OCTOBER 2015

THE WATER REPORT

POLICY | REGULATION | COMPETITION

Express delivery

MOSL CEO Ben Jeffs sets out his plan for on-time central retail market systems implementation

COMPETITION WATCH

- CEO John Reynolds on Castle Water's English market ambitions
- Scots Government backs Anglian's public sector bid
- MEUC launches Water Market Policy Group to combine customer and supplier voices

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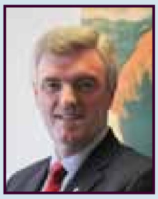

John Tierney
Managing Director
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Adam Cooper
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THE WATER REPORT COMPETITION WATCH

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Address: *The Water Report*, 68 Church Street, Brighton BN1 1RL
Publisher: Kew Place Limited

EDITOR'S COMMENT

Exception proves the rule

Prescription isn't generally popular these days. We live at a time when the regulator does not have a monopoly on ideas, when pretty much everything is discussed before draft proposals are issued and when companies are delighted to own the customer relationship. For many things, this approach makes sense. But in preparing for the competitive retail market, a bit more prescription for companies wouldn't go amiss.

Our interview with MOSL chief executive Ben Jeffs on p24-27 makes it clear that there are two sides to the coin in terms of getting the market ready to open by April 2017: MOSL must deliver central systems on time and companies must be ready to interact with them from day one.

For MOSL, the task ahead looks daunting but achievable – providing success is judged to be provision of a functioning market, rather than on how effective that market is. Given the aggressive timetable and budget constraints, we're likely to be talking about a bare bones delivery rather than bells and whistles. But with an accompanying post April 2017 release strategy, the market should be workable. (The fly in the ointment could be a change in requirements – but how this pans out remains to be seen).

For companies, delivery is looking less clean cut. MOSL will offer systems support on a company by company basis and looks likely to work up some kind of "heat map" showing firms their relative IT readiness. But without more prescription on what readiness more broadly looks like, firms may feel they are working in the dark.

On data in particular they are largely being left to it. MOSL isn't resourced to offer extensive help. And as those with experience in the – simpler – Scottish market will know, data quality there was a big issue. Castle Water chief executive John Reynolds highlights in our second interview on p28-30 that manual intervention because of garbled or absent data was commonplace in Scotland and this needs to be factored in to English plans.

Consensus seems to be building. We report on p23 that the MEUC has launched a new group which unites business customer and water supplier voices in common cause. Among its policy asks are a more proactive and prescriptive approach to company readiness; agreed national standards on customer eligibility; and standards on data quality – including agreement on master data sources and on meter location referencing.

So while prescription is generally out of fashion, for some elements of the retail market it could actually reduce risk and save companies precious preparation time.

Karma Ockenden, editor,
The Water Report

Feedback, comments and suggestions very welcome.

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

SECTOR SPLIT ON WHOLESALE MARKETS AND PR19 PLANS

The Water Report's Expert Forum finds majority support in principle for upstream markets but little consensus on the detail. Meanwhile, more PR19 wholesale controls, PR14 cost model continuation and the prospect of a move to CPI divide opinion.

This month, *The Water Report* asked its Expert Forum – leaders and opinion formers from in and around the sector – for their views on wholesale markets and PR19. This followed Ofwat's publication in the summer of a series of discussion papers which cast out for ideas on these issues ahead of regulatory proposals at the end of the year.

Our research, conducted by our partner Accent, suggests there is consensus in the sector on the challenges facing it and majority support for the concept of using markets more to help address them. But as soon as you start to talk detail, a far more fragmented picture emerges. The industry and its key stakeholders are not homogenous in their views. This suggests finding solutions which sit well across the board looks unlikely and that Ofwat will have challenging times ahead whichever way it turns.

Here we present our findings and selected comments from Forum members.

TWR EXPERT FORUM

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.

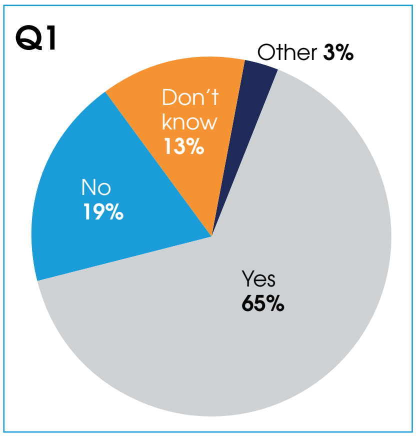
Group members are emailed surveys which should take no more than ten minutes to complete. Responses are treated as confidential. Findings will be reported in aggregate only and any comments used will be anonymised, unless members are happy to be identified.

The next Forum will take place in November for the December 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

Q1. In principle, do you support the introduction of competitive markets into the wholesale part of the water and wastewater value chain?

There was two-thirds support for competitive wholesale markets in principle. Those in favour tended to cite efficiency and customer benefit in explanation. Some supported the move assuming it is applied selectively and where benefit could be proven. Others said the case in favour of more markets was unproven and that policy should be founded on evidence. Others still pointed out that alternative approaches, those that are less risky and less costly, could be pursued to the same ends. Among Forum members' comments were these:

- "After many years of average regulation we now have a team at Ofwat who understand how to get great value for customers at the price reviews. The service levels of many water companies are way ahead of their energy counterparts and customers really benefit from stability in their prices. I have struggled to see where economic value will be created in competitive markets and fear that domestic customers will end up paying more for the privilege of competition."
- "The wholesale part of the chain is where the real value exists. Introducing competition (in principle) will help drive out inefficiencies and improve the services provided to end customers."
- "If it drives efficiency and improved customer services there is clearly a strong business case. However if it results in cutting corners in terms of investment and impacting negatively on utilities' decision-making and coordination on safety and the environment then the answer is clearly no. The challenge – and risk – is that we will not really know the impact until competition is up and running."
- "Where the markets are clearly contestable, and if access pricing can be set in a balanced way that facilitates efficient entry and allows incumbents to recover efficient costs, then there is merit in this policy. The test should always be to assess that the total benefits outweigh the costs of introduction."



Q2. Ofwat has identified the following wholesale areas as prospective early competitive markets. Do you support this move in each case?

Opening up sludge treatment and disposal functions attracted the support of nearly three-quarters of the Forum – a sound endorsement of the policy. Just un-

Q2	Yes	No	Don't know
Sludge treatment & disposal	71%	13%	16%
Water resources trading	61%	23%	16%
More competitive tendering of work in areas that remain monopolies	48%	19%	33%

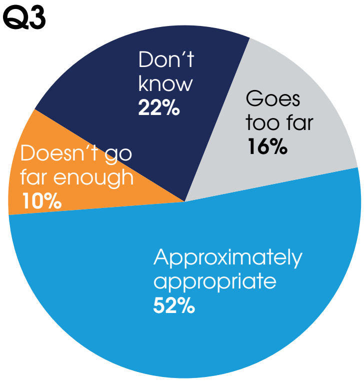
der two thirds supported water resources trading while tendering monopoly work out competitively was less popular, attracting support of less than half of respondents. Some suggested water resources trading could be pursued under existing policy arrangements though, and was not dependent on wholesale reform. For instance, one member said: "I agree that water resources should be developed in the context of a national plan not constrained by geographical boundaries. That said this can be achieved through the current Water Resource plans including a requirement for companies to explore all cross boundary opportunities."

On the subject of more competitive tendering, one participant raised this point: "This approach presupposes that incumbents don't have vigorous procurement processes and competitive processes around work that is contracted and subcontracted. It could be argued that competitive tendering at the level of large scale individual investment is sub-optimal in many circumstances."

Q3. In the round, do you think the extent of the wholesale markets ambition detailed in the previous question: goes too far; is approximately appropriate; doesn't go far enough?

Around half the Forum thought the suggestions put forward in Ofwat's summer papers are approximately appropriate, with the remainder completely split. Those who would like to see a more ambitious policy suggested among other things that water trading could be pursued more aggressively, and that water treatment could be opened up too. Lack of evidence of benefit and lack of detail were commonly cited by those who were either unsure or who felt the proposals go too far.

Q3



Among Forum members' comments were:

- "Government moves very slowly in introducing competition into the water market as they are worried about increasing bills and reducing service quality. Trading and valuing raw water should happen sooner."
- "I cannot see where value will be created outside of better central coordination of water resource plans."
- "It does not seems that the counterfactual (i.e. the situation as it stands today) has been sufficiently articulated against which alternative approaches have been assessed. Again there is a theme of lack of evidence-based decision making."
- "This should be a good start."

Q4. What do you consider to be an appropriate timescale for the introduction of wholesale markets?

This question attracted a very wide range of answers. Some Forum members were keen to see progress soon. One suggested within two to three years. Another said: "A successful implementation of the fully competitive retail market for non-household customers is the first pre-requisite. Establishing an appropriate RCV distribution among the elements of the value chain is the second. Both of these are eminently achievable in the next few years. The completion of abstraction reform would be advantageous but not essential – though in my view the timetable for this could be shortened considerably if the relevant parties would make key decisions instead of dithering." A third member commented: "A well-implemented strategy should be more important than a swift one, but there's no reason to delay stages. Sometimes a degree of urgency generates decisions more effectively."

Many suggested around 2020 would be the best time. This would have the benefit of aligning with the next price review cycle and of following on the heels of retail market opening. One member said: "Retail competition needs to be implemented first before the industry turns its attention to upstream markets. Given the short period of time between 2017 and the next price review, the more radical reforms may need to be tackled in the next period."

Some argued that the timing of introducing markets into water resources trading hinged on the abstraction reform timetable. For instance: "It would seem odd to introduce upstream reforms around water trading without first establishing abstraction reforms and the extent to which a genuine commodity price and market for raw water needs to exist. There is a real risk of unintended consequences if reforms are not sequential. Abstraction reform must come first." Likewise, another said: "Water resource trading needs to link to wider abstraction reforms."

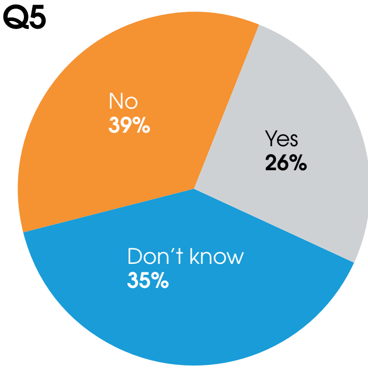
Others suggested reform should be progressed slowly, one citing implementation up to 2030 as an appropriate timetable. Another said reforms should be put in place "slowly and with time to reverse decisions if value creation proves to be elusive".

Of course those opposed to more wholesale markets in principle, or those currently unconvinced by the evidence for them, argued a timetable was not needed at all. This respondent made the case on cost grounds: "We need to explore less complex alternatives such as water resource management planning improvements including marketplaces rather than competitive markets as well as beefing up the right incentives. The level of complexity for the retail market is significant especially given in essence we are talking about call centres plus, and the same approach for wholesale with all the added complexity this brings is totally frightening. Alternative tools from the regulatory tool box need to be tested first; we need to initially chase the 80:20 benefits and contain the complexity."

Q5. Should Ofwat be optimistic that a position acceptable to investors can be reached on the allocation of RCV across the value chain as a result of competition being introduced into wholesale markets?

The result on this was a fairly even split, though even those who felt a solution on

Q5



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RCV allocation could be reached foresaw a difficult journey to get there. One said: “An acceptable position is possible but not a position that investors will be happy with.” Another remarked: “I think Ofwat underestimate the complexity associated with allocation of the RCV and the perverse incentives that may result should this be done inappropriately. I am sure it can be achieved but not without some difficulty.”

Others were unconvinced an acceptable position was achievable. One member said: “To date, there has been little convincing evidence on how this might be done. Whilst there could conceivably be competition over future investment, it is difficult to see how existing investment could be opened to competition without affecting investors’ perception of risk.” Another said simply: “I’ve seen no evidence that investors have found an acceptable position.”

A few Forum participants rightly pointed out that the question assumed RCV allocation would be necessary but in fact alternative routes are available. A few others pointed out that neither the investor community, nor the industry, were likely to be homogenous in their views. “Ofwat is of the impression that consensus around Water 2020 exists [in] the industry. Consensus exists around the understanding of future challenges and the need to evolve and consider how things could develop to achieve better outcomes. It is a leap for Ofwat to consider this consensus extends to solutions it may propose, particularly around the RCV.”

> **I am concerned that further separation will result in silo mentality which will fail to recognise the impact of one business on the other and at best synergies will be lost and at worst environmental deterioration will result.”**

Q6. Do you support the further separation of price controls in the wholesale segment?

Again the Forum was divided on this. The just under half who were supportive of further disaggregation of wholesale controls frequently cited cost revelation in explanation and that the move would be essential for more competition to be introduced. For instance: “Abstraction, treatment and transportation could be relatively separate activities and the separation would aid understanding of where value lies and prepare for any future competition.” Those opposed or uncertain cited a range of reasons, including the following:

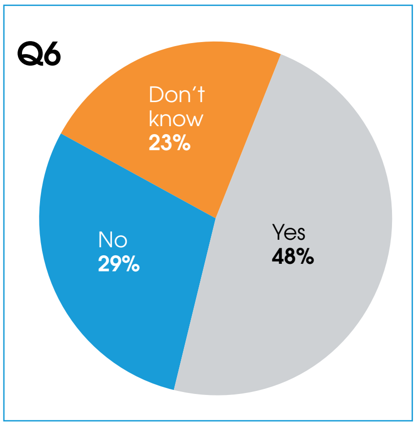
- “Again there is lack of evidence to demonstrate that a better outcome will be achieved by adopting this approach.”
- “I am concerned that further separation of the price controls will result in environmental detriment. Water and wastewater business are both intimately dependent on and connected with the environment. I am concerned that further separation will result in silo mentality which will fail to recognise the impact of one business on the other and at best synergies will be lost and at worst environmental deterioration will result.”
- “There is a real danger that further separation of price controls will lead to disaggregation of charges and unwind cross-subsidies far too quickly. While the winners will be pleased, the losers will create merry hell.”
- “Would like to see how the current separated price controls operate first before agreeing to further separation.”
- “While additional price controls can help to achieve specific narrow policy objectives, the proliferation of price controls is not the direction of travel that regulation in general should be travelling.”

