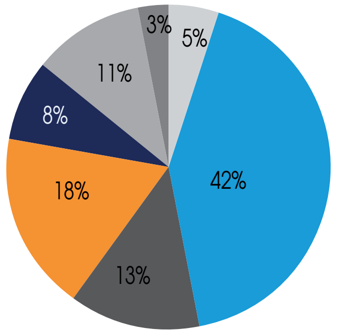
The Water Report Expert Forum explored the practicality of giving customers a greater say in future price and service decisions in more depth in subsequent questions. We asked Forum members to identify difficulties with customers making decisions on water company investment/service levels. Chart 4 shows the issues respondents said posed the greatest difficulty.

Lack of customer understanding and the possibility of ill-informed decisions came out on top by a considerable margin, followed by regulatory rank-pulling and then difficulties accurately establishing customer views.

Comments on these three aspects included:

- "Ofwat proved to be the outlier in the PR14 process, appearing to support the Customer Challenge Group as the plans were developed then choosing to select what to include in the FD to suit its own agenda."
- "I believe that customer consultations are difficult to establish what is a representative view as opposed to a vociferous one."
- "The challenge continues to be how to get customers sufficiently informed to enable them to make the correct decisions about sometimes emotive issues."
- "If we keep the consultation to areas where customers can be reasonably expected to have a view – i.e. many levels of service and price – then there aren't any difficulties. There is also the issue that all views should be uninformed [and] as soon as the customer is fed additional information, they no longer represent the majority of customers."
- "Water 'issues' are relatively ill-understood at present. Businesses are aware that scarcity, quality and effects on the landscape and biodiversity are important, but the concepts are still in their infancy. As we improve our understanding (just as we did with energy/carbon some years ago), business will be better able to react and influence the agenda. That distillation of knowledge is the next essential step."

Chart 4: Which of these poses the greatest difficulty with customers making decisions on water company investment/service levels?



Lack of customer interest **5%**
Lack of customer understanding - decisions could be ill-informed **42%**
Hard to accurately establish customer views **13%**
Regulator will intervene and eclipse customer decisions anyway **18%**
Government policy will drive company actions more than customer preferences **8%**
Investor interests will drive company actions more than customer preferences **11%**
Other difficulties **3%**

UPSTREAM REFORM AND CUSTOMER PREFERENCES

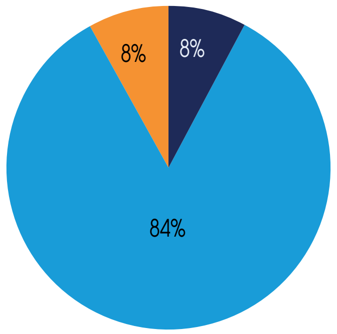
Spearheaded by Ofwat's Water2020 work and companies' own endeavours, upstream (and downstream) reform is starting to be mapped out in earnest now. To the best of The Water Report's knowledge, little work has been done (certainly little has been published) on customer views of wholesale reform prospects and the opportunities and risks that could flow from them.

Yet according to our Forum, customer preferences should be taken into account (see chart 5) While there is little appetite (8%) to put customers in the driving seat in the way PR14 did, 84% said customer preferences must be part of the upstream picture. This suggests an extensive engagement and research programme will be necessary fairly urgently; that those responsible for making decisions on market reform should factor customer preferences in upfront.

Among the comments we received on customer engagement and upstream reform were:

- "As long as the customer understands the upstream reform programme, any views should be listened to and taken into consideration, as they will bring a lot of knowledge and input into the discussion."
- "Customer preferences should play a key role, but market reforms need to consider the long term perhaps more than a lot of customers might be prepared to."
- "Fundamental that customers get value from any changes made and this should be a consistent test."
- "I believe the customer perspective is of less importance in the upstream markets reform. The framework must ensure that there are sufficient safeguards in place to protect customers. The market should then determine the best and most cost efficient solution overall, including taking into account the societal cost and benefits in any solution being implemented."
- "I would be in favour of customers having a significant say in the reform of upstream markets providing they were properly educated and informed of the pros and cons of the proposed reforms."
- "It is only as these markets are reformed that different types of customer, and their preferences will be revealed. This is why current customer preferences cannot dictate, but should be taken into account."
- "My concern is that most customers will not understand the need for such reforms and will be ill prepared to add to the debate on the choices that exist in the upstream market designs."
- "Some customers can drive some aspects of upstream competition."

Chart 5: To what extent should customer preferences be taken into account as upstream markets are reformed?



Customer preferences should dictate the reforms **8%**
Customer preferences should be taken into account along with other factors **84%**
Customer preferences are of minor importance **8%**

- "The process for developing upstream markets and any eventual reform are unlikely to impact the service to customers in the short to medium term."
- "The question is how do you adequately explain the concept to customers, and will they care?"
- "Upstream reform proposals need to be articulated to customers much more clearly than has been done to date. At some point customers need to understand (particularly in the southeast) that price signals that reflect the underlying supply demand position must lead to increasing costs that will transfer through the value chain to end customers. What seems to be missing is the clear evidence to show that this cost increase will be offset by the potential efficiencies that the reform can reveal. Will upstream reform be the next decarbonisation of power generation? Are customers willing to all pay an extra £300 per year to keep rivers flowing and for major strategic transit infrastructure to be built?"
- "Upstream reforms should take into account the views of customers in so far as the output for them is concerned. However, notwithstanding this, consultation for its own sake is not representative or useful."
- "What is the point in the reform if the overall value proposition to customers is not enhanced? This would include the benefits of an improved environment, protection against flooding and reduction of drought risks. But the up-front investment is required from customers and they should be in the lead."
- "Where the outcome result in increased risk of either security of supply or water quality change then they should be taken very much into account."

ed: "All of these are difficulties, but this is not an excuse for not involving and empowering customers more in such decision-making processes. It just means that we have to work harder and be cleverer in customer engagement programmes and use of Customer Challenge Group type models."

95% of Forum members said water companies should do more to educate their customers on water issues, to enable them to engage from an more informed standpoint. According to one: "After years of rising real prices, we cannot keep loading the cost of investments and service improvements on customers. As we understand better the impact of climate change, we have to work with customers to ensure a sustainable balance between supply and demand. All this requires more dialogue and more understanding." Others stated simply: "The ignorance of our service and how we provide it is a barrier to good engagement with customers about investment decisions" and "Otherwise the whole customer engagement stuff is a sham".

Information and education

On a positive note, many Forum members emphasised that these difficulties with customers making decisions could and should be overcome. One comment-

One respondent urged that customer engagement should be ongoing, not confined to price reviews: "Customers have a very limited understanding of their water service currently, which limits the effectiveness of engagement. I think companies are still only inclined to engage with customers effectively during statutory consultations rather than as a business as usual approach currently. It would be interesting to know what customer engagement/consultation has been/will be carried out by companies in 2015-16 now the BPs [business plans] and WRMPs [Water Resources Management Plans] are published."

However, despite the enormously high level of support for companies stepping up their customer education initiatives, some felt this job should not fall entirely on the industry's shoulders. "[Customer education] should not just be down to water companies. Government and regulators have their part to play. Note that accurately understanding customers views is dependent on their level of interest, and their level of understanding. If the regulator wants to override customers views, it should only be for the very best of reasons (not just to keep prices down!). And gov- >

ernment policy should be based on customers' views and only be different for the very best of reasons."

Others highlighted the need to keep some perspective on even better informed customers' opinions: "Companies need to inform (not educate) their customers about water issues. Qualitative research offers the best opportunity to inform customers so that views expressed in focus groups etc are well-based. But it isn't foolproof, and customers' views should always be used to inform company decisions, and not be slavishly followed."

Forum members offered a wide variety of suggestions on how water companies could do more to educate their customers on water issues. Aside from simply doing more, these included:

- Be more proactive: "Be more active in the communities they serve with proactive engagement on topics of interest. We often seem to be defending a position or fixing problems rather than talking about the value we add every day"; "Education and communication programmes, co-ordinated efforts to promote the industry rather than only hearing about the industry in times of stress; e.g. drought, flooding, annual bill increases."
- Get local: "Better reporting on local issues"; "Engage earlier and more frequently at community level and lower."
- Make PR14-style engagement routine: "Build on the consultation process complete[d] for the last price review and make it business as usual."
- Recognise customer differences: "By considering a range of engagements with customers of all types - recognising the very broad ranges of different customers in different regions."
- Use multiple channels. Suggestions included: school visits, local stakeholder events, advertising including TV, social media, employee engagement, mailshots, websites, tours of facilities, open forums, Q&As and Google hangouts with experts.
- Collaborate: "UKWIR carried out a really useful study of the customer engagement programmes and techniques used in PR14. The best practice discovered in this study should be promoted throughout the sector through workshops and conferences. Customer engagement is an issue in all regulated sectors and the UK Regulators Network is looking at experience across sectors. We all need to be open to ideas from other sectors. Finally, this is not just a matter for individual companies. Water UK could be more active in promoting an understanding of how the water sector works and what customer need to think about when using water."

The Forum's thoughts on the extent to which customers should drive the agenda on two major upcoming issues – resilience and upstream reform – are shown in the boxes. TWR

RESILIENCE V CUSTOMERS?

We asked the Forum whether the resilience agenda – especially the need to plan and invest for the long term – would weigh against customer influence over water company investment and service planning.

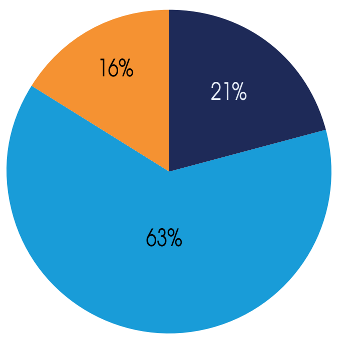
As chart 6 shows, around a fifth thought it would. One commented: "Customers typically tend to be short-termist. I know many have a two year payback requirement, which is at stark odds with water companies' planning horizon of at least 15 (and more like 25) years." Another offered in explanation of this view: "Customers are likely to focus very much on the services they receive to their home and not think too much about what we might call the citizen or public interest such as clean beaches or environmental impacts or sustainability. Also customers tend to think short-term because they face pricing pressures now and it is tempting to postpone investments that might have medium term impacts such as metering or water efficiency."

However, many others saw no fundamental conflict between customer and resilience agendas, arguing variously that customer preferences should underpin resilience actions ("Customers are the best judge of the trade offs that should be made"); that customers actively want resilient services; or that customers would support resilience actions if armed with more information on the subject.

On this last point, some suggested educating or informing customers on longer term issues was a key plank of the engagement agenda for companies going forward: "It is important that all customers understand the need for longer term planning and resilience measures. This is an important part of the better engagement we have to have with our customers in the future, involving them at an early stage to help them realise the need for these works."

Others pointed out that greater resilience did not automatically equal higher bills: "Catchment management approaches can deliver resilient services at a fraction of the cost of conventional solutions. Companies can be innovative if policy makers provide the opportunity."

Chart 6: Will the resilience agenda - especially the need to plan and invest for the long term - weigh against customer influence over water company investment and service planning?



Yes **21%**
No **63%**
Don't know **16%**

Interesting views surfaced on whether resilience should be dictated by local or national needs. One Forum member suggested customer influence would not need to wane as action is taken on resilience "provided it is grounded in local resilience risk assessments and not dictated by national priorities". In contrast, another said: "Resilience if often a long term solution with cost now but benefit later. This is often difficult within (the) current approach for customers to support, especially when dealing with long return periods such as 1 in 100 or 1 in 200 year floods. These differences are difficult for customers to understand and support. There needs to be policy in these kind of areas i.e. national resilience standards – otherwise resilience will never improve unless a failure occurs and this then raises its support by customers."

Finally, some members indicated that if customers can't be swayed to support action to boost resilience, their views may need to be over-ridden in certain circumstances. One said: "Customers understand the concept, but are maybe not willing to pay for increased resilience, if for example they have never experienced a temporary use ban, or a prolonged outage. However, if the risk is going to increase, it is incumbent upon companies, government, and the regulators to take the appropriate action to mitigate that risk, balancing the cost of mitigation with the cost of failure. Sometimes, the economic case outweighs willingness to pay. You can guarantee that the majority of (Thames) customers would prefer not to be paying for the Thames Tideway Tunnel."

RESILIENCE REQUIRES LONG TERM VIEW OF EFFICIENCY

Ofwat's resilience consultation sets out its approach to long term service provision at a price current and future customers can afford.

Ofwat's new primary duty to "further the resilience objective" puts it in the difficult position of having to preside over an industry that somehow must reconcile keeping bills as low as possible for today's hard pressed consumer while also ensuring water services are fit for the future.

This is one of a number of resilience-related issues the regulator grapples with in a consultation published earlier this month. Its response includes opening the door to investment now to protect service in the longer term, and to the use of markets to reveal efficient solutions.

The consultation, which focuses on the role the regulator should play, borrows the broad definition of resilience hammered out by its independent task and finish group: "Resilience is the ability to cope with, and recover from, disruption, trends and variability in order to maintain services for people and protect the natural environment, now and in the future."

The definition steers the industry away from the traditional view of resilience, focused on shoring up infrastructure and assets, towards an all-encompassing understanding based on ensuring services can be provided to customers come what may. These services, the consultation says, depend on the systems that underpin them and while assets are part of that, there are many other parts too, including ecosystems, financial systems (Ofwat will publish a separate document on this in autumn) and customers themselves. What's more, "Resilience is not just about disruptions. It is about maintaining a quality service for the long term at a price that current and future generations can afford."

In keeping with its PR14 principle, the regulator lays responsibility for delivering resilient services on "service providers" (note, not companies – a deliberate decision to emphasise that players beyond incumbents will necessarily be involved in service provision in a reformed water market). It stresses it will not mandate a single approach or set sector-wide targets or standards, because resilience is not a compliance issue. Rather, every service provider should discover and deliver what its customers want.

Ofwat's role is defined thus: "Our role is to create the right regulatory framework to enable, incentivise and encourage service providers to plan and invest for resilient services now and in the future. Where they fall short in doing this, we will step in to provide a safety net for current and future customers." Nicci Russell, the Ofwat director leading this work, says: "There is a role for Ofwat and a role for the sector and they are different and separate."

The regulator has set some high level principles for the sector (see box) and noted some specifics on its role. These include incentivising long term planning and investment; and promoting the use of markets.

Russell comments: "Markets can support resilience and help companies deliver more for less. Markets offer a wider choice of provider and more flexibility and sustainability. It is important our regulation drives better use of scarce resources." She added partnerships will be important too – and not only partnerships funded by water companies, but arrangements under which other players – energy companies, housing associations, local authorities and so on – bear cost as well as benefit.

While such arrangements may reduce the costs of delivering resilient services for water customers, Russell makes it clear that Ofwat won't shut the door on more investment now if that investment will secure service resilience in the longer term. "It's been a criticism levelled at Ofwat in the past, that resilience and efficiency don't go hand in hand," she says. "We make it very clear here that resilience is efficiency, that the two do go hand in hand." She adds: "Where the balance [of responsibility] lies between current and future customers will be a case by case judgement."

Ofwat will say more on providing for the longer term when it publishes its Water2020 discussion paper later this month. The resilience consultation closes on 28 August. TWR

For other views on resilience, see report p10-13

OFWAT'S RESILIENCE PRINCIPLES FOR THE SECTOR

1. Understand risks and how they makes services vulnerable. Plan for the "what if".
2. Act on risk analysis: "Mitigating risk can cost money – but it can also save money in the long term. Service providers should seek to balance these costs and potential savings."
3. Service providers are responsible for ensuring resilience.
4. Customer views should be at the heart of decisions. The environment and wider society must also be taken into account.
5. Resilience is part of everyday service provision but is not limited to it. There is a need to seek to avoid service disruptions as well as to bounce back from them if they do happen.
6. Resilience as efficiency: while resilience does not have to mean higher bills – resilience work in AMP6 is being delivered alongside an average 5% bill cut – increased resilience for the future may mean additional investment now. Service providers must find the most efficient way of delivering what customers want.
7. Partnership: "partnership working offers the greatest opportunity to deliver innovative solutions and move away from pouring concrete".
8. Report transparently: service providers should account for their own performance on resilience. Ofwat will factor resilience in to the strategic assessment framework and assurance framework it is developing.
9. Take a whole-life, total costs approach; consider new and flexible approaches, as well as building new infrastructure and networks.
10. Risk, cost and benefit sharing with partners: service providers should consider this, given resilience will deliver multi-sector benefits.

MOVING FORWARD ON BOUNCING BACK

Ofwat has put responsibility for delivering resilient services firmly on water company shoulders. But in the absence of much customer willingness to pay for improvements, delivering more for less through multi-party working and innovation will be crucial. A report from June's Water UK Innovation Hub.

Resilience is far from a new concept for the water industry. But clearly it has come into sharper focus of late as a key plank of government policy for the sector – particularly since the passage of the 2014 Water Act which prescribed a new primary statutory duty for Ofwat to further the resilience objective. The legislation is part of the policy response to a series of emerging challenges including climate change, population growth and ageing infrastructure.

But what does resilience actually mean? There seems to be consensus in the water industry on the broad definition – essentially, the continued reliable provision of water and wastewater services over the long term – but when you drill down into the detail it soon becomes apparent that the term means different things to different people. That said, overarching trends are discernible – notably a shift away from the traditional definition which heavily linked the continued provision of service to asset health and strength and towards a broader definition which takes a variety of factors into account: assets yes, but also people, finance, supply chain, customers, the environment…the list goes on.

Last month Water UK devoted its Innovation Hub event to scrutinising these issues. *Resilience: Environment, Investment and Customers* brought water companies and other key stakeholders together to share ideas and experience and explore the way forward. The value of this collaborative approach became immediately apparent when Ofwat chief executive Cathryn Ross delivered the regulatory keynote. Her message was loud and clear: it is for companies, not Ofwat, to take responsibility for the delivery of resilient services; there would be no mandated single approach; no regulatory requirements; and no setting of universal targets. Ofwat subsequently published a consultation on it's role in resilience - see report p9.

No regulatory mandate

Ross said: "Our whole philosophy in PR14 was driven by a desire for companies to own their relationship with their customers, and to take responsibility for delivery of the outcomes that customers and society more widely want to see. Resilience is clearly part of this. It is an outcome the sector needs to own." Should Ofwat not like what it sees from companies, it would as a last resort intervene, but Ross anticipated a number of steps before that rock bottom was hit: a monitoring regime with built-in indicators of risk would be invaluable in flagging up problems early, she explained, enabling the regulator to select tools other than heavy handed intervention. Only should such tools prove unsuccessful would more formal options be explored.

Ross did give companies a steer on what she expected to see. This boiled down to three key points:

- **Define resilience broadly:** "The 'resilience objective' we have been given in the Water Act includes two elements. The first talks about the resilience of water supply and sewerage systems. Systems. Not networks. Not kit. But systems. And the second element of the resilience objective in the Act talks about resilience of services – over the long term. Again not networks. Not kit. Services. So I think it is pretty clear that we…are being encouraged to think broadly about the resilience of those services over the long term and about the resilience of the entire system. Yes pipes and other bits of kit, but also ecosystems – that underpins that."

- **Seek customer input:** "[Resilience] can and will mean different things to different people. And there is no obvious level of resilience we should universally strive for. So there is considerable risk that if we take the concept for granted, if we assume 'we all know what it means' we will end up delivering something that doesn't reflect expectations of customers and society. And – albeit with the best of intentions – trust and confidence will be undermined. Talk to your customers."

