THE WATER REPORT

POLICY | REGULATION | COMPETITION

APRIL 2016

Eyes wide open

With one year to go until retail market opening, DEFRA's Sarah Hendry, Ofwat's Cathryn Ross and MOSL's Ben Jeffs remain committed to an April 2017 go-live – but look to manage expectations.

COMPETITION WATCH

- Ofwat to stick with 2.5% margin in NHH retail price control.
- Data concession in readiness licence condition.
- WSSL regime opens for business.
- Credit risk in the household retail market.

INSIDE

THE WATER REPORT COMPETITION WATCH

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EDITOR'S COMMENT

Will good enough be good enough?

It's the one-year-to-go milestone for non household retail market opening, and everyone seems to have an opinion on the state of play. These range from the positive – we're just 12 months away from a new land of opportunity – to the downright negative: companies are struggling, data is bad and customers will be disappointed.

The truth probably sits somewhere between the two extremes. It is welcome, then, to hear the Open Water partners taking a pragmatic line. Our interview this month is a triple-header: DEFRA director Sarah Hendry and the CEOs of Ofwat and MOSL, Cathryn Ross and Ben Jeffs. The three leaders convey a commitment to opening the market on time in April 2017, but are sensibly not over-promising on what that market will deliver in the short term. Hendry sums up the position: "You can't expect any market to be fully functioning and mature on day one. The question is: is there enough in place, are the building blocks there, for it to be a credible opening? The market can evolve and mature after that."

Ross agrees that "open" doesn't mean the market won't need to change. She openly envisages issues surfacing – specifically she mentions issues concerning compliance and the level playing field – but points out that such things are part of the "normal evolution of markets" not anything that should prevent go-live.

This is the business of managing expectations; of treading a fine line between delivering on a political promise to give customers the choice they want (see p27) while not leaving themselves open to criticism that the market isn't immediately living up to the picture they painted of it. It's a matter of central arrangements and company preparations being good enough to go, not perfect.

A good illustration of the approach is the recent amendment to the market readiness licence condition Ofwat has proposed introducing into water company licences. It has been revised to reflect the fact that 100% data accuracy isn't realistic and in fact that the condition only needs to be "targeted at the outcome that must be achieved, specifically that each company's data is sufficiently accurate to enable the effective functioning of the market".

The $64,000 question is: will "good enough" be good enough? It will be good enough to open but will it be good enough for the customer experience to be positive? Good enough for water company reputations not to suffer? Good enough for new entrants to be attracted in?

Karma Ockenden, editor,
The Water Report

Feedback, comments and suggestions very welcome.

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

BREXIT: LITTLE UPSIDE FOR UK WATER

Securing investment would be hard hit if Britain left the EU, according to the findings of our latest Expert Forum poll.

The Water Report Expert Forum – leaders and opinion-formers from in and around the sector (see box TWR Expert Forum) – is far from enamoured by the prospect of Britain leaving the EU. Few see much upside potential for the water industry, but plenty see downside risk.

Earlier this month, *The Water Report* and our research partner Accent polled Forum members on how UK water might be affected by an out vote. As chart 1 shows, in overall terms, two-thirds said Brexit would be negative for the UK water industry. A further 19% considered it would have no effect, and just 14% thought it would be positive. The biggest perceived threats and opportunities identified by Forum members are shown in table 1.

Chief among the issues driving negative sentiment was the expected impact on investment. Among respondents' comments were:

- "It is likely to cause uncertainty and increase interest rates. In addition it will discourage some foreign investors who have big stakes in the UK water industry."
- "It would lead to economic uncertainty and might spook some of the EU based lenders. I think we can expect bank rates to rise in UK and for there to be a risk premium added to EU based and USD based loans."
- "Loss of the European Investment Bank (EIB) as an investor would be detrimental."

Others with negative views cited concern for the possible impact on quality standards:

- "The UK water industry has been strongly focussed on delivering European standards compliance for many years. While these or similar standards would be likely to remain under Brexit, there may well be a change in appetite for, and speed of, work to deliver and maintain compliance."
- "EU policies and rules have driven up improvements in all areas of the water environment."

However, to others, freedom from European quality and environmental standards was a positive. One commented: "A lot of the costs in the industry are related to meeting EU standards. At the moment, there is not much public discussion on those costs which the government is imposing on customers. If the UK exited the EU and had to set its own environmental standards, there [would] need to be more explicit public discourse on those standards and if customers should continue to pay for those standards. This additional transparency would be a positive from exiting." Another saw an opportunity to tailor standards better without the unifying influence of Brussels: "I'm pro-EU but I think the EU Directives which affect our industry are not as good as they could be for an island."

No upside for investment

To gauge sentiment on such key issues in more depth, *The Water Report* asked how respondents felt exit would impact three overarching issues: securing investment, protecting the environment and policy certainty. The results are displayed in chart 2 and show securing investment is the area expected to be hardest hit. Not a single Forum member thought Brexit would be positive for securing investment, while 57% said it would be negative. There were repeated mentions of access to EIB funds in particular.

There was some positive sentiment regarding the environment, but this was still dwarfed by the proportion reporting negative views. One said it was "difficult to imagine a Conservative government giving the protection of the environment much priority without the EU to mandate in this area".

Brexit attracted a fair amount of positive sentiment regarding the issue of policy certainty, with just short of a third of respondents seeing upside. One reason cited was more local control over policy: "Policy will be made in London rather than Brussels and London." However, many others commented negatively, including the following:

- "European policy provides a degree of stability in terms of direction and priorities. Without this moderating effect UK water policy could be much more volatile; bad news for an industry that needs policy stability and clarity."
- "If we leave there will be vocal opposition to some of the current and planned environmental safeguards which will lead to uncertainty."
- "Negative while the exit is being negotiated and also negative because the scope for policy changes with changes of government would be slightly greater."

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.

The next Forum will take place in May for the June 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

A hiatus?

Following on from the certainty question, we asked the Forum: in the event of a vote for Brexit on 23 June, how long do you think it will take for your organisation to be able to confidently make business decisions for the future? A fifth were confident they would be able to act immediately. The rest anticipated a hiatus of some kind. Just over half (57%) felt there would need to be a wait of as yet indeterminate but approximately intermediate length: decisions could be taken once Brexit terms are understood. (However, one cautioned that to even get to this point could be a way off: "I think it will take a number of years to negotiate Brexit and a few more to implement.") The final quarter expected confident decision making to take considerably longer. For instance, one respondent observed: "It will take some time for the 'dust to settle' on what the drinking water quality and environmental performance standards will become." These results are shown in chart 3.

CHART 1: OVERALL FOR THE UK WATER INDUSTRY, WOULD BREXIT BE:

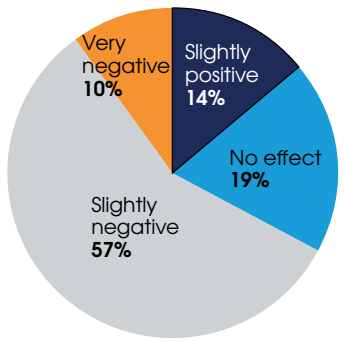
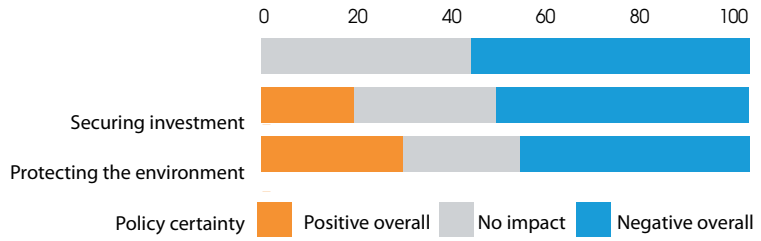


TABLE 1. WHAT IS THE BIGGEST THREAT/OPPORTUNITY FOR THE WATER INDUSTRY FROM BREXIT?

Biggest threat	Biggest opportunity
Investment: ▌"Potential impact on EIB funding and investor confidence." ▌"Access to long term investment." ▌"Temporary financial instability, followed by longer term losses of investors and R&D opportunities." ▌"Withdrawal of foreign investment."	**Flexibility on quality standards:** ▌"A more informed and flexible approach to setting and delivering environmental gain." ▌"Leaving the EU and setting our own environmental standards, with the additional transparency and debate resulting from that process, could create the opportunity to tackle the issue …of the UK Government using the current arrangements as 'an environmental credit card' with too little regard for those paying the bills." ▌"Unfettered ability to determine environmental standards."
Quality protection: ▌"Progress on drinking water and environmental standards has largely been driven by European standards. Although it's difficult to imagine any UK government relaxing standards for drinking water, it is very easy to imagine the temptation of relaxing environmental objectives. This would make it more difficult for the water industry to continue to secure investment in infrastructure and capital maintenance. Progressive asset deterioration would be bad news for customers as well as the ecosystem services on which we all rely."	**More control over policy and regulation:** ▌"Certainty and control around regulation." ▌"Greater freedoms in regulation." ▌"More tailored regulation designed specifically for the UK rather than for average conditions in the whole EU". ▌"Opportunity to develop its own water and environmental policies." ▌"To tailor compliance standards to the specific needs of UK citizens and the UK environment." ▌"Speedy policy decisions."
Uncertainty & increased risk: ▌"Risk that the exit drags on and creates additional financial uncertainty which results in a higher cost of capital at the next price review." ▌"Period of uncertainty for the economy whilst exit terms are negotiated."	**Less red tape:** ▌"Less red tape enabling more innovation and investment into certain areas." ▌"Less rules which inhibit innovation. Ability to form stronger alliances with powerhouse economies outside the EU." ▌"Rationalise the various directives
Reputation will suffer: ▌"The perception of the UK as 'Little England' reluctant to be a full and active player in global markets."	**More domestic investment:** ▌"Opportunity to secure more home grown financial investment."
Research will suffer: ▌"Some loss of collaborative research."	

CHART 2: PLEASE INDICATE HOW YOU FEEL BREXIT WOULD IMPACT THE FOLLOWING OVERARCHING ISSUES FOR THE UK WATER SECTOR:



ENERGY ON THE SAME PAGE

The Water Report worked with energy title *New Power* in pulling the Brexit survey together, and *New Power* readers completed the same poll as the TWR Expert Forum. The idea was to compare sentiment on an out vote between the two industries.

New Power editor **Janet Wood** summarises the energy results below, with little to distinguish them from those from our Forum:

There is little upside to an exit from the EU for the UK's energy industry, a survey for New Power revealed, and significant downside risks.

That concern existed even though respondents felt that the UK's place within a European energy market would be unlikely to change. Existing trading arrangements would remain in place and plans for increased interconnection would mean day to day operations would continue to be closely linked. But that position came with risk: several respondents pointed out that the UK would have to comply with EU market rules but would lose its ability to influence them.

The biggest risk was seen as the ability to access international finance, both because of uncertainty during the referendum and exit process and in the long term for a UK outside the EU. That uncertainty extended to the likely actions of European-headquartered utilities like RWE and E.On after a vote to leave.

Some respondents did see weak upside in an exit, because it would allow the UK to rethink its energy policy. But views here were mixed: Brexit offered an opportunity to escape Brussels' influence, but while some thought that was an opportunity for more flexibility others saw it as increased political risk.

Those looking for upside also saw some potential short term gains for exporters, because they expected to see the value of Sterling falling sharply in the event of a vote to leave. But others said the downside risk for importers and commodity traders was more important.

Overall, a third of respondents thought their company performance would be worse after an exit and just 8% thought it would be better.

Only a quarter of respondents thought that they could take business decisions with the referendum looming. Half considered they had to wait until the terms of any exit become clear and a quarter thought they would have to wait much longer – either after the exit was complete or still further in the future.

The business of water

Water companies are businesses, as well as specialists in the provision of clean water and sewerage. The indirect practical effects of Brexit (both positive and negative) have been raised by many sectors – for instance, implications for procurement processes and staffing. We asked respondents how they felt Brexit would affect their business.

As shown in chart 4, water sector concern on this front is far less significant. A half or more of all Forum members said there would be no impact in any area. Aside from access to finance which has been discussed above, research and development emerged as the area where the highest proportion of respondents foresaw a negative impact.

A significant chunk – 19% – felt procurement and tendering processes would be positively affected by Brexit, presumably a hope that some of the more onerous EU-prescribed aspects could be done away with. Similarly, 10% saw upside regarding use of data – again, presumably a hope of less restrictive legislation.

Finally, *The Water Report* asked Forum members to predict what their organisation's first action should be in the event of a vote to leave the EU. Once again, shareholder relations and financing dominated the action. Some of the comments we received are displayed in table 2. TWR

CHART 3: IN THE EVENT OF A VOTE FOR BREXIT ON 23 JUNE, HOW LONG DO YOU THINK IT WILL TAKE FOR YOUR ORGANISATION TO BE ABLE TO CONFIDENTLY MAKE BUSINESS DECISIONS FOR THE FUTURE?