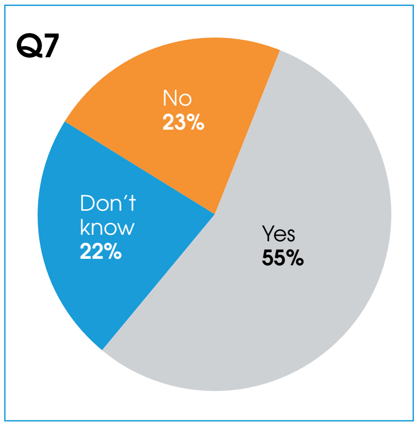
Q7. Ofwat has indicated it is minded to stick with the fundamentals of its PR14 cost models at PR19. Do you support this?

Just over half are content for Ofwat to stick with the fundamentals of its PR14 cost models at the next price review, either because they consider the models to be effective or because they value the continuity. From those opposed or unsure, there were multiple references to the Bristol Water CMA appeal (see report, p11), the complexity of the models, and the value of evolution.

Among Forum members’ comments were:

- “PR14 saw a substantive step change in the Ofwat approach. Better to let these changes ‘bed in’ than to introduce further changes without fully understanding the repercussions of those already made.”
- “There were some good aspects of the cost models, namely that they were totex based and allowed companies flexibility to set PAYG and run-off rates. There appear to be some serious issues with the econometric models though and it would perhaps be wise to review the modelling approach taken for PR19.”
- “Bristol Water case and some of the findings of the CMA/CCW could indicate that a broad brush isn’t necessarily appropriate.”
- “Ofwat should accept that adjustments are part of the cost modelling process and not see them as a failure of the model or a bid by companies.”
- “Standard models used at PR14 did not take enough account of local circumstances.”
- “It seems to have worked and predictability is good for effective regulation.”
- “Whilst the approach of using independent totex baseline models is sound, it is likely that these will have to be based on base totex (opex and capital maintenance), with enhancement dealt with separately (as per the CMA approach).”





Q 8. If there was an attempt to move away from RPI indexation to an alternative such as CPI, how would you expect English & Welsh water companies and their investors to respond?

Sentiment on this issue was in the round more positive than might have been expected. A good number of respondents indicated they believed moving away from RPI indexation, while difficult, would be the right thing to do. Examples include: "I think they will be alarmed as RPI invariably provides greater returns than CPI. However, Ofwat is right to explore this option. No regulator – or industry – should stand still." "Companies have had a beneficial period of easy RPI outperformance, keeping the gains for the most part. CPI would create a tougher environment, but ultimately a fairer one for customers." "As is the usual trend, there would be an initial outcry that would eventually fade. On an infinite timescale, the industry will eventually switch away from the current RPI index."

For others, even the uncertainty of a possible change is damaging and the reality of a decision to move from RPI would be unacceptable. Comments here included: "Investors would seek alternative investments." "CPI is generally lower than RPI so neither companies nor their investors will be happy about this. I would expect some companies to challenge this direction strongly." "The link to RPI indexation has been a fundamental element of water company regulation and as such companies financing and investor expectations have also been based on this – a move from such a position may undermine faith in this regulated industry and cause mis-alignment for those companies with high RPI indexed linked debt."

Finally, there are those who argued the key issue would be how any move to CPI was handled. Comments made here included:

- "If CPI indexation were introduced for customer facing bill increases, but RPI retained for RCV indexation, investors' views of increased risk are likely to be minimised."
- "It depends on the surrounding assurances around NPV neutrality."
- "It would need careful handling and consultation. If past debt is untouched and there is a clear market for CPI debt, it might be ok."
- "The issue is not so much the change in the underlying index but the process of reconciling the cost of moving. Ofwat have indicated an adjustment to the WACC as a potential solution but this would need to be reflected in customer bills."

"There would be an initial outcry that would eventually fade. On an infinite timescale, the industry will eventually switch away from the current RPI index."

This suggests that, should a move from RPI to CPI ever be undertaken, Ofwat has an opportunity to smooth the path – if it handles the situation well. TWR

DEBT INVESTORS UNFAZED BY MORE MARKETS – FOR NOW

No knee-jerk reaction to wholesale market prospects in Moody's latest sector outlook, but a storm may be brewing – especially for the highly geared.

Investors do not appear to have been unduly spooked by the first mention of more competition in wholesale water markets, judging by a UK water sector debt report issued by Moody's at the end of September. The ratings agency maintained its stable outlook for business conditions over the next 12 to 18 months.

This followed Ofwat's publication in summer of discussion papers dealing with PR19 plans and upstream reform – specifically (but not limited to) sludge and water resources markets, and greater use of competitive tendering for asset build. However, regarding the medium term and beyond, Moody's raised some important warning flags about the possible impact of wholesale reform – particularly on highly geared companies.

WATER COMPANY RATINGS AND GEARING, AT MARCH 2015

Company	Rating	Net debt/ RCV
Severn Trent Water Ltd	A3	72.2%
United Utilities Water Ltd	A3	61.9%
Wessex Water Services Ltd	A3	73.6%
Dwr Cymru	A3	59%
Affinity Water Ltd	Baa1	77.9%
Anglian Water Services Ltd	Baa1	82.7%
Bristol Water Plc	Baa1	69.6%
Dee Valley Water Plc	Baa1	72.8%
Northumbrian Water Ltd	Baa1	78%
Portsmouth Water Ltd	Baa1	71.8%
Severn Trent Plc	Baa1	68.6%
Sutton & East Surrey Water Plc	Baa1	75.7%
Thames Water Utilities Ltd	Baa1	83.9%
United Utilities Plc	Baa1	57.2%
Southern Water Services Ltd	Baa2	83.2%
South East Water Ltd	Baa2	82.9%
South Staffordshire Water Plc	Baa2	66.6%
Yorkshire Water Services Ltd	Baa2	83.1%
Anglian Water (Osprey) Financing Plc	Ba3	88.8%
Thames Water (Kemble) Finance Plc	B1	89.6%

Source: Moody's

Stability and risk

The 2015/16 stable outlook is a result of achieved returns for the regulatory period to the end of March 2015 being broadly in line with regulatory assumptions and, while regulatory allowances for 2015-20 are challenging, they are in line with expectations. Moody's commented: "While companies will have less scope for operational or financial outperformance, we anticipate they will manage their financial and dividend policies to maintain credit quality. Recent covenant changes on the back of modifications to the allowed revenue calculation have not materially altered the highly-leveraged companies' credit profile over the current period."

Nor is the increasingly imminent opening of the non household retail market of much real concern to the ratings agency. It said: "With non-household retail services accounting for only 1-2% of companies' consolidated revenues, competition in this area will not significantly alter the UK water sector's credit risk profile."

But looking ahead to prospects for upstream reform after 2020 and other potential regulatory policy changes, Moody's cautioned investor confidence must be maintained. It pointed out: "While the sector has seen significant evolution since privatisation and remains attractive to investors, any fundamental changes may erode the value proposition."

Two issues stand out:

- RCV protection and allocation. Moody's commented: "We note Ofwat's commitment to 'protect' the RCV as at March 2015, which has been reiterated in its July papers. However, the regulator clarifies that its commitment applies to a net RCV, adjusted for ongoing depreciation, i.e. effectively declining over time at the companies' chosen run-off rate. For any RCV added from 1 April 2015, Ofwat will likely apply a more flexible approach, taking into account the detailed allocation of any totex during AMP6 (and beyond) to different parts of the wholesale value chain."
- Inflation benchmark change from RPI to CPI or alternative. Moody's: "On average around half of the sector's debt has been raised through RPI-linked debt, and a mismatch between RPI-linked debt service and CPI-linked returns could put pressure on financial metrics during the transitional period."

Higher risk for highly geared

Highly-leveraged water companies (see table) are most at risk from both lower returns in AMP6 and ongoing reform. The ratings agency noted that about half of the industry's RCV is locked into highly-leveraged and covenanted financing structures. "When these structures where put in place, companies' management and arrangers of finance did not envisage material changes to the industry configuration, which means that the affected companies may face challenging negotiations with creditors under certain circumstances as the industry structure evolves."

Moody's observed also that Ofwat has consulted on a new financial monitoring framework for the sector, designed to explain companies' financing arrangements and highlight any potential risks that these may entail. From March 2016, the regulatory also envisages companies will stress test their business plans and publish the results to illustrate available financial headroom against downside scenarios.

Moody's comments: "Ofwat may want to encourage consistent reporting across companies. Also, any potential divergence in ratio definitions from companies' financial covenants (where relevant) may benefit from additional explanation to avoid unnecessary confusion for investors. Financial covenants restricting dividend distributions may also influence companies' results under proposed stress tests, which needs to be taken into account before drawing any conclusions." TWR

ROSS SEEKS MORE FOR LESS IN SENIOR SHAKEUP

The positions of Ofwat lynchpins Sonia Brown and Keith Mason to go as flatter PR19 leadership structure sought and new Tideway role created.

As part of a plan to deliver more for less in the face of a tight budget and ambitious work programme, Ofwat chief executive Cathryn Ross has proposed a shakeup of the regulator's senior leadership team. Her plan, open to internal consultation until 28 October, would see less reliance on individuals and a more flexible team structure within which senior leaders would have programme or functional responsibilities, but would also be expected to have competencies that could be called on as needed.

The changes are set out in the box. Two key roles, which the organisation has lent heavily on in the past, are earmarked to go: chief regulation officer (CRO) and senior director of finance and networks. Ross said of the CRO: "While this role made sense during PR14, and the CRO was given a position that enabled her to provide strong leadership… the role is problematic in the post-PR14 Ofwat. It creates an apparent hierarchy within the team (CRO above senior directors) but without clarity on what that hierarchy means in practice… It is also not clear how a higher status CRO role would fit with the various roles that the senior leadership team need to perform."

Suggesting a desire to smooth out this power base and distribute its responsibilities more widely, Ross has proposed PR19 will be delivered by a team of four: herself and those in new senior director positions for Water 2020 and finance and governance, together with the strategy and planning senior director. Whether in reality a first among equals surfaces nearer the time of PR19 delivery remains to be seen.

Ross intends to effectively split the finance and networks role into two positions: a senior directorship for finance and governance, reflecting a growing appetite for market intelligence, regulatory reporting, assurance and stakeholder engagement; and a senior directorship for Thames Tideway. Dedicating a leader to the latter (a role expected to last two years) is an acknowledgement of the high profile and contentious nature of the project, and reflects a desire to embed learnings from the work for possible application to other new build infrastructure. Asked where the routine engineering function will sit, Ross said staff with these skills would be spread across the organisation and be deployed on specific programmes as needed.

Posts and people

She stressed the changes are about "posts not people". But given the depth of experience and respect afforded to both CRO Sonia Brown (who delivered a successful price review in very adverse circumstances) and finance and networks director Keith Mason, it is hard not imagine their loss would be difficult for Ofwat – particularly as it would come fairly hot on the heels of other high level personnel changes.

Ross said Brown and Mason "are immensely valuable people for the organisation and the industry" and would have priority in applying for vacant positions, should they want to. She added that the regulator's talent was more widely spread though, and that she was confident of a good outcome: "We are incredibly lucky in the calibre of people we have across the organisation, the good depth". The three new positions (Water 2020, Tideway and finance and governance) as well as the strategy and planning post are available. David Black has been holding the fort in the Water 2020 role, so may reasonably be expected to at least be in the running for that.

In explaining her choices, Ross was frank in admitting Ofwat had "significant shortcomings in the current team structure and roles and an undoubted insufficiency of bandwidth in key areas" including leadership capacity, strategic thinking and depth of understanding of economic regulation. On top of that, Ofwat's future looks increasingly complex. Its bread and butter economic regulation role could well end up featuring more price controls; it needs to steer a path through retail and upstream reform; and it has set itself a challenge that pushes at the boundaries of traditional regulation in seeking to foster trust and confidence in the sector.

All the while its budget has shrunk and the Comprehensive Spending Review looms. On paper, the shakeup is cost neutral (both the current and the proposed structure come in at around £6m over the 2015-20 period; the forecast suggests higher staff costs associated with the changes will be cancelled out by removal of the need to pay an external programme director for PR19). But Ross is clearly looking to get more for less out of her top tier team. "We do need to get the best out of everybody," she said, adding: "There is a premium on great quality leadership…this is an investment in the entire organisation."

Few would argue with the case for change; how well the new arrangements work will depend on the calibre of recruits and whether the structure can in reality deliver as planned in the face of the heavy demands that will be upon it. TWR

Jonson Cox's three-year term as Ofwat chair comes to an end on 31 October. He looks set to be reappointed for another three year term, although there is the possibility of an additional two year extension.

THE NEW FLAT STRUCTURE

Ofwat's existing eight-strong senior leadership team will become nine.

Remaining in place are the CEO (Ross) and general counsel positions (Elizabeth Hillman), and the senior directorships for corporate communications (Nick Gammage acting as interim for Claire Forbes), strategy and planning (vacant), and customers and casework (Richard Khaldi). The operations directorship will be rebranded business improvement (retained by Bev Messinger), reflecting a sharper focus on supporting continuous improvement.

The chief regulation officer position and the senior directorship of finance and networks will go (see main story) and new appointments will be made for the senior director roles of Water 2020, Thames Tideway, and finance and governance.

Ross said the new flat structure and the sentiment behind it was "not a dictatorial leadership model, but empowering".

NO PREJUDICE, NO REMEDY

Draft CMA ruling clears Pennon's takeover of Bournemouth Water unconditionally.