- **Be creative:** "Innovate. Be flexible. Think services, think systems. Really understand and manage risk. I know this sounds self-evident, but one of the things I learned in PR14 is that the sector has some way to go in understanding the value of outcomes, the risks to outcomes, and appraising options for risk mitigation according to that value."

For its part, Ofwat will set the framework – through the allocation of risk and reward – to inform, enable and incentivise the resilience that customers and society want to see, and encourage efficiency and creative thinking.

Ross concluded her presentation by posing key questions for companies to ponder:

- What are the services that matter to customers and society?
- What are the risks to the provision of those services?
- How can we think more creatively about the options for mitigating those risks, to make sure we have the most cost effective option?
- Are we thinking sufficiently long term?
- How can regulation help to inform, enable and incentivise this?

Delivering more for less

Delivering resilient services is a huge challenge, not least because companies need to be mindful of not jeopardising the other elements of the delicately balanced triangle that is referred to in energy as the "trilemma": price, security of supply (resilence) and sustainability. Add into the mix the need to maintain investor confidence too and you can see companies will have their work cut out.

Water UK chief executive Pamela Taylor explored some of these issues in her introductory welcome. She noted both the industry's impressive achievements since privatisation and the enormity of the challenges it faces today: a population of 70m by the 2020s "and it won't stop there"; the growth of (less water efficient) single person households; the fact that water bills "for some are a real struggle" with little prospect of today's severe financial climate be alleviated any time soon; and planning 25 year water resource strategies without a clear view of future supply and demand.

Taylor identified a way through the tangle: that "delivering more for less [had to be] the new normal". She eyed innovation as one practical option, commenting: "These demands do not accommodate the status quo. There are new risks and we have to think outside the box." Another essential will be more extensive working with customers, the supply chain and other third parties. Taylor observed: "In delivering high level outcomes, partners add up to more than the sum of the parts."

Water companies are far from alone in grappling with these issues. Intersector resilience was discussed fairly extensively at the Water UK meeting and there seemed to be widespread understanding that sectors like energy are grappling with very similar challenges. Opening comments from Clive Bairsto, global head of business resilience and continuity at National Grid, indicated energy was some way ahead of water in facing the security of supply challenge head-on, perhaps because of the headline horror of the lights going out. "I have been struck by the similarity of concerns in water as energy," Bairsto said, "but think we have put more emphasis on the impact of availability issues".

He explained National Grid had moved on from thinking about resilience purely in relation to emergency situations such as outages and was increasingly considering it strategically. It was also actively engaging in intersector resilience work – for instance around resilient cities. Bairsto remarked that he rarely saw water sector representatives engaging in such projects.

On the upside, Taylor reported that water companies are up for the challenges that lie ahead. "It's not our style to sit back. We will work and face up to the challenges." There certainly seemed willingness to do so among Innovation Hub attendees. As Taylor noted: "The level of attendance here today shows we want to stay in the driving seat." Three water and sewerage company chief executives showcased their approaches to, and achievements under the banner of, resilience to delegates (see box – Resilience at Anglian, Yorkshire and South West, p12)

Resilience and customers

Customers will clearly be integral to the debate going forward: Ross made it is clear she expects companies to frame their decisions around customer preferences. The industry is no stranger to this approach, having followed it for PR14 business planning (see Expert Forum findings, p4-8). But figures from a study presented to the Innovation Hub by Chris Barker, technical director, and Bruce Horton, principal sustainability consultant at MWH, showed that while customers want resilient services, they are not falling over themselves to pay more for them. MWH >

> **There are new risks and we have to think outside the box.**

Pamela Taylor, chief executive, Water UK is working with Water UK and companies to scrutinise willingness to pay (WTP) data from PR14, with a particular focus on WTP for resilience. Horton noted the caveat that companies asked about this issue in a variety of ways but said broad comparisons were possible as most had, for instance, asked about WTP for Water Framework Directive related quality improvements.

The study showed customers were willing to pay an average of £2.20 more per household per year for a package of environmental improvements. There was a large spread within the industry, with customers of some companies willing to pay up to £4.50 more while the customers of others were willing to pay only pence. Horton commented: "So WTP for additional environmental improvement in addition to the current bill is very small… for most companies, it amounts to £12m a year in aggregate – that's not a huge amount to spend."

In discussion, some delegates raised the point that a simple WTP analysis of customer appetite for greater resilience was "too blunt". For one thing, most wouldn't want to see any deterioration in service, so there may be greater WTP if customers realised the pressures are such that companies will need to run to stand still. For another, average WTP figures for each company can disguise a far greater WTP among large chunks of the customer base; those who are WTP nothing drag down the average number.

Barker offered a suggestion to help companies get over the hurdle. "Perhaps we are looking at this through the wrong end of the telescope," he mused, suggesting that rather than simply asking about WTP, companies might be better off stressing the significant overall cost savings that would flow from a more resilient operations. After all, activities that would bolster resilience would in many cases also have broader benefit – for instance, in managing flood risk, promoting biodiversity and reducing carbon emissions. The idea gained traction in discussion, with some delegates advancing that it would be helpful to monetise these additional benefits and to factor this in to customer consultation.

A related point also surfaced at the meeting: that the role of markets in delivering resilience must also be considered. As upstream reform is increasingly explored, and potentially more parties become involved in providing water and wastewater services, delivering resilience would increasingly become a multi-sector, multi-party function. Anglian Water chief executive Peter Simpson raised his company's work on water trading as relevant here, as well as its current multi-sector approach to Water Resources Management Planning. Ross agreed that greater use of markets would "reveal options" and potentially assist resilience.

Resilience and the environment

As well as customer interests, companies need to be mindful of environmental interests as they plan how to safeguard services for the long term. Even the title of RSPB head of water Rob Cunningham's presentation to the Innovation Hub indicated the possible contention here. In *Resilience: friend or foe to sustainability?* Cunningham said Ofwat's new resilience duty wasn't welcome news. "Resilience can be seen as being all about strength, being more macho, doing everything bigger" he said. "Resilience can be a threat."

He said, though, that he was heartened by the broad definition of resilience he had heard that morning from Anglian chief executive Peter Simpson (see box) and urged companies to realise "that the environment underpins your business; that environmental performance is important to customers and for trust and confidence". He added that he was pleased to see water companies investing more in catchments both up and down stream and acknowledged the billions they had invested so far in environmental outcomes.

But Cunningham also stressed there was plenty more to do: for instance, whatever way you cut WFD classification figures, they don't look good; more could be done on leakage and demand management. Cunningham added that it would be important going forward to "think less in silos", observing that "the water industry is just one player in the systems that underpin resilience". Clearly he would like agriculture and land management interests to play their part far more fully, but observed "Politically, you can't lay a finger on the agricultural sector at the moment."

21st century drainage

Water UK's director of environment Sarah Mukherjee concluded the Innovation Hub line-up with a presentation on Water UK's 21st Century Drainage project – "the biggest piece of work Water UK has ever undertaken, and one which shows we want to take control of our own destiny." In the face of population growth, increasing climate unpredictability and a surge in the number of floods wastewater networks are having to deal with, the industry is facing head on the realisation that it will be unable, alone, to engineer a solution to meet the challenge.

It has convened a multi-stakeholder programme board for the 21st Century Drainage work, featuring among others DEFRA, Ofwat, Water UK and the Environment Agency. It has identified seven workstreams, each with its own project board, to investigate how all involved parties can work together to find solutions to these unprecedented challenges.

Clearly resilience is going to be an ongoing theme in water for the coming years, and the challenges are enormous. But water companies have clearly heeded Ofwat's message about stepping up and are doing so. The 21st Century Drainage work is a concrete example of this spirit and a stark acknowledgement from the industry that it alone doesn't have all the answers. TWR

RESILIENCE AT ANGLIAN, YORKSHIRE AND SOUTH WEST

Peter Simpson, Anglian Water

Simpson defined resilience as "the ability to spring back" – not just in terms of pipes and pumps, but the whole business. This includes its supply chain, with a crucial player here being its power providers. In its resilience activities, Simpson said his management team is willingly supported by the company's owners, who have voluntarily reinvested efficiency savings to bolster Anglian's "sustainability as a business".

He observed that water was central to many of the risks on the Cabinet Office's National Risk Register – drought, heatwaves, flooding – and that his company would also be affected by more general business risks, such as from pandemics and cyber attack. In light of this, he said he was "delighted" about Ofwat's new primary duty.

Anglian's approach has been to cross reference risk against the company's "outcomes wheel" developed for PR14 and customer WTP, and to lay out a delivery strategy for each outcome. Critical processes such as the ability to run treatment plants take priority. Crucial to the whole approach is corporate culture. "It all starts with culture," Simpson said, "we have changed the way we think about things".

In terms of practical delivery, Anglian's resilience-related activities include:

- Data: it has two data centres, in two completely separate areas. Each has two power sources and two communications lines.
- Microwave communications network: Anglian is in the front line when it comes to the threat of an east coast tidal surge, and communications are one of the first things to go down when floodwaters hit. The microwave network should enable communication to continue even if mains services are knocked out.
- An old aircraft hanger has been fitted out as an emergency headquarters, from which the entire business can be run.
- Standby water treatment facilities have been built for the large regional cities of Norwich and Peterborough. These were previously reliant on a single treatment works each, which made service continuity vulnerable.
- Scenario-based Water Resources Management Planning is being deployed, so future possibilities rather than just past occurrences can be catered for.
- Partnership working: "You are only as resilient as your weakest link," Simpson remarked. The company has been working closely with electricity distribution network UK Power Networks to shore up its power supply security, for instance, and is coinvesting in 51 flood defence projects in this AMP period to help protect the region not just Anglian's assets.

Richard Flint, Yorkshire Water

Flint set out key aspects of Yorkshire Water's approach to resilience: it was "absolutely fundamental" that bills be kept affordable and customers are behind its activities; that the supply chain – such as energy and chemical suppliers and construction firms – must be part of the picture; and that the corporate financial structure must be able to withstand shock.

He proceeded to highlight two extreme situations Yorkshire had faced and how it had responded:

- **Drought:** Flint called the 1995-6 drought "the defining feature for us for addressing resilience at a systematic level". At the time, water supply was "highly localised" – a product of the company's municipal history – featuring "a myriad of small, isolated water supply systems". Yorkshire has since built a grid system, the lynchpin of which is a major east to west connection, and today its entire geographical region can be treated as a single water supply zone. The grid is fully automated, with demand and supply balanced daily or more frequently. There is no human interaction whatsoever. Flint said simply: "Nobody touches it…no bending the rules, no pulling levers".
- **Flood:** in stark contrast to the "slow burn" of a drought, a flood can deliver a "knock-out blow", Flint told Innovation Hub delegates, and it did just that to Hull in 2007. He candidly explained that the local response, particularly the coordination of work between the emergency services, Yorkshire Water and others, "didn't go well…we learned a lot". Coordination has improved and flood risk in Hull has been mitigated, though says Flint it is "still sitting there" to an extent.

He summarised Yorkshire Water's resilience strategy as:

- make the right investments
- operate and maintain assets effectively (he viewed totex as a positive development in this context)
- develop the relationships and strategies for collaborative working with partners in steady times as these will stand you in good stead when difficulties arise.

Chris Loughlin, South West Water

Loughlin reported that 71% of South West's customers supported further investment in resilience and that for the company, resilience is "not about one thing, it's about the whole organisation". However, given its historically high bills on the back of receiving a drastically insufficient Green Dowry at privatisation, "the idea of investment for the future is difficult for us…more concrete, more chemicals – it wasn't going to work".

It was this starting point that led to South West's Upstream Thinking work on catchment management. "It's all about the catchment for us," he explained. "We have short, sharp catchments and all our water comes from uplands, transported by rivers."

In AMP5, the company delivered an innovative range of upstream initiatives to protect water quality and quantity – from part-funding the likes of slurry stores to protect water quality to blocking up land drainage ditches on the moors to bolster water quantity and lessen flood risk. Loughlin explained some of the work involved innovative financials. "We didn't want a grant culture, we wanted a business model." The company worked with Ofwat and was ultimately allowed to add its investments on third party land to its RCV, thereby securing a return for investors.

In AMP6, Loughlin said, there would be "far more dramatic intervention, that will have an impact on 75% of our water resources". The company is also exploring Payments for Ecosystem Services markets ("so we are not only delivering for customers but we are working with them") and monetising other benefits from its catchment work – for instance, from carbon sequestration, fishing rights and flooding. South West's Downstream Thinking work will also be developed further. Loughlin said customers had fed back that clean bathing waters are so important to them that they would be willing to fund, for instance, the remedying of misconnections from business premises.

Loughlin wrapped up by advocating "a 'small water', catchment, community based approach to ensuring resilience, not a 'large water' approach driven from Birmingham".

FINANCIAL RESILIENCE

Water companies are far more highly geared today than when they were privatised, prompting some observers to question their financial resilience. Yorkshire's Flint observed: "Issues of gearing and financial structure will form a significant part of discussions going forward."

Neil Griffiths-Lambeth, associate managing director in Moody's Infrastructure Finance Group, provided delegates with detail and observations. He said average gearing at privatisation was c50%; it is now c70%, with companies like Anglian reaching c80%. Going forward, companies' need to raise further debt was certain in the short term and looked very likely in the medium to long term, both to service existing assets and to finance enhancement expenditure. Therefore, ongoing access to debt finance was critical.

He described the industry's financing arrangements to date as a virtuous circle: regulated monopoly supply of an essential commodity under a regulatory regime that was a "global benchmark" had allowed efficient cost recovery and return on investment. Consequently, water is an attractive investment proposition; debt is cheap; bills can be kept down; and customers are willing to pay a reasonable price for a good service.

Griffiths-Lambeth posed some challenging questions for those who would be quick to move away from this model:

- Do we understand what needs to change? What would the costs and benefits be?
- Is anything going to me more resilient than the Regulatory Asset Base funding model?
- Who is driving this bus? (DEFRA, Ofwat, companies?) When will we know the route? Are all companies equally fit to travel or will some financial structures prove difficult?
- Will change impair the investment case, or is it necessary to keep up with changes so the sector doesn't become uninvestable?

"Think about what you are giving up," he concluded.

BRISTOL: UPLIFT WELCOME BUT CMA DEAL STILL NOT GOOD FOR CUSTOMERS

CMA finds Ofwat's wholesale cost modelling was inadequate but still suppresses scope of Bristol's planned investment.

It's quite a roller coaster ride reading the Competition and Market Authority's draft decision on Bristol Water's price appeal. On one hand, the key principles on which the company appealed are upheld and the CMA accordingly makes positive adjustments relative to Ofwat's final determination – particularly on base wholesale costs. But on the other, many of its enhancement expenditure plans are slapped down and its capital maintenance costings questioned.

This leaves Bristol's hopes of securing a deal that meets what it considers to be customer best interests somewhat scuppered – at the draft stage at least. On mounting the appeal, regulatory director Mike King argued: "A substantial reduction is scope is not in our customers' interests." He added: "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."

Better but inadequate

On the core matter of wholesale totex, the CMA has allowed £429m, a £20m uplift on Ofwat's £409m but still well shy of Bristol's business plan number of £537m. It advocates a total allowed revenue for 2015-2020 of £529m. This translates for the average Bristol customer as an annual pre-inflationary bill of £159 across AMP6, just £4 more than Ofwat's £155 number. This is down from £191 in 2014/15 and is significantly short of Bristol's pitch for £187.

King's overview of the CMA's provisional findings reflect the positives and negatives of the decision for the company. He says, firstly, that on the basis of the draft numbers, appealing was "definitely" worthwhile. The new settlement offers what is "a significant uplift for a company of our size". He adds: "We had no choice, anyway. We couldn't have lived with Ofwat's determination."

What's more, he feels vindicated on the three high level principles his company took to the CMA: that Ofwat's cost modelling was poor and did not reflect Bristol's costs accurately; that the cost of capital it had been allowed was too low; and that the performance targets it had been set following the regulator's comparative analysis on outcomes went beyond the level its customers were willing to pay for.

So is the new deal better for customers? King says: "I still don't think the balance is right. Our customers do not want to trade off higher risk for lower bills." He explains there is an asymmetry in that risk: if you set allowances too high, customers would pay a bit more than they need to (which obviously wouldn't be good) but at least investment would go in and would yield customer benefit; conversely, if you set allowances too low, there is a risk of service failure which is the absolute last thing customers want. King notes that where the CMA calculations have come up with a range of numbers for any given element of the settlement and it has taken the mid point forward in its draft decision, it would be better for it to take the high point.

Nor does he believe the CMA's deal would get Bristol out of the financeability hole it said Ofwat's determination put it in. "I still believe there is not enough revenue in the period to cover what we need to deliver," says King. "It would be very, very difficult to live with this determination."

Ofwat's response to the draft decision has been brief but rebuts these two points. It said: "We are committed to protecting customers and ensuring efficient companies can finance their provision of these vital public services."

Flawed modelling

Looking in detail at the main elements of the new ruling, the CMA has sensibly paid attention to the key areas Bristol disputed rather than the determination in the round. Inevitably, wholesale totex dominated the investigation. Bristol argued Ofwat's £409m number was insufficient to deliver the outcomes customers wanted, was an unrealistic assumption of what was required to run the business, and that the scale of operating costs demanded would not be achievable in practice. The reason for these miscalculations, it said, was that Ofwat's modelling was flawed.

The CMA reviewed and discounted use of Ofwat's benchmarking econometric models for its wholesale cost assessment, having identified "significant concerns… and risks that it did not adequately reflect Bristol Water's efficient costs".

It accepted Ofwat's rationale for use of its model – that using benchmarking analysis as a starting point for cost assessment, rather than companies' business plans, reduces the risk of over-stating cost or taking insufficient account of opportunities for cost savings while also being a practical and proportional approach. It also accepted that "no benchmarking analysis or cost assessment method will be perfect". But nonetheless it preferred to develop an alternative cost assessment approach for its inquiry, both because it was "concerned with the emphasis that Ofwat had placed on these types of models" and because of specific problems with the design and specification of Ofwat's model itself.

It said: "We recognised that Ofwat's special cost factor process provided companies with opportunities to mitigate, to some degree, the limitations or inaccuracies in Ofwat's econometric models. However, we did not consider that Ofwat's approach to special cost factors was sufficient to fully mitigate the limitations in its benchmarking analysis."

While a significant blow to the regulator's position, the decision is unlikely have have much in the way of implications beyond the Bristol case. In the short term, all other companies have accepted their determinations and are getting on with delivering them. Looking ahead to PR19, Ofwat's Water2020 work is likely to result in a different approach next time anyway.

The CMA proceeded to come up with new numbers, based on thorough re-assessment of wholesale cost using its alternative benchmarking models, cross-referenced by an assessment of efficient base expenditure from separate analyses of opex, capex and overall review of Bristol's business plan. To this outcome it added an assessment of efficient enhancement expenditure. In King's view there are "no gross errors" in the CMA's high level approach, but there is "devil in the detail". He gave as an example its approach to identifying possible efficiencies, arguing the CMA had based these on limited evidence and "if you look at wider evidence, you get a different result".