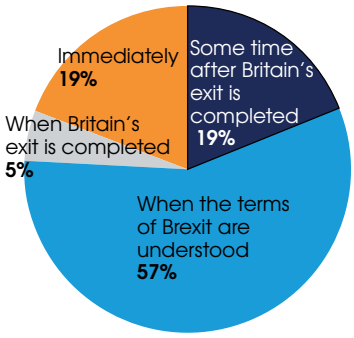
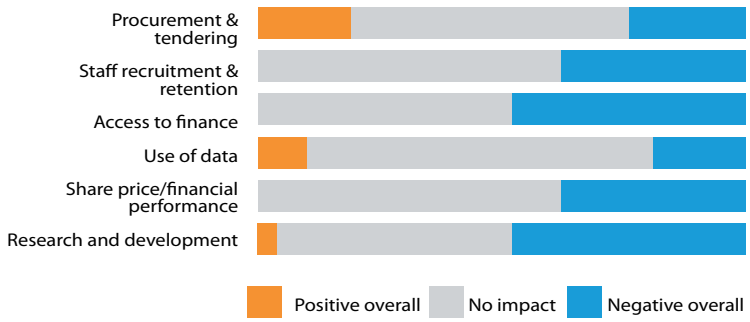


TABLE 2: WHAT DO YOU THINK YOUR COMPANY'S FIRST ACTION SHOULD BE IN THE EVENT OF A VOTE TO LEAVE THE EU?

Strategy	Comments
Protect the money	"Spend time trying to persuade shareholders that it will be alright really!" "Activate our plan to replace Euro bank loans on the open market." "To confirm existing financing facilities."
Take stock	"A Board and Risk Management Committee review." "Seek advice on potential impact on competition law."
Keep calm and carry on	"Business as usual." "Wait to understand the full terms and how they will be implemented, particularly around the application of regulations."
Strength in numbers	"Ensuring that Water UK briefs the government's negotiators on Brexit on the requirements of the sector." "Work with the rest of the water sector to clarify investment."

CHART 4: HOW DO YOU FEEL BREXIT WOULD AFFECT YOUR BUSINESS IN TERMS OF EACH OF THE FOLLOWING:



THE WATER REPORT
EUROPE WATCH

IN BRUSSELS THIS MONTH: COMMON SENSE ON DWD; OVERFLOWS UNDER INFORMED

There are some new developments on two topics that have been mentioned a few times already in this column.

DWD revisions…again

First the latest on the Drinking Water Directive. It looks like the policy options are going to be revised again – I think this will be the third time in four months. The good news is that some of the more unachievable and hopelessly complicated options like a water safety label are no longer in the Commission's thinking. That's good as it was never clear where the label would be applied – was it to the water as it leaves the treatment works or as it leaves the tap, or somewhere in between?

Also, it looks like any plans to introduce mandatory EU-wide benchmarks on water services are now also off the agenda. I am glad the Commission has listened to sense on this. The Commission is still sticking to its plan for a body like the Consumer Council for Water in every EU Member State. Perhaps this will be an opportunity for the sector to export its expertise, just as water minister Rory Stewart suggested at the recent Water UK City Conference.

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

Overflows report

Next, another regular topic for this column – overflows. We have just seen the latest version of the report from the Commission's consultants. Overall, the Commission seems to be concerned about the lack of information and monitoring of overflows, their impacts and how information is given to the public.

This review found that all Member States address storm water overflows on some level: for example, those with incomplete transposition of the Urban Wastewater Treatment (UWWT) Directive have standards or guidance that mention the issue. However, the review found that the majority of Member States do not have a national definition for key terms, including "storm water overflows" themselves.

The review also showed that, in addition to a limited understanding on the occurrence of overflows, limited data is available at Member State level on the underlying drivers of storm water overflows, i.e. rainfall variability, design characteristics of sewer and overflow structures and the impervious area that is connected to a particular combined sewer system.

The review identified three broad areas where action could be taken to improve the knowledge base and better assess the impacts of storm water overflows:

- Better understanding of the impact of storm water overflows on the quality of the receiving water body.
- Better assessment of health risks, based on the exposure of human activities to contaminated water.
- An approach to monitor storm water overflows .

The review mentions the UK infringement case from 2012 which affirmed the need for Member States to implement the provisions on storm water overflows in the UWWT Directive. It suggests EU guidance could be developed and could clarify several concepts and principles cited in this case, in the UWWT Directive and in discussions of storm water responses. For example:

- What are "normal climate conditions" under which the occurrence of storm water overflows would be non-compliant?
- What are "circumstances of an exceptional nature" under which storm water overflows may be acceptable? In particular, how would "exceptional rainfall" be defined?
- Could quantitative objectives and standards be set to control and reduce the occurrence and impact of storm water overflows?

A common approach?

The review suggests that guidance on applying this provision would help to ensure that Member States follow common approaches to address storm water overflows, including how to quantify in monetary terms the effects on the environment and health of untreated discharges. However it adds Member States have established standards and guidance for storm water overflows, and different collecting system situations and local climatic conditions. So the review concludes that it will be difficult to reach an agreement between 28 Member States on a common European approach.

We will find out very soon more detail about the overall timeline for the review of the UWWTD. TWR

CPI: OFWAT SHARES NEUTRALITY MODEL AND OPTIONS STUDY

An Oxera report finds the impact on bills, not investor arguments, may justify a gentle transition to changing the indexation of RCV

Ofwat has heeded calls from investors and others to share details on exactly how it plans to ensure the RPI-CPI transition at PR19 is value neutral. And ahead of the publication of its decision document on the indexation of future price controls next month, it has shared other research which suggests it will press on with its groundbreaking plan to change the indexation of regulatory capital value (RCV) as well as revenues.

Following calls for more transparency – for instance, at Water UK's City Conference last month and in a KPMG paper for United Utilities on the nature and depth of the commitments required from Ofwat to deliver revenue and value neutrality – the regulator held a workshop in March where it presented an illustrative model to demonstrate how true-ups could be calculated in practice. It has now made its thinking publicly available, publishing on its website:

- the RPI-CPI illustrative true-up model
- a guide to assumptions and use of the model
- a study commissioned from Oxera on the potential benefits and costs of different options for change.

Speed of change

The Oxera work, *Indexation of future price controls in the water sector*, suggests success in alleviating investor concerns about revenue and value neutrality will be one of the determining factors in when (the implication is not 'if') the RPI-CPI transition is made. It noted: "The desirable speed of transition may depend on the extent to which Ofwat and the industry can work together to alleviate some of the existing concerns about the NPV-neutrality of the proposed changes, and on the emerging bill profiles."

Oxera scrutinised several options for indexation change, ranging from no change, a change to the indexation of revenues only, a change to the indexation of both revenues and RCV, and options which involve different proportions of the RCV continuing to be linked to RPI. Given the uncertainty around the final UK Statistics Authority decision regarding the status of CPIH, it also considered both CPI (the generally used measure of inflation) and CPIH (which is CPI including the costs of owner-occupied housing) as potential candidates to replace RPI. These options are summarised in table 1.

Oxera's work suggests the impact on customer bills, rather than any financing or operational concern raised by companies and their investors, is the thing might justifiably put the breaks on the speed of indexation change.

Revenues and RCV

The report snubs the arguments made by some investors that RPI remains a legitimate index and should continue to be used. It said: "Overall, we find that RPI is calculated using a statistically flawed method, has been discontinued as a national statistic, and generally results in an upwardly biased measure of consumer inflation. It is therefore appropriate to phase RPI out of the price control framework."

This supports the findings of the 2015 Johnson review which urged regulators and other public bodies to aim to discontinue the use of RPI and to rely on more internationally accepted statistics. In the case of water, Oxera found there to be a "clear case" for moving away from RPI revenue indexation and "good reasons" to change the basis of the RCV indexation. The report added: "Given the identified issues with RPI as an inflation statistic, options that involve faster transition of the RCV to CPI (or CPIH) indexation might be preferable."

The report came down on the side of moving to CPI rather than CPIH, but noted this may change if the government were to adopt CPIH as its primary measure of inflation (as suggested by the Johnson review). Investors have pointed out that a CPI market may take years to emerge: there is little demand for CPI-linked debt currently and a liquid CPI government bond market may not develop. They argue Ofwat would in effect be putting the cart before the horse in creating CPI demand and expecting the market to respond.

The Oxera analysis dismissed this as an issue, finding it is "not evident that there is a need for Ofwat to demonstrate that a sufficiently liquid CPI-linked debt market exists". It accepted the CPI-linked debt mar-

TABLE 1: OPTIONS FOR CHANGE

Option	Indexation of revenues	Indexation of the RCV	
Option 1: no change	RPI	RPI	No change in the forecast level of bills
Option 2: only revenue indexation is changed	CPI (or CPIH)	RPI	
Option 3: full switch	CPI (or CPIH)	All RCV indexed to CPI (CPIH)	Options imply a change in the forecast level of bills
Option 4: transition based on the notional proportion of RPI-linked debt	CPI (or CPIH)	15% of the RCV indexed to RPI; the rest, including new RCV, to CPI (or CPIH)	
Option 5: transition based on Water 2020 preferred option	CPI (or CPIH)	50% of the RCV indexed to RPI; the rest, including new RCV, to CPI (or CPIH)	
Option 6: transition based on notional equity	CPI (or CPIH)	62.5% of existing RCV indexed to RPI; the rest, including new RCV, to CPI (or CPIH)	
Option 7: transition based on new RCV only	CPI (or CPIH)	existing RCV indexed to RPI; new RCV additions post-2020 indexed to CPI (or CPIH)	

Source: Oxera

ket was "currently in its infancy, with the absence of a government CPI-linked bond market being a key driver of this". It commented that predicting the costs and speed of development of such markets is difficult: "On the one hand, it is conceivable that, at least initially, CPI-linked products will be more expensive than other debt instruments currently available to the industry. On the other hand, there are other drivers, such as growing pension fund demand for CPI-linked assets, that could help to unlock a competitive CPI- linked market more rapidly than has been observed historically for other nascent financial instruments."

In light of this uncertainty, the report concluded it was reasonable for Ofwat to hold fire on plans for 2025 onwards and to keep a watching brief on developments. It said: "Companies' financing choices are driven by a range of factors, not just the indexation metric used by the regulator in the price control. It may well be the case that companies continue to use a mix of nominal and RPI-linked debt, as well as explore opportunities for CPI-linked issuances. This may reveal useful information about the costs of such products for future regulatory periods."

Risk and NPV neutrality

The report looked at regulatory risk and acknowledged that changing a long standing element of the regulatory framework – particularly a change to the indexation of RCV and the use of more discretionary tools such as pay as you go levers and run-off rates to adjust cash-flow profiles – carries the potential of a regulatory risk increase. It advocated the tonic of transparency and good communication, pointing out that "the more clarity Ofwat can provide on how the NPV-neutrality commitment will be achieved in practice, the more the concerns raised are likely to be alleviated".

Specifically, it suggested the following elements could help to ensure NPV-neutrality in practice:

- ensuring that nominal totex allowances are not affected by changing the indexation measure
- ensuring that the nominal allowed WACC is not affected by changing the indexation measure
- continued assurances that Ofwat will enable companies to use cash-flow profiling tools to maintain balance between cash flows within a price control period and RCV growth.

TABLE 2: BENEFITS AND COSTS: SUMMARY

Dimension	Benefit or cost relative to Option 1 (no change)?	Does the impact differ significantly by option?
Legitimacy of the inflation statistic	Overall, any change is likely to bring a benefit, but one that cannot be reliably quantified.	Options that involve faster transition of the RCV to CPI (or CPIH) indexation might be preferable.
'Fairness' of consumer bills and volatility of consumer bills	Overall, any change is likely to bring a benefit, but one that cannot be reliably quantified.	Difficult to distinguish between the options on the basis of these two specific criteria.
Reflectivity of movements in companies' operating costs	No material cost or benefit.	The impact is similar under all options considered.
Impact on financing costs	No material benefit or cost.	The impact is similar under all options considered.
Impact on regulatory risk	Ofwat could take mitigating actions to ensure that perceptions do not translate into a direct cost to consumers.	Perceived increase in regulatory risk likely to be higher, the faster the transition of the RCV indexation to CPI (or CPIH).

Source: Oxera

Oxera added: "However, as with any change to the regulatory framework, there are inevitable limits on what can be committed to, in particular beyond a five-year price control period. In this regard, the regulator's track record of managing change is likely to be an important driver of the overall perceived risk and stability of the sector."

The research concluded: "Overall, it is not clear that the concerns raised should translate into a cost to companies (and therefore a cost that needs to be passed on to consumers) under any of the options considered."

Similarly short shift was given to any suggestion that changing indexation arrangements (under any option considered) would materially change the industry's operational risk or financing costs – in aggregate. Oxera accepted "the impact may be felt differently by different groups of debt/equity investors" but said holistic considerations were more important: "Given that, in aggregate, risk is not increasing and there is a market for equity and debt finance in the sector, it is unlikely to be in consumers' interests for the indexation choice to be unduly influenced by the needs of one specific investor group."