Pennon looks set to emerge unscathed from its trip to the Competition and Markets Authority (CMA) over its April purchase of Bournemouth Water for £100m. Under a provisional ruling, the company will not have to cut customer bills, divest any of its business or perform any other remedial actions to compensate for the deal.

The CMA found the tie-up would result in adverse impacts, but that these were "not significant enough, either individually or in combination, to amount to prejudice to Ofwat's ability to make comparisons between water enterprises under the Enterprise Act 2002 (the Act)". It noted this effectively ruled out the imposition of remedies: "We are mindful that in the absence of a finding of prejudice to Ofwat's ability to make comparisons between water enterprises, the CMA is unable to consider the question of remedies."

During the case, Ofwat did not oppose the merger, but its submission all but demanded remedial action from Pennon to offset what it deemed to be the detrimental impact on its ability to make industry comparisons from the loss of Bournemouth as an independent comparator. This was particularly acute because of Bournemouth's sterling performance in a number of areas. Throughout, Pennon was robust in its assertion that far from causing detriment to Ofwat's abilities to make comparisons, its takeover of Bournemouth would in fact benefit the wider regulatory regime to the tune of £43-50m.

The CMA came to its conclusion after examining the following areas.

- **Wholesale price controls:** the Authority scrutinised whether the merger may result in a reduction in the precision of Ofwat's modelling through reducing the effectiveness of its comparisons between water companies' efficiency levels (the precision effect) and whether the merger may lead to the loss of a particularly valuable comparator which harms its ability to set a demanding efficiency challenge for the rest of the industry (the benchmark effect). It found there would be some adverse impact on wholesale price control setting, but that the impact would not be significant.
- **Retail price controls:** Ofwat told the CMA that it was unlikely to use an 'average cost to serve' measure in the next price determination but would likely replace it with an 'efficient cost to serve' target (for example, upper quartile or at the frontier). However, the authority scrutinised the retail impact of the deal, given the importance of comparisons would remain, irrespective of where Ofwat choses to set the benchmark. The CMA said: "We undertook our analysis using a range of assumptions on how the current poorer performing water companies are likely to converge to the performance levels of the top performers. We find that the merger is likely to result in a more stringent price control (that will benefit customers). We therefore provisionally find that the merger is unlikely to result in an adverse impact on Ofwat's ability to set household retail price controls."
- **Outcome Delivery Incentives:** the CMA scrutinised the areas where Ofwat deployed comparative analysis in the wholesale water control at PR14: supply interruption duration, water quality contacts, and mean zonal compliance. A merger could affect these because the combined company would report its ODIs together, which could affect the outcome of benchmarking, and as such may lead to water companies receiving a less demanding determination. The investigation did not find any adverse impact resulting from the merger on mean zonal compliance. It found on the other two measures: "Allowing for some convergence in performance of the bottom-performing company closing 35% of the gap to the upper quartile by 2020 for water supply interruptions and closing 50% of the gap for water quality contacts, suggests that the scale of the potential detriment (which would be within PR19) is around £23 million in total (over five years)." However, given mitigating factors including the continuation of separate reporting for PR14, it was not persuaded that the adverse impact was likely to be significant.
- **Service Incentive Mechanism:** Bournemouth has been a consistently good performer under the SIM. Ofwat submitted that the company had performed well on the SIM since 2011/12 whereas over this period Pennon's South West Water had been ranked below the upper quartile. CMA analysis found the merger would result in the removal of a high-performing company with a resultant detriment to customers of around £6 million over three years. However, taking mitigating factors into account, it found this figure reduced to only £1.9 million over three years.
- **Best practice:** Ofwat uses comparisons between water companies in informal, qualitative terms – for instance, for ongoing monitoring. The CMA concluded the loss of Bournemouth would not result in an adverse impact regarding Ofwat's ability to encourage good practice or assess qualitative aspects of submissions made by water companies during future price reviews.

The CMA welcomes responses until 21 October. As might be expected, Ofwat confirmed it would be making a representation. The final decision is due by 22 November. TWR

RELAXING THE RULES

The CMA last month opened a consultation on draft water mergers guidance following changes to the special water merger regime in the Water Act 2014.

The Act removes the need for all water mergers to be automatically referred for an in-depth phase 2 investigation. It gives Ofwat a statutory role in a phase 1 investigation and in line with the general merger regime, gives the CMA the power to accept undertakings in lieu of a reference to a phase 2 investigation.

The new draft guidance explains the arrangements and how the CMA will approach its assessment of water mergers. This includes what procedures the CMA will follow and the approach it will take for the analysis. It also explains how the CMA and Ofwat will work together in the new regime.

DEFRA expects to commence the changes to the special water merger regime next month.

CMA HOLDS ITS LINE ON BRISTOL

The final price determination offers a slight improvement for Bristol and leaves questions for both company and regulator.

The Competition and Markets Authority (CMA) earlier this month issued a final determination for Bristol Water that was a mild improvement on its provisional findings, but which will no doubt leave the company with a settlement it considers difficult to live with.

As the table shows, the crucial wholesale totex number remained flat from the provisional ruling, though this comprises a slight fall in base expenditure and a slight rise in enhancement expenditure.

The CMA said Bristol had provided evidence to support a £3m rise in the opex number it allowed at the draft stage. On capital maintenance, the competition body said an efficient level of infrastructure renewals expenditure was in a range of £68–£72 million, up slightly from the £65-£70m in its provisional findings. Its allowance for non infrastructure remained approximately flat in the £49–£69m range.

Southern Resilience gain

There was some movement on the details of allowed enhancement expenditure. The CMA stuck by its earlier decision not to allow any funding for Bristol's proposed new Cheddar 2 reservoir. Along with disagreeing with Bristol's business plan case for the new resource on demand grounds, the Authority snubbed its argument that customers backed the plan. It said: "Bristol Water had not provided sufficient evidence to demonstrate that immediate investment in Cheddar 2 was necessary to achieve the resilience objective, or that customers would be willing to pay higher bills to finance this increase in security of supply."

Likewise the Authority stuck by its interim plan to knock back the company's proposed £20.8m investment in a new works to cope with raw water deterioration at Cheddar reservoir, instead allowing £1 million for further investigation and minor works.

There was brighter news for Bristol though on the Southern Resilience scheme. The provisional deal found Bristol had partially demonstrated its case but demanded further justification for a service reservoir with a substantial capacity and in the location proposed. The CMA this month said: "In response to our provisional findings, Bristol Water provided further evidence that a service reservoir was necessary, at a different location to that in the original scheme and slightly less expensive than initially envisaged. We agreed that this reservoir was necessary, and we allowed £27 million for the Southern Resilience scheme, the revised amount requested by Bristol Water."

In addition, the CMA reported: "Our review of smaller enhancement projects totalling £60.6 million were all allowed in full. In our provisional findings, we had decided to place an efficiency challenge on the asset reliability scheme, reducing this scheme from £10.2 million to £9.54 million. However, Bristol Water provided further evidence and we accepted the cost of the scheme in full."

Financeability

The CMA allowed a small uplift to its interim 3.65% cost of capital figure to 3.67%. It found that the total allowed wholesale revenue for this five-year period should be £469.9 million, which when retail income is adding in results in a total revenue of £534.7 million. The average annual bill was up just £1 from the provisional figure to £160.

The Authority was confident its settlement left Bristol financeable: "We assessed the impact of our determination on the financeability of Bristol Water. We considered that the assumptions we used (including a depreciation of new assets of 3.7%, RCV run-off of 6%, PAYG rate of 55.3%, wholesale WACC of 3.67% and gearing maintained at 62.5%) resulted in a determination under which Bristol Water was financeable and which fulfilled our statutory duties."

Response and implications

Bristol formally looked on the bright side, welcoming the small improvement in the settlement in the round and specifically the Southern Resilience shift. Chief executive Luis Garcia assured: "It has been worthwhile going to the CMA as this is an improved outcome that we are confident will better serve Bristol Water's customers by allowing us to maintain our network and invest in essential improvements."

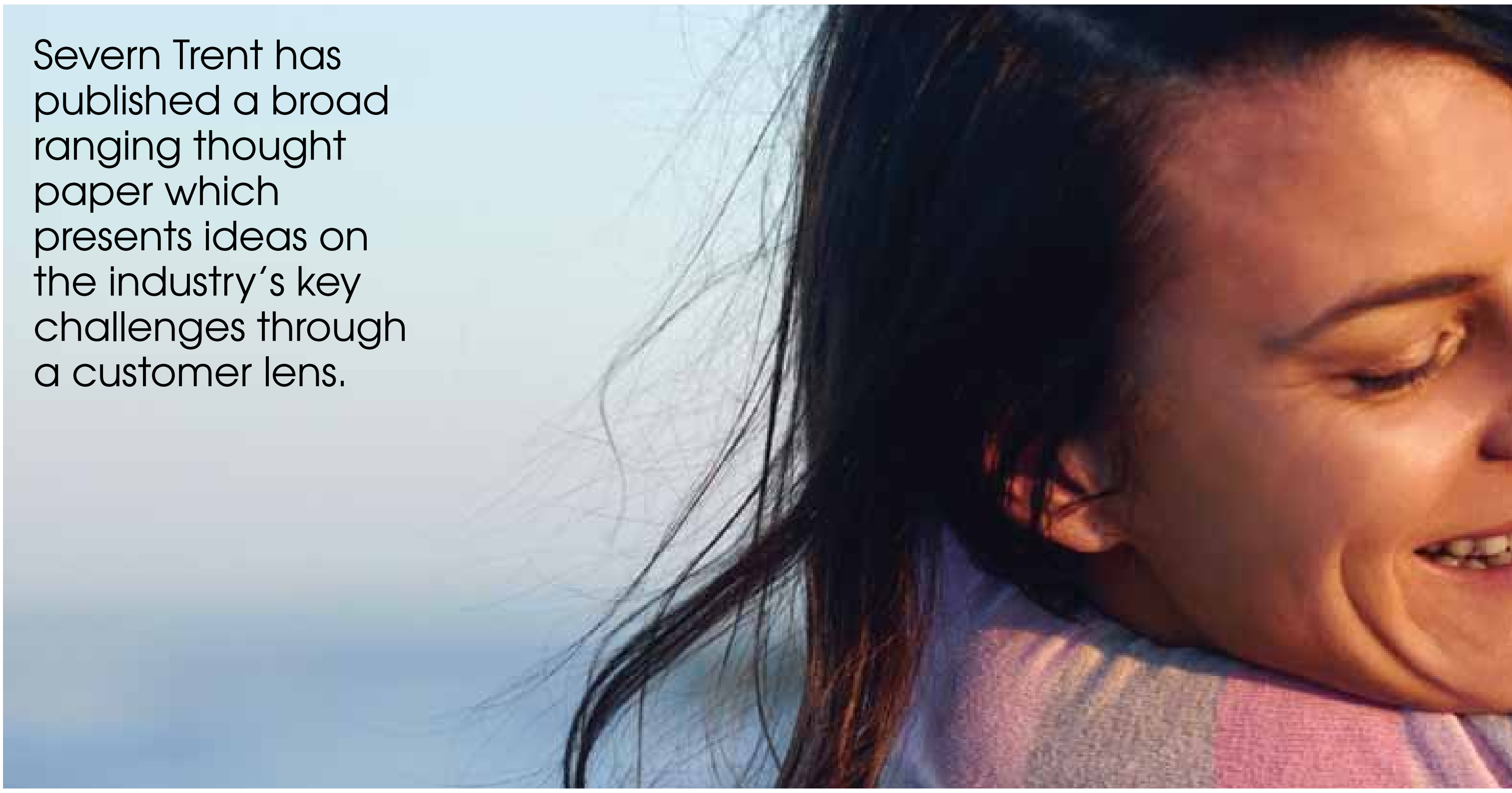
Ofwat called the outcome "an excellent result for Bristol Water's customers" and pointed out: "It is now for Bristol Water to challenge itself to improve, and look closely at the way that it runs its business in the future. It needs to deliver a much more efficient service, at a lower cost whilst ensuring that it keep its customers at the heart of its decision making."

For both parties, the closure of the case leaves unfinished business. When the CMA's provisional findings were announced, regulatory director Mike King said: "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." How Bristol lives with a very similar final determination remains to be seen.

For Ofwat, the CMA's views on the inadequacy of its PR14 cost models seems to need addressing – particularly as Ofwat intends to stand by the fundamentals of these models for PR19. The CMA's views have prompted others to question continued use of the models, as we report on p6 (see Q7). TWR

BRISTOL'S PRICE APPEAL – THE KEY NUMBERS

	Bristol business plan	Ofwat final determination	CMA provisional	CMA final
Wholesale totex	£537m	£409m	£429m	£428.6m
Base expenditure	£385m	£318m	£346m	£340m
Enhancement expenditure	£152.3m	£91.2m	£83.1m	£88.6m
Average annual bill	£187	£155	£159	£160
Cost of capital	4.37%	3.6%	3.65%	3.67%



Severn Trent has published a broad ranging thought paper which presents ideas on the industry's key challenges through a customer lens.

EMBRACING THE FUTURE

Severn Trent has long been active in the debate on water reform policy. In 2010 it published its first *Changing Course* paper, which called for a financially and environmentally sustainable approach to be taken to future developments. It subsequently published three follow up papers under the *Changing Course* banner. These dealt with water trading, sustainable financing and Water Framework Directive implementation.

In its latest contribution to the debate, the company has referenced its *Changing Course* series but opted for a different title: *Charting a Sustainable Course*. This reflects a slightly different approach; one that is less prescriptive on solutions and more in keeping with the spirit of ideas-sharing Ofwat is keen to foster. Director of strategy and regulation Tony Ballance comments: "We are keen to share ideas, to work collaboratively and to build consensus."