Base and enhancement spending

The CMA settled on a base wholesale expenditure of £346m over the 2015-20 period. While not an exact split down the middle of Ofwat and Bristol numbers, it is somewhere thereabouts, being £28m above the regulator's FD and £39m less than in the company business plan. This comprises:

- **Opex:** £215 million, compared with £228 million in Bristol Water's business plan
- **Capital maintenance** – infrastructure renewal expenditure: £65–£70m, compared with £76.3m in the Bristol plan. Of note here is the CMA's view that mains replacement costs (which account for 62% of this type of spending) could be driven down by 10-15%.
- **Capital maintenance** – non infrastructure expenditure: £49–£74 million, compared with Bristol Water's plan of £80 million. Insufficient evidence of need appears to be the company's biggest failing here in the CMA view. Its £6m case for a new reservoir at Bedminster was thrown out on this basis. Meanwhile the draft decision said the company had provided inadequate detail of what specifically needed replacing at its treatment works, especially because at £34m, its planned spend for AMP6 was 50% higher than in AMP5 and 200% higher than in AMP4. According to the CMA: "It is therefore not clear why expenditure on treatment works should be substantially higher than in previous periods, with direct evidence provided which would only justify a small increase. We therefore provisionally consider that the level of treatment works expenditure should reduce towards AMP4/5 levels."

The CMA hammered Bristol's proposed enhancement expenditure of £152.3m down to £83.1m. While this is lower than Ofwat's proposed £91.2m, the scope of the programme has also been reduced. King comments that while Bristol will be submitting additional evidence to support its position on scope, "we have enough to deliver what we have to deliver under this settlement; they [CMA] have taken out the arbitrary efficiencies Ofwat put in." They key scope reductions are:

- **Cheddar 2 reservoir:** the CMA backed Ofwat's decision to exclude this £42.8m construction project from AMP6, arguing it is not necessary to address demand in the short term and that there is not evidence customers are willing to pay higher bills to finance this increase in security of supply. King said the company was "disappointed" and that the decision would mean a new reservoir was not feasible until 2033 at the earliest, because there would be no activity at all before 2020, and planning permission would lapse. He indicated the company would put forward an alternative solution that would deliver the new resource between 2025 and 2030.
- **Cheddar water treatment works:** instead of the company's proposed £20.8m investment in a new works to cope with raw water deterioration at Cheddar reservoir, the CMA allowed £1 million for further investigation and minor works. It said at present, there was insufficient evidence a new WTW would be the most suitable and lowest cost option to deal with the marked increase in algae. King said the DWI's view on this would be crucial.

Beyond wholesale costs

Beyond wholesale costs, the investigation assessed the appropriate cost of capital for Bristol Water through a bottom-up analysis of individual components; determined the financial adjustments to reconcile allowed expenditure with actual historical performance for the period April 2009 to March 2015; and considered the ODI framework and whether changes were required. It left Ofwat's AMP5 reconciliation numbers in tact but made some ODI adjustments in Bristol's favour.

Its cost of capital estimate of 3.65% wholesale offered the company a mild improvement on Ofwat's 3.6% number, but fell well short of Bristol Water's value of 4.37%. King said his company would take issue with points of detail on cost of capital – for instance, he said market evidence did not support the competition authority's asset beta range point estimate of 0.32.

> **I still believe there is not enough revenue in the period to cover what we need to deliver. It would be very, very difficult to live with this determination."**

"There are lots of little bits of detail that could lead to a materially different end result," he commented.

On financeability, said the CMA, "our provisional findings would have a negligible impact on both gearing and credit ratios and hence on Bristol Water's financeability. Therefore, we provisionally found that Bristol Water is financeable under our determination".

As noted, Bristol begs to differ and at the time of writing was clearly working flat out to respond to the draft determination and present additional evidence in support of its case. King noted history wasn't on its side. "The CMA will challenge hard everything we go back with," he said. "If you look back over the past, there doesn't tend to be much movement between provisional and final findings. But we are hoping for some."

Further main party hearings are due at the end of July and final representations by 7 August. The CMA will issue a final determination by 3 September. Could Bristol live with a final determination very similar to the draft? King: "Let's hope it doesn't come to that." TWR

PENNON TAKEOVER: HOW, NOT IF

Remedies look set to take centre stage in the CMA's inquiry into the merger of South West Water and Bournemouth Water.

Pennon Group's acquisition of Bournemouth Water looks sure to gain the Competition and Markets Authority seal of approval after none of the initial submissions to the inquiry raised objection in principle. Thoughts of all involved parties will have turned to how the tie-up will proceed rather than if it will – and specifically, what remedies will be deemed necessary.

And here there is disagreement. Without specifying what exactly, Ofwat's submission all but demands remedial action from Pennon to offset what it deems to be the detrimental impact on its ability to make industry comparisons from the loss of Bournemouth as an independent comparator. This is particularly acute because of Bournemouth's sterling performance in a number of areas. Ofwat said the merger would result in:

- Detriment to its SIM benchmark: Bournemouth Water has demonstrated upper quartile performance in the service incentive mechanism (SIM) over the three years 2011-12 to 2013-14. The detriment could amount to around £10m by 2025.
- Detriment to its wholesale cost benchmark: Bournemouth was in the upper quartile in PR14 for wholesale costs. The detriment could amount to £43m by 2025.
- Detriment to its assessment of outcome delivery incentives: Bournemouth demonstrated upper quartile performance against each of the three comparative ODIs for the water service at PR14. The detriment could amount to between £8m and £66m by 2025.
- Loss of precision that applies in relation to Ofwat's wholesale cost econometric models.
- Qualitative assessment impact. For instance, Ofwat said Bournemouth "provided good evidence in respect of its proposed spend for a new customer relationship and billing system, which helped us to challenge the requests for billing system investment from other companies."

However, Ofwat accepts there would be benefits for South West and Bournemouth customers too, and concludes "the assessment of prejudice is not so great as to lead us to oppose the merger". Rather it lists a range of possible remedies (see box).

In stark contrast, Pennon is robust in its assertion that far from causing detriment to Ofwat's abilities to make comparisons between companies, its takeover of Bournemouth would in fact benefit the wider regulatory regime to the tune of £43-50m. It argues this would result from the creation of a better wholesale cost comparator (it points to its PR14 enhanced status and specifically its A-rated wholesale cost assessment) and an improved industry benchmark on retail costs.

Moreover, playing to Ofwat's reform agenda (and specifically the licence changes it desires to make regulation "more effective" – see top point in the box), Pennon sets out its plan for the merged business. This includes combining the two companies' household and non household retail businesses and legally separating the contestable part; and enabling separate elements of wholesale as well as retail operations to be targeted for change and innovation. It said: "Following approval, Pennon plans for a new licence structure for the combined wholesale / retail activities to be put in place following discussion with Ofwat. This will provide the opportunity for new forms of water company licences to be considered."

Looking beyond comparative competition, Pennon argued that a merger would directly benefit customers in Bournemouth and the South West by lowering costs (which would be passed back at PR19) and by improving service. It added that it will relinquish the allowance for financing given to Bournemouth as a small company premium. Moreover, investors will benefit and no changes are envisaged for Bournemouth staff.

In short: "Pennon considers the merger is in the best interests of customers, investors, stakeholders and the wider industry regulatory regime. The merger will not give rise to any prejudice in Ofwat's ability to make effective comparisons for the purposes of regulating water companies. The CMA should therefore clear this merger unconditionally."

Inquiry submissions from other parties are largely supportive of the merger. Bournemouth's Customer Challenge Group considered the merger to be in the customer interest. Wessex Water said Bournemouth's small size meant its loss as a comparator should not prejudice Ofwat's abilities to make comparisons between companies. The Consumer Council for Water said continued separate reporting should be a merger condition and that the CMA should require the merged company to make firm commitments to customers in a number of specified areas.

So remedies are likely to take centre stage as the inquiry moves to the hearings stage next month. While Pennon looks set to push back on any calls that may surface for immediate price cuts or divestments, it has cleverly already put some of the things Ofwat cites as possibilities on the table. TWR

POSSIBLE REMEDIES CITED BY OFWAT

- A commitment to licence amendments that would allow Ofwat to regulate the sector more effectively – for example, ones that reveal information in different parts of the value chain that could be subject to different forms of regulation or competition. The regulator said it was considering introducing "modular licences" with elements that can be switched on and off to allow for separate reporting and for price controls to be set at a disaggregated level in the future. It said: "To the extent that the merger parties offered modifications… that were capable of being introduced to other companies, this could be considered…a possible remedy".
- South West Water's adoption of Ofwat's full suite of ring-fencing licence conditions.
- A partial divestment from Pennon to create a new independent comparator.
- Price reductions accompanied by an undertaking that confirms when savings will be passed back to customers and their value.
- PR14 clawbacks – for instance Bournemouth relinquishing its small company cost of capital premium, and South West offering not to recover the full amount allowed for bad debt in its average cost to serve assessment.

YEAR-END RESULTS REVIEW

The Water Report reviews selected highlights from each company's annual results statement. By Trevor Loveday.

Pennon's move on Bournemouth and a reported return of Borealis interest at Severn Trent have stolen the financial headlines, but over the past couple of months, companies across the sector have reported results for the year to 31 March 2015. Of note is that the sector is mandated to adopt the International Financial Reporting Standard (IFRS) next year. A feature of IFRS is full exposure of gains and losses from financial derivatives and hedges which can bring significant volatility to profit and loss statements. With only a few companies yet to adopt IFRS we are directed to underlying figures to give a clearer picture of company performances.

WATER AND SEWERAGE COMPANIES

Anglian Water

Revenue for the year was up 2.5% – about £30m – to £1,244m in line with inflation but including a £10m cost from foregoing the full allowed price increase.

Adhering to common practice under the soon to be mandated IFRS, Anglian included its underlying profit figures stripped of the impact of moves in financial "fair value" gains or losses. Underlying operating profit fell 3.5% to £452.6m. The reduction was the result of a £38m increase in operating costs and depreciation and amortisation arising from a 3.2% boost from depreciation on new assets and a decision not to implement in full allowed bill increases. That was only partially offset by the increase in revenue.

Anglian's underlying pre tax profit was £182m up from £167.9m in the previous 12 months. The 8.4% increase aligns with inflation-reduced finance costs – not including fair value derivative or hedge gains and losses.

The potential volatility that IFRS introduces was demonstrated in the statutory income statement pre-tax profits which show a 63.6% fall including a £212m loss on derivatives from an £86m gain in the previous year.

Anglian wrapped up its £2.1billion, five-year programme of investment in 2015 with £439m invested during the year. It was able to generate some £235m in efficiency savings during AMP5 which it reinvested.

Dwr Cymru

Dwr Cymru's sales to 31 March 2015 were £753m – up 2% from £737m arising almost exclusively from a regulated average price increase of 2.05%. Additional revenue from new customers has been offset by lower consumption among household customers switching to metered charging.

The company said some 50,000 low-income customers were benefiting from social assistance at a cost to the company of some £4m. And Dŵr has launched a social tariff to help up to 100,000 of its "most disadvantaged customers" this period.

Dwr Cymru's total operational costs (excluding infrastructure renewal expenditure, depreciation and exceptional items) were level at £295m, with cost increases offset by efficiency savings.

The company has embarked on a redundancy programme to reduce the workforce by around 360. The estimated £18m cost of this commitment has been provided for during the year. It is part of a move to slim operating costs by 20% over the next five years.

Net interest payable of £145m (excluding accounting losses on derivatives) was £10m lower than the previous year as a result of lower inflation on index-linked bonds. Fair value losses in 2014-15 amounted to £157m compared to 2014 gains of £94m.

Year on year underlying profit before tax was up 54% at £77m. The consolidated income statement shows a loss before taxation of £100m – the gain in 2014 was £145m.

Northumbrian Water

Northumbrian Water reported for 15-months following a shift in accounting period from the year to 31 December to the year to 31 March.

Turnover was £984.9m for the 15 months ended 31 March 2015 – 27% up on the £774.6 m sales for the year ended 31 December 2013. The 2015 figure reflected the company's 2010 price control of 2.6% less 1%.

Operating costs, including capital maintenance costs, for the 15 months were £600.6m – up 36% on the 12-month December 2013 costs of £443.4m. This included an exceptional asset impairment charge of £30.7m after Northumbrian abandoned a 25-year-old sludge drying facility following its construction and deployment of plant to produce methane from anaerobic digestion of sludge. The increase in costs between the 15-month and one-year results, without the exceptional item, was 29%. Staff costs, power prices, depreciation and inflationary increases, offset in part by the company's efficiency programme, made up other operating cost changes.

Its management described the underlying performance for the year to 31 March 2015 as "broadly in line with performance for the previous year [to 31 December 2013]." On a historical cost basis the company reported turnover for the year to 31 March 2015 up 1.5% with profit before tax down 11.8% at £187.2m compared to the previous 12 months.

For the financial year ended 31 March 2015 Northumbrian's parent company, Northumbrian Water Group, was indirectly, wholly owned by Cheung Kong Infrastructure, Cheung Kong Holdings and Li Ka Shing Foundation. From 3 June 2015 CKHH became the ultimate parent undertaking following its acquisition of Cheung Kong Holdings.

South West Water

South West's parent, Pennon, took the market by surprise by being the first out of the traps to beef itself up after the price control concluded and before the retail market opens with its acquisition of Bournemouth Water. >

Over-endowed with water resources, Bournemouth was viewed by Pennon as an "attractive opportunity to expand wholesale capabilities." Meanwhile, combining its retail operations with South West's would reduce the cost to serve and, according to Pennon, be "modestly earnings enhancing".

Acquiring Bournemouth would add 5% to South West's regulatory capital value (RCV) currently at £2,928m following growth of 19% over the previous five years.

South West added a shade to revenue for the year to 31 March 2015 compared to the preceding year taking it to £522.2m with operating profit down 0.7% to £225.4m. The company said mitigation of the impact of a tariff freeze through strong cost control and higher demand was reflected in a 0.1% increase in Ebitda to £331.3m. Profit before tax was up 3.3% to £167.9m.

Scottish Water

Revenue from household customers was up £21.9m to £800.8m fuelled by a 1.6% tariff increase and an increase in connected properties. A reduction in wholesale tariffs slimmed revenue from wholesale services by 1.5% to £289.2m.

Regulated revenue for water and wastewater services from the year to 31 March 2015 was up 1.7% to £1,096.9m on the previous year. But total revenue was up only slightly to £1,187.4m as Business Stream revenue fell £44.2m to £320m.

Over the same period, the operating surplus before tax was 1.9% higher including a £7.9 m drop at Business Stream to £30.4 m.

Surplus before taxation was up 9.6% to £110.7m.

Severn Trent Water

Borealis and Severn Trent have recently been reported as having returned to the table for acquisition talks. Borealis made a bid for Severn Trent in 2013 but baulked at the water firm's price of 1.35x its regulatory asset vale (RAV). Recently, Agency Partners said Severn Trent's current share price at 1.25x RAV did not include a bid premium.

Group turnover at Severn Trent was up 2.5% to £1,801.3m for the year to 31 March 2015 while underlying group profit before tax for the same period – at £300.4m – was 8.8% higher. The company showed a 15.9% hike in earnings per share, year on year.

Group profit before tax as reported under IFRS was 53.5% down at £148.2m as gains on financial instruments went from £58m to a loss of £133.5m in 2014-15.

The company incurred exceptional cost of £18.7m in its regulated and non-regulated operations. These were headlined by £28.3m of restructuring costs to transform the regulated business for AMP6 with a reduction in its cost base and taking out management levels which was offset by a £7.7m of profit on disposal of property.

The company said it had re-focused its non-regulated business on core activities – operating water and waste water assets, retail and renewables – which has led to the sale of its desalination business to its Italian partner Industrie De Nora for US$81m.

Southern Water

During 2014–15, Southern's operating profit before exceptional items was £326m, a 0.3% increase from the previous year which reflected a price-increase driven 2.7% rise in turnover of £22m to £828.6m. This was offset by a 9.6% increase in depreciation charged as a result of new asset investment. Operating profit was up 7.3% to £328m.

Profit before tax was up 46% to £203.9m boosted by an exceptional item and a £45m decrease in interests charges. The exceptional cost in the year ended 31 March 2014 of £18.8m arose from remedial action following storms during the winter of 2013–14. During 2014–15 Southern received an insurance payout of £2.4m in relation to this event which was recorded as an exceptional item in the results for 2014-15.

Thames Water

Thames Water's total revenues in the year to 31 March 2015 grew 4.3% to £2026.8m driven primarily by a price increase and a small, population growth-fuelled hike in water consumption. This was offset by a £48.4m rise in operating costs to £1,348.8m. Operating profit increased 4.5% over the year to £684.9m while profit before tax was up 29.5% to £335.8m due largely to increased revenue and interest gains.

Total dividend distributions during the year were £169.9m, of which £69.9m was used to service the group's debt and £100m to compensate Thames Water's shareholders for their capital investment.

Higher-than-industry-average bad debt costs are a "key focus" for Thames. It said having a high proportion of its customers in short-term accommodation exacerbated its difficulties in collecting debts. Its gross bad debt charge for 2014/15 was £71.8m up almost 20% on the previous year due to a combination of a price increases and an increase in the level of bad debts relating to current year billings.

United Utilities

Sales at United Utilities were up 1.9% to £1,720m. A customer discount applied to this year's bills meant the revenue lift came in lower than the allowed regulated price rise for 2014/15 of 3.8% nominal made up from a 1.2% price increase allowance and 2.6% retail price index inflation.

Underlying operating profit increased by £30m to £664m year–on-year which the firm attributed to tighter management of its cost base offsetting depreciation and other cost pressures, including bad debt.

Underlying profit before tax was up more than 15% to £447.4m.

Widespread low income in United Utilities' region was the main cause of its higher-than-average bad debt which increased from 2.2% to 3.1% of regulated revenue.

Wessex Water

Turnover at Wessex increased 2.9% to £540.5m to carry operating profit up also by 2.9% to £248.4m. The company opted to forego the 1.5% regulatory capital allowance element of its permitted price increase, pegging its price hike to 3.1%.

Operating costs rose by £8.5m to £291.9m, largely as a result of the costs of bringing on new plant to meet new obligations. Other significant contributions to the rise in operating expenditure included increased non-regulated activity and bad debt.

Profit before tax was £171.8m. Tax was reduced to £12.8m after a £14.3m tax credit arising from first-time adoption of IFRS.

Yorkshire Water

A 3% increase in turnover to £1,014.1m during the 12 months was largely interest rate driven.

Close management of costs, the company said, left inflation as the chief driver of a £9.7m increase in operating expenditure to £663.7m. This generated an increase in operating profit of 6.1% to £350.4m from £330.2m.

Net profit was curbed by a rise in interest costs and a tax charge. Profit for the financial year was, at £122.4m – 40% down from the previous year.

As part of the company's bid to reduce gearing it has not made dividend distributions to shareholders during the year. All payments out of the company were to cover costs and interest on intercompany loans at its holding company, Kelda.

WATER ONLY COMPANIES

Affinity Water

Operating efficiencies reduced Affinity's cost of operations in the year by £3m. The company reported earnings before interest, corporation tax, depreciation and amortisation up by 2% and a 10% increase in net cash inflow from operating activities on the previous year.

Affinity's financial results for 2014-15 were subject to assorted non-trading gains and losses.

The company said outperformance of its Ebitda target arose chiefly from a refund and credit note for £5.5m in abstraction-related Environmental Improvement Unit Charges levied in earlier years. Offsetting that in part were unbudgeted payroll related and recruitment costs.

Meanwhile £900,000 in efficiency savings and £1.9m savings in electricity consumption countered increases in inflation-linked costs.

Bournemouth Water

On 16 April 2015, Pennon Group acquired 100% of the share capital of Bournemouth.

Bournemouth exceeded its £53.9m five-year regulatory investment target to 2015 by £2.5m.

The overshoot was almost entirely down to the need to upgrade disinfection and other water treatment improvements following a 2013 outbreak of cryptosporidiosis.