Bill impact

More than any other factor, it is the impact of RPI-CPI transition on bills that gives the researchers pause for thought. They find indexation of revenues would have no impact on bills but options that involve a change to the indexation of the RCV would. Without any mitigating action, there would be an increase in bills in the short and medium term which would be offset by lower bills in the longer term. The report explains: "The size of the short term bill increase will depend on how much of the RCV is indexed to CPI (or CPIH) versus RPI—the more of the RCV is switched to CPI (or CPIH), the bigger the bill impact. However, we note that Ofwat has suggested that companies may need to explore options for smoothing the bill impacts through other regulatory levers. These levers include expenditure that is reimbursed as PAYG and the speed of depreciation of the RCV (run-off rates)."

Oxera said some price rises could be justifiable – "if some indexation options imply a change to the level and profile of bills that helps to improve the cost-reflectivity of tariffs, such change could bring bills closer to their fair level. This suggests that some change in bills might be justifiable, if phased in gradually without prompting an undue adverse response from consumers. Overall, this would support options that involve changes to the indexation of the RCV, but a specific desirable speed of adjustment is difficult to establish."

Given this, the report concludes: "However, we are mindful of the potential bill impact of a fast transition, and the impact that this appears to have on the perceived credibility of Ofwat's NPV- neutrality commitment. Therefore, on balance, there is a credible case for some form of transition of the RCV indexation." TWR

WICS: BACK OFF ON BORROWING AND RING FENCE RESILIENCE FUNDS

Scotland's regulator continues with its year-long strategy to inform its methodology for the next price review. On the agenda this time: sustainable finance.

WICS has set out a possible long term vision for the Scottish water industry which envisages low or no borrowing from the Scottish Government, increased maintenance spending and ring fenced resilience funds, all the while keeping customer bills at or around inflation. It put its ideas forward in a series of papers which are designed to promote discussion by an "Advisory Panel" – a group of experts who will provide comment, challenge and insight on the regulator's proposals for how the regulatory framework could be enhanced ahead of the next price review (see box – WICS Advisory Panel p13).

The theme of the latest set of Panel papers is to explore options for establishing a practical and sustainable governance and financing framework for the water industry in Scotland, in the context of public sector ownership and other background factors (see box 2 – the Scottish water environment). WICS suggests that the combination of a long term vision and a stable financial/regulatory framework would be useful to Scottish Water as it pursues innovation and further efficiency improvements to deliver more for customers. In particular, today's low inflation environment provides an opportunity to develop this further – to allow for higher levels of capital maintenance and resilience funding. It sees an opportunity to reduce or remove the need for the government to lend to Scottish Water, which would increase predictability for the company, and argues there "is a reasonable prospect of customers' bills being below the rate of expected inflation for the foreseeable future". Below we unpack and explore the key themes.

Borrowing…

Contrary to expectations in 1999 when economic regulation was introduced to Scotland's water sector, high levels of enhancement expenditure look set to stay, largely on the back of ongoing European quality requirements. This raises the question of what level of borrowing is appropriate to fund it. WICS notes the high levels of borrowing that have come to characterise the sector in England and Wales and the high dividend levels these have helped sustain. Chart 1 shows the proportions of debt and equity finance employed by the water industry in England and Wales over time.

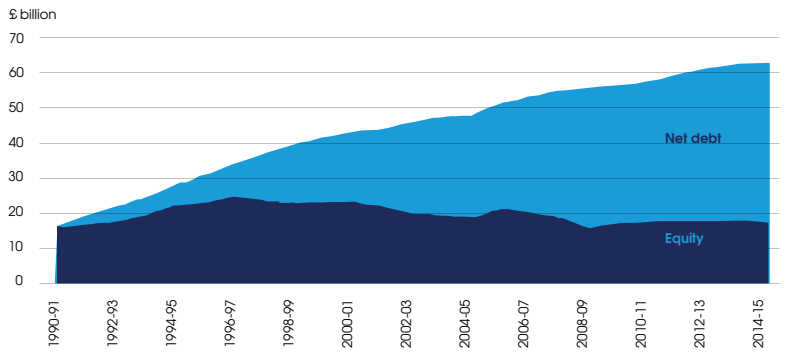
WICS questions the intergenerational equity associated with ongoing borrowing: "Current shareholders and customers may be benefitting at the expense of future generations. The risk is that the cost of financing the water industry increases over time. Sooner or later such an increase in the cost of financing would be to the detriment of customers. Even at today's low interest rates, it would likely… take no more than 25 years for the interest cost accumulated on this regular borrowing to exceed the next annual instalment."

Scottish Water is in a better position than companies south of the border, having borrowed less and paid no dividends. But nonetheless the regulator would like to see a reduction in its reliance on borrowing to finance enhancement investment. As chart 2 shows, there has been a steady increase in the level of net new borrowing as a proportion of the enhancement investment programme. Alan Sutherland, WICS chief executive, points out that far from coming under government pressure to reduce water borrowing, the Scottish Government has committed to delivering finance. The initiative on this is entirely from the Commission.

Timing is key for WICS in commenting on what the actual level of prudent borrowing should be. In the long term, it argues it is appropriate to borrow only a proportion of the cost of an incremental enhancement and that the term of the borrowing should be shorter than the expected life of the asset that is created. In fact it argues there is no intrinsic reason to borrow if the level of average annual expenditure on enhancing assets is expected to remain broadly constant over the medium to long term. To do so is to increase cost as interest charges will be incurred.

It cites the option of Scottish Water redirecting cash flow internally to its next highest priority investment as an alternative to regular borrowing, in a similar way that some governments and

CHART 1: DEBT AND EQUITY IN THE WATER INDUSTRY



THE SCOTTISH WATER ENVIRONMENT

WICS' vision for future financing and governance is designed to cater for, and respond to, the following background factors:

Ongoing investment requirements. "The original expectation was that the significant investment in improving water quality and environmental performance would be required for up to about ten years. It is now clear that current levels of enhancement investment are set to continue beyond the deadlines for the implementation of the Water Framework Directive (in 2027). Further directives relating to hazardous substances and, potentially, rural supplies will require further, potentially significant, expenditure."

Scottish Water's de facto limitation to borrowing only from the Scottish Government. The overview paper advises: "Scottish Water could theoretically borrow from any source – but it must be able to demonstrate that it is the cheapest source available. This has the effect of ensuring that all medium and longer term borrowing is provided by the Scottish Government."

The range of pressures on the Scottish Government budget inevitably leads to uncertainty over the levels of available borrowing over the regulatory control period. According to WICS: "Such uncertainty may be detrimental to the effective management of the business. It could remain little more than a distraction or it could, in future, impact on the efficient planning and procurement of larger improvement projects."

The long run cost of borrowing. "From a customer perspective, borrowing a consistent amount year in, year out may reduce bills in the short to medium term – but it increases bills over the long run. Even at today's low interest rates, say 4%, it takes just 25 years for the interest cost accumulated on this regular borrowing to exceed the next annual instalment. And if new borrowing covers the cost of anything other than true increments to the asset base, future customers could be left with more than their fair share of the costs. A 'pay as you go' approach is both cheaper and is likely to be more transparent."

Scottish Government objectives and charging principles for the water industry have been consistent over time and according to WICS "there is little reason to believe that they will change markedly". This supports a long term and sustainable approach to the industry. Common themes include: a desire to keep charges stable and predictable over the long term; that Scottish Water should continue to improve levels of service to customers and value for money; and that economic growth should be accommodated. Delivering these objectives will require Scottish Water to innovate.

Price expectations. There has also been a broad consensus that bills should not increase faster than inflation. WICS adds: "The increased political scrutiny of the water industry in Scotland (a function of its devolved status and Scottish Water remaining in public ownership) also means that the level of bills in Scotland is regularly compared to that in England and Wales…It seems likely that there will continue to be an expectation that water bills in Scotland should be cheaper than in England and Wales and that they should not increase faster than the rate of inflation."

large companies do to self-insure (using cash flows from their range of activities to underwrite the risks that they run). The WICS papers model four borrowing scenarios and their impact on prices (see below).

…from customers

The regulator accepts there would need to be some exceptions to this low/no borrowing approach – for instance, short term borrowing to manage cash flow may be necessary, or there may be a specific set of circumstances where enhancement borrowing is sensible. It explains: "This could be the case if there were a short-term pressure to comply with a new Directive or to deliver some other desired output and future expenditure was brought forward without affecting the long run average level of spending. One example could be a decision to remove lead from the entire water supply system. This would be a demonstrably one-off initiative, which would benefit both current and future customers. As such, it could be appropriate to spread the cost of this work over a much longer period than the actual period required to complete the work."

Should such financing be necessary, the WICS paper offers some possible options as alternatives to borrowing from the government. They centre on involving customers in sustainable financing.

Customer bonds. These could be bought by Scottish Water customers only. WICS notes: "The recent low-interest rate environment has meant that retail bond issuances have become more popular and have been met with strong demand. An example can be found in Severn Trent's 2012 retail bond issue to help finance its 2010-2015 capital investment programme." This raised £75m through an RPI linked 10 year sterling bond. The regulator adds that

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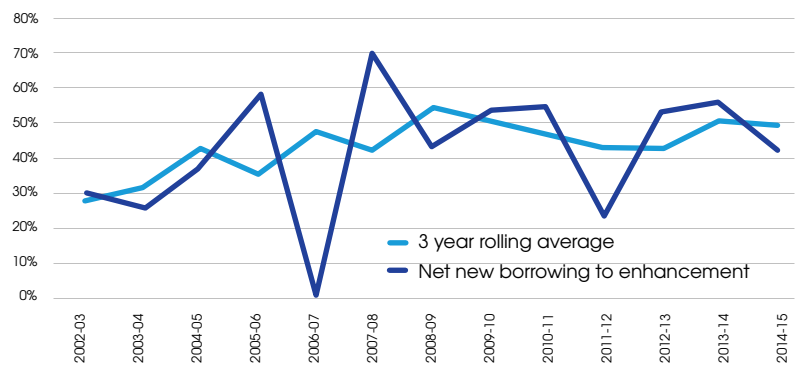
CHART 2: NEW BORROWING AS A PERCENTAGE OF SCOTTISH WATER'S ENHANCEMENT EXPENDITURE 2002 – 2015



BILL IMPACT SCENARIOS

Scenario	SW average bill relative to average E&W bill	SW average bill relative to Severn Trent average bill
Currently	SW £39 cheaper	SW £17 higher
SW annual nominal increase of 1.6%, by 2027	SW £76 cheaper	SW £2 cheaper
SW annual nominal increase of 1.9%, by 2027	SW £63 cheaper	SW £10 higher

Sutherland: customer borrowing would be a win win.

some companies – for instance online wine retailer Naked Wines – have offered product credit as an alternative to cash interest payments, usually on more favourable terms. Potentially, Scottish Water could credit customers' accounts as an alternative to paying returns out in cash.

Customer prepayment. Customers could be offered interest on payments made ahead of consumption. For example, Ovo Energy pays 3% interest on any credit balance for customers that prepay by direct debit. The interest is paid monthly based on number of days in credit and the amount left in a customer's account after the bill has been paid.

WICS notes such mechanisms would likely be complex to implement but offer benefits including: increased flexibility for Scottish Water and the opportunity to enhance its relationship with customers; reduced demand on the public sector purse; financial benefits for customer investors; and a lower cost of finance (and hence lower charges) for all customers. Sutherland comments: "If you are going to borrow, wouldn't it be better to pay lower interest rates than are available in the market to customers, and for customers to get a higher return than they would from an average bank or building society?"

Maintenance and resilience

The Panel papers discuss the condition and lives of Scotland's water assets, along with maintenance allowances and Scottish Water's associated expenditure. They conclude: "There is currently broadly sufficient spending on maintaining assets but that, at some point in the future, there will likely be a substantial bill to replace old and failing assets. The challenge is that we do not know when or how assets will fail. Nor do we know how much it will cost to restore levels of service. We also do not know what the consequences of a failure could be on the daily life of a community served."

Consequently, WICS has suggested a possible approach which would allow an amount in price limits consistent with the expected average life of Scottish Water's assets but with a proportion of this sum ring fenced for use only after a clear need has been defined and demonstrated appropriately. That way, the company will continue to face a hard budget constraint for ongoing maintenance requirements (driving efficiency and innovation) while also accruing resources for addressing expenditure 'spikes' associated with clearly identified replacement needs.

Sutherland explains the thinking is really concerned with doing the right thing in the long run. "It's easy to say we've got enough money just now…but the question is, will there be enough money in the system in 20, 30, 40 years time?" He likens the approach to the nuclear industry making provision for future clean up costs – something that was originally considered as a matter for the future and not funded at the outset.

The regulator is first to admit that its previous attempt to encourage Scottish Water to build up a financial reserve to deal with unexpected shocks proved ineffective. While, in extremis, the financial resilience of Scotland's water sector is under-pinned by government, there is no inherent equivalent of the financial cushioning of the private sector, where the presence of equity can offer a lifeline in times of extreme need (WICS cites the

SCOTTISH/ENGLISH DIVERGENCE

The English and Scottish water sectors have never mirrored each other exactly but now seem to be on increasingly divergent paths:

Ofwat is pursuing upstream reform, with sludge and water resources markets earmarked to be opened some time after 2020. The WICS paper explains: "The Scottish Government does not appear to have any interest in pursuing similar reforms. WICS has no plans to require any similar changes to the vertically integrated Scottish Water." Around 50% of the sludge produced in Scotland is treated at Daldowie under a PPP agreement, which expires in 2026. While WICS expresses "considerable concerns" about the efficiency of the current PPP arrangements, it expects Scottish Water to demonstrate efficient and sustainable sludge management going forward.