The content of *Charting a Sustainable Course* is wide ranging, dealing with a great number of issues the company identifies as important if the sector is to continue to provide a high quality water supply for a growing economy while sustaining the environment and keeping prices affordable. It puts forward policy suggestions for further consideration on subjects as diverse as expanding the role of water companies on flood defence, safeguarding against financing risk rises, preserving existing charging structures, exploring scarcity pricing, empowering customers and expanding the use of markets.

The thread that runs throughout is the primacy of the customer and the crucial role of the water company in delivering for the customer. The document considers the following six key policy areas.

Empowering customers

Severn Trent praises the progress made on customer engagement at PR14 but questions the extent to which company plans truly reflect customers' choices. It advocates building on achievements to date by attempting to find out, openly, what customers really want and then act on it. Ballance does not see any major difficulty reconciling this customer-led approach with political or regulatory preferences on prices. "Intuitively, if the policy back-

drop is that affordability is an issue, customers aren't going to say 'put our bills up by £20'."

The company believes genuinely reflecting customer choices in business plans will necessitate moving away from reliance on stated preference research. Instead, companies will need to gather evidence on customer preferences through a range of channels including analysis of company data, revealed preference research, and innovative approaches. It cites as an example of the latter an interactive digital app it used during PR14 which enabled customers to alter a range of variables (for example, leakage and metering) using a slider tool and immediately see the bill impact.

Ballance comments: "It's difficult, as customers tend not to want to engage too much. But we could milk more from our existing data; we could take key data points from Twitter; we can do better research. Our experience engaging on the Birmingham resilience issue was instructive. That was a low probability, high impact event, but customers did get engaged."

In terms of the policy framework to make this happen, the company believes better informed customer challenge groups should be empowered to play a bigger role in the price setting process. Key to making them better informed will be early and active engagement between the groups and Ofwat, in much the way WICS provided information to and engaged with the Customer Forum in Scotland during the recent Strategic Review of Charges.

Ballance says: "Interesting things have been done in Scotland – and elsewhere. We want to see that explored further. With more interaction from the regulator, on matters such as comparative efficiency, finance and cost of capital, the groups could be used to better effect." He points out this is not advocacy of a full negotiated settlement: "If I were in Ofwat's shoes, I'm not sure I'd see the benefit of a full negotiated settlement: comparative competition is enshrined in the sector, and customers would have to interrogate a complicated plan. But a halfway model may be attractive."

Specifically, Severn Trent suggests customers should have more freedom to choose the package of prices and services they want, rather than being forced to pay for what the regulator deems efficient costs and Outcome Delivery Incentives (ODIs) set according to an industry-wide upper quartile service level target. The report observes: "Although this is helpful in defining a single benchmark for price and service, it can remove customer choice from the equation. Under the current structure, if customers wanted a lower service package in exchange for a price reduction, then the water company delivering that package would be seen to fail as it would miss its ODI targets. Hence there is a disincentive to deliver the package of service and price that customers may really want. Not all customers should be necessarily compelled to pay for upper quartile service if they would prefer to trade a lower level of service for a lower price."

The diagram shows an example of how packages that are higher and lower than the price review determined package could be offered to CCGs in future.

Affordability

Companies got the affordability message during PR14 and responded by proposing flat or falling bills. Severn Trent believes it is imperative that bills remain affordable going forward and notes the low interest rate environment that provided a backdrop to the last price review will not always be there. It advocates a three-pronged approach: keep average bills affordable; preserve existing charging structures; and provide additional help where it is needed.

On the first point, the company cleverly highlights the role efficient financing costs play in not overburdening the customer purse. It takes the opportunity to bring up two key investor concerns arising from Ofwat's latest Towards Water 2020 policy papers – allocation of Regulatory Capital Value (RCV) along the value chain and a move away from RPI indexation – and to emphasise the possible customer impact. *Charting a Sustainable Course* points out: "…not unbundling company RCVs…and continuing inflation indexation for RCVs and prices – would allow confidence in the sector to be maintained for the benefit of customers."

Ballance says: "On moving away from RPI, the view from investors is that it would be very difficult for Ofwat to do without negatively affecting their confidence in the sector. RCV allocation at the moment is less of an issue but if Ofwat pushed it, they would find a similar view." He accepts the case for looking at costs more transparently and at a more granular level, but cites Oxera's paper for Severn Trent (submitted as part of the "mar- >

PRICE/SERVICE PACKAGES EXAMPLES

The package of lower service, lower price may for example allow a higher level of leakage and more interruptions to supply than today – compensated by a lower bill.

Future package 1		Today's package		Future package 2
Lower service Lower price Average bill £306	←	Upper quartile costs and service Average bill £316	→	Higher service Higher price Average bill £327
Change to service package - 10% Change to bill - 3.2%				Change to service package + 10% Change to bill + 3.5%

ketplace for ideas" hosted on Water UK's website) which argues RCV does not need to be allocated to get access prices right. On RPI he adds: "The evidence is strong. I can't see why we need to change this now. The government is still issuing RPI-linked gilts and the CPI market is not there."

On other affordability matters, Severn Trent urges that the benefits of existing water charging structures should be recognised and enhanced, and that tariff policy development should be "evolutionary and incremental, in line with the wider set of policy objectives". This issue relates to the possible deaveraging of regional prices as cost reflective access pricing is considered. The company argues stability of regionally averaged end user charges can be reconciled with de-averaged access prices through the choice of access pricing methodology. Ballance cautions: "The desire to better reflect cost is good, but we need to be careful how far one wants to pull that piece of string. There are huge subsidies in the industry. One sure way to destroy trust would be to unwind them."

Severn Trent also makes the case for companies to lead on securing socially desirable outcomes through charging policy. It does not want government- or regulator-mandated action on social tariffs. It also acknowledges site area based surface water charging has been challenging where it has been introduced, particularly for voluntary organisations who have seen radical changes to their bills. It calls for concessions where appropriate: "Customer support and the sensible management of negative bill impacts through transitional arrangements ought to be the guiding principles for extending site area charging."

Water resource resilience

While individual water companies measure and plan for resilience, there are no common metrics and no coordinated national picture. *Charting a Sustainable Course* suggests the government or regulator should lead a collaborative effort to establish common resilience measures. This is a rising theme in the industry (see report, p18). Severn Trent suggests: "The existing ODIs could be used as a starting point to develop a small basket of measures that reflect key aspects of water and wastewater service provision, with the addition of further forward-looking and capability building measures."

"We need to be careful how far one wants to pull that piece of string. There are huge subsidies in the industry. One sure way to destroy trust would be to unwind them."

In line with its customer centric approach, the paper argues local resilience standards should be determined by local customer choice. The exception is for critical national infrastructure, where it supports the adoption of the common standard identified in the Pitt Review across all sectors (a minimum of one in 200 annual probability for flood hazards.)

Severn Trent goes on to argue water companies should retain accountability for supply/demand planning in an upstream reformed world, and that water efficiency should be a planning condition.

Flooding and drainage

The report's big idea here is that water companies could be empowered to play a greater role in managing, operating and funding flood defences. Severn Trent lists the following advantages of this route:

- **Access to capital:** water companies are low risk and enjoy a low cost of debt. This would enable further flood defences to be constructed at an efficient cost.
- **Experience in delivery:** water companies have to deliver significant capital programmes within tight timeframes and cost constraints. This private sector discipline would help keep project delivery risks low.
- **Asset maintenance:** flood defence maintenance has been an area where the Environment Agency has been subject to criticism over a number of years. Water companies have a track record of managing assets and could be well placed to manage another class of assets.

Ballance explains extending the familiar RCV model to flood assets is definitely worth further exploration. "It's certainly one of the potential options," he says. "It's been looked at before but given current public expenditure pressures, it is well worth revisiting."

Elsewhere in this area, the company gives its backing to some long running industry wish list items: for companies to be statutory consultees in the planning process; for the automatic right to connect to sewer to be removed; and for policy clarity on the adoption and maintenance of sustainable drainage systems. It also backs exploring opportunities to make better use of surface water through, for instance, water sensitive urban design projects.

Environmental improvement

Severn Trent notes the dramatic improvements in river and bathing water quality delivered on the back of water industry investment over the past two decades, and states its commitment to deliver more. But it argues environmental legislation should be implemented in a way that delivers improvements while also keeping water bills affordable. It notes the slow and patchy progress of Water Framework Directive implementation and recommends: "We think that it is appropriate to debate the pace and scale of WFD implementation. In particular the feasibility gap in meeting the overall target needs to be discussed further, along with the pace and scale at which good status is achieved."

Like the wider industry, the company calls for other sectors make a proportionate contribution to environmental improvements. Diffuse pollution is the thorniest issue. The report offers the following three action priorities:

- Support of Common Agricultural Policy reform, so existing funding is re-prioritised to help farmers make environmental improvements.
- Prevent pollutants from entering water courses, through banning some pesticides, or introducing an environmental impact levy on them.
- Product labelling for consumers to show environmental impact, and/or the cost of removing the harmful products from the environment. This would allow consumers to make a clearer, more informed choice.

These come on top of catchment management work the company is already progressing with farmers and other landowners. A key project has been to establish the first metaldehyde free catchment. Farmers around Staunton Harold Reservoir were offered incentives that encouraged them to switch to ferric phosphate, a water friendly alternative to metaldehyde-based slug pellets. The scheme will be rolled out in other catchments in the Derbyshire/Leicestershire area over the next five years.

Separately, *Charting a Sustainable Course* urges abstraction reform be progressed at the earliest opportunity. Of the two options originally consulted on, Severn Trent prefers the "current system plus" model – largely on a speed of progress ticket. According to Ballance, "the key thing now is that we make progress". The diagram shows the current timeframe earmarked; it will be well into the 2020s before new approaches and systems are in place.

Finally in this area, Severn Trent takes the bold step of raising the prospect of scarcity pricing in the long term. This is an issue that is generally considered unpopular and politically difficult, so is often bypassed in favour of easier demand side options. But it is one that needs exploring.

The report explains: "The government's reform proposals on abstraction – under either option – will be designed to improve the link between what we pay for abstraction and the actual volumes taken. This reform is long over-due. Further beneficial reforms will be to take account of the reliability of an abstraction need and to charge less to abstractors who return more water to the environment."

Higher abstraction costs for water companies could be channelled through end user tariff structures that are designed to reveal the value. The report continues: "In time, the way in which companies charge customers for water could more closely mirror how companies are themselves charged for the water they take from the environment. Essential needs are satisfied at an acceptable price, while less essential and discretionary usage is discouraged through higher rates."

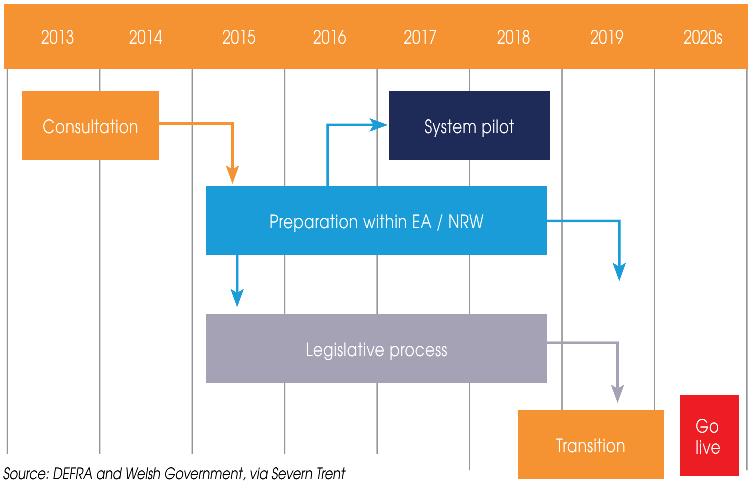
Severn Trent would like to see research commissioned on options for scarcity pricing.

Market solutions

The final section of *Charting a Sustainable Course* looks at increasing competition. The company's priority here is clearer policy direction and criteria on where markets should develop and how they should be developed. Among the issues raised are:

- Challenges such as flood management, managing diffuse pollution and managing upstream sources are currently lost in the separations of responsibility between providers of water services and custodians (regulators) of the water environment.

ABSTRACTION REFORM TIMETABLE



Source: DEFRA and Welsh Government, via Severn Trent

- Free entry and exit from parts of the value chain would be an essential part of the necessary reforms. Could we encourage greater competition by allowing further flexibility in the licensing framework? Can we create modular licences, allowing companies to enter and exit contestable parts of the value chain?
- Lessons should be learned from retail market opening – which suggests implications for the timing of upstream reform. Ballance says: "I wouldn't advise rushing ahead now and planning upstream reform until we understand the success of retail."

That said, the company agrees there is scope for progressing markets in the two wholesale areas Ofwat has recently identified – sludge treatment and water resources. Severn Trent says sludge could be fully deregulated, subject to a number of barriers being reviewed including around environmental permitting; licensing (including options to create separate sludge licences – the company says a move to modular licences would seem essential for this); access pricing (in particular sunk costs arising from pre-privatisation investments); and separating regulatory assessments of the wastewater totex and the cost of capital.

To progress water resource reform, the company identifies among other things a need for greater market transparency: "Interconnectivity remains a constraint beyond very localised movements of water. Market participants will need greater visibility of water companies' infrastructure and a more coherent approach to prices and costs in these markets."

Finally, the paper raises the recently much debated issue of system operation in a more fragmented market. Severn Trent sees a role for water companies, not only as buyers and sellers of services, but also potentially as the broker or system operator sitting in the middle. "Water companies as asset heavy businesses are well versed in the tasks of managing and financing physical capital assets. Extending this to the management of natural capital assets could provide new and innovative opportunities for water companies." It advocates this role for companies at catchment level, but also calls for further debate on whether a national or pan-regional system operator to coordinate activity between catchments would be beneficial. TWR

- *Charting a Sustainable Course* is available at http://bit.ly/1WEvurW

IN BRUSSELS THIS MONTH:
WAREG ACTIVITY PICKS UP PACE

The regulation of the water sector varies considerably across Europe's jurisdictions. Despite this, water, and its regulatory environment, continues to grow as an area of focus for the European Union. WAREG wants to build its credibility such that it can be an effective partner to the EU and other international organisations.