A freeze on domestic tariffs for 2014/15 kept sales flat while employment, power and other operating costs shaved more than £1m off operating profit taking it to £14.7m. Pre-tax profit fell 6.7% to £9.8m. Bournemouth sold 0.3% less water in 2014-15 despite upping the number of properties it served by 800 to 204,800 due to an increase in metered customers who typically use less water.

Its tax charge increased by over £2m – a 600% hike after a deferred tax credit from a decrease in the standard rate of UK corporation tax. Profit after tax tumbled more than 28%.

Bournemouth adopted the new UK accounting framework based on IFRS and like many in the sector made some largely insignificant adjustments in its figures as a result.

Dee Valley Water

A price increase and an increase in consumption raised revenue at Dee to £0.8m higher than 2014. The gains from a 2.2% lift in bills was offset by a £0.9m increase in operating expenses relating to the PR14 process, increased maintenance and bad debt.

Retained profit for the year of £3.5m was £2.2m lower than for the prior year but the position was inflated by a gain of £1.3m from a pension scheme curtailment and a prior year deferred tax credit of £1.7m.

Portsmouth Water

Operating profit remained unchanged at £5.9m although this included a £0.4m increase in the provision for bad debts as a result of a change in the method of calculation. Cashflow from operating activities at £15.6m was £0.5m ahead of last year.

Turnover increased by 3.1% to £38.2m fuelled mainly by a 2.5% tariff increase and increased income from developers for connecting new properties.

Operating costs increased by £1.1m (3.5%), including the bad debt provision.

Sutton and East Surrey Water

Turnover at Sutton and East Surrey Water (SESW) was all but flat at £62.3m despite a price increase of 1.45%, reflecting inflation of 2.65% and a 1.2% regulatory price cut.

Revenue from growth in demand from new properties was cancelled out by savings customers made from having their water metered along with discounts resulting from the implementation of the company's pilot social tariff. Total demand remained static yet operating costs increased 1.1% to £44.9m due largely to inflation at £0.9m. Operating profit fell by £0.4m to £17.4m.

SESW's tax charge for the year was £2.6m, £2.5m higher than in the previous year, due to a change in corporation tax arrangements in 2014.

South East Water

During 2010-2015, South East spent £429.2m on its assets above and below ground.

Revenue was slightly greater than in the previous year at £214.7m from £213.6m. Nevertheless South East saw its profit before tax for the year slip to £48.4m from £51.4m. Group operating profit was shaved by £3.4m to £92.8m. The reduction in profit was principally due to a hike in expenditure on the mains network, a charge for impairments of tangible fixed assets and increased energy costs with some offset from cost savings.

South Staffs Water

Turnover in South Staffs Water increased by £4.4m – a 3.6% improvement – to £126.9m due in the main to a 2% increase in water bills and greater consumption.

The company highlighted cost reduction measures including a cut in the number of staff from 511 to 478. Staff costs increased in the year by £1.3m to £22.9m due largely to a £0.9m increase in pension costs. Operating profit was lifted 4.9% to £35.7m.

Profit before tax was up 6% to £24.2m

Dividends of £13.8m were paid during the year including a final dividend of £0.3m paid in respect of 2013-14 and £13.5m dividends paid in respect of 2014-15.

Bristol Water was yet to publish its annual financial performance statement as *The Water Report* went to press. TWR

ACT OF UNION

WICS' strategy director Katherine Russell has just taken on the vice presidency of EU water regulators' network WAREG. She will be working to formalise the organisation and influence the debate as the eyes of Europe turn increasingly to water.

Harmonious the European Union hasn't been of late, with early July characterised by Grexit brinkmanship while closer to home David Cameron remains committed to an in-out referendum on Britain's membership. These divisions notwithstanding, there has been undeniable activity in Brussels on the water front recently, which as a current member of the EU, Britain needs to take note of.

As Eureau secretary general Neil Dhot reports on page 22, the continent-wide Right2Water campaign has triggered a broad review of European water legislation and a shift towards closer benchmarking of member states. Water is also capturing the interest of the Organisation for Economic Co-operation and Development (OECD), which until a few years ago, had been all but silent on water and wastewater issues (see box – OECD water projects).

Increasingly, UK water stakeholders are coming around to the view that it is better to engage with these developments from within rather than just respond to them from without. A significant new development on this front is the appointment of WICS director of corporate affairs and strategy Katherine Russell as one of two vice presidents of WAREG, the Network of European Water Sector Regulators. Russell will help to spearhead WAREG's development from a start-up body to a formally constituted, resourced and operated organisation.

WICS and WAREG

WAREG was founded a little over a year ago, in April 2014. It was the brainchild of the Italian electricity, gas and water regulator AEEGSI, which having experienced Brussels' intervention in the energy regulation space was keen to be proactive on water regulation. It approached a few of its peers in other countries to gauge their interest and the network has grown from there. Membership is entirely voluntary and open to any European water or sewerage regulator to apply to join. Its 11 original members have now grown to 18 (see box – WAREG members and observers). Along with Germany – usually the lynchpin of EU activities – England's Ofwat is conspicuously absent from the member list, electing only to have "observer" status.

But WICS has been involved from the start. Russell explains the Commission's enthusiasm: "We are there under the Hydro Nation umbrella. Because water is fully devolved to the Scottish Government, we were able to get straight in there from the start."

WAREG's primary aim is to promote closer cooperation among its members. This could be pursued in a number of ways, including:

- **Benchmarking:** the network aims to become the European benchmark for water regulation and a place where water service regulatory models can be compared and contrasted.
- **Best practice:** WAREG will work to be the point of reference for best practice – for example on encouraging investment, efficient service provision, environmental sustainability and consumer protection.
- **Leading the debate:** WAREG offers regulators the opportunity to develop and prepare shared strategies, agreed at a European level. It is also a solid platform from which to engage with the European Commission and Parliament as well as regional, national and international water service organisations. Russell comments: "WAREG is not a lobbyist. But we do want to be proactive, to lead the debate on key issues, and to use our influence to ensure the right policy choices are made." It is on this ticket that the network is engaging with a number of the OECD's water projects.

Russell is not underestimating the challenge that comes from bringing together 18 different water regulators, from different country situations, at very different states of progress in terms of regulatory maturity and with very different approaches to common EU issues – for instance, the polluter pays principle, cost reflective service provision and compliance. "The range of different ways in which economic regulation of water services is delivered across Europe really hits home when we discuss issues at the WAREG Assembly," she says.

But Russell's WICS background – a relatively small regulator from relatively small Scotland – should give her some insight into where many of the WAREG members – overwhelmingly from smaller states – are coming from. "Scotland is a small country. It's pretty nationalistic and it's not alone," she says. "It wants to be respected for its contribution, as do others. This wouldn't work if it was dominated by a single player.

Formal phase begins

Russell's priority now is getting the organisation properly fit for purpose in a mutually agreeable and workable way. WAREG is currently based in Milan, in the AEEGSI office, and has operated with an informal secretariat and governance arrangements.

A good start has already been made. Alongside Russell's appointment, WAREG now has a president and a second vice president, and held its first board meeting at the start of July. In Dublin in January, it adopted a set of internal rules specifying among other things: membership eligibility and process; powers for the WAREG Assembly (which comprises one high level representative per member, and has decision making and strategic responsibility for the network); presidential and vice presidential terms; the arrangements for working groups and task forces; the secretariat structure; voting procedures; and resourcing.

Over the next few months, Russell will be working with the other board members to pin down the details. She identifies a number of short term priorities:

- A professional secretariat: Russell indicates that this would likely require a permanent administration staff and technical advisors, with other staff pulled in from member regulators and possibly others as and when needed.
- A set of specific objectives for WAREG over the coming one to two years.
- Evaluating WAREG's corporate status.
- Funding: while members have already pledged support in kind – for instance by offering to host meetings and conference calls, by seconding staff and providing IT support – how best to organise additional forms of voluntary contributions including financial ones needs to be thought through. There could also be the possibility to secure EU support for colleagues who are less well funded.

In it to win it

The UK water industry has tried its hand overseas and famously – for the most part at least – got its fingers burnt. But backed by the Hydro Nation agenda, WICS and Scottish Water (whose international arm has secured a number of foreign contracts since it was set up) are venturing forth again.

But even if commercial pursuits are a bridge too far for most UK players, it seems to make perfect sense now that water is firmly on the European and global agenda to at least have a seat at the tables where future policy and regulation will be debated. It is good to see WICS and others including Water UK (Dhot is seconded to Eureau from the UK trade body) playing a part. TWR

WAREG MEMBERS AND OBSERVERS

- KSST – Denmark
- PUC – Latvia
- SEWRC – Bulgaria
- SSW – Greece
- VMM – Belgium (Flanders)
- WICS – Scotland
- AEEGSI – Italy
- ANRSC – Romania
- CER – Ireland
- ECA – Estonia
- ERRU – Albania
- ERSAR – Portugal
- ERSARA – Azores
- HEPURA – Hungary
- MAGRAMA – Spain
- MRA – Malta
- NCC – Lithuania
- NIAUR – Northern Ireland

OBSERVERS:

- Ministry of Environment – France
- ANRE – Moldova
- Ministry of Sustainable Development– Montenegro
- OFWAT – England & Wales
- VODA – Croatia
- WWRO – Kosovo
- Ministry of Environment - Austria

OECD WATER PROJECTS

The OECD is engaged in an ongoing programme of work on water governance – the set of rules, practices and processes through which decisions are taken and implemented, and decision-makers held accountable. The work is being performed against the backdrop of an extraordinarily "gloomy" outlook for the sector as it struggles to cope with population growth, climate change, ageing infrastructure, underinvestment, and over-abstraction. Noting the fragmented nature of water services, the Organisation believes "water crises are often primarily governance crises" and that in contrast, good governance can help policymakers and all other stakeholders reap economic, social and environmental benefit. It says: "There is now an urgent need to take stock of recent experiences, identify good practices and develop practical tools to assist different levels of governments and other stakeholders in engaging effective, fair and sustainable water policies."

To this end it has produced a number of studies on water governance practices, and most recently published in April two key documents of relevance to WAREG's work: The *governance of water regulators* and *Stakeholder engagement for inclusive water governance*. These and its other governance publications are underpinned by 12 well-thought through principles of good governance, summarised in the diagram.

Among other water related work the OECD has or is undertaking are a study of independent regulation and a study of models of international regulatory cooperation. WAREG is providing input on the former project. The OECD is also developing best practice principles on stakeholder engagement and a series of case studies on applying behavioural insights, including in the field of consumer protection.

Details can be found at: http://www.oecd.org/environment/

Overview of OECD Principles on Water Governance

THE WATER REPORT

EUROPE WATCH

IN BRUSSELS THIS MONTH: RIGHT2WATER PROMPTS POLICY REVIEWS AND BENCHMARKING

Water recently became a very political issue in Brussels and there will definitely be some challenges for the UK sector as a result.

We can expect the European Commission to attempt to establish more comparisons and benchmarks around the performance of water and sewerage services across the EU, in a bid to increase transparency. Indeed the Commission has already started work on this.

But what we don't know yet is whether the Commission will get involved in transparency and benchmarking around corporate governance issues like ownership, tax and profits. EU-wide comparisons are incredibly difficult to make meaningful, simply because of the vast variations in environmental, economic, political and social conditions across Europe. Some have tried this before and mostly failed.

The UK has a very good story to tell when it comes to published data and information on all these issues. And on a separate but related point, I also don't believe there is anything in the EU as near as good as the UK example of customer and stakeholder engagement in business planning and price setting.

The challenge for the UK will be to convince the EU decision-makers that it has sufficient measures in place already and that the Commission needs a bullet-proof methodology before it starts comparing performance and other issues – for example, leakage rates, or costs and investment across Europe.

What has prompted all this? Last month the European Parliament's environment committee approved a very politicised report calling for a range of EU measures to ensure all Europeans have access to water services, to promote public sector ownership of water and to ensure greater transparency and benchmarking of water providers.

The report itself has no legal standing. It also needs to be approved by a meeting of the full Parliament in September.

But the Commission is under considerable political pressure to respond due to the Right2Water campaign. If you are not familiar with this, the story is that about two years ago, a collection of trade unions across the EU organised a petition calling for the EU and Member States to be obliged to ensure that everyone in Europe has the right and access to water and sanitation.

No-one would disagree with that. But, the campaign also called for the water supply and management of water resources to not be subject to "internal market rules" and that water services must be excluded from liberalisation. So basically, calling on the EU to ensure water is taken out of the hands of private operators.

The Right2Water petition gained almost two million signatures from EU citizens. Crucially, it only needed one million signatures to qualify as a European Citizens Initiative (ECI) – meaning there had to be a debate on the issue in the European Parliament (which led to the recent report) and an obligation on the European Commission to respond.

Even more significant was that the Right2Water campaign was the first ever to reach the one million vote threshold and qualify as an ECI.

The Commission cannot act on most of what the Parliament's report suggests because decisions on how water is provided are for Member States.

But after the initial Right2Water debate in the European Parliament last year, the Commission has already promised a review of all water legislation, and said it was focused on increasing benchmarking as a way of improving transparency in the European water sector.

We already know the Commission has started a Drinking Water Directive review as a direct result. And we already know of three separate pieces of work currently ongoing by the Commission, to look at how water services can be compared across the EU. One of these is technical and linked to the Drinking Water Directive review, focused on pesticide metabolites in water. Another one, which we have just learned of, is apparently looking at leakage rates.

So we should adopt a watching brief on this one. It is an issue I am sure we will come back to in a future column. TWR

Neil Dhot is secretary general delegate at EurEau, the European Federation of National Associations of Water Services. Neil will be providing an update from Brussels each month.

RIGHT2WATER IRELAND

The Right2Water campaign is very active in Ireland, where water charges are being introduced as part of a wider water reform package. Last month it published "A New Fiscal Framework for a Progressive Irish Government" which called on policymakers to abolish domestic water charges and fund water provision, sanitation and investment through general taxation.

WHAT EXACTLY IS A CCG SUCCESSOR GROUP?

The Water Report's early forays into exploring how different companies are following up on their PR14 CCGs shows opinion varies on what qualifies as a successor group.

Last issue, *The Water Report* carried an interview with Roger Darlington, chair of South East Water's new Customer Panel, the successor group to its PR14 Customer Challenge Group (CCG). In the piece, we reported that six water companies all based in southern England were leading the charge in getting their CCG successor groups up and running. We said all other companies were expected to get their groups up and running in autumn or after; some not until into 2016.

This was Darlington's understanding, and *The Water Report* checked with the Consumer Council for Water (CCW), on the grounds that it had been heavily involved with PR14 CCGs; its people had chaired most of the groups and sat on all. A CCW spokesman confirmed: "Some of the successor bodies to the CCGs are developing now and we think it is likely that some will be in place between the autumn and the new year. Other bodies will take longer to set up because each company will go at its own pace."

However, *The Water Report* has subsequently been contacted by a number of company representatives to say that in fact their CCG successor groups are already up and running. Experienced consumer advocate and until recently CCW's Northern chair Andrea Cook got in touch to say she has chaired successor groups for both Yorkshire Water and United Utilities since 1 April (see interview, p24-25). Anglian Water pointed out that its refreshed CCG, the Customer Engagement Forum, met in June under the chairmanship of CCW's Central and Eastern chair Bernard Crump and has a full set of meetings lined up for the year.

On subsequent discussion with CCW, it became apparent that the reason for this baffling mismatch of information is that there doesn't seem to be a common definition of what a CCG successor group actually is. CCW's view is that there is a difference between CCG successor groups and what it calls "interim AMP6 monitoring groups". The former will be set up (for the most part in 2016) for the purpose of representing the customer in the next price setting round. Ideally, they will be organised according to customer preferences as revealed by its research (see box). Interim AMP6 monitoring groups on the other hand are essentially holding the fort until the time comes to constitute CCG successor groups.

CCW said it places groups such as Anglian's Customer Engagement Forum into the interim category and hence said when asked by *The Water Report* that CCG successor groups beyond the Southern six were still work in progress. However, Anglian (and Cook in respect of United Utilities and Yorkshire) clearly felt differently, both defining their groups as CCG successors.

The Water Report was unaware of the distinction being applied by CCW. Distinguishing between groups labelled as interim monitoring groups and those that fit the CCG successor group box is not easy:

- Both types have similar roles and responsibilities – notably, monitoring and providing assurance on the delivery of AMP6 business plans, and providing ongoing challenge on a range of issues relating to customers.
- Some of the groups accepted as CCG successors are due to refresh their membership and chairs ahead of the price review, in much the same way as those termed interim monitoring groups will. Darlington for instance has a two year contract and anticipates stepping down in 2017. Anna Bradley, chair of Southern Water's Customer Advisory Panel, anticipates being around for the full five years but has a three year contract to facilitate flexibility, should the group need to adapt to participate in PR19. Meanwhile Andrea Cook's tenure at Yorkshire Water runs for the full five years.
- In addition, companies "own" the groups and it seems unlikely Ofwat will be prescriptive as we head into PR19 on exactly how these groups should be structured, funded or chaired. So we are likely to have a mix of group types, many of which will evolve from one stage of the process to the next, at the discretion of the company and the group chair.

Nevertheless, *The Water Report* apologises to United Utilities, Yorkshire Water, Anglian and any other company whose customer groups are active already when we reported they weren't, simply because of the definition issue. Please get in touch if you would like us to cover the work of your company's group in more detail, as we have with United Utilities and Yorkshire on p24-25.

In the meantime, other companies are pushing on with putting their customer group arrangements in place. For instance, in the last month or so South Staffs Water advertised for a chair for its Customer Panel; Wessex for a chair for its new Wessex Water Partnership panel; and Thames for a chair to replace David Bland as chair of its Customer Challenge Group. TWR

CCW RESEARCH ON THE CUSTOMER VOICE AND PRICE SETTING

In June CCW published research which among other things sought customer views on what makes a credible CCG that customers could trust to represent their views during a price review. In its covering note, CCW highlighted the following key findings:

- Customers want to have a direct say on their water company's proposals.
- Customers want CCW to play an "active role" on CCGs as the "customer expert".
- Customers expect the chairs of CCGs to be impartial and independent – qualities which they believe could be undermined if the role is funded directly by a water company.
- Customers liked the idea of a levy or pooled funding from across the industry to fund CCG chairs to mitigate the risk of paid chairs being "in the pocket" of a water company.
- CCG membership should be refreshed on a regular basis so the groups hear new voices and avoid becoming stagnated.
- Customers expect CCGs to act transparently, including publishing the minutes of meetings.

The report can be found at http://bit.ly/1Je2tP2

IN GOOD COMPANY

Ex-CCW Andrea Cook relishes the prospect of working with Yorkshire Water and United Utilities as chair of their CCG successor groups – and downright rejects any suggestion that her independence will be compromised by being paid by the companies.

Consumer advocate extraordinaire Andrea Cook stepped down as chair of the Northern region for the Consumer Council for Water (CCW) on 31 March, a post under the auspices of which she had chaired the PR14 Customer Challenge Groups of Yorkshire Water, United Utilities and Northumbrian Water. The next day she took up two new posts, chairing the successor groups to these CCGs for Yorkshire Water and United Utilities. As chair of the new Yorkshire Customer Forum and United Utilities' YourVoice panel, Cook is independent and no longer allied to CCW.

She is clearly enthused by the prospect of continuing to work with these two companies, and can't speak highly enough of them. She says working with them in PR14 "was the most fantastic experience" and that she was "inspired" by their conduct. She cites as an example of their willingness to do the right thing for customers United Utilities' huge shift on totex once challenged by Ofwat.