Increased water trading looks set to be a feature in England. This is unlikely to be followed in Scotland, given the country's resources, geography and structure. "The unwinding of geographical cross subsidies would not be consistent with the current policy of the Scottish Government," the paper adds. "Indeed, the political motivation for the creation of Scottish Water was to ensure that there were not substantial differences in the charges paid by customers depending on where they lived and worked."

There appears to be no political support for the introduction of household competition in Scotland, where household charges are considered to be progressive through the link to the Council Tax band of the property served. There is little appetite for metering in Scotland (more metering is a likely result of allowing domestic switching) and the potential impact on lower income households could be significant. WICS notes both the additional cost of supplying meters plus the loss of cross-subsidies outweighs any possible benefit from reduced water consumption.

The opening of the non household retail market in England next year will bring the country into greater alignment with Scotland, whose market has been open since 2008. However, WICS observes that in practice, the English market is likely to operate differently. "It does not require organisational separation. The framework in Scotland includes quite detailed 'rules of engagement' whereas the framework in England appears to rely exclusively on market participants understanding, and operating within, the requirements of competition law. Enforcement, if required, would likely be by means of ex-post interventions."

WICs cautions that pursuing a different path from England may require the Scottish Government to demonstrate the benefits that accrue to customers from its choices. This would require the governance and regulatory frameworks to be robust and effective and for Scottish Water to respond well to the incentives created. It concludes: "These planned changes to the governance and regulatory framework in England are likely to have an upfront cost and impact on customers' bills. The challenge in Scotland will be to ensure that the regulated industry can at least match any gains delivered by this new framework."

Yorkshire drought of 1995 as illustration). In recognition of this, in the 2006-10 price review, the regulator introduced the concept of a "gilts buffer" under which Scottish Water was required to invest the proceeds of outperformance in index linked gilts to reduce the exposure of customers to operational or financial shocks. "However, the combined effect of a reduction in available borrowing from the Scottish Government and a lack of formal governance around the buffer meant that, by the end of the 2010-15 regulatory period, outperformance had become part of Scottish Water's general cash balance and the gilts buffer ceased to exist."

A future resilience fund would require stricter governance. WICS envisages the following:

- A long term resilience trust fund, with independent trustees. Scottish Water would make regular contributions to the fund from the difference between the long-run economic allowance to maintain service levels and the cash expenditure in any year, together with outperformance gains. It could apply to the trustees to fund long term asset replacement; to improve the overall resilience of the water and wastewater service; and to provide additional customer service improvements in agreement with customers and the Scottish Government.
- A short term "half way house" reserve, under Scottish Water board control, to allow for the effective management of cash resources within a regulatory control period. The company could voluntarily feed into this reserve from a variety of sources.

The regulator would comment on transfers into the two funds.

WICS ADVISORY PANEL

WICS has convened an Advisory Panel, facilitated by Tom Sharpe QC, to provide expert comment on its thinking on how the regulatory framework should be enhanced. On the panel are Stephen Littlechild, Julian Franks, Tim Tutton, Steve Johnson, Nick Pollard and Keith Harris. Representatives of Scottish Water and the Scottish Government also participate.

To inform the discussion and provoke debate, WICS chief executive Alan Sutherland will set out his thoughts on possible developments of the regulatory mechanism in a series of discussion papers to be published periodically through to summer 2016. The Advisory Panel is asked to discuss, challenge and comment on these discussion papers, after which WICS will finalise its proposals and prepare a draft methodology statement for the next price review, SRC21. It plans to hold one final panel meeting in September 2016 to conclude discussions and to publish its methodology in October 2016.

The first discussion session was held in October 2015, and focused on deepening customer involvement in the industry and achieving better value for money. Financing and governance issues were discussed in the second session, as detailed in the main article. Two further sets of papers and discussion sessions are planned ahead of the summer: one to discuss the monitoring regime and the other the cost reflectivity of wholesale charges.

Widespread implications

Collectively, these changes would have significant implications for a number of parties, were they to be implemented. WICS specifies the following aspects.

Implications for bills. The papers provide indicative models of how water prices could be affected under three different borrowing scenarios – halving annual borrowing; transitioning to no borrowing with the next decade; and no further borrowing – against the base case of the current determination rolled forward (this allows for £3bn of investment, includes a price cap of CPI-1.8% over six years and requires Scottish Water to borrow £720 million from government). It also considers the implications of two potential price profiles – annual increases of 1.6% or 1.9% nominal – and looks at how each would compare with likely prices in England and Wales. For the purposes of this comparison, average company bills in England are modelled as increasing in line with the CPI measure of inflation (or RPI-0.9%). The outcome is shown in the table p11.

Implications for Scottish Water. Operationally, many of the suggested changes would impact on how Scottish Water does business. But an overarching theme would be an increased onus on its board to consider its annual financial performance and its annual performance in the context of the overall regulatory contract. This would bring Scottish Water more into line with private company practice, where boards routinely indicate their views of current performance through dividend distribution and reinvestment. WICS adds: "Scottish Water will also have to be more transparent in its reporting of its costs, appraisal of its approach to delivering required outcomes and its levels of service to customers. It will also need to work towards a more collaborative relationship with its quality regulators to reduce the accumulation of organisational buffers against risk – to the detriment of customers."

Implications for WICS. Aside from steering the introduction of the new approach, the regulator would need to up its game on monitoring Scottish Water's performance, looking at each financial year as well as performance across the whole regulatory period. It says: "In essence the regulatory monitoring of a company should become similar to that which a specialist equity analyst would typically carry out. The regulator should comment on current performance and on any significant changes in the operating environment that the company faces." In addition, WICS would have to alter its historic approach to setting allowances – in particular to allow more for asset replacement and higher returns for innovation.

Implications for the Scottish Government. Should the industry's regulatory and governance framework be altered in the way envisaged, it would allow the Scottish Government to focus on its policy-setting function. Its other two current roles would diminish: with lower lending, it would be able to reduce or eliminate its role as banker; and with the Scottish Water board taking on more, the government could play a more passive role as owner. WICS notes: "There are many policy issues that the Scottish Government may want to consider. These could include the incidence of lead, the household charging framework, the provision of improved water services to rural communities and the encouragement of more innovation in the water industry to name but a few."

The regulator added that it would be vital that the Scottish Government accepted the importance of maintaining the resilience fund in the face of the inevitable pressures on budgets. TWR

> **It's easy to say we've got enough money just now…but the question is, will there be enough money in the system in 20, 30, 40 years time?**

COULD DEVOLUTION BOOST RESILIENCE?

Devolved cities have the potential to deliver more water resilience for their communities through efficient spending and new fund raising. But they must have financial control as well as responsibility if they are to have a real shot at success.

How might cities with devolved powers steer water resilience policy and action? That was one strand of debate scrutinised by March's Indepen Forum, which brought infrastructure sector leaders, investors and regulators together to explore the possibilities around financing city regions. The debate was framed by the Treasury's regional devolution policy, under which significant powers may be transferred from central government to city regions or combined authorities.

Democratised decisions

One speaker described devolved cities and regions as "very exciting" in terms of water resilience possibilities. If local power and decision making is underpinned by robust local consultation and engagement, devolution offers an opportunity for bottom-up insight into community priorities and willingness to pay. For instance, the residents of a flood prone city may volunteer to contribute tens or even hundreds of pounds to fund its defence – sums that would be very unlikely to be volunteered by those out of area. Hence city-led engagement could be at a much more granular level that is currently routine. This fits with Ofwat's PR19 objectives that water companies' understanding of their customers must be more intimate and less generic. Armed with information on residents' priorities and preferences, cities could also influence wider government and regulatory policy as well as in-area investment.

The speaker highlighted an example of good practice from the US on community decision making. In San Francisco, social media, e-governance and related channels were used to enable local people to be directly involved in deciding whether to deconstruct the Hetch Hetchy reservoir. He said the example was just "the thin end of the wedge" in terms of the possibilities around democratising infrastructure choices.

To put his view in context, the speaker set out a grim picture of UK water resilience under existing approaches. He said in terms of clean water supply, we are at the end of an age of abundance and in fact are stepping into an age of net deficit. One third of catchments are currently closed to economic growth via traditional means and this figure will be one half within ten years. We need investment of £10-20bn in clean water supply just to stand still.

The speaker concluded that our exposure to the risk of water shock is greater than most people appreciate. Consequently, a number of new approaches must be considered. On top of greater local decision making, the speaker argued in favour of a greater use of markets, provided this is teamed with appropriate governance to manage risk; and for the regulatory evolution we have already seen to be progressed further. The goal should be to enable water companies, customers and society to secure the resilience they want at a price they can justify, with regulators taking a hands off approach (but without abdication of responsibility).

Governance and flooding

In discussion, a number of other points came up. One participant argued cities with powers and appropriate governance structures could go some way to improving the way existing funds are spent. To illustrate, he cited the forthcoming Indepen report which analyses the annual £13.5bn spent in England on catchment management, noting this is derived from and managed by some 50 different organisations per catchment. In practice this means silo budgets, silo outcomes and inefficient allocation. He urged that we look at other models – be it the Environment Agency coordinating spending; something akin to the Dutch model whereby regional water authorities with publicly elected boards have tax raising powers; or examples from other world cities where the municipality takes control of water as part of a bid to ensure wider economic bounty. A devolved city region could adopt this role and make better use of the money that is already allocated to resilience.

Among other points raised were that cities would need to decide on how investment decisions that are surrounded by deep uncertainty should be managed. For instance, following some of the worst flooding ever in Cockermouth, Cumbria, six years ago, investment was ploughed into flood defences. But these were toppled last year by even more extreme rainfall, despite the use of design standards that were more protective than required by future climate models.

In another instance, how can an asset that might be deployed only once in 20 years (for instance, a desalination plant or flood barrier) be justified, and if so, how is it best funded? Also, cities would need to consider how to fund the ongoing maintenance of assets, not just their procurement and build. How can they best ensure there is money in the system in future when it is needed?

Together these issues raise another matter touched on in discussion: if cities are to make local decisions, how should this best be done? As outlined above, some advocated a democratic process, whereby individuals are directly involved in decision making. However, an alternative view was expressed too: that referendums of this sort are not optimal and rather that city authorities should base investment decisions on rigorous economic assessment of the costs and benefits of competing projects.

On the subject of funding flood management and defence specifically, the Forum gave an ongoing discussion an airing: would the best approach be to let water companies access low cost finance for flood investment by adding flood spend to their regulatory capital value, as they do with other assets? Some spoke in favour of the approach and it has found support among some water companies. However, one participant argued that

should this happen, people would need to see the resulting water bill rises cancelled out by equivalent reductions in other outgoings. The move should not be allowed to add to household budget burdens.

Paved with gold?

More broadly, the Forum debated the pros and cons of devolved cities. On the pro side, there are positive examples of what can be achieved with a coherent city structure – the chair noted that since the Greater London Authority was established 16 years ago, for instance, London has been able to move forward markedly, with a more joined up approach to issues including transport, energy, higher education and strategic planning. Greater Manchester too has been successful in this sphere, though other areas including Birmingham, West Yorkshire and Merseyside have had less success, in part because of local rivalries and entrenched interests.

The meeting heard that a principal benefit of empowering city regions is it enables money to be spent more efficiently. Moreover, a city region could potentially raise new sources of income which could be spent on local priorities. A key thread in the discussion was how municipal bonds could be explored in pursuit of raising funds, given many cities may have a AAA rating and theoretically could raise billions on the back of this (see box).

However, participants identified a core problem with this empowered city vision: that the proposals on the table from the Treasury do not amount to genuine devolution; cities are offered responsibility without financial control or all the necessary legal powers to act in the best interests of their areas. On average, 83% of local authority spending is funded by central government, with just 17% raised locally. The chair observed that a feature of the current government is the piling of more and more responsibility on to local government without the extra funding to match.

The consensus was that the Treasury has a real aversion to handing financing power over to other public bodies through fear they may default. In the absence of real fiscal power, this leaves the option of the Treasury keeping control of revenue-gathering but then handing chunks of money raised through general taxation to city authorities to spend. This brings its own difficulties and could well be challenged by tax payers in non-devolved areas that do not stand to benefit. And even if, over time, there is acceptance of the need to replace central funding with locally sourced funding, this may not be palatable to the populace: the former is collected largely through Pay As You Earn taxation, which means the money is taken before it ever touches individuals' bank accounts; the latter would most likely need to be collected like Council Tax via direct debit or cheque payments, which would naturally be harder for individuals to stomach.