For those of you who are not familiar with WAREG, we are the Network of European Water Sector Regulators founded primarily with the aim of sharing our experience and learning to benefit the customers we protect in our respective countries.

Katherine Russell is vice president of WAREG and director of strategy and corporate affairs at WICS.

20 MEMBERS	
AEEGSI – Italy	AEEGSI – Italy
ANRSC – Romania	ANRSC – Romania
CER – Ireland	CER – Ireland
ECA – Estonia	ECA – Estonia
ERRU – Albania	ERRU – Albania
ERSAR – Portugal	ERSAR – Portugal
ERSARA – Azores	ERSARA – Azores
HEPURA – Hungary	HEPURA – Hungary
MAGRAMA – Spain	MAGRAMA – Spain
ANRE - Moldova	ANRE - Moldova
4 OBSERVERS	
OFWAT – England/Wales	Hrvatske vode – Croatia
Min. Dev. – Montenegro	WWRO – Kosovo

Membership is voluntary but since our inception just 18 months ago we have attracted 20 decision-making members and 4 observers who are permitted to attend our quarterly Assembly meetings (see box). Most recently, we welcomed the French Ministry of Environment as a full member.

At the 5th Assembly meeting in Budapest, held at the end of September, it was agreed that Assembly meetings will act as a platform for members to share knowledge and experience on specific regulatory issues.

A first topic for discussion was identified: RPI-X regulation. At the next Assembly meeting, WICS will lead a discussion on price cap regulation and its implementation. The aim is to encourage members to learn from each other and identify common challenges.

The Assembly agreed to appoint a "head of secretariat" as a day to day leader of WAREG activities and to establish a board made up of the president and vice presidents.

Alberto Biancardi, a founder of WAREG, was elected president in May and will serve for a term of two years. Alberto has been commissioner of the Italian electricity, gas and water authority (AEEGSI) and is leading water sector regulation. He was previously director general of the Italian Equalization Fund for the Electricity Sector and has served in various public institutions. He is also currently professor at the University of Studies of Genoa and is responsible for energy and infrastructure at AREL.

Alberto is supported by two vice-presidents: Dr Szilvia Szalóki of the Hungarian regulator HEA and myself.

Szilvia has been vice president of the Hungarian Energy and Public Utility Regulator (HEA) since 2012. In her experience as a lawyer she has worked in many different legal fields and has thorough experience regarding the regulation of water utilities. She also has a long-standing background in the Hungarian water sector and has provided legal advice to local governments on regulation in this area. In her role at HEA, she is responsible for developing regulations for the Hungarian water sector and engaging with external stakeholders on a national and international level.

I have been with the WICS since 1999. During my time I have helped to develop a regulatory framework which has seen Scottish Water improve services and substantially reduce its costs. In particular, I was heavily involved in the design and implementation of the non-household retail market in Scotland – a world first. More recently, I played an important role in the creation of the Customer Forum and the introduction of more customer-centric regulation. I currently serve as WICS' director of strategy and corporate affairs and lead its work on the Scottish Government's Hydro Nation initiative. This initiative aims to establish Scotland as an international leader in water management and governance.

As WAREG's representatives, Alberto, Sylvia and I have been invited to speak at multiple conferences. Most recently, Alberto and I were invited to share our experience with a global forum of water regulators at the International Water Regulators Forum in September.

Alberto participated in a session on regulatory tools for sustainable financing and I contributed to a panel session discussion on stakeholder engagement .

Alberto and Szilvia will also participate in the 3rd Water Festival at Expo Milan held from the 5th to 9th October.

Over the next two years, the three of us hope to drive forward WAREG's development from a start-up body to an effective association facilitating the maximum possible amount of effective collaboration. TWR

Complaints continue to fall

Customer complaints to water companies continued a seven-year downward trend during 2014-15. Interestingly given the approach of retail competition in 2017, business users' rate of complaint was significantly higher than the domestic customer rate; there were 48 complaints per 100,000 business connections, compared with 33 complaints per 10,000 household connections.

CC Water interpreted the 13.4% fall in overall complaints direct to companies from 123,000 in 2013-14 as a result of its "continued pressure to drive down complaints by embedding a right-first-time ethos into their [the companies'] customer service". The scores take the rate of grievances registered to about 25% below the level seen when CC Water was formed in 2005. Meanwhile problems taken to the customer watchdog have remained flat at about 10,000 a year since 2012-13.

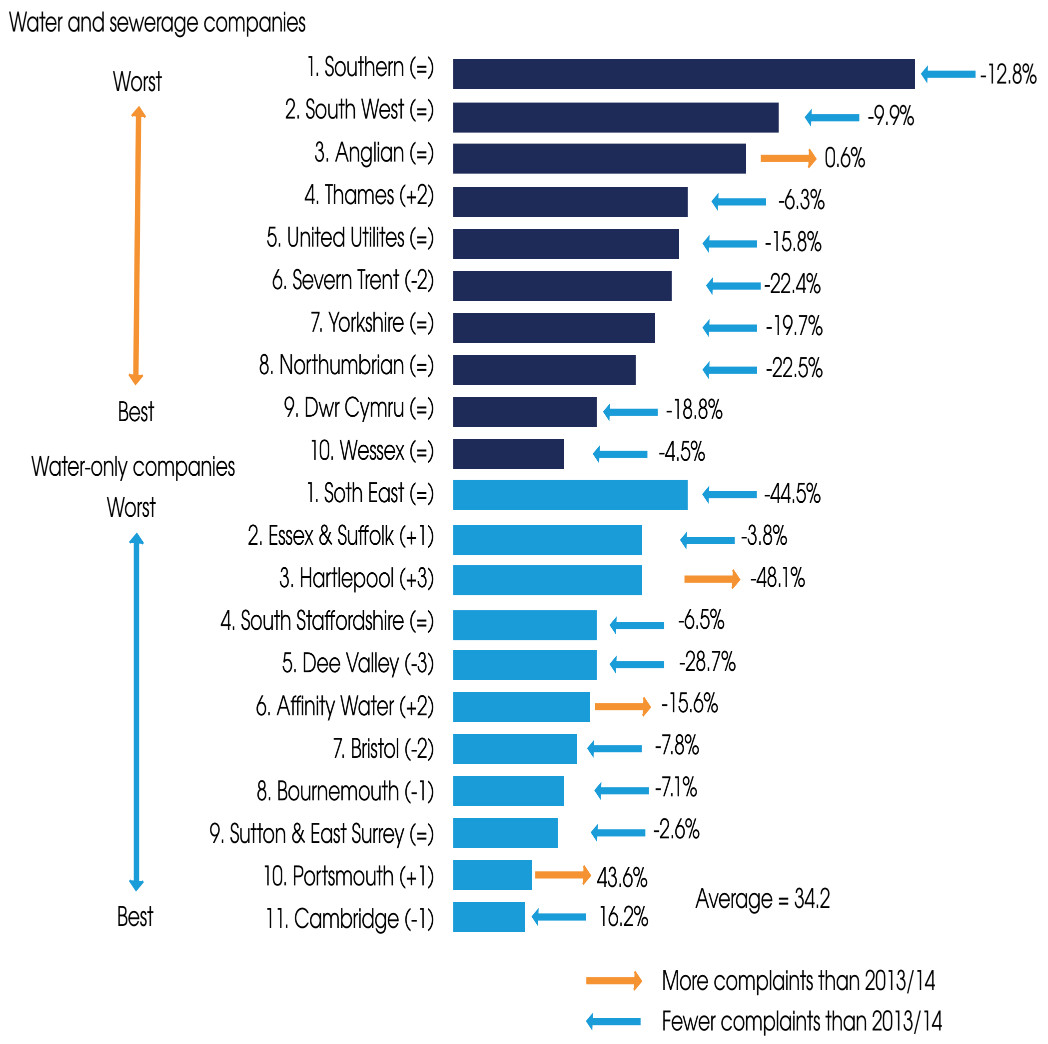
Continuing an established trend, water-only companies (WOCs) drew less flak from customers that water and sewerage firms (WASCs). Looking at total domestic and business complaints per 10,000 connections made direct to companies, the lowest performing WOC (South East Water) was only a little poorer than the median value for the WASCs. South East's ranking came despite a 44.5% decrease in its rate of complaints.

CC Water had harsh words for Southern Water. "It is unacceptable that its complaints per 10,000 connections are more than twice the industry average, despite falling by 13 per cent in 2013/14."

Southern responded in a statement saying: "We are disappointed not to have made more progress on reducing complaints." It said its £13 million outlay on an upgrade to its billing system will help.

Billing issues were by far the main cause for customers' grievances generating 63,000 written complaints in 2014-15. All other causes for complaint totalled only 43,000.

Written complaints from customers to companies per 10,000 connections in 2014/15 and change from 2013/14



Legal bid on Natura 2000 sites

The High Court has granted permission for WWF-UK, the Angling Trust and Fish Legal to challenge DEFRA and the Environment Agency over their "failure to protect some of England's most precious rivers, lakes and coastal areas from agricultural pollution".

The focus of the court case is on Natura 2000 sites – habitats that are protected by law under the Habitats Directive and the Birds Directive. These include Poole Harbour and the Rivers Avon, Wye and Eden. The groups say "pollution is having a harmful impact on species that should thrive in these habitats".

Under the Water Framework Directive, water bodies are expected to be in good health by December 2015, but this will not be achieved across the board. The groups say: "This is because current action is not sufficient to tackle the scale of the problem. WWF, the Angling Trust and Fish Legal want the government to use all the tools at its disposal to ensure these precious places are properly protected and restored for people and wildlife."

Specifically, they want Water Protection Zones (WPZs) to be used. The groups note: "These are a basic legal measure to control and prevent diffuse agricultural pollution. They were introduced specifically as a regulatory tool to ensure the protection of the freshwater environment against diffuse pollution and were included in the 2009 River Basin Management Plans to be applied alongside other regulatory and voluntary measures. They have not been used to date for this purpose."

David Nussbaum, chief executive of WWF-UK, said: "We hope this legal action will lead to a rethink of the approach of government and the Environment Agency so that we can see real improvements in these precious places." TWR

DEFRA mulling "difficult" choices on industry resilience standards

Deputy director of water reform Gabrielle Edwards told a Westminster Energy Environment and Transport Forum last month that DEFRA had some difficult choices to make over the next few months on whether and how to set resilience standards for the water industry. Among the complexities she listed were:

- Resilience covers so many things, from cybersecurity to levels of service, so even defining resilience standards is complex.
- Customer views are important on some aspects.
- Does the government need to set minimum requirements?
- Companies take different approaches on Water Resource Management Plans – for instance on whether a hosepipe ban is ever acceptable. So what would minimum standards mean for WRMPs?

Edwards commented: "One of the things we did do in the Water Act was to introduce a provision which enables the secretary of state to set service standards and we need to decide whether or not we want to use that power for the next Water Resource Management Planning round. There is some attraction to it, but is there really a one size fits all approach, or alternatively a minimum service standard that we could specify and companies could choose to go beyond? … There's some quite difficult judgments to be made over the next few months."

Her comments came in response to a question from South East Water's Dave Hinton, who observed there was not a national picture on resilience levels at the moment as water companies don't share their information. He noted that a robust means of setting central standards could address variability, but how this should be approached was open to question.

Severn Trent's strategy and regulation director Tony Ballance argued in support of agreeing a common basket of measures on resilience but then allowing customers to determine levels of resilience locally. (See feature, p12-15)

All quiet on the policy front

A series of written parliamentary questions from Tory peer Lord Moynihan last month on a range of water industry issues yielded little in the way of new information.

Lord Gardiner of Kimble confirmed the following:

- The government has not asked water companies to do more to coordinate and implement flood defences, nor is it planning to launch a tender process in the market to meet this objective.
- There are no plans for a third-party audit of the Thames Tideway Tunnel, (raised in reference to the optimal use of outside contractors and specialist companies capable of constructing reservoirs).
- The non household retail market is on track for April 2017. Ofwat will be able to impose financial penalties on companies which do not comply with any readiness-related licence condition.
- Updated guidance is currently being prepared for the next Water Resources Management Planning round.
- The government is working on finalising the legislative approach to abstraction reform. It remains on track to deliver abstraction reform in the early 2020s. On whether it would introduce a one-size fits all approach, Lord Gardiner said: "Our aim is to introduce fairer, more flexible and more efficient systems to manage water abstraction tailored to differing catchments within a national approach."

Meanwhile at Labour's annual party conference in Brighton early this month water barely got a mention. The Conservative conference was underway when *The Water Report* went to press.

Debt agency guidelines

Ofwat has clarified its expectations of companies who employ third parties to recover water debt. The regulator said this was primarily to acknowledge the that Financial Conduct Authority only regulates consumer credit debt and does not regulate water debt.

It told water companies who use third party debt collection agencies to adhere to, among other things, the following:

- Use reputable companies who abide by industry codes.
- Have systems in place to ensure standards are being followed.
- Verify that customers are being sensitively dealt with through a robust audit process.
- Keep customers informed, retain access to their account and enable them to raise any complaints with the water company.
- The debt collection agent should offer the same range of payment options as the company.

Ofwat also set out expectations for companies whose charges are collected through local authorities or housing associations.

The changes are part of Ofwat's 2015 version of its debt guidelines for household customers. The regulator said it had only made minor changes from 2014.

NEWS IN BRIEF

Making tracks: Water UK has appointed Michael Roberts, currently chief executive of the Association of Train Operating Companies and director-general of the Rail Delivery Group, as its next chief executive. He will succeed Pamela Taylor when she steps down at the end of 2015.

In charge: Ofwat has published a statutory consultation on draft rules governing water company charging schemes for 2016-17, along with its emerging thinking in relation to wholesale charging rules and special agreements. This follows changes introduced by the Water Act 2014.