"These are two companies that are totally committed to building on the CCG process," she says. "Under the previous groups we had extensive engagement, robust research and board level attention. I have absolute confidence our new groups will be listened to and their challenge accepted. These companies are fully committed to good governance and getting the right deal for customers and shareholders, not benefitting one at the expense of the other."

Cook adds "the same applies to Northumbrian Water – I've nothing but good wishes for them". She explains Northumbrian Water is still working through plans for its CCG successor group, and specifically how it manages the relationship between its main northern group and the group attached to Essex and Suffolk Water in the south.

Pay and independence

In making the move from chairing the PR14 CCGs as a representative of CCW to chairing the successor groups under her own steam, Cook has taken the very step that her former employer is staunchly set against (see report, p23): she has entered the employment of both Yorkshire Water and United Utilities and consequently, under CCW's interpretation, risked compromising her independence. Cook is having none of it.

"I cannot be bought," she declares firmly. "I guard my independence very carefully." She warms to her theme: "I have represented consumers for 30 years across multiple sectors and I will not have my independence questioned because of my employment status." She explains she debated with Yorkshire Water and United Utilities how best to structure her relationship with them and together they agreed employee status, rather than consultant status, would be the most transparent and straightforward arrangement in relation to paying tax and National Insurance.

Cook goes further and questions CCW's view on remuneration arrangements for group chairs more broadly. "I just don't understand why being paid by a company jeopardises your independence. Their view is 'he who pays the piper calls the tune' but I have only had pressure on my independence from CCW [to fall into line with its corporate views and messages] and not from any company."

She considers it a pity that in publishing its latest research on the customer voice in price setting (see p23), which was broad ranging and had "so many messages," that CCW has chosen to highlight as a key finding "the same old sterile debate about payment". She adds that the chair payment model promoted by CCW – via a levy or pooled funding from across the industry – is complex and hasn't found much support among companies. Certainly neither Yorkshire Water nor United Utilities were attracted by it. She notes that the research is "entirely consistent with the views CCW has held for about a year, and the findings come as no surprise".

Cook does agree though with some of CCW's other conclusions on CCG successor groups. It suggests that chairs should be independent rather than representatives of CCW as many were for PR14. Speaking from experience she says "it is difficult to wear two hats". She explains: "All the way through the process, I was having to balance my role as a CCW employee v being an independent chair. We came to conclude that the policy manager [another CCW representative on the groups] should represent the CCW line."

Cook also agrees that CCGs should act transparently, commenting: "The research offers some sound suggestions on transparency – on processes, publishing minutes and so on. But these are things which the CCGs led on from the start."

Integral not interim

As for YourVoice and the Yorkshire Customer Forum, they are work in progress rather than the finished article. As chair of the Yorkshire Customer Forum, Cook has a five year contract and will establish and lead the new group, interface with the company on delivery and planning, interface with stakeholders on priorities and report to the Yorkshire Water board and Ofwat. The transition phase, where new members are brought on board and so on, should be completed by September. The key activities ahead are:

- Set a vision and direction for the Forum over the next five years.
- Plan for and lead the recruitment of Forum members.
- Timetable Forum meetings, allowing time to actively engage in the development of plans prior to the company drawing its own separate conclusions.
- Establish subgroups where necessary to provide adequate independent review of key customer matters.
- Engage with Ofwat and other regional stakeholders.
- Receive and review the company's monthly performance commitment report.
- Chair the quarterly performance commitment review meeting; coordinate the development of the agenda.
- Produce the Forum's independent annual report on Yorkshire Water's performance and rewards/penalties.
- Produce the Forum's independent report on the company's plans for the periodic review.

The YourVoice panel will have an integral part in monitoring, assuring and reporting on the delivery of United Utilities' commitments to customers and other stakeholders and will look at how company research can continue to capture and strengthen the views of its customers. With United Utilities, Cook has a 12-15 month contract, with an explicit part of that contract focused on looking at how best to put arrangements for YourVoice in place for the longer term. "As a FTSE100 company, they [United Utilities] are very mindful of governance," she relates. "It's possible they may advertise for a future chair, but that will be part of the transition debate."

In the short term, Cook will focus on helping the company reflect on what type of consumer representation is needed and how this relates to the company's existing governance arrangements. Meanwhile, new members will be appointed with a view to conducting the next full meeting in September. There will also be subgroup meetings that month around non-household retail activities and monitoring of Outcome Delivery Incentives.

Cook disagrees with CCW's view that there is a distinction between groups that are not fully fledged – what CCW terms "interim AMP6 monitoring groups" – and price-review ready CCG successor groups (see report p23 for details). In fact she sees the current formative period as integral to the longer customer representation journey rather than an interim fort-holding exercise. "What's the distinction between the transition body and the successor body?" she questions. "My new groups are part of the process. They are meeting. They have objectives. They are contributing for customers."

Membership

There will be some carry over from the PR14 CCGs in terms of group members but also some new blood. Cook says each group lost a few members along the way of the last price review, because the input required was very technical and time consuming. "So we need to look at replacements, but do we ask someone else from the same organisation or a different organisation? We do wish to have some new organisations involved."

Unlike Roger Darlington, chair of South East Water's CCG successor group the Customer Panel, who The Water Report interviewed last month, she won't be recruiting "ordinary" customers to the Forum or YourVoice. "They would cease to be ordinary customers pretty quickly, as they become informed," she explains. "With a greater level of knowledge, they cease to represent Joe Public."

Nor will Cook slim down business customer representation on her groups as Darlington indicated he would in view of retail market opening. "If anything, we see the need for a greater level of dialogue," she observes, "particularly with those representing small businesses".

She confirms the Drinking Water Inspectorate is unlikely to want to have a place on her groups – in part because it found the whole process a real strain on resources in PR14 and in part because the monitoring function the new groups will have overlaps with the quality regulator's statutory role. She says she is "waiting to hear" what the Environment Agency decides on membership.

In terms of payment for participation, Cook agrees with Darlington that an attendance allowance for certain members is a good idea and will implement this policy at Yorkshire Water and possibly at United Utilities (it is one of the things yet to be explored). "The process inevitably puts demands on people's time," she explains. "It's not an issue for those who have statutory duties but it can be an issue for individuals and organisations…in PR14, members like Citizens Advice and Age UK actually had to take on staff to cover for those on the groups, so membership actually carried a cost."

Finally, Cook says she would like to see greater cooperation between CCG successor group chairs across the country than PR14 delivered. "Divisions between CCW chairs and non-CCW chairs was an issue last time around and I don't want that kind of division again. It was not helpful and stopped people building partnerships and sharing good practice." TWR

NATURAL SELECTION

The Welsh Government has published a bold and broad new Water Strategy that integrates water into wider natural resources policy – and begs the question whether the rest of the UK needs something similar.

Water companies in England could be forgiven for gazing with envy across the border to Wales, where the Welsh Government has recently published a broad, ambitious and in many areas agenda-leading new water policy document. The Water Strategy for Wales grapples with issues as thorny and diverse as multi-agency water service delivery, affordability, water quality, sustainability, 21st century drainage and resilience – and takes a long term view of the lot. It is a genuine attempt to respond to the multitude of challenges facing water and, because these challenges are not by any means confined to Wales, it begs the question whether DEFRA needs to produce something equivalent for England.

Ian Plenderleith, chief executive of Dee Valley Water, says the Strategy is an "excellent document" and could be viewed as "a blueprint for the rest of the sector". He observes that, through its Water2020 work, Ofwat is wrestling with a response to the overarching pressures of climate change and population growth, and how best to accommodate multi-agency involvement in water and wastewater service provision. Referring to the Welsh Government's Strategy, he says: "It would be very helpful for water companies across the sector to have something similar from the UK government, to help bring the Water2020 work together under a policy framework."

In particular, he notes such a strategic policy would encourage longer term thinking. "I really welcome the long term perspective of the document," he says. "We need to get coherent long term thinking in place across the entire water sector, and move away from the five year cycle. We need something holistic, integrated and more strategic."

The Water Strategy for Wales is just that, and Plenderleith is not alone in praising it highly. Peter Matthews, chairman of Natural Resources Wales (NRW), welcomes "the explicit recognition of what has hitherto been rhetorical – the integration of the management of water and land. The Water Framework Directive is as much about land as about water, and I am very pleased the Water Strategy sets a policy framework for this."

Dwr Cymru chief executive Chris Jones says the strategy is "a progressive and ambitious document" which is in his view "95% positive". Aside from a few specific policy points, his main reservation is the challenge of delivery. "It won't be easy," he mulls. "It will involve lots of organisations working together. But we are keen to play a full role."

"It would be very helpful for water companies across the sector to have something similar from the UK government, to help bring the Water2020 work together under a policy framework."

Integrated and local

So what does the strategy actually contain? The key plank underpinning the whole is the adoption of an integrated, multi-sector approach to water resources and water management, delivered at catchment level and with local participation as standard. Introducing the document, natural resources minister Carl Sargeant says: "We are committed to a more integrated approach to the management of water in line with our natural resources management policy and proposals in the Environment (Wales) Bill [which sets out a statutory approach to manage natural resources in a joined up way and should be on the statute book on 1 April 2016]. This will ensure we have the right approach in place to sustainably manage our natural resources in a more proactive and joined up way. It will also drive green growth, ensure resource efficiency, enhance the resilience and diversity of our environment and help us to tackle poverty."

The Bill proposes a duty on Natural Resources Wales to produce Area Statements which will set out how the Welsh Government's strategic priorities play out locally and enable decisions on natural resource matters to be made holistically at catchment level. Crucially for water, this means solutions to catchment challenges – for instance, on water quality – could come from stakeholders from far beyond the monopoly water companies.

Jones says this couldn't come at a better time. "Seeing water companies as part of a wider effort to improve is absolutely right. We are just one of a number of key actors here which include agriculture, customers and industry. The Water Framework Directive (WFD) is about to go into the second cycle and we can't deliver on it alone."

There has been heightened attention recently on whether water will need a System Operator as it moves to a multi-agency setting (see feature, p32-34). Plenderleith says that is one of many areas up for discussion in Wales on the back of the Water Strategy. "Someone needs to perform that role," he explains. "I welcome the government facilitating that discussion. My initial view is that water companies would be well placed, but I appreciate the need to determine that through debate." Mark Squire from NRW's water policy team suggests "a lot of that work will fall on our staff; we are well placed to lead on that coordination".

On civic engagement, the strategy prescribes a participatory approach from local communities, but it is completely flexible on how this plays out in each area. It states: "The WFD encourages community involvement and this is done in Wales through the River Basin Management Liaison Panels. However, their large scale can make it difficult to address specific local issues. We expect Natural Resources Wales, as the regulatory body with responsibility for ensuring the effective management of our water environment, to encourage improved community involvement at an appropriate scale using the multiple approaches and support systems available."

Matthews comments that this is about "adapting regulation from the past to the new landscape".

Abstraction reform

In terms of specifics, abstraction is high on the strategy's list. Like DEFRA, the Welsh Government is committed to reform of the abstraction licensing system and to bringing historic exemptions to heel – a policy few would argue with the principle of. Plenderleith comments: "Currently we have fixed allocations, an overly complex system of making changes, and environmental considerations not built into the system – in short a system that is well out of date and needs tidying up." He supports the Welsh Government's integrated approach to catchment management, which looks to move to abstractions based on water availability rather than fixed licences, and its civic engagement policy "which fits in well with Ofwat's approach to community based water systems".

Plenderleith adds: "I welcome the results of Defra's and the Welsh Government's discussion document to have catchments that are classified as basic and enhanced, with only enhanced catchments subject to trading. I think that the Welsh Government's approach of using pilot schemes on catchments classified as enhanced is sensible as we will have empirical evidence [on] providing better solutions to this challenging issue." He observes: "If managed collaboratively and holistically, abstraction reform will enable the industry to efficiently rebase the abstraction system prior to developing upstream reform, which will only benefit upstream reform."

Diffuse pollution and PES

Governed by the demands of the WFD, improving water quality is also high on the list for the integrated approach. With point source pollution already regulated, the top target is controlling diffuse pollution, which threatens the country's chances of achieving good ecological status.

Along with specific actions including regulations to reduce oil pollution,the government will work with landowners and other relevant sectors to address diffuse water pollution through understanding, reviewing and where appropriate changing current practices and regulatory approaches. Matthews says: "We are very keen on the principle of general binding rules, as has developed in Scotland. This is a set of rules, within a statutory framework, binding people to good practice and if you don't follow them, you have committed an offence. It avoids the need for positive licensing." He notes, though, that while the strategy presumes Wales will move forward with general binding rules on diffuse pollution, "there is no legislative provision for them in the Environment Bill, and we are keen to see that there".

Matthews is also keen to see what he dubs a "Sewage Safe" scheme set up. Following Water Safe and Gas Safe, this would encourage excellent practice among septic tank contractors, which currently range from the responsible to the cowboy. "We have shared our thinking on this to British Water and they are investigating an industry-led scheme," he reports.

Another tool in the Welsh Government's water quality armoury is Payment for Ecosystem Services. PES involves a willing buyer or beneficiary (such as a water company) of an ecosystem service (such as water quality) to voluntarily pay a seller (typically a land manager) who is willing to adopt measures to ensure the provision of the particular ecosystem service. The strategy document explains: "Effectively it provides incentives to address market failure, for example, not all services that society demands

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are marketable which leads to under or over supply. By altering the economic incentives faced by our land managers or others who can affect delivery of ecosystem services, PES attempts to correct these market failures."

PES can be used to deliver a broad range of water services, but water quality based markets are viewed as the most easily valued and are likely to be the first type of PES scheme to be developed in Wales. In an industry leading move, the Government said it will support the development of these types of schemes and review legislation if required to enable their long term establishment. This is new ground; while individual companies in England are exploring PES, there has been no explicit policy support.

Jones explains that PES is already being trialled in three catchments – for instance, to tackle pesticides. He stresses that the incentives involved are not always financial and could involve supplying advice, equipment or support rather than cash. "It's not necessarily all about markets and trading, it's about creating a transaction between two groups. We haven't got a great big pot to fund people to do what they should be doing anyway. We are glad to see focus is also going on diffuse pollution. It's important our customers are not paying for perfection while others get out of paying their way.

"A good example of the required co-operative approach is the recent launch by Dŵr Cymru and NRW of a weed wiper trial, whereby equipment is hired out free of charge to farmers to reduce the inappropriate spraying of the MCPA pesticide, which has started to appear in raw waters. This is a good example of PES in action."

SUDS

The strategy also takes an industry-leading approach on sustainable drainage. It pledges to review options for the implementation of Schedule 3 of the Flood and Water Management Act 2010, which requires new developments to include SuDS features that comply with national standards. Until then, it will publish interim national standards on an advisory basis. "This will enable designers, property developers, local authorities and other interested parties to both demonstrate that they have taken account of the Welsh Government's planning advice on development and flood risk and to pilot the standards, so that if necessary they can be revised before being placed on a statutory footing."

Dwr Cymru's work on sustainable drainage through its RainScape programme is advanced. Jones comments: "This is a big priority area for us and I am glad it is a government priority. It will be great for the Welsh Government to show a lead in terms of standards and maintenance."

The SUDS provisions are part of a broader subset of work on drainage reform which includes a review of existing legislation, revised guidance on sewerage schemes for rural communities and guidance on septic tank maintenance.

Customers and affordability

The final major theme in the Water Strategy concerns customers, with the emphasis on fairness and affordability. There is an overarching commitment to "deliver a programme of work to address water poverty, reduce the number of households who struggle to pay their bills and ensure fair and flexible charging structures and options for all customers in Wales".

Among the specific commitments are to monitor the uptake and effectiveness of social tariffs and to review and revise guidance as appropriate. Policy makers said they expect companies to regularly review their tariffs and wider support packages for vulnerable customers and to offer flexible payment options at no extra cost to the customer.

Again, Jones endorses this inclusion as a top strategic priority. "It's high on our list," he says, as is evidenced by the fact that Dwr Cymru's HelpU social tariff supports almost as many customers as the rest of the industry put together. Around 50,000 customers are helped in this way already, with another 50,000 due to be added by 2020. Jones suspects government social tariff guidance will be tweaked down the line, but that overall it is "going in the right direction". Dee Valley Water expects to introduce a social tariff in April 2016, and will be using the same engagement process as Dwr Cymru did with a view to consistency across the country.

In conjunction with such assistance packages, policymakers expect companies to actively manage bad debt, coping with which currently costs the average Welsh customer £20 a year. Again to the envy of the English companies, the Welsh Government enforced the Water Industry (Information about Non-owner Occupiers) Regulations 2014 on 1 January 2015. These require owners of residential property to provide any non-owner occupier's name, date of birth and the date they started occupancy to the relevant water company. The regulations enable suppliers to send accurate and timely bills for these properties, identify vulnerable customers earlier, provide suitable support and pursue non-payment of bills. The strategy commits to assessing the impacts the regulations, reviewing their effectiveness and where appropriate, making changes.

Elsewhere, the Welsh Government will monitor the costs and benefits of retail market reform in England to inform future policy in Wales and consult on options for encouraging reduction in water consumption – including further investigation into the costs and benefits of metering.

Delivery

If you could criticise the strategy on any count it would perhaps be that it is so broad it could prove unwieldy. But the Welsh Government deals with that, for the short term at least, by identifying six priorities for the immediate future (2015-18). These are:

- Supporting the development of the area based approach to natural resource management.
- Ensuring access to fair and affordable water and sewerage services.
- Devolution of all matters relating to water and sewerage and the removal of the unilateral of power of the UK Government to intervene in respect of water resources in Wales.
- A more focused approach to sewerage and drainage management and development and implementation of legislation to support sustainable drainage solutions.
- Reform of the abstraction license system in Wales to ensure sustainable management of our water resources now and in the future.
- Review and where appropriate change current practices and regulatory approaches to tackle diffuse pollution.

The strategy then packages up its remaining key objectives and the supporting actions required to deliver them into three time periods: short term (before 2020); medium term (2020-25); and long term (beyond 2025).