An additional factor is that some central funding is likely to continue to be needed in some devolved areas – where business rates are low, for example, even collecting 100% locally would not make up their historic spending requirement.

Among other practical challenges to the vision of devolved cities discussed at the Forum were:

- The public and private sectors do not really understand each other and are reluctant to work together.
- London and other large city regions are well placed for suitably knowledgeable and experienced staff to manage investment decision making. But not all areas will be.
- The theory of losing the silo mentality and investing more efficiently is laudable in its intention but looks impossible to deliver in reality. In healthcare, it proved impossible to get social care and healthcare budgets merged despite years of trying.

The chair concluded the debate had raised more questions than it had answered. However he cautioned that we should be careful what we wish for: while devolution looks attractive, budget powers must go with responsibility – and even then the picture is complicated. Looking purely at the repatriation of business rates to cities as one aspect of the debate, thriving economies like London could well benefit but where business rates are low or where a major local company closes, the outcome could be unhappy. TWR

MUNICIPAL BONDS

Could municipal bonds be used in the UK, as elsewhere, to fund infrastructure in devolved areas? One Forum speaker scoped out some options, drawing on the US experience. Muni-bonds are common in the US, where public sector bodies of various sorts issue them with the view to paying back the borrowed money via taxation or revenues from the financed project at some point in the future. They are tax exempt to investors so offer a financing advantage. Among the types commonly employed in the US are:

- **General obligation bonds** – these can be spent on any local investment deemed necessary and the issuer is under a general obligation to repay the borrowed money, through any means available (commonly a variety of taxes).

- **Revenue bonds** – these are raised to fund a specific project such as the construction of a desalination plant or a transport link. Here the issuer uses revenues from the project to pay down the bond.

- **Industrial revenue bonds** – these are loans issued by state or local government to finance a private company's expansion or other activities on the grounds that the economic wellbeing of the community will be improved as a result.

The speaker advised that applying the muni-bond model here in the UK would enable devolved cities or regions to invest in local priorities – for instance, to build a football stadium in Sheffield, if that was a community desire. Greater Manchester or London could act as pathfinders for other cities to follow.

However, he said that for the model to take off here, investors would need to be assured that:

- the city has the legal power to borrow
- the city has the power to decide how the money raised is spent
- any relevant covenants would stand up if tested
- the Treasury has agreed its long term relationship with the city and won't pull the rug from under it at a later date.

Significantly, the Treasury would have to relinquish control of taxation revenue from the devolved region in question and transfer both collection and spending powers to that region. In the US, states and municipal authorities have huge powers which are completely de-linked from the federal government, though the option remains for the federal government to support big ticket projects. For example, the California North-South link has some federal funding but it is controlled, procured and voted for (including in terms of revenue stream) locally.

The speaker concluded this model is very different from the UK's current situation, and devolved city regions offer a huge opportunity for change. However he was challenged in discussion when the legitimacy of holding up the US muni-bond market as an example of good practice was questioned. Some argued this sort of model has led to a lack of coherence and consequently that US infrastructure has suffered.

CONTRIBUTED BY **ROGER MILNE**

Water issues dominate Irish government negotiations

The fate of Irish Water and water charging remain the most contentious issues as senior politicians from Fine Gael (FG) and Fianna Fáil (FF) continue negotiations on how a minority government might work. Some 50 days after an inconclusive general election the Irish Republic is still without a new administration.

Fianna Fáil wants to suspend charges for five years and abolish Irish Water in favour of a national water directorate, while Fine Gael insists that a public utility and payments for water must stay. The gap between the two parties on water could "make or break" negotiations, commentators acknowledge.

However, merging water charges and the property tax has emerged as a potential compromise that might open the door to a minority government deal between FG and FF.

Figures in both parties have been talking up the idea of "amalgamating" water charges and the property tax into a so-called "household package". This would allow FF to claim that charges have been effectively scrapped, while still potentially satisfying EU rules, according to a senior FG source quoted in the Irish media.

FF leader Micheál Martin has said he was committed to suspending the water charges within six months of entering office and abolishing the €100 water conservation grant. His party wants to hold a referendum on enshrining a water utility which could not be taken out of public ownership. And Martin has demanded an investigation into the money spent by Irish Water on a "post-election lobbying campaign" designed to prevent its abolition.

In a document circulated earlier this month FF insisted a slimmed-down body to replace Irish Water could be up and running within 12-18 months. The document said it would cost €210m per annum to scrap charges – but that the abolition of the Water Conservation Grant would save the taxpayer €110m. FF has accepted that it will need to address the issue of non-payment prior to the suspension of charges.

NI Executive launches new water strategy

The Northern Ireland Executive (NIE) has launched a long-term water strategy for the Province which includes a number of specific targets for Northern Ireland Water but which is predominately aspirational. The document covers the period up to 2040. An action plan is promised but won't be published until after the upcoming elections for the administration which are due next month.

The document stressed that the blueprint "seeks to reduce the cost of providing water and sewerage services by promoting and encouraging more sustainable treatment solutions".The strategy said that priority would be given to reducing the risks of pollution from sewage discharges. It acknowledged that the new regime of River Basin Management Plans will be key to improving the water environment but recognised that improving the ecological status of many water bodies will take longer than initially expected and will last longer than the current RBMP timeframe which runs until 2021. The timeframe for improvements may have to be extended to 2027, said the strategy.

It noted that NI Water is the largest single electricity consumer in Northern Ireland with power costs possibly rising to £43 million by 2020. That figure, though, does not factor in growth in demand for water services or future improvements in infrastructure needed for compliance with EU regulations "which will see energy costs rise even further".

NI Water will have to deliver "greener services" said the strategy. "This means moving away from conventional high energy water, wastewater and drainage solutions and adopting innovative, natural approaches where issues are addressed at source." This will involve catchment management, storm water management and water demand management. And entail reducing leakage, water abstraction and gradually transforming the wastewater infrastructure and asset base so that it costs significantly less to operate and maintain while simultaneously enhancing compliance and providing for growth.

This will also mean that NI Water increases the amount of energy from green sources such as wind, solar, hydro and anaerobic digestion, although this is not quantified.

The strategy highlighted that a significant amount work is required in addition to existing initiatives to replace lead supply pipes, particularly privately owned systems. "Should another more sustainable technology or method to mitigate lead plumbosolvency in drinking water become available, NI Water should investigate such options in place of orthophosphate treatment," stressed the strategy.

As well NI Water will be expected to implement and extend its so-called Sustainable Catchment Management programme which already involves the Mourne Mountains, Garron Plateau and the River Derg.

On water consumption the long term target is to reduce average consumption from 146 litres per head per day in 2014 to 130 by 2040. That figure is being suggested as the consumption limit for all new residential developments.

In 2008/9 NI Water reported a leakage figure of 181million litres a day. By 20141/5 this had reduced to 166Ml/day. In 2014 the Sustainable Economic Level of Leakage (SELL) was estimated to be 159 Ml/d. By 2021 the strategy expects NI Water to go beyond SELL and achieve 153 Ml/d.

The blueprint commits the NIE to establish new organisational arrangements for integrated urban surface water drainage investment, planning and delivery. Sustainable drainage systems (SuDS) should be the preferred option for managing surface water in new developments although the document recognised that long-term maintenance, ownership and liability for SuDS requires further consideration.

The strategy has a long-term policy to "progressively reduce the amount of rainwater in the combined sewerage system". This will mean separate drains for roads and other hard surfaces.

As well, NI Water will be expected to reduce the number of properties at risk of sewer flooding over the strategy period.

Ofwat sizes up shared services….

Exploring the practical steps needed to share, provide, outsource or jointly deliver services with other regulators features in Ofwat's new five year business plan for 2016/17-2020/21. This follows plans announced by George Osborne in last month's Budget. The chancellor said the government would work with economic regulators to review the business case and implementation issues for co-locating and sharing back office functions. The review is due to report in summer. Ofwat said it was "committed to driving value for money and finding efficiencies in all we do" and looked forward to contributing to the review over the coming months.

Elsewhere in its five year plan, the regulator said it would more generally continue to "transform how we operate to work in more flexible and efficient ways and find… new ways of delivering our work" in a bid to meet the financial settlement it received in last year's comprehensive spending review.

The business plan includes:

- making final arrangements for opening the new retail market for business customers in England from April 2017;
- reviewing the options and benefits of extending retail competition to residential customers in England and Wales
- publishing a framework for the 2019 price review and completing the first phase of its delivery model
- establishing an approach to modernise and simplify water companies' licences to allow the sector to deliver for customers at a time of change.

…and fills empty seats

Some months after announcing a restructure of its senior leadership team, Ofwat has appointed new executives for the three vacant positions:

- David Black, director of economics and acting senior director of Water 2020, has been permanently appointed to the latter role.
- Aileen Armstrong will from the summer be senior director, finance and governance. Armstrong has been head of the competition, markets and regulation team at HM Treasury since 2013, and has 20 years' experience across the public sector.
- John Russell will take up post as senior director, strategy and planning, also in summer. Russell is currently working in Shell's group strategy and business environment team, and leads the company's international programme of energy transition engagements. Prior to working at Shell, Russell was COO for Infrastructure UK in HM Treasury.

They join existing members of the senior leadership team Keith Mason – senior director, Thames Tideway; Claire Forbes – senior director, corporate communications; Richard Khaldi – senior director, customers and casework; Bev Messinger – senior director, business improvement; and Elizabeth Hillman –general counsel.

OTHER APPOINTMENTS THIS MONTH

- **Dwr Cymru owner Glas Cymru** has appointed Alastair Lyons CBE to chair its board. He will succeed Robert Ayling after the company's AGM on 8 July. Lyons has held executive positions extensively, including in the finance, insurance and development industries. Early last month, Glas created a new holding company, Glas Cymru Holdings Cyf, to enable the potential creation of new subsidiary companies, joint ventures and other commercial activities.
- **Affinity Water and Bristol Water** have appointed new customer champions. Long term consumer advocate Teresa Perchard is chair of Affinity's Customer Scrutiny Group, taking over from Robin Dahlberg. Bristol has appointed business and community leader Peaches Golding OBE to chair its Challenge Panel.
- **Investor Aster Capital** has appointed Water UK's former director of European Affairs Gaëtane Suzenet as venture advisor. She will bring water sector players together with other stakeholders in a dedicated investment fund.

Welsh natural resources Bill becomes law

The Environment (Wales) Act 2016 became law on 21 March. The Welsh Government said the act puts in place the legislation needed "to plan and manage Wales' natural resources in a more proactive, sustainable and joined-up way".

It includes provision for:

- planning and managing Wales' natural resources at a national and local level
- providing Natural Resources Wales (NRW) with a general purpose linked to statutory 'principles of sustainable management of natural resources' defined within the legislation
- enhancing the powers available to NRW to undertake land management agreements and experimental schemes
- providing a requirement for public authorities to maintain and enhance biodiversity;
- creating a statutory framework for action on climate change including targets for reducing emissions of greenhouse gasses
- providing powers to Welsh Ministers in relation to waste recycling (including the separate collection of waste); food waste treatment and energy recovery in business
- establishing a Flood and Coastal Erosion Committee
- changes to the law on land drainage and bylaws made by NRW.

Water and energy join up vulnerability signposting

The water industry is partnering with the energy industry to offer a more joined up service to customers in vulnerable circumstances.

Last month, Water UK, Energy UK and the Energy Networks Association announced plans for water and energy companies to signpost customers not just to their own services but where to find support from any participating water or energy company – for instance, where to obtain a large print bill or a bill in braille.

Michael Roberts, chief executive of Water UK, said: "Water companies' customers are also energy companies' customers, so together we must help our customers to be aware of all the help available to them from their utility companies."

NORTHUMBRIAN THINKS ON MENTAL HEALTH

Northumbrian Water has joined the Time to Change initiative, led by MIND and Rethink Mental Illness, to confront and combat the stigma associated with mental health issues. It will train all of its 500 people managers on mental health awareness and will also hold personal resilience workshops which are open to all employees. The company said it believes its actions will also benefit some of its 4.5million customers.

Separately, Northumbrian made it into the World's Most Ethical Company list, compiled by the Ethisphere Institute. It was the only water company in the world to be listed and one of just four UK firms.

INDUSTRY COMMENT

OPEN THE SUDSGATES?

Indepen's Alan Moore and Daniel Weeden tell the story of SuDS so far, and explore whether water companies should be more proactive on sustainable drainage as a first step towards playing a broader role in flood management for society.

Government policy encourages the use of Sustainable Drainage Systems (SuDS) and the potential benefits are well known and substantial. But rolling them out hasn't quite gone to plan. Few seem keen to take on their adoption and be responsible for their long term maintenance, and retrofits and community solutions are still in their early days. There appear to be insufficient incentives. SuDS are seen as being outside water companies' traditional boundaries, culture and investment profile. Yet they could be a game changer in opening a wider flood management role as well as managing water quality and providing other natural capital benefits. Here we examine how this story is unfolding and some of the challenges and opportunities.