New commission: High Commissioner to India Sir James Bevan will take up the role of chief executive of the Environment Agency on 30 November. Former chief Paul Leinster left on 25 September.

Crypto report: Risk specialist Marsh has published a report on how water companies can prepare for and deal with contamination incidents. It said current practice was good, but the recent cryptosporidium outbreak in Lancashire served as a timely reminder of the need to review risk. United Utilities may have to pay millions in compensation to its customers for the incident.

Going to extremes: The UK Water Partnership has published *Droughts and Floods*, a report which proposes a more holistic approach is needed to extreme water management. It focuses on joining up research, innovation and implementation, and explores opportunities for a range of ecosystem-related markets.

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INDUSTRY COMMENT

FOLLOW THE LEADERS

Lessons for water on how to foster innovation are there for the taking in other sectors, as research from PA Consulting reveals.

Across every business sector and market, innovation has become a critical factor in driving increased customer satisfaction, shareholder return and improved productivity. But in too many organisations innovation is broken. Earlier this year, PA surveyed 750 senior leaders about their approach to innovation (including 100 from the energy and utilities sector). We found the majority of organisations are struggling with innovation. They are not generating enough good ideas and, even when they do, many of those ideas go to waste. As a result, companies are losing out financially and missing future opportunities to develop their businesses. By applying our findings to Nesta's latest figures on innovation spending, we estimate that UK organisations are wasting £64.7bn by failing to implement innovation effectively in their organisation.

Against this negative backdrop, it has never been a more essential, or better, time to innovate in the water industry. The increasingly demanding requirements for cost effectiveness set out in PR14 provide a very powerful motive for companies to think about new ways of running their business. In addition, the expansion of non-household competition from April 2017 will place entirely new demands on many companies both in developing and positioning their retail businesses. Innovation will be essential to survive in what looks likely to be a crowded market. New approaches will be needed to identify profit opportunities beyond the standard 2.5% margins and to instil a cultural change in wholesale to enable it to adapt to the new regime.

Further significant change in the sector will come from the provisions in The Water Act 2014 and the current Competition and Markets Authority (CMA) consultation to amend rules on merger and acquisition. This effectively reduces the merger decision timetable from c30 weeks to c7 weeks. The final driver of change is the likely advent of upstream competition from later this decade.

Ofwat is increasingly recognising the need to allow flexibility. The PR14 move to outcome based regulation and the introduction of totex are opening up a whole range of opportunities for more innovative approaches.

Sector performance

Given this context, how is the utilities industry faring on innovation compared to its peers and what lessons can the water industry learn to maximise the opportunity in PR14?

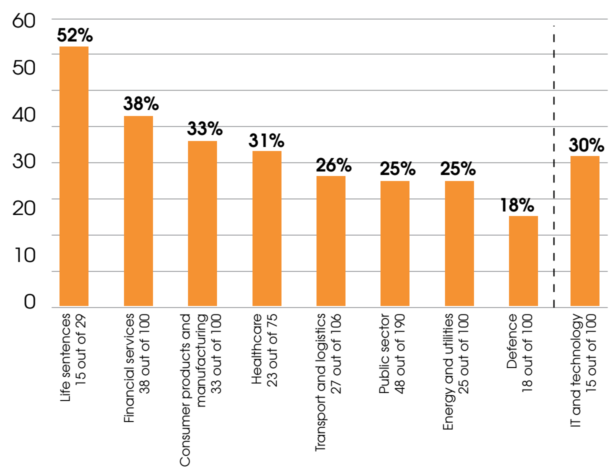
As the figure (bottom left) shows, energy and utilities lies joint sixth in the ranking of innovation leaders, tied with government, but ahead of defence. There are some good reasons behind this position relating to the essential public and workforce safety requirements facing the industry and the consequent need for a cautious and careful approach to new ways of working. However, other industries such as life sciences and healthcare have similar onerous requirements, but show greater innovation.

The more detailed comparative results (see chart, right) show that the energy and utilities sector lags the cross-sector average on all counts, but with particular challenges on the availability of skills and the use of digital technology. Again, this is not surprising given the history of the sector, but the industry now needs to find ways to address these issues.

This starts by understanding what innovation means, and how it is changing. That is not obvious. More than half the respondents to our survey said that they used the term "innovation" to describe different things. In some sectors, there can be a risk of thinking of innovation as something that is done by the R&D department and that is focused on incremental improvements in technology. A further problem is that the work tends to be carried out in pockets of the organisation that do not have access to the full spectrum of people, skills and capabilities required to maximise the potential for successful innovation. In addition, their activity is often not widely understood or supported across the organisation.

It is clear that this approach will have to change.

Sector league table
Based on the number of innovation leaders in each sector



Innovation killers

Alongside this lack of understanding of what innovation means, we found five common "innovation killers" across all sectors. The first of these is fear: 58% of respondents said they were unlikely to back high-potential but risky innovations. Part of the reason for this fear stems from the extent of their focus on risk management, which was a particular driver in energy and utilities companies. This is understandable when the financial and reputational costs of network or equipment failure can be so high. However, the industry will need to learn how to balance this with the need for innovation.

The second barrier to innovation is a lack of focus. 42% of respondents said that innovation is something they talk about more than they do. This suggests that many organisations lack a clear innovation strategy. That reflects the fact that nearly half said that they were not aiming to be pioneers. This underlines that a key challenge for many businesses is that their culture does not value innovation.

A further barrier lies in the difficulty many organisations face in implementing their ideas at pace and scale. Utility sector executives say scaling up ideas is their toughest barrier to rolling out innovative solutions. This reflects the need to *improve alignment between any incubation hub, or constrained pilot and the operational business.*

The fourth barrier to innovation is concern about the return on investment (ROI) from innovation projects which can often take some time to deliver results. ROI clearly needs to be measured and assessed carefully when making decisions about investing in innovation but organisations should be aware that a strict accounting mindset can kill creativity, and that it is vital to recognise the appropriate point to start modelling ROI seriously on innovation projects.

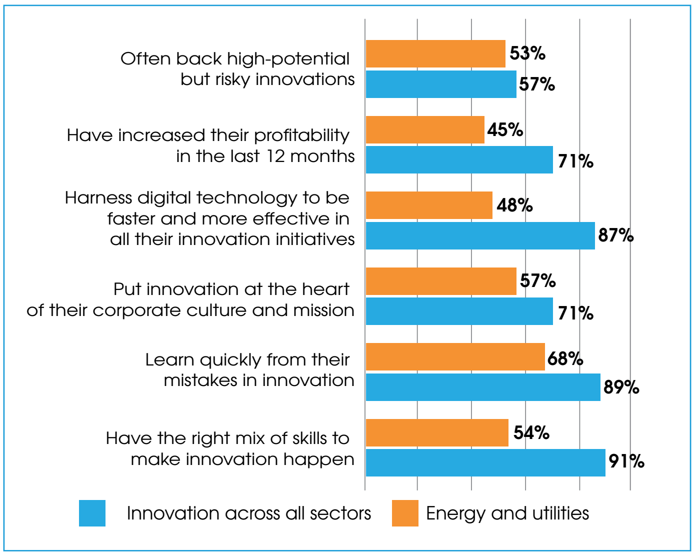
The final sector wide obstacle to innovation lies in a reluctance to invest. A quarter of the respondents to our survey said that insufficient investment was the top barrier to innovation in their organisation. As a result, when ideas failed for avoidable reasons, the reason was usually a lack of budget, people or skills.

Lessons for water

Our survey showed that, of the private sector respondents who strongly agreed their leadership is good at nurturing and encouraging innovation, 71% had seen profitability increase in the last 12 months, with 35% of this group delivering over 10% earnings before interest, depreciation and amortisation. The key characteristics of the leadership group were to:

- *Have the right mix of skills to make innovation happen (91% of leaders compared to 57% of the rest)*
- *Learn quickly from mistakes in innovation (89% compared to 60%)*
- *Strive to be pioneers (73% compared to 45%)*
- *Harness digital technology (87% compared to 64%)*
- *Often back high potential, but risky innovations (57% compared to 36%)*
- *Put innovation at the heart of the culture (71% compared to 43%)*

So the clear challenge for water



companies is to learn from this group's success and embrace innovation in a way that delivers real value. This has to start by company leaders putting innovation at the heart of their corporate culture. Senior managers in truly innovative organisations provide clear direction and make the case for change with employees. That then creates a culture where innovation is valued and is seen through to the end. This is reinforced by a willingness to create innovation project teams from across the business. This makes everyone feel part of the work and makes them greater champions of change.

The next step is to provide the right resources, both financial and personnel, to in-house R&D and innovation teams. This includes recognising that these teams need to position themselves to compete with the technology sector for top talent and resources.

Co-creation

One aspect that is particularly pertinent to the water industry is that of co-creation, working with your partners and suppliers to innovate together. A cross sector example of this is the approach taken by Procter and Gamble (P&G). P&G identified promising ideas throughout the world which were then developed further applying P&G's internal R&D, manufacturing, marketing, and purchasing capabilities to create better and cheaper products, faster.

The company has created several networks/hubs both internal and external to drive this collaborative innovation model. A key element in these networks was co-creation with suppliers. P&G's top 15 suppliers have a combined R&D staff of 15,000, representing a huge source of innovation. Using a secure IT platform, P&G shares technology briefs with their suppliers which are then worked on jointly. P&G state that they have driven more than £3bn of additional sales through these innovation activities. Innovation productivity has increased by nearly 60% and R&D investment as a percentage of sales is down from 4.8% to 3.4% today.

A further example of co-creation is Mars. Mars encourages innovation in its suppliers and allows them to retain 100% of the benefit of any overall saving until they recover their investment and make an agreed level of profit.

Another important characteristic of leading innovators is their use of digital technology to enhance the innovation process. Mobile solutions can be particularly effective in helping to embed new ways of working, as employees tend to be comfortable using similar technologies to those they use in their personal lives.

Finally there is a need to learn from outsiders – even competitors. Innovation leaders invite other companies to present to them and find by sharing ideas and gaining a broader perspective on the work others are doing they stimulate their own work.

How is the industry responding to this challenge? There are positive indications, with industry wide collaboration in recent years to further develop the innovation approach across the water sector. British Water has been convening innovation exchanges to bring together industry players, their partners and suppliers and British Water members to identify technology needs and explore available and potential solutions. Cross industry learning opportunities have also been identified; October's Innovation Exchange with The Coal Authority, who are responsible for the pumping and treatment of 98 billion litres of water each year as the result of their mining activities, is one such example. Some individual companies also have innovation higher up the agenda than in previous AMP cycles and we are seeing increased activity in this area.

Our survey showed very clearly that taking steps such as those noted above enables the innovation which makes a real difference to the bottom line. The market and regulatory environment in water is now right for innovation. By learning the lessons from these innovators, the water sector as a whole will be able to serve its shareholders and customers better, and retailers will be well placed to increase their market share and profitability. TWR

Ted Hopcroft is a water expert at PA Consulting Group.

SCOTS GOVERNMENT BACKS AWB'S PUBLIC SECTOR BID

The long-delayed award of the Scottish public sector supply contract to preferred bidder Anglian Water Business (AWB) now looks set to proceed within weeks.

The Water Report understands the open-ended standstill period is now expected to close on 16 October, after which the contract could be signed fairly swiftly. The Scottish Government recently extended existing public sector supplier Business Stream's contract to 31 December, so potentially AWB could take over supply from the start of 2016.

On 6 October, the Scottish Government endorsed AWB's bid, on price and consumption saving grounds. It said: "AWB's bid offered immediate savings of £5m a year compared to the nearest bid, and water efficiency support to reduce customers' water consumption. As well as helping the environment, these 'green' measures could reduce bills by a further £5m a year. This means the contract will save public bodies up to £40m over the next four years."

AWB was awarded preferred bidder status back in February, and the contract was originally due to start on 1 April. But the process moved to an open ended standstill shortly after. On paper this was to allow for bidder feedback and queries to be dealt with, but the undercurrent was political discontent with a private company taking work away from publicly owned Business Stream.

The Scottish Government's October announcement emphasised the competitive tender was required by legislation; that Scottish Water remained in public hands and would continue to provide wholesale services; that AWB would manage the contract from Edinburgh and provide jobs and apprenticeships; and that savings would benefit public services.

Cabinet secretary for infrastructure, investment and cities Keith Brown said: "The biggest benefit of all will be the money that can be ploughed back into the services provided by those buildings – the schools, hospitals and public offices – throughout Scotland." TWR

CUSTOMERS AND SUPPLIERS COMBINE ON RETAIL POLICY

The Major Energy Users' Council last month launched a new initiative, the Water Market Policy Group. The objective is to bring MEUC customer members together with water suppliers and other expert parties to make suggestions for retail market policy improvements.

Alongside editing The Water Report, I chair the steering group (see box) of the Water Market Policy Group. We met last month and agreed the following policy priorities. We will be meeting with water minister Rory Stewart this month to seek his responses.

- **Retail margin:** The group believes the 6% average gross retail margin currently proposed is too low and risks a sluggish first few years of trading. It would like Ofwat to review and lower wholesale prices next year when it reviews non household retail prices ahead of market opening.
- **Level playing field:** The group thinks it essential that all incumbents publish details of their separation arrangements, the terms on which their wholesale and retail operations interact, and what measures are in place to ensure that the wholesaler provides fair and equal access for all retailers. A set of rules should be established that clearly define appropriate separation.
- **New entry:** All aspects of retail market policy should be viewed through the lens of the new entrant and actions taken where necessary to remove obstacles and disincentives to entry.
- **Meter reading:** MEUC members are concerned about the quality of market data, given that even the seemingly simple matter of locating water meters so they can be read is not straightforward. An obligation should be placed between incumbent water suppliers ahead of market opening to a) assist customers in locating meters and b) ensure meters are accessible and readable.
- **Eligibility:** Water companies need to be able to interpret Ofwat's eligibility guidance consistently to avoid a patchwork of arrangements across the country.
- **Company readiness:** A more proactive and prescriptive approach should be adopted on company readiness. Standards should be introduced on data quality, including agreement on master data sources.
- **Retail exit:** Customers need longer notice that their incumbent supplier will be leaving the business retail market than envisaged in DEFRA's draft exit regulations.
- **Customer awareness:** Only 15% of businesses are aware the retail market is opening shortly. There should be a concerted programme of coordinated action to raise business customer awareness. TWR

STEERING GROUP

On the steering group of the MEUC's WMPG are:
- Stuart Read, procurement category manager, Bernard Matthews
- Andrew Wilson, business process transformation manager, Enterprise Inns
- Ken McRae, chief operating officer, Gemserv
- Neil Pendle, managing director, Waterscan
- James Cardwell-Moore, commercial director, Business Stream
- Jonathan Clarke, customer service director, Anglian Water Business.