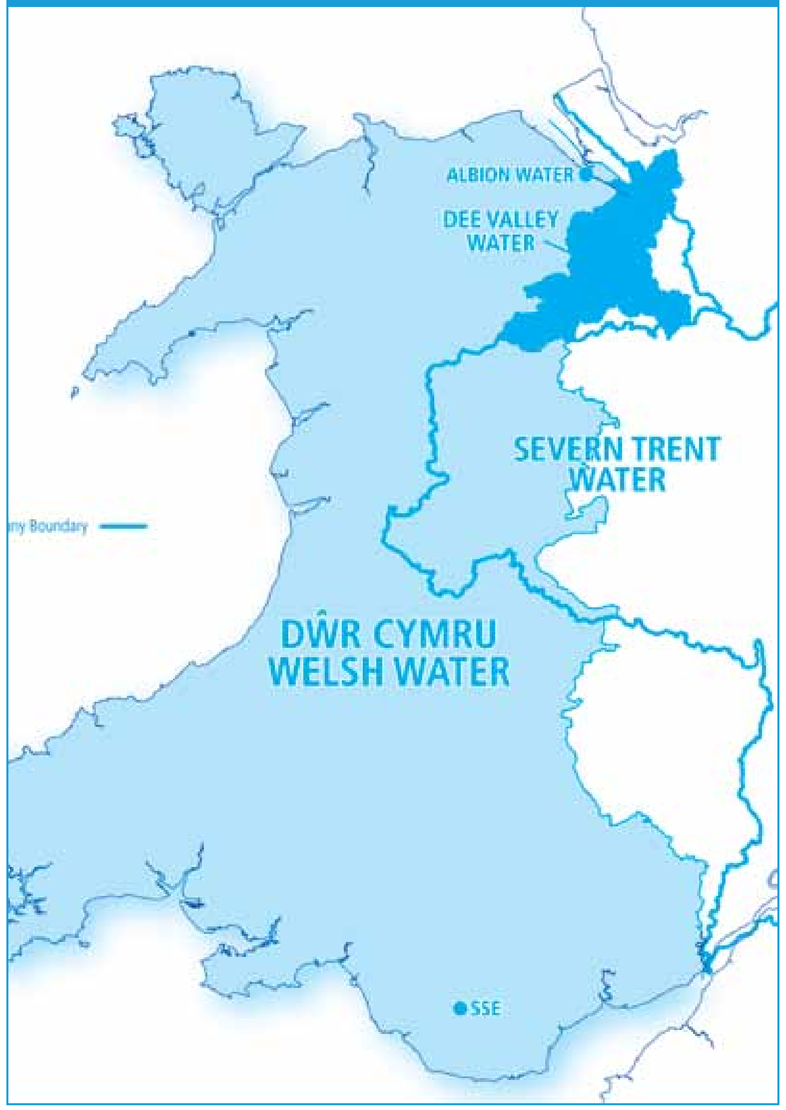
Squire says the focus now is turning the strategy into a plan. Essential here will be better alignment between existing plans – namely, Asset Management Plans, Water Resource Management Plans and Drought Plans. The Government says it will review existing planning functions to secure "a more strategic approach and where appropriate actions from various plans can feed into each other, facilitating collaboration between the water companies and other key water industry stakeholders". In addition it will introduce long term collaborative planning for wastewater and sewerage management, describing this as "critical to address urban flood risk and deliver WFD and Urban Waste Water Treatment Directive outcomes".

Beyond better planning, the Welsh Government eyes a package of delivery support mechanisms, chief among which is full devolution of responsibility for all water and wastewater matters (see box). Squire points out also that delivery of the Water Strategy must be consistent with other strategies in the natural resources space. These include the Agriculture Strategy, the Marine Strategy and the Woodlands for Wales Strategy as well as the Wellbeing of Future Generations Act, and the likes of the Food and Drink Action Plan, the Marine Plan, the Tackling Poverty Action Plan and farm payment schemes.

Matthews notes: "In itself, water is a big topic, but it is part of a much bigger picture. There are lots of pieces that have to be managed together. It is important we keep our vision on the big picture. Our board and executive teams are focused on making sure it all fits together."

In an ideal world, Matthews says, the Water Strategy would have come out after the Environment Bill. In effect, the strategy articulates the Welsh Government's intentions for the Bill. But that aside, all parties agree that while the strategy might be difficult to manage and deliver, it is smart, welcome and refreshingly holistic. TWR

WATER COMPANY BOUNDARIES IN WALES



DEVOLUTION AND DELIVERY SUPPORT

To facilitate the integration of water within the country's broader approach to natural resources management, and for simple clarity, the Welsh Government is pursuing constitutional reform in respect of water. It wants the Welsh National Assembly to have full legislative competence for all matters relating to water and sewerage. It wants regulatory boundaries for water and sewerage aligned with the geographical border between Wales and England.

At present the situation on political responsibility is messy. Water policy is devolved but wastewater policy isn't, on top of which the Welsh Government has some powers which apply across Wales and other which relate to Dwr Cymru and Dee Valley's licence areas, which straddle the border (see map). Both water companies consider the proposed reform sensible in principle but emphasise that practical work needs to be done to ensure customers are protected, the change is manageable, and all implications are evaluated.

The Welsh Government has committed to working closely with the UK Government, regulators and water companies to undertake a detailed assessment of the issues that will need to be addressed with a view to moving towards a new settlement. Squire comments: "Practically, it can be done but at what cost? It may necessitate some novel ideas."

The Water Strategy envisages some important changes for Ofwat, too:

- A new Strategic Policy Statement for Ofwat setting out the strategic framework and policy priorities within which Ofwat must operate. This will detail how policymakers expect Ofwat to take account of the impact of differences in water policies set by the Welsh and UK governments and to collect appropriate evidence to inform effective regulatory and wider policy decisions.
- Elevation of Ofwat's current secondary duty in relation to sustainable development to primary status. The document says: "Sustainable development is the central organising principle of the Welsh Government, and as such we believe that is of fundamental importance that it should be a primary duty for Ofwat."
- Implementation of a clear and joined-up regulatory system – both economic and environmental – which is outcome based and meets the requirements of the people and policies of Wales.

A number of other delivery mechanisms are noted. These include financial support schemes, a focus on innovation, support for business, education schemes and the development of an evidence and evaluation framework to sit alongside the Strategy.

There will be also be regular reviews of the remit and membership of the Water Forum for Wales – a multi-stakeholder group that meets quarterly to discuss and collaborate on water issues – to ensure a focus on the wider water management challenges and the delivery of the strategy.

INTEGRATED WATER RESOURCE MANAGEMENT | REPORT

INDUSTRY COMMENT

WATER AS A SERVICE

Water services should be supplied locally by a wide range of providers in ways customers want. Integrated water resource management is essential, but what are the challenges for reformers to deliver it?

David Arscott is founder and director of PyTerra – see www.pyterra.co.uk. With contributions from Noel Wheatley, Ricardo-AEA and Ola Holmstrom, WSP.

The water industry has a tendency to look within its own experience and culture for answers. But the world is changing, and one way is the influence that society is bringing to bear in defining the services it wants and the way they are provided.

This movement potentially turns our water industry on its head, away from a top-down planning regime and more to a locally driven system where water infrastructure and services are better engineered to reflect local needs. This change is being reinforced by the development of catchment partnerships, by partnership funding for flood schemes and by the local volunteer work of the Wildlife Trusts, Rivers Trusts and other voluntary organisations in caring for local waterways. Catchment Based Approach (CaBA) Partnerships are now actively working in 100+ catchments across England and Wales, and many water companies are already involved in local partnership schemes.

We look here at where this localism could take the industry.

Localisation

It is not too big a leap of imagination to think of local communities being served by a wider range of water service providers than is currently on offer. The range of such services is surprisingly broad: drinking water supply; raw water supply; sewage and waste water treatment; flood defence and mitigation; biodiversity conservation and enhancement; hydropower; carbon storage; fire control; recreation; tourism; and wellbeing.

How would such a services-focused world look? Reflecting trends in other industries, providers would need to offer their services using customer-facing systems which are easy to use and responsive to needs – "water as a service". The water companies will still be there, but less in a customer-facing capacity and more on the heavy infrastructure and treatment side – perhaps like National Grid. Distribution will be done by a plethora of private or not-for-profit organisations using infrastructure offered by multiple providers. With the emergence of better small scale treatment systems and the rapid improvement of low cost sensors, this is becoming a more realistic possibility.

Supply would be facilitated by a new breed of broker (again private or not-for profit) who will sit between buyers and sellers, using systems that allow the integration and optimised use of distributed water networks and the trading of water as a service.

The wholesale side could also develop into an increasingly integrated water services network. Surplus water is captured in thousands of new retention ponds and wetlands, to then supply water during dry months. This would also provide beneficial support to local eco-systems in times of drought.

As these local networks expand, they link with neighbours and grow into catchment-wide networks and then, perhaps, into a national network. The scalability of this approach is attractive, from both an investment viewpoint and also for stakeholders where a trial-and-see basis allows future stages to respond to the impacts of earlier ones.

Integrated management

If localisation is a driver of the demand for water as a service, the integrated and optimised management of water resources is a fundamental necessity for its delivery.

Businesses are thinking holistically about their water risks. According to the Carbon Disclosure Project (CDP), 39% of companies reported significant and imminent impacts, including operational disruptions from drought and flooding, poor water quality causing higher pre-treatment costs, increases in water prices, and fines and legal costs linked to pollution incidents.

Whilst the demand for integrated services is there, infrastructure and service capabilities are not. We have partially integrated natural and man-made water networks with split responsibility across various agencies. The development of this infrastructure lacks strategic planning and resourcing at a catchment level and its overall effectiveness is limited by each stakeholder's objectives.

The water industry has been historically focused on asset ownership and outputs rather than outcomes, though at the 2014 price review Ofwat began to regulate in a more outcomes-focussed way, emphasising total expenditure rather than capital expenditure and requiring companies to demonstrate accountability to their customers.

Furthermore, the ability of the industry to deliver integrated water services from existing infrastructure and within available funding constraints would be challenging; this would be asking too much in view of the many physical, environmental and regulatory constraints. Diffuse water pollution is forever an issue, with water companies often abstracting supplies from waters polluted by agricultural run-off. Drought is also a growing challenge and not just in the South-East and East of England. Annual flood damage costs are enormous and could rise to £27bn by 2080. Yet central government spending on flood defences is reducing in real terms and is reliant on partnership funding to raise investment from local communities. The environment, whilst it has seen improvements under the Water Framework Directive, will continue to experience stressed water courses and endangered biodiversity. The "greening" arrangements under the CAP do little to incentivise farmers to address environmental issues.

Integrated Water Resource Management (IWRM) is a globally recognised concept, and though both UK and international case studies have been cited, this does not yet appear to be a key plank in government or regulatory policy in the UK.

Water as a service

If we can say that localism can help drive the case for IWRM, and that a systems approach to delivery of integrated water services supports the concept of water as a service, how might this work in practice?

> **The water companies will still be there, but less in a customer-facing capacity and more on the heavy infrastructure and treatment side – perhaps like National Grid.**

Take a large town which suffers from a range water issues. Rather than focus on more traditional large civil engineering solutions, there is growing evidence that a network of smaller solutions can be more effective in providing flexible and resilient responses to changing weather and varying demand.

But that only takes us so far and does not ensure that every cubic metre of water is reused multiple times. This requires water service providers to be allowed access (through regulatory reform) to these enhanced water networks, and to be incentivised (through market reform) to exploit their potential. It also requires the systems to be in place to allow the water networks to operate efficiently and for buyers and sellers to trade.

In this way, customers can be offered a choice of service to meet their specific needs. A farmer may only want raw water supplied for a few months each year. A flood authority may want to purchase capacity within upstream retention ponds for limited periods but with more flexible options at other times. An industrial park may want to have water treatment services and reuse of treated water (thus lessening their supply bill) which don't require heavy investment in plant.

There is also significant untapped potential for creating virtuous circles by networking raw water abstraction, clean water supply, grey water recycling and rainwater harvesting so that water recirculates and users can access the water of the quality required, where it is needed, and at a cost effective price.

In these scenarios, local water services could be traded both traditionally (by water companies), and within new markets where intermediaries would sit between suppliers and users. Accredited "responsible" suppliers could also help to develop and manage enhanced water networks, possibly on behalf of landowners, and working closely with bodies such as the Environment Agency and Natural England to protect the environment, meet standards and mitigate risks. Significant projects could be overseen by a strategic catchment authority, one which provided a framework for the market to deliver innovative sub-catchment infrastructure solutions (using money from the capital markets).

Barriers

There are always barriers to change: culture constraints, risk perception, fear, lack of resources, lack of political leadership and other issues which might get in the way. But it is also important to highlight the barriers which might hold back the innovation which is necessary for change.

Whilst investment in water-tech products is increasing, what is less clear is how the industry is going to support innovation in the types of water services and systems described above. The complexities of our fragmented industry effectively promote innovation in product development to serve the existing regimes, but do little to promote radical thinking in the delivery of truly integrated water services and the systems to support them. There is also little crossover between capital projects for say upper catchment water supply and flood retention schemes, so that they can become more cost effective, more numerous and more able to create the opportunities to support investment into innovation in services and systems.

Part of the reason for this lack of investment comes down to the under-valuing of water. Consequently, there remains a discernible gap between what we pay for water and its true value.

However, getting users to place more value on water will never happen until either shortages are reflected in price (which is largely controlled), or systems are in place which can deliver services in such a way as to demonstrably add value to people's lives and businesses – water as a service.

If 'water as a service' can add more value to customers, then a higher financial return can be delivered from water infrastructure and more investment can be attracted to support innovation into water services and systems. If innovation can be funded then change can happen. This will require investors to take a longer term view on their investments, for regulators to collaborate more proactively with innovators, and for industry and public sector bodies to be more willing to commission pilot studies.

Challenge

The challenge for reformers is therefore threefold. Firstly: to facilitate the development of markets for freshwater services so that water, through the way services are provided, is valued. Secondly, to develop the supply side to offer an integrated water services network that is able to reuse every cubic metre of rainfall multiple times before it is lost. Finally, to structure policy making and regulatory control to support IWRM at both a catchment and a local level.

Whether or not water as a service become a reality depends on "if" and "how" IWRM evolves. Professor Dieter Helm suggests establishing a new strategic authority (or "catchment system operator") for catchment services. However, if such an authority were to turn to the traditional contracting market to deliver services on a prescriptive basis, this would be unlikely to unlock a catchment's full potential. If, on the other hand, the authority were to competitively open up the market to solutions providers, there would be wider opportunities for developing and operating an integrated and optimised water services infrastructure, which could in turn deliver water as a service.

Should such a strategic authority not evolve and instead the current structure more or less remain in place, some opportunities for new services might be created around the gaps between current service providers, and at the fringes of deregulated markets. However, investors will not see this as such a rewarding market and water as a service would be more difficult to deliver on such a widespread basis.

If the door for change opens and current policy makers, regulators and statutory suppliers take a bold step all the way through, there is every opportunity to realise the advantages of a localised and democratised IWRM approach.

We therefore come back to the three fundamental parameters within which change in the water industry needs to respond if IWRM is to become widely adopted: democratisation, integration and optimisation. Democratisation is needed because users' voices will become stronger; but this is only achievable if the sector becomes more outcome-focused, giving value to all aspects of water and not only the drinking water from a tap. Integration is needed because users have multiple needs at different times; only by bringing services together, through the development of water as a service, can these demands be met. And finally, optimisation of supply and demand better allows our limited resources to be made available. TWR

WHAT'S THE SCORE?

Will a more fragmented water market need a System Operator to conduct it? If so, on what scale and who should perform the role? Water leaders discuss the issues.

Last issue, *The Water Report* looked in detail at Dieter Helm's new paper on a System Operator (SO) for water. Helm's vision is for an SO in each catchment, with responsibility for planning and coordinating catchment functions including abstraction, discharges, flood defence and agricultural subsidies in an integrated way. These catchment system operators (CSOs) would not perform any of these functions themselves but rather tender them out to a wide range of companies and organisations, including water incumbents, new entrants, farmers, land managers, facility management firms and not-for-profit organisations.

Mid-June's Indepen Forum – a group of senior influential figures from all parts of the infrastructure sector – chewed over the whole subject of system operation and SOs. The debate was wide-ranging, covering energy, rail and other network industries as well as water. But for water specifically, where the concept of an SO has gained traction alongside the possibility of greater fragmentation of services as markets are reformed, some of the debate was particularly pertinent. The industry and its key stakeholders are increasingly asking questions such as: if more parties are involved in performing services, who will coordinate the activity, safeguard security of supply and ensure investment is made where it is needed?

The role of a water SO

The Forum heard first of all that system operation and a System Operator are not one in the same. Systems can operate without an SO; that is just one way of ensuring operation is effective and efficient at interfaces, be they between or within companies. Among the things an SO can bring to the coordination party are:

- **information** – for instance, shining a light on the outcomes the system needs to deliver
- **mechanics** – for instance, facilitating a market place
- **prescription** – specification of how the system should respond
- **delivery** – perhaps as a service provider.

In the context of water, an SO could help better use be made of markets, by helping buyers of services meet sellers. One contributor identified three key sets of issues in the sector that would benefit from improved coordination:

- **Vertical issues** – for instance the need to get water from A to B, or to integrate customers better into the value chain. Traditionally such vertical issues have been solved by companies being vertically integrated, but it need not be so.

>

- **Horizontal issues** – the coordination of water resources across geographical boundaries could be improved, and companies could make increasing use of out-of-area resources through trading. The same principle could apply to other water and wastewater services and extend beyond traditional water company boundaries to the likes of ecosystem and catchment services.
- **Inter-generational issues** – water companies are well used to evaluating whether assets should be repaired or replaced, but once broader services such as ecosystem and catchment services are part of the picture, these decisions will be harder to make in a way that is fair to current and future customers.

Command and control?

So theoretically, there is plenty an SO could do in water. The question is, do we need one?

Some Forum attendees were unconvinced that a SO of any kind was necessary. One argued that unlike in electricity where the electrons being used to boil your kettle could have come from anywhere, water is inherently local in nature and heavy to transport. Water companies do a good job of coordinating their local systems – River Basin Management Planning is testament to this. There are no problems to solve and there is no reason to think that there would be benefit from the SO functions water companies currently perform being conducted at arms' length or by others.

Another contributor added that, to the contrary, setting up and running an SO would carry cost, so as the idea is explored it will be important to pin down exactly where a SO might add value. On a similar theme, another participant urged that we "should not look for a superhero SO" that will fix or improve everything in one fell swoop – we won't find one.

We should not look for a superhero SO that will fix or improve everything in one fell swoop – we won't find one.

The SO question raises an ideological issue too: is it better to put faith in central control administered through the SO mechanism (one Indepen Forum participant referred to this as "the Fat Controller view of system operation") or to trust stakeholders to coordinate their own activities? Both arguments found support. One participant for instance, stressed the importance of leadership that a SO would provide, and said this would likely speed up decision making processes and facilitate innovation. This would be particularly necessary when the industry was in crisis mode – for instance, in coping with floodwaters.

Others expressed instinctive wariness of the "command and control" approach and cited examples from other industries where many parties collaborate without anyone taking an absolute lead – such as the Smart Grid Forum in energy. One attendee raised a practical point: that the legitimacy of an SO would be put to the test as soon as it made an unpopular decision and parties deferred to the courts.

Perhaps a route through this would be if any SO for water focused on enabling markets without actually making the decisions on what and how those markets delivered. Either way, transparency will be crucial.

Independent or embedded?

Among those disposed to give the concept of an SO for water time of day, the debate moved on to how independent that SO would need to be. Would a stand alone body, independent of any water company interests that could operate at arm's length be better than incumbents taking on the role, or would an independent third party simply add to transactional costs and risk? There were strong advocates of both arguments.

One delegate said who the SO was should depend on the system being operated. Ten years ago, it would have made sense to embed a SO in the industry, but now that so many outcomes – water quality, water scarcity, flood management and so on – are dependent on multiple parties from multiple sectors, it will be critical that any SO is seen as objective. If water companies acted as SOs, it would be very easy to question their legitimacy and for external parties to question whether they were making the right "make or buy" decisions.

Another delegate countered that on practical grounds, arguing it would be far better to use a SO "that's already there". Another observed the problems that have arisen in other sectors when separation was forced – in rail for instance, where the vertical separation of network operators from train operators has been difficult.

While there was no consensus on this issue, a few offered bridges across it. One delegate suggested that the endgame should be independence, but during the transition period, existing system operators could carry out the role.

SO and SOs

In terms of a single national SO versus a number of local SOs, there was clear agreement that the latter would be preferable for water. Within a single water company area there can be multiple catchments, each with different challenges, so the idea of national operation just doesn't fit. This is despite the success of the single SO model in other sectors – notably electricity, where National Grid is the national SO (performing functions such as system balancing and administering capacity auctions) as well performing its more well known role as transmission network operator.