The basics

A definition of SuDS is provided in the box. Government policy as set out in the White Paper Water for Life seeks to encourage sustainable drainage. In its recent charging guidance to Ofwat, DEFRA said the government expects the water industry to play its part in innovative and strategic approaches to surface water management: "To fulfil their statutory duty, water companies may construct, maintain and operate drainage systems which relieve the public sewer. Such SuDS are part of a water company's functions and can be financed through charges contained in a water company's ordinary charges scheme with maintenance costs funded through the surface water drainage element of sewerage bills...Ofwat should encourage water companies to raise awareness amongst their customers of the environmental and economic benefits of SuDS."

The numbers involved in surface water management are surprisingly large. Water companies bill around £1bn annually in surface water charges, and are spending around £600m a year on new sewer infrastructure. Developers could be spending £500m a year or more on constructing SuDS for new housing developments (although the specific composition of the SuDS is unclear).

Benefits

SuDS provide an opportunity to enhance natural capital and resilience in the water environment. The benefits of SuDS include reductions in surface water flooding and combined sewer overflows (CSOs) and reduced demand for wastewater network infrastructure and lower wastewater bills. They can assist with retention and treatment of surface water contaminants (e.g. hydrocarbons), protecting the downstream environment. SuDS also have the potential to relieve pressures on other water company assets. A range of tools, such as CIRIA's Benefits of SuDs Tool (BEST) are available to evaluate the natural capital gains from SuDS and help to structure the cost and benefit evidence.

Once built, SuDS should be adopted and maintained for the life of the development. Occupants of developments with SuDS need to have trust and confidence that the systems will continue to work and to provide the benefits. Following the 2007 floods, the Pitt Review recommended that the responsibility for ownership and maintenance of SuDS should be clarified. The Flood and Water Management Act (FWMA) 2010 set out to do this but in England the legislation was not implemented in the way that was envisaged.

Blurred vision: water companies' SuDS policies are not uniform

Missed opportunity

Prior to the FWMA, the National Planning Policy Framework required SuDS to be prioritised only for new developments in areas at risk of flooding. Schedule 3 of the FWMA sought to enforce a more general requirement for SuDS. Unitary and county councils were to form SuDS Approval Bodies (SABs) responsible for approving and then adopting and maintaining these systems.

Lobbying by housebuilders, concerned with having two parallel approval routes, and uncertainty on how SABs would be funded, resulted in a rethink and Defra's consultation in September 2014 proposed a different approach. In December 2014 the Secretary of State for Communities and Local Government issued a written statement to Parliament.

SuDS are now required for developments of ten dwellings or more and for equivalent non-residential schemes unless the developer can demonstrate that they would be inappropriate. A recent House of Lords Committee on the Housing and Planning Bill noted that around 100,000 minor planning applications are approved each year

WHAT ARE SUDS?

- Sustainable Drainage Systems (SuDS) are local drainage solutions that form part of the response to surface water flooding, water quality management and can also contribute wider benefits in the urban water cycle.
- SuDS include permeable surfaces, filter drains and strips, swales and infiltration devices as well as ponds, basins and artificial wetlands. They seek to control flows at, or as near as possible to, their source and to minimise the amount of surface water that enters the sewerage system.
- Some 1.7 million properties in England are at a greater than 1:100 risk of surface water flooding which has been estimated to cost up to £600m annually.
- SuDS are designed with four key objectives: to control the quantity and rate of run-off; to improve the quality of the run-off; to provide amenity; and to enhance the biodiversity value of the site and its surroundings.
- "Community solutions" take the concept further and include rain water harvesting and greywater storage and recycling, and local wastewater treatment. These systems use water and waste water assets and resources more efficiently.

which are not subject to the new safeguards.

The requirements of Schedule 3 of the FWMA have not been implemented, including the requirement for SABs. It is up to developers to identify and propose a suitable mechanism for the adoption and maintenance of SuDS as a condition for obtaining planning permission. This mechanism can include a service company, water company, local government or private individuals. None of these have shown much enthusiasm, suggesting that the current balance of risk and reward is unattractive.

Legislation is said to have helped Scotland to make more effective progress than England and Wales. In Scotland, SuDS can be adopted by Scottish Water, the local authority or a public body. Sewers for Scotland contains Scottish Water's construction standards and if certain components are constructed to these standards, then Scottish Water has a duty to adopt. Even so, few believe that this has been completely successful and the reluctance to adopt and maintain complete systems remains.

Stakeholder views

Local authorities are not keen to adopt SuDS and will do so only where they are in public open spaces. Most will not adopt, but seek proposals from developers for adoption by water companies or management companies.

Whilst the process for the adoption of conventional sewerage assets is relatively well known, there is less certainty about the approach to SuDS adoption. Two quotes from a report to the NHBC, standards setter for UK house-building for new and newly converted homes, illustrate this:

- *"In terms of water and sewers, sometimes it is in an industry's interest to maintain an air of mystery. Then they can just say we have always done it that way. Water is impenetrable to us." (Local authority)*
- *"We are happy to accept sites with SuDS, but we are not currently adopting them. They are being adopted by the local authority or in some cases by a private management company. But we don't really accept management companies as the risk is too high. We will only consider them if it is clear the local authority won't adopt them and there is a commuted sum. But SuDS is still up in the air." (Water company)*

Developers say that the cost of SuDS to housebuilders can be higher than conventional drainage due to the extra land take, although this will depend upon the design. Developers believe that the approval process adds time to the development cycle, that construction standards can be demanding and that maintenance costs are higher. However, this is very case specific and open to challenge.

Some housebuilders have indicated that they think the water companies are best equipped to adopt and maintain SuDS, which should ensure their maintenance in perpetuity and are concerned about water companies failing to step in. At the same time, some leading developers are embracing SuDS and have responded to the land take issue by designing SuDS into public open space provision and engaging design teams early to deliver cost effective solutions.

The water and sewerage companies do not all have the same policy. Some believe that they are best placed to manage SuDS; others have policies of not adopting SuDS or only adopting the hard assets; and still others focus on integrated drainage partnerships.

A number of private sector players are interested in adopting and maintaining SuDS systems but none of these has achieved significant scale.

Barriers to adoption

The barriers that prevent water companies from wanting to adopt and maintain systems include legal, technical and cultural issues as well as opaque policy and the lack of incentives.

First, if SuDS do not constitute a positive outfall and deal with land drainage then they cannot be regarded as a water company drainage asset, and therefore there is no formal mechanism to require a water company to adopt the SuDS. This, together with the right to connect to the sewerage network, provides more incentive for wastewater to be dealt with by conventional solutions.

Second, there is no common standard for the design and maintenance of SuDS. The non-statutory technical standards for SuDS are primarily focused on flood risk outcomes, rather than practical issues or wider outcomes such as amenity, biodiversity and water quality. Developers use these standards as their level playing field when designing SuDS, hence the wider benefits are rarely realised. A SuDS equivalent to "Sewers for Adoption" could help to ensure that the systems that are constructed can be adopted. CIRIA already publishes a comprehensive SuDS manual that provides a design framework rather than a prescriptive process.

Third, there is uncertainty about contamination. Over time even the best designed system will accumulate contaminated silt. Maintenance regimes need to include removal options and any system should be designed for ease of maintenance to deal with groundwater contamination.

On top of this, there is little incentive for water companies to take the lead. Investment in conventional drainage has a clearer return. In Water for Life, the government committed itself to working with Ofwat to look at removing regulatory incentives to implement traditional piped drainage solutions. What incentives or measures would facilitate companies adopting SuDS? Should, for example, commuted sums be paid by the developers for adoption by water companies or should SuDS costs, including maintenance, be included in totex? Ofwat's Water 2020 consultation does not refer to SuDS.

The approach to charging for surface water drainage provides further challenges. Even though surface water often constitutes a large proportion of flows in sewers, surface water charges form a small proportion of waste water bills – with the result that customers are not incentivised to act to reduce surface run-off.

If surface water is diverted through SuDS, customers are entitled to exemption from surface water charges. If more exemptions were granted, how should water companies recover their largely fixed costs? Would including maintenance charges for SuDS in totex compensate for this? Would the reduced demand on the sewer system justify or pay for SuDS adoption and maintenance? Even houses not connected to a water company surface system (and therefore eligible to receive a surface water rebate) would benefit from community flood control and arguably should contribute to its cost.

Historically, surface water drainage charges for non-household

INDUSTRY COMMENT

customers have been based on rateable value. Ofwat has encouraged (but not required) companies to switch to charges based on site area as a better reflection of the load on the system.

Retrofits

While there are barriers to the adoption and maintenance of SuDS for new developments, there are other opportunities that are in their infancy, including retrofits and community solutions. The current approach, focused on new development, is to stop the surface water flooding problem from getting worse. Some believe this will not be sufficient to address the consequences of climate change and urban diffuse pollution, which may entail retrofits, such as removing impermeable surfaces in existing urban environments.

The implementation of retrofits has been slower. Some water and sewerage companies are now conducting large-scale pilots – the Thames Water Twenty4Twenty project is set to spend £20m converting 20 hectares of impermeable surfaces into sustainable drainage, and Welsh Water's Rainscape programme will spend £80m on SuDS projects.

Community solutions

Some SuDS include innovative systems for rainwater harvesting and greywater recycling. As well as providing systems to lower surface water run-off, these community-level solutions provide an opportunity to collect and use local surface water and can substantially reduce the demand for water company supply. Community based wastewater systems, using treatment plant and reed beds, can provide effective ways to reduce or remove demand on conventional sewer systems. Albion Water, which is now in a joint venture with Wessex Water, has been a pioneer in this space. Such solutions have been under the inset regime but they have not been widespread, apparently because the current approach restricts the ability of the inset to charge cost reflective tariffs for SuDS adoption.

With the market for retail service to non-household customers opening in 2017, retailers may offer added-value services including water and waste water efficiency. These could include services to developers on SuDS and services to non-household customers related to retrofitting SuDS as part of efficiency and cost saving measures, as well as services for the maintenance of SuDS and related systems.

Flood management

Is there an opportunity for the water companies to take a lead in wider aspects of flood management? Ofwat's CEO, Cathryn Ross, has suggested water companies think about outcomes beyond the boundaries of the traditional water company, including flood defence and flooding. Likewise, water minister Rory Stewart has said that the government would welcome ideas about companies identifying their interest in flood schemes.

SuDS and surface water management are important in flood management. For water companies to demonstrate a willingness and capability to go beyond their normal boundaries in the adoption and maintenance of SuDS could be a first step to exploring a broader role.

What's next?

Implementing SuDS on a broader and more substantial basis has a high potential value and will increase the resilience of the sector. It has been in the offing for a long time. There has been significant work on SuDS with cross sector groups convened by DEFRA and Water UK including the involvement of developers, but the same barriers remain.

> **The challenge will be to find solutions that enable companies to make appropriate returns on their traditional assets, whilst incentivising innovative solutions to include the development and maintenance of SuDS**

Water companies are being regulated to deliver outcomes and to contribute to a resilience duty. SuDS create valuable outcomes for water customers that they might otherwise pay for through investments in upgraded sewerage, wastewater treatment and water supply assets. SuDS are therefore multi-function assets that perhaps could be adopted by water companies irrespective of their legal status as sewers.

But to create the right incentives, there is a need to reassess the basis of surface water charging, and to develop approaches that send the right signals to customers to make changes that will limit demand in the sewers. Establishing the costs and benefits of surface water drainage is a complexity that will have to be resolved before sensible outcomes and incentives can be adopted.

The challenge will be to find solutions that enable companies to make appropriate returns on their traditional assets, whilst incentivising innovative solutions to include the development and maintenance of SuDS – for new developments and retrofits, and encourage the creation of innovative community solutions that will provide greater resilience through demand reduction. Innovative solutions are available and can make a significant contribution to sector resilience.

Once again, the problems caused by the UK's fragmented governance of catchment spending rear their head. Where multiple parties receive benefits, then combined funding models need to be explored.

The water industry is moving into a new era of thinking outside its traditional areas and in considering how it can play a broader role in society. SuDS, the use of community solutions and the approach to the management of surface water drainage within catchment management remains an area of opportunity for both companies and regulators. TWR

ALAN MOORE AND DANIEL WEEDEN

Alan Moore is an associate of Indepen, with 30 years' experience of international infrastructure projects in: urbanisation, transportation, utilities, water, telecoms, oil and gas, energy, mining, and associated smart and clean technologies.

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THE WATER REPORT

COMPETITION WATCH

2.5% NET MARGIN SET TO STAY

Ofwat plans to stick by its guns on retail margin and cost allowances when it reviews non household (NHH) retail price controls later this year. In a draft statement of method for the review published last month, the regulator acknowledged the vigorous arguments for bigger margins and cost allowances put forward by stakeholders including prospective new entrants, customer groups and at least one incumbent retailer. But it went on to rebut the assertions one by one.