EXPRESS DELIVERY

On-time implementation of central systems for the 2017 retail market is MOSL's top priority. The timetable is aggressive, and CEO Ben Jeffs says a combination of transparent progress checks, daily delivery targets and a codes freeze is the way forward.

Chief executive Ben Jeffs is hopeful that when MOSL members meet on 15 October, they will sign off its business plan and funding requirement for 2015/16. There has been ongoing engagement on both aspects since August, and the documents are currently out for formal consultation.

The business plan and budget are the latest pieces to be added to the Market Operator Services Limited (MOSL) jigsaw; a jigsaw that has been pieced together rapidly over the summer. From a standing start in July when it took over responsibility for delivering central systems and processes for the non household retail market, MOSL has barely stopped for breath. It has appointed a permanent board and senior management team; recruited members (26 of the 31 eligible incumbents in England and licensed providers from Scotland have joined to date); and tendered and awarded the critical central systems build contract to CGI (see box – CGI delivery deal, p26).

Jeffs says this level of progress has only been achieved because of the huge commitment from across the industry, especially MOSL's founding members – United Utilities, Anglian Water Services and Northumbrian Water. Until recently, the systems procurement was led by a team from United Utilities, supported by many industry colleagues. Jeffs comments: "We wouldn't be where we are with the CMOS [central market operating system] procurement without Steve Mogford [United Utilities chief executive] putting the weight of his organisation behind this, which was tremendous."

But this is just the beginning. MOSL has a five-phase programme to implement the CMOS ahead (see box, p27), a major programme of engagement with market participants, plus duties to discharge as a core member of the Open Water programme team. All the while it is eyeing taking on the role of enduring market operator after April 2017.

On the first of these alone, there is mountains of work to do and very little room for manoeuvre. MOSL's raison d'être is to ensure the market is ready to open on time and within budget. Jeffs says both are vital but it is delivering a functioning market on time that takes top spot. "We are acutely aware that bringing this in on time at a level that allows the market to work on day one is the biggest requirement for everybody."

There are two halves to this coin: MOSL must deliver the central system on time and companies must be ready to interact with it from day one. Jeffs says: "Everyone needs to cross the line at the same time."

Transparent and together

Jeffs is adopting a policy of transparency and openness to navigate these difficult waters. "I'd like to be able to wave a magic wand and give everybody everything they need today, but we are where we are and we are committed to working to deliver the plan we have," he says. "That plan states MOSL will build trust and confidence by revealing as much as it can, when it can, and in the meantime it will be clear on what companies can expect, by when.

"At every stage of implementation we will try to be as open and transparent as we can and give everybody everything possible on where we're at and the issues we have seen so they can take that into account as they are preparing. It will work if we work together towards success with our eyes wide open, our radar finely tuned and developed so we understand where everybody is at and what needs to happen to make this a success."

Specifically, MOSL will review its progress at each implementation milestone and assess its readiness to move into the next phase. Given the importance of the programme to the entire industry, is there a case for independent assurance? "I think there is," says Jeffs. "In our business plan we set aside some money next year in the budget for independent assurance. We're currently thinking through what that might look like. It could be anything from a high-level controls audit through to a risk based 'deep dive' review approach. I am acutely aware we run this business on behalf of members and we have an independent board so I need to ensure they are all comfortable with what we're doing."

Jeffs adds that layers of assurance are built into the programme already. MOSL intends by the end of this month to have appointed a test partner, which would add a degree of independent validation to CGI's delivery, and a data partner. He adds: "I am comforted that Ofwat has said it will look to do a similar review to the baseline review once the letters of assurance have been received during spring. That'll give everybody the opportunity to really check point where everyone is at."

Despite these efforts to build trust and confidence, Jeffs expects the period up to Christmas will be "a bit of a voyage of discovery for everybody". Some crucial work is scheduled for the next three months, including signing off the detailed system design, developing a data quality strategy and publishing a readiness plan for companies and the market. He comments: "Clearly on a programme like this that is evolving, when you disclose one level of information it raises questions for the next level. I do think over the next three months we are probably going to see that continue; as we continue to mobilise, as we get our test and data partners on board; as CGI starts to do their detailed design work, we are going to be able to publish more and more information on where we're at and what we're looking to do."

Company readiness

Incumbent companies are understandably eager to get their ducks in a row for market opening, and to some extent are dependent on MOSL to support them in that. How much help will they get? Jeffs explains each company will be assigned a portfolio manager from the five-strong team that has been appointed.

"First and foremost we see ourselves working individually with companies to help them understand their readiness from a systems perspective," he says. "Portfolio managers will be putting our plans together with participants' plans so companies know where they are and what they need to do. They will help companies understand their status in terms of their ability to interact with MOSL and the CMOS system."

It also looks likely that MOSL will offer guidance on where individual companies sit relative to their peers on readiness. Jeffs explains: "Dealing with all participants gives us a unique view of how the whole industry is doing on readiness. We've been asked by a number of participants to develop some sort of 'heat map'; a sector-wide map of how companies are preparing and how ready they are for market opening. Our initial view – and it is an initial view – is we are likely to give companies their own statuses but anonymise all the others. We will be working it up over the autumn."

Data quality is a particularly thorny issue for companies, and Open Water has made it clear that responsibility for this lies with the industry. MOSL will play a limited role; it has a duty to make sure it has sufficient validation and controls around the data. Some companies have indicated they would like MOSL to play a more hands-on role on data quality assurance. Jeffs responds: "There are questions around where our responsibility should end. There is recognition that we are not resourced to help individual companies and there are a large number of commercial offerings in the market to help companies prepare their data.

What companies are really looking for from MOSL is to be open and transparent. So where we spot any issues with the quality of data that's been loaded, or about their ability to comply, that we let them know and we do what we can to support them. From our perspective there is wide recognition that while there might be desire, it is their responsibility to get their data lined up and ready for market opening."

All participants will ultimately be expected to go through market entry assurance to demonstrate they can comply with the provisions of Open Water's Market Architecture Plan (MAP). Jeffs comments: "On successful conclusion of that process, they will be allowed to load data into the production CMOS system ahead of shadow market, and then conduct transactions within the CMOS system through the shadow market, which will create a more stable basis on which to open the market." He adds: "Companies that fail market entry assurance – and we expect them to only be in small numbers, if any at all – will be managed through a separate process."

Slippage control

MOSL itself, while not countenancing a market opening delay, acknowledges the risk of slippage along the way. It is investing in expert programme management resources and undertaking detailed programme planning, management and reporting to plot a critical path and identify variance, and will work with others to take any remedial action early.

Jeffs has ambitious plans on this front. MOSL already has a weekly steering group meeting and an outcome based dashboard that monitors its progress across the piece. He says: "I would like to move to the stage where we actually have daily delivery targets. We need to get into the mentality where 'you do the washing up before you go to bed'.

"I'm acutely aware that we only have 380 working days or so until market opening; it's a constant part of our discussion – how many days we have left…It's important we get into the rhythm of daily delivery; you can't be left with a massive mountain to climb with only a couple of months to go. We're starting to move into that mindset."

Jeffs says a common question he is asked concerns how much leverage there is on quality and scope, seeing as time is immoveable. MOSL will give little ground. "The MAP sets out the requirements for market opening. It's not optional, it's required. It's a set of contracts between all parties that enable the market to open and operate. Our plan is that the systems will be in place in April 2016 to allow companies to start testing.

"I think where we get into the qualitative aspect of market opening is in the realms of what gets loaded into that system. So it's about the degree to which companies are ready to load the data. But there's been no market opening that has been totally perfect. We can't go and fix all of the data and all of the imperfections that have arisen over time, so a lot of it is about how much companies can do to get their data and their systems and their processes in as good a shape as possible to allow the market to open at the lowest possible risk. And that's largely in their hands."

Budget and codes freeze

Back to the business plan and of all the details it contains, the budget will be one of the most highly scrutinised areas – particularly by incumbent company members who between them are liable for all expenditure up to market opening, under the Water Act. In July, Ofwat issued a revised (and much larger than previously expected) budget for the Open Water programme of £41.8 million, £26.2 million of which was to cover MOSL's costs.

There has been some good news since then; former MOSL programme director Tim Burfoot worked with the tax and finance functions of MOSL's founder members and succeeded in establishing VAT was recoverable on a proportion of its costs. Jeffs says this is "a fantastic outcome for all participants" and will save £3m. So net of VAT, MOSL has budgeted to the tune of £23.1 million up to market opening, plus a £3m contingency fund, taking its total costs up to market opening to £26.1 million. The business plan includes a full budget to the end of March 2016 as well as an outline budget up to April 2017.

Given costs crept up significantly in July, how confident should members be in the latest budget? Jeffs responds: "We are still at an early stage of our planning. But on the basis that MOSL now has a management team in place, plans that take us through the market opening, we've carried out our own risk assessment and due diligence on the programme and have signed up to deliver the market opening, I think we can have a reasonable degree of confidence – subject to the assumptions we have set out in the business plan."

Many of those assumptions have been shored up. "A lot of work has been done over the summer to get a really good view on the policy issues and to get CGI's input to the MAP." But delivery of the plan to budget does hinge on the codes required for market opening being "frozen" from 30 September 2015 to April 2017, to lock down system requirements.

Jeffs explains: "The main thing that would drive a change in the budget is a change in requirements. Change does two things. It potentially increases the cost of delivery but bigger than that, it actually potentially impacts the timeline to get us to market opening. The timeline is clearly very tight, but we still believe, and the plans we have from CGI support the fact that it's still feasible. When you start to inject change into that model, it starts to affect the risk to timeline and cost.

"Virtually every response we had to the draft business plan process said the code freeze was essential. I am acutely aware that company preparations for market opening dwarf what MOSL is doing on their behalf. So companies also need the certainty around timescales and their boards need certainty around cost. If we constantly change requirements, that's going to make it very difficult for everybody to have confidence in what we're doing."

While a code freeze is clearly desirable, is it feasible given the rate of change seen other markets? MOSL says a good sign is that there has been little change since July and, because codes are based on those in the Scottish market, they are reasonably stable. Nevertheless, it accepts the need for a mechanism to consider essential change.

"We are putting in the business plan a change mechanism to allow changes to be considered," Jeffs says. "Clearly it is for the Interim Codes Panel to make its recommendations to Ofwat to decide on code changes, but from our perspective, we're stressing that the changes would have to be critical; it's got to be about a functioning market rather than the overall effectiveness of the market. It really does have to be those essential items that get approved.

CGI DELIVERY DEAL

MOSL has awarded CGI a fixed price (£15m) contract to deliver the CMOS system. It made the selection on the basis of rigorous technical and commercial criteria; confidence in CGI's ability to meet the programme timetable; and the support offered for user testing and shadow operations. Jeffs says: "We had two very good and credible bids going into 'best and final offer' and CGI came out ahead."

He explains CGI has been co-located with the MOSL team since the third week of August. "CGI has put forward its plan, which we've been through and challenged to make sure my team are signed up to everything that's in it. We've now agreed the mobilisation plan and moved into the detailed design phase."

Will the contract provide good value for members' money? Jeffs: "The proof of the pudding will be in the eating. We ran a good process and had a rigorous evaluation procedure, which we had member involvement in. When we made the decision to move to preferred bidder, we had input from the interim board and the advisory panel we had put in place, which had new entrants and incumbent members. There's been a lot of support to the process and it was a unanimous decision to appoint CGI."

IMPLEMENTATION IN FIVE PHASES

Phase 1: ***Mobilisation - August to September 2015***
- Finalise market codes ahead of the freeze on 30 September
- Establish the review and change control processes to support the Interim Codes Panel
- Mobilise the CMOS vendor, CGI Group
- Start the system design
- Develop a test strategy
- Mobilise the MOSL business.

Phase 2: ***System design - November 2015 (Phase 1) and January 2016 (Phase 2)***
- Sign off the detailed system design
- Finalise the technical interface specification
- Build test products and processes for acceptance, market and entry testing
- Develop a strategy for achieving the highest possible data quality for market opening
- Develop a market and company readiness plan
- Issue early guidance for participants, including timetables and interface standards, to aid participants' preparations.

Phase 3: ***System build – April 2016 (Phase 1) and June 2016 (Phase 2)***
- MOSL notes some lower priority areas of system functionality will be delivered after April 2016. This reflects the very tight critical path.

Phase 4: ***User testing – April to September 2016***
- Data uploading begins in April and is expected to finish in August/September 2016.
- Entry testing for incumbent retailers will be conducted separately from wholesalers in this period – whether or not retail exit is envisaged. Consideration will need to be given as to whether entry testing for incumbent retailers can be achieved ahead of formal retail exit.

Phase 5: ***Shadow operation – October 2016 to March 2017***
- MOSL notes during this period there may be entry to the market of retailers that were not dealt with during the testing phase. It is likely that there will be a moratorium on entry for a period before go-live.

"That puts an onus on everybody involved in the process to be very clear about what can wait for a future release. MOSL needs to work up a release strategy for post-market opening to support the ongoing development of the market. This can happen once the market has been opened."