Incidentally, one attendee raised a flag for the future on this. He said that National Grid had performed effectively and had a good track record as an SO, but would have to face new challenges in the near future. Most significantly, distribution networks which have hitherto been passive recipients of Grid's SO decisions are likely to have to manage their own local networks more actively going forward on the back of rapid low carbon capacity connection. This will pose new complexity, and the relationship and hierarchy between the national SO in the form of Grid and the local SO in the form of the DNO will need to be ironed out.

Moving on, there is a flip side to the local v national debate: the possibility of the need for what is effectively an infrastructure SO arising. The Labour Party was struck a body blow at the general election, but said one participant, its idea of a National Infrastructure Commission has not gone away. "We could find ourselves talking about a National Infrastructure Commission SO at some point," she said. There are practical matters to support this trend, inter-sector resource and budget conflicts, for instance. One delegate asked simply: "Where will cross sectoral decisions get made?" TWR

EXTERNAL DATA: NO MATCH MADE IN HEAVEN

Incumbent water companies readying their business customer data for the retail market can't rely on shortcuts, a data pilot published by Open Water suggests.

Eight companies which between them serve 60% of non-household properties in England took part in the nine-month study to consider if external datasets could be used to help identify non-household premises (each with a Unique Property Reference Number), ready for inclusion in the central market register held by the market operator.

The companies all used National Address Gazetteer and Valuation Office Agency records of properties liable for non-domestic rates but were free to choose their own matching methods. Most used a combination of automated matching (using software algorithms alone) and semi-automated matching (where matches suggested by the algorithms were reviewed manually and agreed or rejected).

The headline results were:

- 68% of non-household premises matched to individual water company records
- 31% of water company non-household records were not found in the list of non-household premises
- 23% of non-household premises provided were not found in water company records.

Moreover, different companies had very different rates of matching success – from under 40% to over 95%. Open Water observed this resulted from the data structure in company systems; the company's historic data quality; and the use of different thresholds for what was deemed sufficiently close to be an exact match. The programme noted a lesson from the fact that different companies had their data organised in different ways: "Techniques that worked well for some companies were less successful for others. This demonstrates that it is important that companies use matching techniques that are tailored to the structure and quality of their own data."

Trouble spots

The pilot companies identified a number of common challenges that all those preparing data for the new market would be wise to watch out for:

- Boundary issue: difficulty in identifying exactly which company a premise was served by at company boundaries.
- Two suppliers: it will be important for water only companies and the WASCs who provide sewerage services to non household customers in WOC areas to treat premises consistently.
- **Similar addresses:** domestic and commercial premises with similar addresses require extra work.
- **The un-served:** there is lack of visibility of premises not served.
- **Eligibility:** there were different interpretations of Ofwat's historic eligibility guidance, particularly around mixed use and multi-occupancy premises. The study said: "It is important that companies master the finalised Ofwat eligibility guidance and apply the guidance consistently to their records to identify non-household premises to include on the central market register. This is vital to ensure a level playing field for retailers and customers."
- Too many/not enough: the pilot highlighted examples of a single water company record covering more than one premises on the National Address Gazetteer/ Valuation Office Agency roll or of several water company records covering a single premises. It said: "In the future it will be necessary to have a more consistent approach to allow the market to operate fairly and efficiently."

Robust validation

Water companies are accountable for the quality of their non household data. The pilot suggests that while cross referencing with external data sets is valuable, it won't identify all the non household premises served because the definitions deployed in water and by other data-keepers do not exactly align. Therefore companies shouldn't rely on automated or semi-automated data matching from external data sets alone.

The study concludes: "Additional steps will be necessary to confirm that all non-household premises have been unambiguously identified for inclusion in the competitive market." TWR

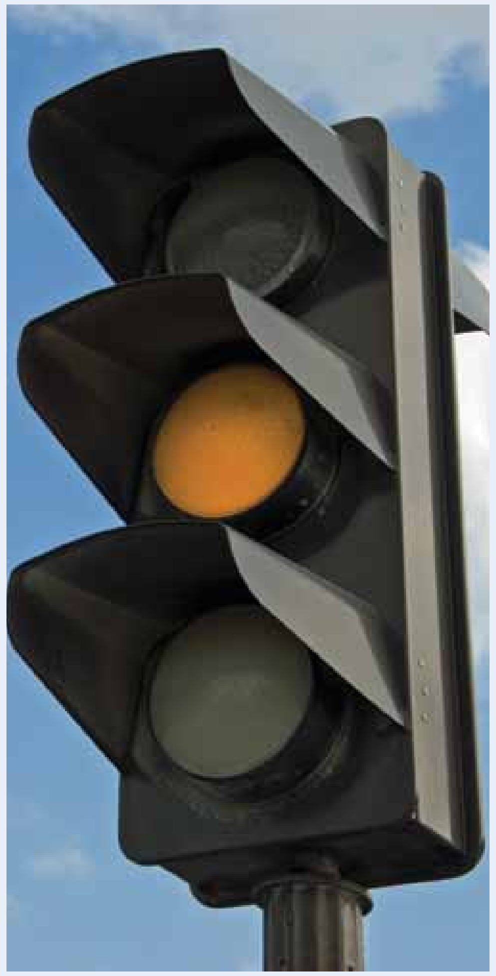
ORDNANCE SURVEY FINDS MOST FIRMS ARE FAR FROM READY

Ordnance Survey asked delegates at a water industry workshop it ran in June to vote anonymously on market readiness and data issues. The key findings were:

- **Market readiness:** At the start of the workshop, 11% said they were ready; 33% were fairly ready, a little behind; and 52% said they had started, but still lots to do. By the end of the workshop, these numbers had changed to 9%; 26% fairly ready; and 61% started, but still lots to do. Interestingly, 100% of WOCs said they still had lots to do compared with 50% of WASCs.
- **Quality of billing data:** 67% said they thought their billing data quality was ok, but needed some work. Only 4% rated it excellent, while 19% said some data was out of date.
- **Billing data completeness:** 74% felt it was ok; 19% stating some was missing; 4% rated it excellent. 100% of WOCs compared to 63% of WASCs felt their data was ok – an indication perhaps that while WOCs have lots to do to get ready, they feel the scale of the data task is not as great as for WASCs.
- **Importance?** Worryingly, only 78% felt it essential to have good quality, maintained addressing data in their businesses.

NO ROOM FOR ERROR AS OPEN WATER BOUNCES BACK FROM BASELINE REVIEW

Scoring "amber" in an independent review in May has galvanised activity among the Open Water parties and on paper, the programme is in a much better place than it was a few months ago. But now it's time to deliver in practice, without delay or any further surprises.



Open Water's stakeholders have emerged with fighting talk from a far from glowing independent review of progress towards on time and effective retail market opening. This "baseline review" (see box – Baseline basics, p39) gave the programme an amber rating, which means the April 2017 target opening date appears feasible but significant issues require urgent management attention.

While not quite the stuff of claxons and blue flashing lights, nor does the review make comfortable reading. Its core message? Fix the issues identified (there were 18 recommendations) and just get on with delivery, for there is very little contingency left in the programme to accommodate further slippage or change. So no more decision making delays. No more confusion over roles and responsibilities. No more lack of clarity on budget.

Ofwat published both the baseline review and a response to it on 30 June. DEFRA's director of water Sarah Hendry took the opportunity to stub out any rumour that market opening might be delayed just a few days after that. Speaking on 2 July at Marketforce's Water Market Reform conference, she said the new government was "firmly committed to April 2017" and would deliver a market that is "fair for new entrants, incumbents and customers alike".

Ofwat too is in buoyant mood. Its director for market opening Adam Cooper told delegates at a meeting of the Major Energy Users' Council's Water Competition Group on 17 July: "The programme is on solid ground, not on a knife-edge." He said the three core components of delivery – codes, licences and systems – were in hand and that "the bigger risk is: will companies be ready?"

MOSL's (Market Operator Services Limited) new chief executive Ben Jeffs spoke at the MEUC meeting too and outlined the rapid pace of work that had taken place since he joined the company a few weeks earlier. "I'm at the end of my sixth week in the job," he said, "and in that time we have moved from being a number of different OWML [Open Water Markets Limited] work streams to a properly structured and staffed organisation."

This fighting talk is all to the good, and perhaps essential to claw back confidence from the industry and other stakeholders.

But the Open Water parties would insist this renewed enthusiasm and combined show of strength is far more than just a confidence-building tactic. For one thing, OWML's work led by Alan Sutherland has provided a solid basis to the market opening work. When Sutherland and his team first became involved in early 2014, operational arrangements were in their infancy and there was little in the way of a common view on how the market would work.

OWML will walk away from the programme this month having delivered a complete set of market codes and rules – the pre-vendor Market Architecture Plan was published mid July – and with the procurement of central systems well underway under MOSL's auspices. It has also spearheaded a proactive industry engagement programme, which companies appear to have hugely valued.

The baseline review acknowledges this substantial contribution, commenting: "To date the programme has made good progress thanks to the contribution and commitment of OWML and its key personnel."

But Ofwat, MOSL and DEFRA's fighting talk is also founded on the fact in the six weeks since the review was completed, they say they have substantially answered the 18 recommendations for success made by the baseline reviewers. These recommendations fell into six categories: transition planning; organisational capability; governance; risk management; communications and engagement; and readiness for the next phase.

Transition and capability

By the time of the independent review, a Transition Planning Group had been

formed to address the practical issues involved in transferring the responsibilities of OWML to Ofwat and MOSL. But it was clear that the planned handover date of 31 May was not going to be met. The baseline review recommended:

- The transition plan needs to be finalised, agreed and communicated as a matter of urgency.
- Critical resources need to be identified and secured with appropriate priority given to securing continuity.

This transition has now fundamentally taken place. At the time of writing (mid July), OWML had delivered the pre-vendor MAP and had one further CEO session to deliver before officially winding down. The handover had become possible because both Ofwat and MOSL have shored up their capabilities and resources to deliver their new responsibilities significantly in the period from the end of May.

The two organisations were at the time of the review either under resourced or operating with interim resources. The review recommended:

- Ofwat should produce a detailed and fully funded resource plan identifying key roles and the people who will fulfil those roles, particular attention being paid to the need to maintain continuity of understanding.
- The present action to identify a MOSL CEO and permanent chair needs to be brought to the earliest possible conclusion.
- MOSL needs to ensure that its credibility with incumbents and new entrants is actively promoted.

Ofwat's resourcing issues have been no secret, and are not eased by its intellectually demanding work programme. But on retail market opening specifically there has been progress. It has announced PA Consulting as delivery partner, an appointment that brings with it a strong team, broad experience and continuity from OWML. PA has begun working with Ofwat already – for example, delivering workshops on credit terms and licensing.

In addition Ofwat has recruited new customer protection staff and identified leads for each of its retail market workstreams. PA's Michelle Ashford who was on the OWML team will transfer to Ofwat and oversee programme management until a permanent hire is made.

Finally, and importantly, the regulator has updated the market delivery budget (see box – Market price £42m, p38). While the increase in cost won't be welcomed by companies, the greater clarity at least will.

MOSL, meanwhile, has developed in leaps and bounds since the review was conducted. Following the appointment of Jeffs as CEO, a meeting of the interim board on 16 July made the following permanent board appointments: Andrew Pinder as chair; Margaret Beels and Peter Bucks as independent non-executive directors; Anglian CEO Peter Simpson as the director representing licensed undertaker members; and Castle Water CEO John Reynolds representing new entrant members. Interim directors Steve Mogford and Heidi Mottram have stepped down.

The MOSL board has also signed off a new management structure, which crucially manages to hold on to some of the existing OWML team.

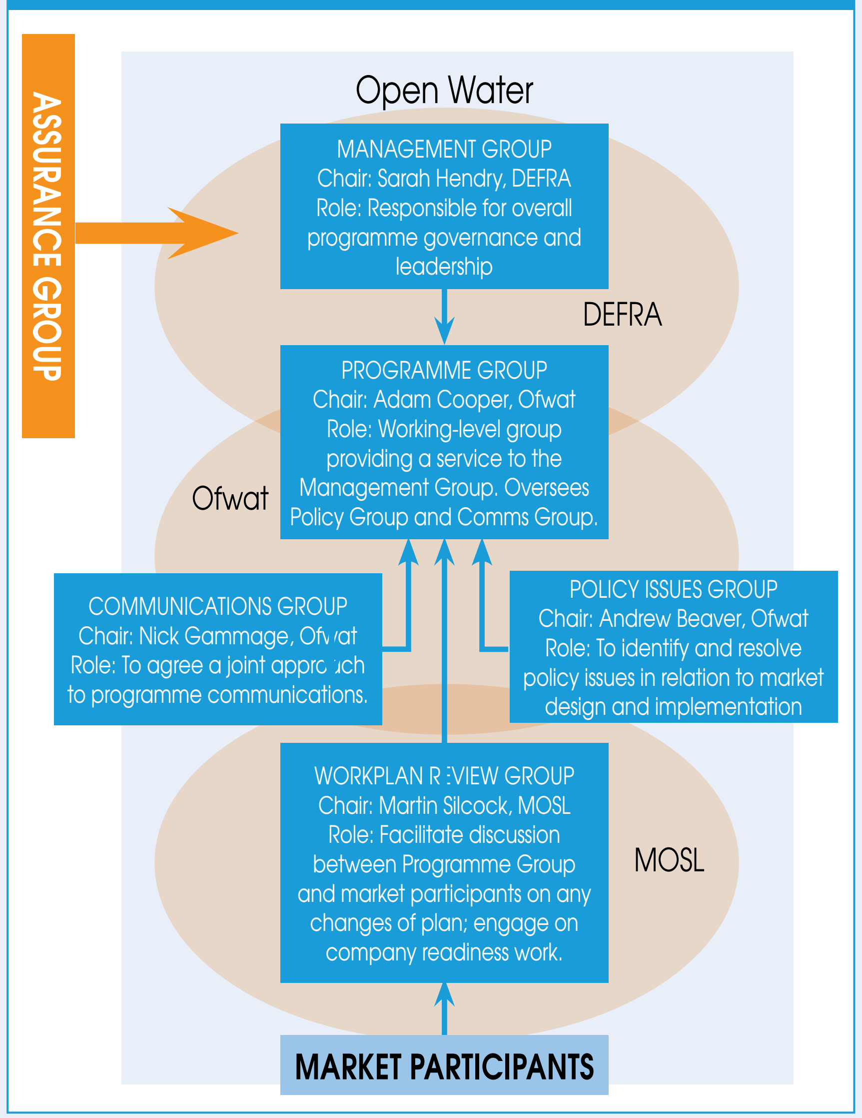
Central systems procurement, MOSL's immediate priority, seems well in hand too. The 16 vendors who completed a pre-qualification questionnaire have been boiled down to four (CGI, Tata, Wipro and Capita) who have submitted detailed solutions. Jeffs described these as "four credible bids from four credible bidders," adding: "I'd be happy to go with any of the four of them". However, only two will be invited to make best and final offers before the preferred bidder is announced the week of 3 August.

On the new entrant issue, Jeffs confirmed MOSL's voting structure is one member, one vote, regardless of size or financial contribution – and that incumbent retailers do not have a separate vote from the wholesale part of their business.

Governance

Governance arrangements have been the thorn in the side of Open Water. Since the programme's inception in 2013, there

GOVERNANCE OF THE OPEN WATER PROGRAMME



have been a number of changes to the governance plan, which have naturally caused nervousness among stakeholders, raised questions about leadership and impeded progress. And yet good governance is absolutely critical to success.

By the time of the review, it had been decided that Ofwat would assume overall accountability for the programme, but exactly how the new structure would work in detail and how accountabilities for parts of the programme would be delegated was unclear. Similarly, a multi-stakeholder Retail Market Opening Programme Management Group (RMOPMG) had been established to manage the programme, but there was lack of clarity about its scope and responsibilities. The baseline team recommended:

- The RMOPMG must create a vibrant and shared vision of the path to successful delivery. The views of new entrants as well as incumbents must be given full opportunity to be heard.
- Ofwat should ensure that the names of individuals of the respective groups within the revised governance structure are identified.
- The escalation procedures between the levels of the structure should be clearly set out.

The Open Water parties have responded with a new governance structure, as shown in the diagram, p37. At the top of the tree is the Retail Markets Opening Management Group (RMOMG), responsible for overall programme governance and leadership, oversight of plans, budgets, risks and policy issues. The group is chaired by DEFRA's Hendry, but the emphasis has been put on the multi-stakeholder membership (senior executives from MOSL, OWML, Defra and Ofwat) rather than DEFRA as ultimate decision maker. How effectively the parties work together and how well informed they are kept by the members of the groups below them, particularly on the Retail Market Opening Programme Group (RMOPG), will be crucial given effective decisions need to be made promptly if April 2017 is to become a reality.

Chairs have been assigned to all the groups that sit below the RMOMG, except for the Assurance Group. Given the ultimate customer for assurance is the secretary of state, it is being left to DEFRA to appoint someone it has confidence in to chair this group.

Risk and communications

The review team noted that the risk strategy and risk register maintained by OWML was "soundly based" but that transition posed a danger: "At present there are risk registers associated with workstreams and in different organisations. It is essential that there is a comprehensive programme-wide risk register giving a view of risks across the programme." It recommended:

- a post-transition and programme-wide risk review, to inform an integrated risk management framework
- RMOPMG should develop a critical path and monitor progress against it.

The Open Water parties agreed and said the recommendations would be pursued under the ultimate auspices of the RMOMG.

On communications and engagement, the baseline review emphasised the value of OWML's stakeholder work, and recommended:

- There should be a communications plan, identifying appropriate activities across all levels of relevant organisations.
- At least the current level of engagement is sustained until the target date of April 2017.
- Regular programme information should be published on a firm timetable.

The value of communications work was acknowledged in the response document published by Ofwat. It committed its Communications Group to "agree a joint approach to communications and manage engagement through a shared planning tool (a 'common communications grid')." It also committed to continue OWML's engagement activities including further workshops and running a fortnightly call for market participants.

Readiness for next phase

The final set of issues flagged up for attention in the baseline review concerned the readiness of market participants. Three key areas were noted. Firstly that policy gaps, particularly on licensing, the in-area trading ban and exit regulations were holding some companies back from making key strategic decisions about how to adapt their businesses to market opening. Secondly, that discussion was ongoing on the form assurance would take. And thirdly that companies needed continual support to help them adapt their behaviour, organisation, finances, operations and systems for the new market.

The baseline review recommended:

- It is for the secretary of state to determine what form of readiness assurance would meet the government's needs.
- DEFRA and Ofwat must produce timely policy guidance to inform any remaining rules in areas of their responsibility.
- Attention needs to be paid to, and responsibilities clarified for, delivery of support to companies in all aspects of market preparation.

Many of the policy gaps have been addressed since the review was conducted. While far from done and dusted yet, Ofwat has now published a licensing consultation (see report p40) and is conducting workshops on the back of it. DEFRA has issued new charging guidance (also p40) and Ofwat is due to produce resulting charging rules in August. DEFRA's work on exit regulations is understood to be on track and it is due to consult on draft regulations imminently. Finally, while there remains some work to do on the detail, Ofwat's late intervention on credit terms that held up publication of the covering note for MAP3 has resulted in a menu of payment options being made available to retailers.

On assurance, DEFRA is working with other parties to finalise the framework and process so that parties are able to provide their first report on readiness in autumn 2015.

As for company support, the response document said this is on the radar, but that "further work is required to identify the level of support, its universality and the potential support organisation(s)".

Delivering the market

The baseline review has clearly been a force for good and seems to have directly galvanised activity. The Open Water stakeholders' response to the amber rating – positive and proactive – is a smart strategy and has inspired confidence among some observers. Reviewing market prospects in mid July, Ken McRae, COO of independent expert Gemserv, agreed that on-time market opening is within reach. Waterscan director Claire Yeates has been involved with some of the recent Ofwat workshops and says she is encouraged by what she has seen and also by some of the new appointments including that of Jeffs at MOSL.