On margin, Ofwat said it had "not found any compelling evidence that suggests we should revise the overall NHH retail net margin of 2.5% allowed at PR14". Retailers and others had put forward arguments including that such a low margin would render retailers unfinanceable as stand-alone businesses; would deter new entry; and would not reflect the working capital requirements that had emerged as retailer-wholesaler payment terms had been developed (see credit terms story, p30). Ofwat disagreed, citing among the following arguments:

- The CMA's energy sector investigation supports a net margin in the range 1% to 3%.
- PwC's analysis on which the 2.5% is based remains valid.
- There is evidence of interest in the NHH retail market in England both by incumbents and potential entrants.
- Recent developments in credit costs and working capital requirements are consistent with a net margin of 2.5%.

The regulator drew similar conclusions on the case made for bigger cost allowances. These arguments were wide ranging in nature and drew on, among other things: energy sector comparisons; evidence of cost increases since 2013-14 (price control calculations were based on NHH costs that year); and new costs that had emerged since PR14 including for bad debt, market operator arrangements, IT and marketing.

Ofwat rejected calls for adjustment on the grounds that:

- There are a range of factors that explain why the absolute cost to serve in the energy sector is significantly higher than in the water sector.
- In 2014-15, some companies experienced cost increases and others experienced reductions; "the causes of the cost increases appear to be company-specific factors and not external factors outside of the control of management".
- There is significant scope for efficiency improvement and innovation by companies.
- Actual and expected inflation is lower than anticipated at PR14 "so the PR14 efficiency challenge should be easier rather than more difficult to achieve".
- New costs proposed by stakeholders "are not relevant, have moved in the opposite direction to that suggested by companies or have not been supported with evidence".

Although not unexpected, Ofwat's strong indication of intent on margins and costs will undoubtedly come as a blow to the likes of Scottish market retailers Business Stream and Clear Business Water; Ofwat said both put in detailed submissions on these issues. Moreover, lessons from Scotland suggest wider retail margins have been a key factor in the activity of that market (see report, p28).

Uniform caps

Elsewhere in the document, Ofwat puts forward the idea of simplifying default tariff caps for large customers. The NHH controls are in essence default tariff caps, designed to provide backstop protection for customers. The caps comprise wholesale charges, a retail cost allowance, and the 2.5% net margin, with each company then free to allocate costs and margins to individual price caps. This has led to complexity, with more than 250 default tariff caps in play across the industry. Ofwat notes: "Differences in how companies have approached allocating their costs and margins to individual tariffs has reduced transparency and consistency, making comparability across companies difficult."

In response, the regulator has suggested continuing with bespoke caps for small consumers, but introducing uniform caps on gross margins as a percentage of wholesale charges in two bands for larger consumers – 1-50Ml and 50Ml+ – with similar application to wastewater, trade effluent and surface drainage charges. Ofwat said this would not affect underlying tariff structures (a concern of many incumbents), though it noted it would consult separately on wholesale charging, including on the scope for tariff simplification, later in 2016.

If adopted, the move should come as welcome news to large customers, who crave as much simplicity and uniformity as possible (see MEUC story, p30). Simplification could increase transparency and tariff comparability for customers, and help avoid any incentive on companies to make proposals for reallocating costs/margins between default tariff caps in a way that could skew cost recovery and limit competition.

Ofwat confirmed the NHH PC would run for three years from April 2017 and issued a slightly revised timetable for the process, as shown in the table. TWR

TIMETABLE FOR THE 2016 NHH RETAIL PRICE CONTROL

Date	Milestone
19 May 2016	Ofwat confirms method and data table requirements
20 July 2016	Companies submit cost and margin allocations & data tables
15 Sept 2016	Ofwat publishes draft determinations
28 Oct 2016	Deadline for response to draft determinations
15 Dec 2016	Ofwat publishes final determinations
April 2017	NHH price controls take effect

EYES WIDE OPEN

With one year to go, DEFRA, Ofwat and MOSL remain committed to an April 2017 go-live for competitive business retail, but are managing expectations about exactly what the market will look like. An interview with Sarah Hendry, Cathryn Ross and Ben Jeffs.

Ben Jeffs

> **We have rolled out all of our thinking about how the market will function. The year ahead is about implementation.**

Aside from the obvious mile marker aspect of it being one year to go to market opening, the Open Water programme is at a critical juncture: the balance of preparation activity will soon be tipped away from getting central market arrangements ready – the aspects handled by DEFRA, Ofwat and MOSL – and towards how water companies respond to and interact with those arrangements.

But we are not quite there yet. In fact at the time of writing, MOSL is keeping its programme status red, indicating it is still grappling with the challenge of completing the build phase of the Central Market Operating System (CMOS) and moving to user acceptance testing.

MOSL update

MOSL has been up-front with its members about its challenges, explaining that despite an intensification of resources and management attention in the weeks ahead of the 4 April deadline, it didn't see a step change in the number of tests CMOS was passing each day. Following discussion with its partner CGI and members of the top level Retail Market Opening Management Group, it opted to hold off releasing the first phase of CMOS until 25 April.

MOSL chief executive Ben Jeffs expresses disappointment that the key 4 April milestone was missed, but insists everything possible has been done to minimise disruption to market participants' readiness activities and takes comfort from feedback from companies that it has been largely successful in doing so. MOSL has deployed the capabilities it can already (see box – Rephasing CMOS delivery, p24) and has rejigged the training timetable so this has started before the drop rather than after.

Jeffs insists that, while regrettable, the few weeks' delay won't hold up the wider programme – shadow market opening or 2017 go-live – because the situation has been managed. "Some will disagree with that, but those who are able to use what we have given them already have validated the plan." He explains that one-third to a half of companies have connected successfully and that MOSL is working through the remaining teething issues to get everybody connected.

Jeffs' stance is endorsed by DEFRA director Sarah Hendry. She identifies system delivery as "the most challenging" part of the whole market opening process and notes the phase 1 CMOS completion deadline has had to be put back. But she adds: "I am comfortable that will not have a knock-on impact on the programme."

Sarah Hendry

Cathryn Ross

> **Appropriate conditions for market opening are not the same as appropriate conditions for the long term success of the market.**

> **Civil servants running marketing campaigns is not where we want to be.**

Is Jeffs absolutely confident the new deadline of 25th will be hit? He says: "It is inconceivable we wouldn't deliver the system on 25th," before going on to explain that there is a possibility of some secondary aspects being released soon after. "Certainly the lion's share of capability will be ready, and we are working hard to deliver it all."

Jeffs is well aware (and says most water companies pointed out in their first letters of assurance) that MOSL is a "key dependency" for the programme. Delivery of CMOS on 25th will in fact be delivery of 80% of what the market needs to open. Jeffs says once the system is delivered, subject to any bugs being dealt with, there will be "no technical impediment to market participants' ability to be ready" – aside from the sheer volume of work they have to complete in the year ahead.

ACHIEVEMENTS SINCE THE BASELINE REVIEW

Within weeks of the Baseline Review, the Open Water partners had substantially addressed its main recommendations, including putting a new governance structure in place and stabilising personnel. As noted many times in industry literature, the foundations for the new market had been ably put in place by Alan Sutherland and the Open Water Markets Limited team. But whatever your take on the policy and delivery choices made since then, there is no denying that the programme has moved at a breathtaking pace over the last year.

MOSL has been mobilised, the Market Architecture Plan finalised, CMOS procured, build well underway, and MOSL members have embarked on their interaction and testing journey. On the policy and regulation side, Ofwat and DEFRA in partnership with water companies and a range of other stakeholders have completed or substantially worked through issues including retail exit, licence modifications, customer protection, eligibility, margins, new entry and data quality.

Ross highlights two standout achievements. First, the extent to which all parties have worked collaboratively together. "Twelve months ago, the interdependency issue felt very much like the biggest risk." Second that the new governance arrangements put in place on the back of the Baseline Review have worked – even when "tested in real time" when MOSL called red over the risk to its 4 April CMOS delivery milestone. "The gratifying thing was the effectiveness of the governance process," she says. "We had an open, honest discussion."

Hendry agrees, saying: "The programme really feels like a programme – we work together in the right way and have the right kind of conversations". She is confident the arrangements will hold up "through thick and thin".

Managing expectations

So assuming there is no technical impediment, can we expect the market to open on time? The Open Water partners all remain confident. Hendry summarises the position: "We have an absolute commitment to open in April 2017. If something catastrophic happened, we'd have to look again, but at the moment it is very much deliverable."

The partners are managing expectations on what exactly that market will look like on 3 April though. Hendry reminds us: "You can't expect any market to be fully functioning and mature on day one. The question is: is there enough in place, are the building blocks there, for it to be a credible opening? The market can evolve and mature after that." She adds that part of the discussion at the first meeting of DEFRA's multi-stakeholder Assurance Group was around what success would look like. "Appropriate conditions for market opening are not the same as appropriate conditions for the long term success of the market," she observes.

The sentiment is echoed by Ofwat chief executive Cathryn Ross. She describes herself as "confident but not complacent" that the market will open on time, noting there remains "a hell of a lot to do", and she points out that 'open' doesn't meant the market won't need to evolve. "Will there be issues after the market opens? I'm sure there will be issues…Of course there will be compliance issues; of course there will be level playing field issues." But she sees such things as part of the "normal evolution of markets" not as anything that should prevent go-live.

Current state of play

So with the market makers united in their commitment to April 2017, the obvious questions are: where are we right now with one year to go, and how do we get from here to there? We will soon have more clarity of the former point. An independent review has just been carried out. The findings have been drafted but remain unpublished at the time of writing.

Information can be gleaned on the current state of play though from the risk and issues register that the high level Management Group updates monthly. This was published for the first time in March. The MOSL programme is the only issue with a red status. The following have amber status: limited resilience in timescales (as would be expected); lack of assurance of the continuity of core programme staff (management actions are in place); and lack of business customer/wider stakeholder awareness (activity is set to ramp up from now – see box, Awareness and communication).

As for individual stakeholders, the least clarity is available on where water companies currently stand. Their first letters of assurance were robust, but those letters detail planning and intent rather than delivery. It is common knowledge that different companies are at different stages of readiness, but whether the industry as a whole can be regarded as on track is not transparent. MOSL has started charting companies' self assessment of readiness. Jeffs endorses the received wisdom that there is considerable variety in the industry but stresses that the engagement of each and every company has been "exemplary". This issue is that "they have started from different positions and progressed at different paces".

Of the Open Water parties, MOSL's current position has been discussed. Hendry says DEFRA's main remaining work stream has been around catering for exit for incumbents. She says she has a "reassuring story" to tell on exit: that the draft regulations consulted on have been well received and that DEFRA is on track to lay the regulations in Parliament in May "in good time for October" when the applications process is scheduled to open for companies. "All of that is in transit; nothing can get in the way now." The Department is also the overarching owner of the assurance work and that is really just getting going.

The pace of work at Ofwat, particularly recently, has been breathless. Ross comments on a few highlight pieces:

RE-PHASING CMOS DELIVERY

Ahead of the fully tested version of CMOS being made available on 25 April, MOSL has deployed the following capabilities to enable market participants and their teams to undertake set-up activities as planned:

- Load master data received from companies (4 April)
- Activate user setup screens in the portal (4 April)
- Deploy the CMOS portal to enable market participants to view their data within the CMOS database and compare this to their own records (4 April)
- Provide market participants with Northumbrian Water's successful test scenarios to test end-to-end connectivity in the core CMOS (4 April)
- Commence rollout of training (5 April)
- Load market data provided by companies (from w/c 11 April).

AWARENESS AND COMMUNICATIONS

The Open Water partners have always been willing to speak at customer events and respond to customer queries. But their proactive customer communications have been distinctly lacking. According to a survey conducted last year, only 15% of businesses were even aware market opening was on the horizon.

Ross says this lack of communication has been by design rather than omission. Now there is one year to go, it is time to act, but driving up awareness too early, particularly as the market was still being worked out, would have been "abstract and irrelevant – actually, you can shoot yourself in the foot if you do that". She says it will be for companies to do the bulk of the awareness-raising – "civil servants running marketing campaigns is not where we want to be" – but that they will be supported by central activities. These have been designed following a workshop with companies' communications teams and comprise:

- Production of a central communications plan: the workshop participants called for this, saying it would help frame their individual activities and prevent duplication. It is expected later this month.
- Provision of a central hub of information from which company comms teams can draw.
- Improvement of the Open Water website so when the message gets out, customers will have a user-friendly and information-packed online resource at their fingertips.

There are no plans to produce an English equivalent to Scotland on Tap – a website providing links to all the licensed providers in the Scottish market. Ross says she prefers the concept of companies speaking up for themselves to a centralised provision.

Hendry agrees that now, one year to go, is the right time to ramp up awareness-raising activity. DEFRA will do its bit and has already begun to engage with the public sector, the farming community and others to that end. One strategy will be to work through customer intermediaries and encourage them to disseminate information to their members.

WSSLs: Ofwat received one application on the day the process opened (5 April). It has a working assumption to expect 30-40 applications, though this is a rough estimate.

Readiness licence condition: Ross says initially some companies questioned the need for this, arguing they were preparing adequately anyway. "But we asked them, 'how confident are you everyone else is doing what they need to do?' Once we talked it through, people came to understand the need." The wording of the condition has been amended to reflect the reality that the data companies will put into CMOS won't be in pristine condition by April 2017 (see p30). So what level of data quality will be needed for companies to pass muster on the assurance condition? Ross says Ofwat doesn't have a specific measure in mind but will go down the targeted review route on readiness later this year. "We will identify the areas of greatest risk…and see if companies are doing everything they can." Jeffs adds that accurate data is a code condition, and that once the market is live the code requires that that erroneous items are rectified as soon as they are identified.