Any changes introduced from now on will need to be paid for on top of the existing budget. MOSL offered members three options on this and waits to see if they will sign off the route it adopted in the business plan. Essentially this involves using the contingency pot as a cash buffer to fund change, which MOSL will report on quarterly. When what's left in the pot hits a certain threshold, the budget will need to be re-baselined to include the changes that have been authorised and also to form a view on changes in the pipeline. This is essential, as Jeffs explains: "The contingency pot is a true contingency. It is set at a level that allows some increase in cost for delivering what is already in the plan. We don't know what changes companies will request going forwards and as such this makes it difficult to plan for. The budget assumptions have not changed in this respect and previous forecasts have been presented based on the same assumption."

According to Jeffs, the level of change required and hence the scale of the additional cost, will primarily be down to market participants, given there is a framework in place for the big ticket policy items now. "When you are dealing with 26 participants and potentially more, there will be different views of what should have been contained in the market architecture. Everybody will have a desire to be opening it if they possibly can to get their thoughts back on the table and reconsidered. So market participants themselves have a large role to play in giving us the space over the next 18 months to deliver what's required."

He adds: "The other thing is we haven't yet delivered a system and when we start to deliver it at the back end of the year – when CGI starts to engage with companies on a technical level, test firewalls and message flows, load some trial data; and when we message metering data in and out in the first quarter – I'm sure there will be lots of calls for things to be tweaked and changed. It's inevitable. That will be the real test to the programme; to what extent those changes are viewed as being critical."

Next steps

While participants are considering the plan, MOSL will press on with its organisational preparations. It has a new London base and has so far mobilised around 30 staff (a mix of full time employees, contractors and secondees from the industry). Jeffs says going forwards it will recruit permanent staff where possible, though roles that are by nature short term will continue to be filled by contractors and where seconded or contractor staff have vital relationships established, they will stay on.

MOSL is about a month behind where it would like to be on recruitment, partly because of the summer and its heavy workload elsewhere, but also partly because it has not yet been confirmed as the enduring market operator. Jeffs admits: "We have made offers of employment to a few people over the summer which have subsequently not been successful because of that concern."

While Ofwat and DEFRA have spoken openly about their belief that MOSL is likely to become the enduring market operator, Jeffs will be working with both parties, the Treasury and the Office of National Statistics over the autumn to pin this down. At issue is the legal status of MOSL as a private entity; who controls it and how it operates. Jeffs sees it as within MOSL's gift to demonstrate it is fit and proper to operate the market after 2017.

"From my perspective, I'm very clear. We're a membership based organisation, we're funded by our members, our articles of association provide for members to have control over the way we are funded and the activities we do. I have a board of directors who perform as any private business in the world would do and I have an executive team made up of people who have come from industry and therefore operate on a commercial basis. So from my perspective it's very straightforward but I do understand the sensitivities involved and see it as in our gift to get our wider stakeholders within government comfortable with who we are and how we operate."

Whatever happens regarding the post 2017 role, Jeffs is unwavering in his certainty that MOSL will deliver a central market on time, to the benefit of both its members and all stakeholders.

On that last point, he recognises the pivotal role his organisation plays in the wider Open Water programme: "We are in a unique position of being a private business working on behalf of the whole industry, alongside Defra and Ofwat, to liberalise the water and sewerage market in England and provide customers with choice." It is a transformative programme that requires close collaboration and a partnership approach. Jeffs concludes: "The real test of this is the way in which we are able to openly discuss issues and challenge each other's thinking". TWR

CASTLE'S MOVE

Ambitious independent retailer Castle Water plans to negate thin margins in the English market through no-commission customer acquisition. CEO John Reynolds explains, and urges a sales code of practice is needed to protect consumers.

When John Reynolds was invited to take the stage at a conference on water market reform in the summer, he objected to being introduced as a new entrant. He said his company, Castle Water, was a born and bred retailer and is actively serving customers in Scotland right now. Given a fair chunk of the audience comprised English incumbent representatives, the implication was that competitive retailing would be newer to them than to him.

Established last year, Castle Water is a licensed provider (LP) in the competitive Scottish market, retailing to over 5,000 supply points (SPIDs). Its chief executive Reynolds says it is one of the two fastest growing independents in the sector. It has a simple but compelling sales proposition: keeping cost low and service quality high.

Affinity partnerships

One of the key planks of its low cost proposition is holding customer acquisition costs down, through the use of digital marketing and – innovatively – affinity deals. Its headline affinity partnership is with the National Farmers Union Scotland (NFUS). Castle Water offers NFUS members a group discount with a three year contract. Prices are guaranteed not to rise above inflation for the length of the contract. It also offers an "evergreen" clause each year which gives NFUS members the opportunity to switch tariffs. The company says it believes this to be the first affinity partnership in the water sector and that take-up has been good.

Castle has similar deals with a number of other organisations including the Scotland Food & Drink, and it recently unveiled a partnership with the Scottish Council for Voluntary Organisations (SCVO). The Scottish Government exempts many charities from paying water charges and under the SCVO deal Castle manages applications to the scheme on behalf of charities. It also guarantees that those qualifying for a 100% discount (those with less than £200,000 of annual income) do not have to pay charges before applying for an exemption and that those qualifying for a 50% discount on wholesale charges (those with £200-300,000 of annual income), will not be charged a supplier margin on the exempt proportion of charges. For charities and other voluntary organisations that do not benefit from the exemption, Castle offers a group discount agreed with the SCVO.

Reynolds comments: "The reason we do affinity deals is to keep costs down. We use standardised contracts, bulk procurement power and don't use brokers, so there is no commission to cover. Instead of paying commission, we cut costs for customers."

On the service side, Castle offers all the things you would expect to see from a competitive retailer – account management, billing and payment choices, value added services and so on – but on top emphasises its transparency and plain dealing. For instance, its quotes break prices down into their individual elements so customers can see how they have been calculated and full terms and conditions are on its website.

UK strategy

It is with these two offerings that Castle is gearing up to enter the English market after April 2017.

It is far more enthusiastic about crossing the border than many of the other LPs in Scotland seem to be; many of these are hesitant because of thin margins and the greater complexity in England. As a board member of Market Operator Services Limited (MOSL – see box), Reynolds is in fact actively working to make the post 2017 Anglo-Scottish market a good place to do business. So why is Castle so sure the English market offers opportunity?

Reynolds explains: "We have the cost base of an independent but the financial capability of a major integrated company. We set ourselves up specifically to compete in England as well as Scotland. We are working on our strategy for England at the same time as we are operating in Scotland."

And it is not planning a niche offering. Reynolds continues: "We will be ready to take on any size of company and any number of customers. Other independents are likely to go for niches across the UK but we have set up at the outset with a strong capital base and our aim is to have 10% of the customer base across the country. We were able to bid for the largest individual contract in Scotland [a £350m deal to serve over 200 public sector organisations over 15,000 sites and 27,000 SPIDs]; we believe we were the only independent capable of doing that."

Reynolds won't be drawn on specifics but he indicates Castle plans to deploy its affinity partnership model south of the border as part of its customer acquisition strategy, and also that Castle Water has a strong interest in acquiring customers from exiting incumbent retailers.

MOSL PRIORITIES

Reynolds was appointed to the MOSL board in July. He beat two other representatives of the "new entrant" contingent in a vote by LPs in Scotland that are not associated with English incumbents. His priorities as a board member are to make sure the market opens on time and that costs don't spiral out of control. He says of the work ahead for MOSL: "There's a lot of time pressure, but it's doable."

| See interview with MOSL CEO Ben Jeffs, p24-27)

Working capital

Looking at its time operating in Scotland, Reynolds finds a lot to praise about the market. Prices have fallen dramatically, there is differentiated service provision, and while errors have been difficult to correct, the switching process is good overall. He praises WICS, Scottish Water and Business Stream for the commitment they have shown to making the market work. As a former WICS member, he was close to the market and party to its development.

There are also issues, though, that Reynolds believes need attention, both within the Scottish market and with reference to the development of the English market. Chief among these is working capital – in fact, he describes this as "the mammoth in the room". The ability and cost of raising finance is critical to any business, but Reynolds says "a two tier system which unfairly favours the subsidiaries of English companies" has operated in Scotland around payment terms. He says the nub of the issue is that incumbents are assumed to have lower credit risk than independents with the result that financing costs are double for independents.

Reynolds notes that some early proposals for the English market suggested different payment terms for companies with an investment grade credit rating, which would have disadvantaged Castle for instance because it has no debt and hence no credit rating. However more recent proposals on payment terms seem to have resolved this "discriminatory and unfair" approach to Reynolds' satisfaction.

Sales code of practice

Another lesson Castle Water identifies from its Scottish experience is the need to develop a sales code of practice to protect customers. Reynolds references what he calls "the sad history of utility sales – every deregulated market has had a scandal" – be it on misselling, erroneous transfer, uninformed contact centre staff providing misleading information or similar. "All of these are problems I see day to day in the Scottish market".

He continues: "There are broad licence obligations and market codes but no sales code of practice. When the market was set up, there were so few LPs it wasn't an issue. Now, 10% of customers might switch in a single year and there are over 18 LPs. So there is more scope for abuse and we need action."

Reynolds would like to see specifically:

- Full disclosure of terms and conditions, including how much commission the sales agent gets, as happens in financial services markets.
- Full disclosure of prices. Unit prices should be quoted so customers can compare supplier to supplier easily. At present he says the tariff basket is overcomplicated and not fully understood by many customers. The supplier should also have a duty to highlight matters such as price escalation clauses rather than being able to bury them in large documents.
- No "gun to the head" sales practices, where customers are encouraged to sign deals immediately and without due consideration.
- More responsive complaints processes.

"These matters may not be an issue for large customers, but they are an issue for a large number of customers who are not sophisticated purchasers," comments Reynolds. "Many SMEs, the likes of guesthouses, don't realise they aren't afforded the same

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protections as domestic customers." He adds that a significant group of LPs support the idea of a sales code.

Manual intervention

A third key learning from Scotland Reynolds identifies concerns data quality. This has been patchy and problematic, and many customers have come to Castle Water with historic problems that weighed against automated switching. He says by and large these issues have proved manageable in Scotland because of the market size and the willingness of all involved parties to work together on resolution. The larger size of the English market and the larger number of players involved doesn't bode well for data quality, and this should be prepared for.

Reynolds: "What was actually a big positive for Scotland is a big warning for England. Often a critical mass of customer transfers couldn't be automated – for example because the data wasn't present or was garbled. There had to be lots of manual intervention, and that was managed with cooperation and good will between Scottish Water, Business Stream, us, other LPs, WICS and the CMA. The Scottish market wouldn't be as good as it is if the parties had not been intent on making it work. There is lots of informal back office cooperation.

"But this won't be possible in England because of the multiple wholesalers, retailers and other parties involved. So a whole piece of architecture that was not needed in Scotland is needed in England…the interpretation of codes, the resolution of disputes requires an interface of its own. This is not an optional extra, it's fundamental." Reynolds believes taking care of this would best sit with MOSL. He says while there is emerging understanding of the issue, it is not currently a priority while systems build consumes so much attention.

English market

Looking beyond these learnings from Scotland to how the English market itself is shaping up, Reynolds is reasonably positive about some of the issues that are often cited as difficulties by incoming retailers. Assuming payment terms do not impose unfair financing burdens on independents, he is not overly concerned the playing field will be uneven.

On the issue of the thin retail margin on the table, he observes "this does not look to us to be sufficient to fund commission-based activity" – so the standard broker model may be out the window. However, he adds: "We have developed a route to market without commission. Other LPs are also looking for sensible routes to cross to England. There may be a series of different niche strategies. But we are confident we can operate in the market."

Reynolds would, though, like to insulate the margin from further erosion by rationalising the complexity created by multiple wholesale service agreements and tariffs. He says contractual compliance in such an environment will be problematic and cumbersome and hence costly. "But the issue isn't unresolvable. I can envisage a strongly recommended wholesale service agreement with only minor variation company to company. That sort of template would have significant advantages." TWR

GSS to be extended and split

All business customers will remain protected by the Guaranteed Standards Scheme (GSS) regardless of who supplies their water and sewerage services under plans Ofwat will recommend to DEFRA.

The GSS, which entitles customers to minimum compensation payments if their supplier falls short on service standards is currently only an obligation for incumbent companies but will be extended to cover all retailers. This will ensure customers are not deterred from switching and that those whose incumbent supplier opts to exit the business retail market are not adversely affected.

Ofwat has proposed existing standards covered by the GSS are allocated as either wholesale or retail functions under the GSS Regulations as shown in the table, so there is clarity over who is responsible for what in the reformed market.

Under the plans, customers will not be able to opt out of the GSS. The standards and payments themselves will not be reviewed at this stage, but could be after market opening.

SUGGESTED ALLOCATION OF GSS STANDARDS TO WHOLESALE AND RETAIL

GSS Regulation	Wholesale	Retail
Making appointments – GSS Regulation 6		✓
Keeping appointments – GSS Regulation 6		✓
Low pressure – GSS Regulation 10	✓	
Notice of interruption to supply – GSS Regulation 8	✓	
Supply not restored – GSS Regulation 9	✓	
Account queries and requests to change payment arrangements – GSS Regulation 7		✓
Complaints – GSS Regulation 7		✓
Flooding from sewers (internal flooding) – GSS Regulation 11	✓	
Flooding from sewers (external flooding) – GSS Regulation 12	✓	

Self-lay troubleshooting

Ofwat is consulting until 13 November on how self-lay agreements can balance the interests of competitive new connections providers and water companies concerned about infrastructure quality assurance.

Richard Khaldi, Ofwat's senior director, customers and casework said: "Last year we set out our general expectations on a series of common areas of dispute for new connections charging. This has helped to reduce the number of disputes arising on these issues and we are keen to expand that approach to other areas of dispute, such as self-lay agreements."

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