Nevertheless the fact remains that with barely 21 months to go before customers expect to be able to switch, there is an awful lot to do and, crucially, no margin for any further error or delay. Speaking at the Marketforce event on 2 July, Wessex Water chief executive Colin Skellett said that while there was "a good chance" of delivery for April 2017, he was "not totally confident we are going to get there… the programme assumes IT systems will be delivered on time and everything will work".

In view of this, some fixed commitments on what precisely should be achieved by when would be welcome, as would some indication of the quality of the market that will open in just under two years time.

However, what is important now is that all the parties involved actually deliver on the good intentions they set out on paper. With transition all but in the bag, the budget updated and Ofwat and MOSL better staffed (with more to come), attention should turn to keeping to the other commitments made – including pinning down outstanding policy items, proactively engaging with market participants and supporting their preparations, managing risk, and perhaps most importantly given the emphasis it received in the baseline document, ensuring the new governance arrangements work in practice. Anglian Water's director of wholesale services Ian Rule urged: "It's a tight programme and the number of stakeholders is wide and varied. Openness and collaboration are going to be absolutely key. There can be no more surprises."

If all goes to plan, attention might shift away from programme management risk and towards company readiness risk, which many agree might yet prove the toughest nut to crack. TWR

BASELINE BASICS

The baseline review was conducted by Adam Green, managing director of Carillion Construction Services, Jon Carlton, director of Guille Carlton Solutions and Bob Irvine, deputy director at the Scottish Government. It followed the principles of the Gateway Review commonly applied to large programmes and projects within government and involved a combination of document assessment and interviews with key participants in the programme.

Carried out 13-27 May, the review took place against the backdrop of the publication of MAP3 on 11 May and during a time of transition of programme responsibility from OWML to Ofwat and MOSL, following OWML's designation as a public body. Consequently, Ofwat requested the review be treated as a "baseline," to assess the status of programme management on its transition from OWML to Ofwat at the end of May.

There will be further reviews at key stages of the programme. Currently these are expected in Q1 2016 (prior to system testing); Q3 2016 (prior to shadow operation); and then post go-live.

The review made nine "critical" (act immediately) and nine "essential" (act very soon) recommendations to get the programme back on track, and overall gave it an "amber" rating, which means market opening remains feasible but there are significant issues to overcome.

MARKET PRICE: £42M

Alongside the baseline review and response documents, Ofwat published a revised budget for the Open Water programme. This put costs at £41.8m for 2014-15 to 2016-17 – a hefty £16.5m change from the mid-level estimate of £25.3 million that was provided in 2013. The bulk of this cost – £26.2m – sits with MOSL (see table). The work to design, build and implement the systems necessary for the new market is the single biggest cost, accounting for £14.2 million or 34% of the budget.

While no cost rise is welcome, an increase of one order or another might have been expected. The earlier numbers were based on high-level top down estimates and the experience of other sectors. Now Open Water is at the implementation phase, a full bottom-up cost assessment has been possible.

This higher bill will fall on the industry to find, most likely under the terms of licence condition R1 which Ofwat consulted on in July 2014. The regulator said, that being the case, "each wholesaler would expect to incur costs of between 0.6% and 20% of this or between £250k and £8.4 million over three years in nominal prices."

Speaking at the Marketforce event, Southern Water's director of strategy Simon Oates described the hike as "pretty challenging". Ofwat indicated that the industry's response had been on the whole understanding, given the new information and the magnitude of the task in hand. And at least now the numbers are more robust.

Of note however is that the new figures cover only central market set up costs (Open Water's running costs as it develops codes, licences, contracts and other market architecture; central IT system costs; and the costs of setting up the Market Operator) and exclude a number of elements that will make the total cost of delivering the market significantly higher. Excluded costs include:

- Post 2017 running costs. Open Water's current estimates for these costs are £5.6 million a year (2014 prices). But these costs have not been subject to the same bottom-up process as other costs and the precise form of the MO has not yet been agreed.
- Incumbent costs for preparing their systems and introducing organisational change to be ready for the new market (though these have been factored in to PR14 settlements).
- Government costs – including for implementing new legislation and setting out retail exit arrangements.

Moreover, there are a number of risks to the revised costings, notably the final cost of IT systems and the publication of MOSL's business plan, due in August. Ofwat said it will re-issue the budget following the agreement of that plan. On the plus side, the regulator will also factor in recommendations from an independent assurance exercise. And if MOSL qualifies for VAT registration (this is being explored), it would knock £5-7m off the bill.

Either way, it will benefit all parties for costs to be transparent and regularly communicated. Describing the revised £42m number as "a surprise" Oates said: "We've got to stop these surprises as we move forward…that would be positive for the whole sector." In terms of cost management, Ofwat said the RMOMG will consider programme expenditure on a monthly basis as well as taking stock at key programme milestones. It added: "Individual budgets and expenditure will also be held at the organisational level between Ofwat and MOSL and, where appropriate, at lower work-stream levels. Each organisation will be responsible for managing their own budgets and putting in place appropriate controls.

Revised budget for Open Water programme

Organisation	2014-15 (£ million)	2015-16 (£ million)	2016-17 (£ million)	Totals for three years (£ million)
Ofwat	0.2	4.1	1.5	5.6
OWML	4.1	2.3	-	6.4
MOSL	-	12.6	13.6	26.2
Totals per year (£ million)	**4.3**	**18.9**	**15.2**	**38.4**
Totals plus 10% contingency (£ million)	**-**	**20.8**	**16.7**	**41.8**

Ofwat has issued a consultation dealing with a tricky array of licensing and policy changes needed for the retail market.

MARKET READINESS MAY BECOME A LICENCE CONDITION

Ofwat is mulling the introduction of a new licence condition which will require water companies to make themselves ready for the non household retail market. The regulator said it was responding to a request from Open Water and identified particularly important readiness tasks as:

- Preparing datasets on eligible premises and supply points of the required format and quality to allow the data transfers scheduled for April 2016.
- Developing company systems and processes to enable interface with the new market systems.
- Participation in the testing of the new market arrangements and the initial set-up of the market.
- Preparation and maintenance of company specific transition plans and the sharing of those plans to support market assurance and market readiness assessment activities.

Ofwat has proposed that a water readiness condition could have three parts:

- A general obligation to carry out any activities required to ensure the smooth and timely expansion of the competitive retail market.
- A more specific obligation to carry out the set of activities defined in a formal transition plan produced by the overall programme.
- If necessary, additional provision in regard to areas of specific concern to participants – for example, if there were concerns about the provision of confidential data.

Other licence changes

The readiness condition is one of a raft of changes set out by Ofwat in a June consultation on licensing and policy issues relating to non household retail market opening. A related readiness proposal is the removal of the in-area trading ban, which prevents the holder of an existing water supply licence from acting in the area of a related undertaker. The provision is no longer deemed necessary and the change will mean that all retailers will be able to compete effectively for customers with multiple premises across different areas.

More widely, the regulator plans to introduce "standard" conditions for new supply licences and changes to existing licence and appointment conditions that are necessary or expedient to deliver the competitive market. The new retail licence is based on the current licence. Alterations are proposed – for instance, to reflect the increased scope of the retail market and to remove outdated provisions such as on access codes. In addition, the new retail supply licences will include customer protection measures, a new condition to enable the Market Arrangements Code and changes to ensure equivalence of obligation and opportunity for all retailers.

Among Ofwat's licensing proposals beyond these standard conditions is provision for a new self-supply licence, which will enable customers to buy water wholesale for their own use. The regulator also flags up that further work may lead to additional licence or appointment proposals later this year. These cover issues such as guaranteed service standards, deemed contracts and the need for a level playing field.

Codes and charging

The consultation goes on to set out Ofwat's thoughts on a small number of key issues within the proposed industry codes developed by Open Water. The regulator confirmed it was working on the detail of an expanded menu of credit arrangements than the second Market Architecture Plan contained. Limiting choice, said Ofwat, would "create unnecessary costs for all participants in the new market, disadvantage smaller new entrants and prevent possible innovations around credit arrangements".

On Supplier of Last Resort provisions (dubbed interim supply arrangements), Ofwat said it was minded to introduce "a flexible auction style arrangement similar to that already used in Great Britain's retail gas and electricity markets" to supplement existing backstop provisions in the Open Water codes. While the backstop provisions have worked in Scotland, the regulator felt the larger scale of the market in England and the greater number of sizeable participants from the outset would be more demanding.

The regulator added that while it broadly agreed with MAP3 proposals on developer services and the handling of gap sites (Supplier of First Resort arrangements), it still needed to finalise points of detail.

Finally, Ofwat set out its thinking on some practical matters concerning the new charging rule framework introduced by the Water Act 2014. This requires Ofwat to set rules that companies must comply with in setting their charges. (see box). TWR

DEFRA ISSUES CHARGING GUIDANCE TO OFWAT

The government has issued a consultation on its new Charging Guidance to Ofwat. The document – see http://bit.ly/1JpM2iR – sets out four equally-weighted overarching policy objectives for water and sewerage charging:

- fairness and affordability
- environmental protection
- stability and predictability
- transparency and customer-focused service.

It covers the following charging regimes: charging schemes for household and non household customers; charges in the new non-household retail market; charges in current and future upstream markets; and developer charges.

The new guidance has been issued in light of the Water Act 2014's competition provisions and revised framework for the regulation of charges. This creates powers for Ofwat to issue binding charging rules for the water industry and requires ministers to develop new charging guidance which Ofwat must have regard to in developing these rules. Responses should be received by 6 August. Ofwat is expected to produce the rules that month.

INDUSTRY COMMENT

PRICING WATER IN A COMPETITIVE MARKET

Price will be a critical success factor in the open market. How should suppliers go about setting prices that are commercial, compliant and sustainable?

The competitive market for non-household water services opens in April 2017. While this is 21 months away, retailers who will compete in this market will need time to develop compliant prices they are confident will be attractive and profitable. The estimated £394m plus of water bill savings that retail competition will deliver indicates the scale of the changes in the level of prices. Savings will be driven by a fundamental shift from regulated monopoly prices to doing deals with business customers who will be able switch to other suppliers.

Competition has already started and a number of major water companies including Business Stream, Severn Trent and United Utilities are currently targeting customers so they get off to a flying start.

Taking advantage of the new opportunities to grow market share requires the right approach to pricing but also a cultural revolution which puts meeting customer needs at the centre of a business which is agile, dynamic and sales orientated.

Although there is much to do to prepare for competition, this article is focussed on pricing as a critical success factor. The aim is to identify key factors to analyse when setting prices which are compliant, commercial and create sustainable relationships with customers.

Price discovery

Whilst pricing in utility markets is not rocket science, it is new and novel in the water sector in England and there are important lessons from best practice in water pricing in Scotland and other sectors such as electricity. Broader utility experience provides relevant insights and techniques which can and should be applied in the water sector. Particularly, in the early days of the new market there will be a need for a price discovery process including open engagement between retailers and customers to uncover the products and pricing which customers most value and which are profitable for retailers. There may be a number of initial deals where the pricing is unsustainable as market participants gain experience and reliable pricing norms emerge. After an initial focus on competing on price, I expect that competition will shift more to product innovation and added value.

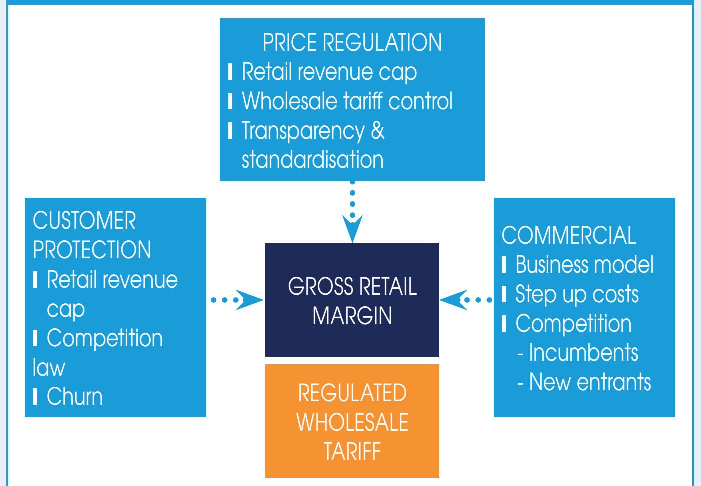
For the retailer, there is a real benefit from getting the right balance between increasing market share, improving profitability and building sustainable long-term customer relationships. An important requirement for success is to listen carefully to customers, to understand competitors' pricing and to be willing to evolve retail pricing and indeed your business model in the light of market forces. This is part of a free market revealing the preferences of consumers, encouraging innovation and rewarding those who adopt the right approach. Key considerations impacting on commercial pricing decisions are illustrated in Figure 1.

Companies wishing to win new customers and to retain existing customers need convincing and profitable answers to customer questions including what value added is being offered and how much will they charge. These questions are critical whether the company's marketing strategy is:

- *A relationship driven approach focussed on particular customers*
- *Targeting national coverage of all customer types, or*
- *Initially seeking to defend existing customers*

However, the strategy selected will have an impact on the level of costs and pricing.

FIGURE 1: KEY PRICING CONSIDERATIONS



Price components

The retail price of water consists of two building blocks: a regulated wholesale tariff plus a gross retail margin (see Figure 1). Ofwat control the gross retail margin by capping retail revenue per customer by customer type and in addition this margin is subject to competitive pressure which may push it below this cap.

In more detail, price consists of:

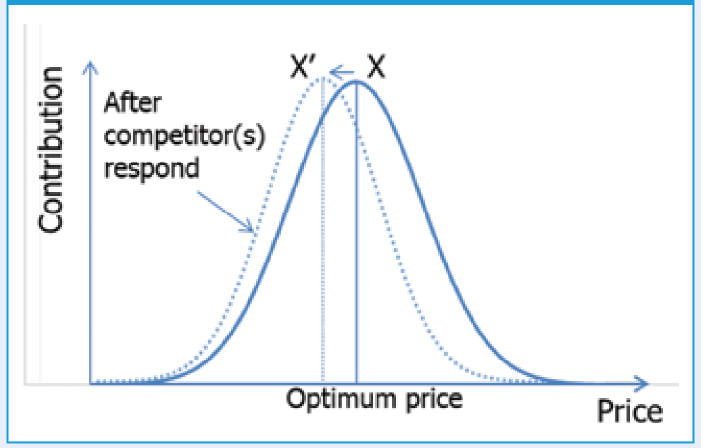
- ***Price** = regulated wholesale tariff (the largest cost component) +*
- ***start-up costs** (significant during the early years of the market) +*
- ***overheads** (tricky to allocate within a company which is both a wholesaler and a retailer) +*
- ***variable retail costs** (e.g. commission) +*
- ***profit margin** (Ofwat have set an overall net retail margin of 2.5% on top of the allowed wholesale and retail costs)*

Although there is much to learn from pricing best practice in related markets such as energy, there are a number of unique characteristics of the water market including the low value of the product, the regulatory cap on the net retail margin, and critically a regulated wholesale price that is transparent and is the same for all retailers. Therefore pricing is to recover start-up and overhead costs and to generate the target profit margin.

Competitive forces have a significant impact on the gross retail margin realised. High prices could be counter-productive if they lead to low volumes and hence low total contribution to set-up costs, overheads and profits. While it is clear that the shape of the price contribution curve is an inverted U (see Figure 2) the trick is to locate the optimum point X which maximises the contribution.

An important part of determining the optimum point is exploring the implications of different levels of pricing in a dynamic market. For while one retailer is seeking to determine and achieve this optimum, competitors will adjust their own pricing in search of their own optimum. It is here that multi-player game theory can help retailers to understand how competitors will react and optimise their plans. Thus if an important competitor(s) reduces price / improves the value of its offering then the curve shifts to the left (the dotted curve in Figure 2) and the optimum price falls (X' in Figure 2). The first retailer's pricing decisions should be influenced by how he thinks competitors will respond in a dynamic game.

FIGURE 2: CONTRIBUTION AND PRICE



Face the competition

Competitors can be categorised as:

- *Entrepreneurial entrants*
- *Incumbents*
- *Multi-utilities*

Each of these competitor types will have their own business model and approach to pricing; and will respond in different ways to changes in market prices and discovery of customer preferences.

In practice, the profitability of the retailers will depend upon how well they select and then execute their strategy as compared to competitors. Thus it is important to understand the policies strengths and weaknesses of competitors some of whom will compete on price and therefore pressure profit margins while others will focus on building market share.

Smaller entrepreneurial entrants will often seek to establish themselves by innovating with the introduction of disruptive new products and business models. New entrants are well positioned to establish a fresh new brand through, for example emphasising quality of service and customer focus. Entrants have an opportunity to leap-frog existing systems and move straight to more agile systems based on modern system architecture which are customer centric, and support rapid and accurate pricing so that profitable but discounted deals can be struck quickly.

Incumbents have the advantages of existing staff, systems and relationships but they also carry baggage in terms of culture, image and decision making processes which grew out of a regulated market and are not optimised for the cut and thrust of a dynamic, competitive market in which all business customers can switch supplier.

Experience in Scotland indicates that as the regulated wholesale price is the same for all retailers, competition will focus on quality of service, product design as well as the gross retail margin. While the basic services of water supply and sewerage disposal are reasonably standardised there remains opportunities to discount, package services in new ways and to provide value added services such as online monitoring, water efficiency and aggregated billing. This will be a key area in the battle for customers.

The third competitor, multi-utilities, will be seeking to provide bundled services including water and sewerage. The prospect of cost savings, increased market share, and other competitive advantages is prompting more and more utilities to cross traditional industry lines and offer services in several sectors. A number of energy companies are contemplating entering the water market and offering a bundle of services which spread customer relationship costs including billing over a number of services and make customers stickier. These multi-utility offers typically include discounts for customers who buy more than one product, e.g. water and energy.

Regulatory considerations

Ofwat is keen that the market is transparent and avoids unnecessary complexity for a number of reasons including encouraging entry into the market and competitive rivalry. Ofwat is making it easier to offer simple pricing across a number of water supply areas and for customers to compare prices and so have the confidence to actively participate in the market. Sensible standardisation of charges, especially for items generating limited revenue such as swimming pools, and pricing transparency will support the development of a successful vibrant market.

As part of consumer protection, Ofwat and Defra are also concerned about incidence effects and how they are managed. This important agenda is at the heart of creating a market which consumers trust and which clearly serves their needs. Incidence effects are where price changes cause customers to face bill increases significantly out of line with overall price changes. Where companies make significant changes to their tariffs, Ofwat requires that they carry out a proportionate impact assessment and develop a strategy for handling any resulting incidence effects.

Water companies also need to be aware of competition law and the requirement that there is no anti-competitive pricing. Competition authorities will particularly be looking for retail businesses having privileged access to information from a related water wholesaler.

The price is right

While no retailer likes to lose customers this is a normal part of a competitive market and will happen even with the optimum pricing strategy. Some customer churn is to be expected and should not be a cause for concern unless there is a significant net loss of customers or there is an unwanted negative trend in customer numbers or profitability. However, for a solely "in area retail business" which will start with 100% market share their customer numbers can only go down.

To be successful companies will have, among other things, to get their pricing right. This will be a key area of focus at market opening, and thoughtful analysis, focus on customers and agility will be required to come out on top. However, even when the market starts to settle down there will need to be continuing focus on prices to respond to customers and competitors. TWR

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