Non household price control and retail margins: In a statement of method for the forthcoming NHH retail control, Ofwat has given a clear steer that it intends to stick with a 2.5% net retail margin (see p21). Ross says there is "no compelling case" for changing that plan. She adds: "I don't expect the debate around margins to go away. I would be arguing the same [for a larger margin] if I was in a new entrant position…But whichever way you go around it [she lists CMA support of a 1-3% margin in energy; the fact that the original PwC analysis that suggested the 2.5% stands up to fresh scrutiny; and evidence of interest in the market from prospective retailers] there is no reason to change." Hendry is less strident. Noting Ofwat is independent, she adds she has personally heard new entrant concerns on margins; that entry levels sit on Open Water's risk register; and that the programme is keeping a watching brief on the situation. She comments: "The market wouldn't be a success without entry and we are mindful of that."

Credit terms: This is work in progress. Ofwat has validated the list of credit options it proposes to use and, following a workshop in February, is now working through ideas on specific payment terms.

Outlook

In assessing where we are right now, what has been achieved to date should not go unremarked. Ross describes achievements since the Baseline Review as "phenomenal", with all stakeholders having played a part (see box – Achievements since the Baseline Review p23). As for outlook for the year ahead, it seems that within a few weeks most of the work that remains to be done will sit with water companies.

Hendry points out that DEFRA is only in the "foothills of the assurance process" but that ministers were comfortable with the company assurance letters of February. She echoes points made earlier on company variation: "The bigger incumbents are further down the path, and the smaller ones are finding it more challenging – but that is as we expected. We didn't set the bar high at this stage; the assurance process is phased."

Going forward it will get more gritty. Jeffs observes: "It will become obvious in the next six months where everyone stands." He adds: "2015-16 has been more about MOSL's readiness; 2016-17 is more about market participants' readiness."

A key question that has surfaced over the past six or so months is: how should readiness be defined? Should it be sufficient for companies to be technically compliant or should their readiness in a broader sense – structurally, organisationally, culturally and strategically – be a factor too? Hendry's take is that companies need to own responsibility for readiness. She explains: "We have tried to avoid a facile, tick-box approach. Companies are different beasts. They need to ask themselves that question." She returns to her earlier point, though, that it is possible to iron out many issues after the market has launched.

For Ross, readiness has three distinct parts. First the technical aspects. Here, companies made "strong confident statements of assurance" in February. But that's the easiest bit. Ross says it is "harder for companies to make progress" in the other aspects. Second, she lists cultural issues including "what it is to be a retailer, or a wholesaler supplying multiple retailers". Many companies are recruiting from competitive sectors to boost their capabilities. Ross comments that companies' structural choices will be influential here; it will likely be easier for those who have separated retail operations to develop a retail culture while "the cultural leap could be a bit harder to make" for those who have remained more integrated. Finally, there is the strategic piece: where do companies want to be in retail and how are they positioning themselves? Companies like Portsmouth Water, United Utilities and Severn Trent have already made their strategic choices, while many others have yet to publicly announced their intentions.

Do companies need more support through the year ahead, and will they get it? Jeffs says MOSL is effectively at a crossroads now: "We have rolled out all of our thinking about how the market will function. The year ahead is about implementation." He points out though that this won't mean a significant upscaling of support to individual companies, as MOSL isn't funded for that and has limited technical resources at its disposal. Its priority is to "get the market ready and open for everybody, not any one party". He adds MOSL will "give them [market participants] everything they need, but maybe not all they want". Hendry, with the bigger picture in mind, takes a softer line, commenting: "Smaller companies may need more support from the programme. That is there for them."

Transformative change

Jeffs concludes by stressing the significance of retail market opening for the industry as a whole. In creating competitive retailers as a new group of stakeholders, it will shine a light on current practices in every relevant area – pricing, metering, connections and so on. "The competitive non-household market is not an isolated project – it is the beginning of a transformation in the industry."

Ross says Ofwat's thoughts are already turning to establishing what an effective market looks like for customers, and to how it can best monitor the market after it opens and ensure any necessary interventions are "proportionate, not Draconian". TWR

THE INS AND OUTS OF WHO'S IN AND WHO'S OUT

Practical scenarios help to iron out market eligibility inconsistency

Confusion and differences of interpretation on whether customers have the right to switch supplier from 2017 will have been eased by publication of supplementary eligibility guidance by Ofwat – though inevitably some inconsistency of application will remain.

The regulator has sought to clarify the guidance it issued in August 2015 on which customers should be defined as non household and hence eligible to switch, and which should be defined as household and hence ineligible, by applying the general principles it set out then to specific scenarios. It has also suggested other criteria which may be considered where the application of the general principles does not result in a clear conclusion. The supplementary guidance applies to both England and Wales and supply by both licensed water suppliers (WSLs) and by new WSSLs (see report, p26).

This followed requests for clarity from water retailers, who ultimately carry the can for allocating customers correctly. The new guidance points out: "Each licensee is responsible for assessing the eligibility of premises/properties it supplies. Where a household has been incorrectly placed into the market and then attempts to switch supplier, the onus is on the receiving supplier to assess the premises/property and refuse the transfer if the premises/property is not eligible." It builds in outputs from workshops convened by both MOSL and Ofwat to hammer out the thorniest issues.

In general terms, the supplementary guidance ranks eligibility considerations in a hierarchical order as follows:

- 1. Determine the extent of the premises. This is particularly relevant to sets of premises with a single supply point. According to the guidance: "In cases where a company supplies several properties through a single supply point – for example, because they are connected to a private network – these properties should be defined as a single set of premises for the purposes of the licensing framework."
- 2. Determine the principal use of the premises. In the majority of instances this should be sufficiently clear to allow premises to be placed within the household or non-household market.
- 3. Where principal use is not readily apparent, liability for business rates or council tax may provide a first approximation.
- 4. Where the premises are liable for neither or both rates (mixed usage), the principal use must be determined. "We suggested in our eligibility guidance that if the 'household' part of a single set of premises is dependent on the 'non-household' part, the premises would generally be considered non-household."

Scenarios and prioritisation

Where ambiguity remains after this point, Ofwat had previously advised

USEFUL SCENARIOS ON ELIGIBILITY

Premises type	In	Out	Maybe
University accommodation	Campus with single supply point; catered hall of residence with its own supply point	Self-catered hall of residence with its own supply point	
Housing		Housing association units; local authority housing; serviced apartments; residential properties run by management companies	
Hospitality	Holiday lets; short stay accommodation		
Homes for the sick & elderly	Care homes (including staff residences if on a single shared supply point)	Care home staff residences with separate supply points; assisted living & sheltered housing	
Car parks & garages	Those with supply points not attached to residences	Those on household supply points	
Animal troughs	Standalone troughs		Where supply point is shared with other premises, category is dependent on how those premises are classified.
Allotments	Both individual plots and those managed by associations		
Developments	Building sites; show homes	Buildings in/around existing household premises - eg sheds, extensions	
Zero rated & rate exempt properties			Dependent on principal use
Vacant properties			Dependent on principal use

companies to allocate the mixed use premises to the non household category and then use a number of techniques to establish whether it should stay there. These included scrutiny of company data; desk based research; requesting information from the customer; and gathering evidence on-site while, for instance, taking a meter reading. In the supplementary guidance, it provides explanatory scenarios for some likely common problems – the principles of which could also be applied to other similar situations. These are shown in the table.

The guidance also takes a practical line on prioritisation, advising: "We note that in certain circumstances, the application of the eligibility guidance may result in some very small sites becoming eligible for the market. We consider these sites should be eligible for the market, but generally, that priority in the identification of eligibility and uploading of data should be guided by those sites which have the greatest potential to benefit from competition."

Ofwat's retail market opening director Adam Cooper said water companies had given a "positive response that we have provided as much guidance as we can – but it is still guidance". There will inevitably be premises that don't neatly fit the principles and are not catered for by the scenario examples. One particular difficulty relates to sites that have different water and sewerage providers, each of which will have to assess eligibility separately. The guidance says: "In the majority of cases we consider that both services providers are likely to come to the same conclusion about eligibility, but there may be examples where water supply and sewerage supply systems operate differently. For customer ease of understanding, we encourage companies to take a consistent approach where possible, although we accept it may be possible for a site to be considered household in relation to one service and non-household in relation to the other based on the circumstances of their principal use and the configuration of the relevant infrastructure."

It will also be an ongoing challenge for suppliers to keep tabs on eligibility as the use of premises changes – for instance, if a vacant property is brought back into use or as building sites become completed properties.

Consultation on the supplementary guidance closed on 7 April. An associated consultation, *Updated eligibility guidance*, is open until 2 May. This updates Ofwat's eligibility guidance to take into account commencement of relevant provisions of the Water Act 2014, development of its thinking on the transition from the WSL to WSSL regime, and the position reflected in the supplementary guidance. TWR

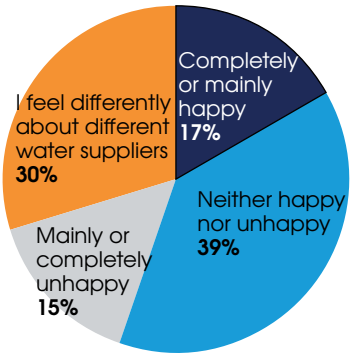
BIG USERS ALL PLAN TO SWITCH

Virtually all large water users are likely to switch after 2017 and three quarters of multi-sites plan to use a single supplier. The Major Energy Users' Council (MEUC) canvassed opinion from its members – industrial and commercial customers – at its Spring Roadshows in Manchester and London.

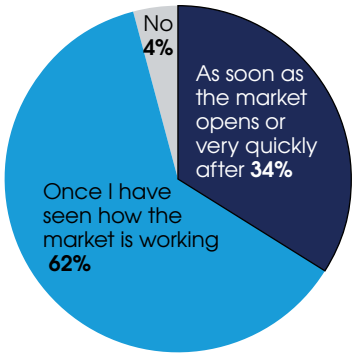
Elsewhere, the poll suggested opportunity for good retailers to attract MEUC member custom: only 17% were happy with their current supplier while 39% were neutral – suggesting a better deal on price or service might galvanise a switch. Just under a third (30%) said they felt differently about different suppliers – evidence already that retailers can distinguish themselves in the market.

Finally, the MEUC asked large customers which was the most important issue to address before the market opens. Ensuring consistency in processes and pricing across the regions was the clear winner, taking nearly half the vote. Ensuring data is correct also featured prominently: a quarter listed this as their top priority. TWR

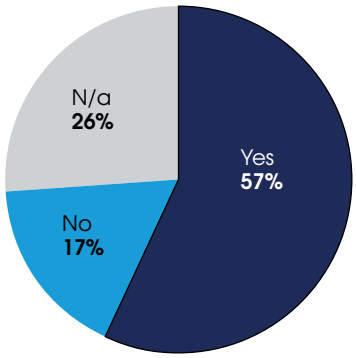
Q1: HOW HAPPY ARE YOU WITH YOUR CURRENT WATER SUPPLIER(S) OVERALL?



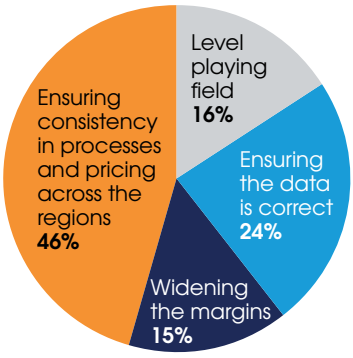
Q2: ARE YOU LIKELY TO SWITCH SUPPLIER:



Q3: IF YOU ARE A MULTI-SITE CUSTOMER, ARE YOU PLANNING ON USING ONE SUPPLIER FOR ALL YOUR WATER NEEDS?



Q4: WHICH OF THESE IS MOST IMPORTANT TO ADDRESS BEFORE THE MARKET OPENS?

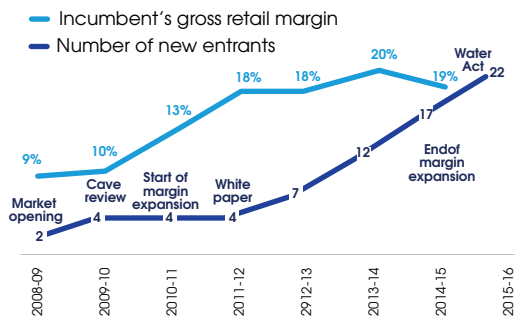


SCOTTISH LESSONS ON NEW ENTRY AND SWITCHING

Alan Sutherland says margin expansion and the Water White Paper galvanised market activity in Scotland. England looks set to be a different story.

While the formation of the English business retail market has drawn on Scotland's experience, replicating the factors that kicked the Scottish market into gear looks a remote possibility. At the Future of Utilities conference last month, WICS chief executive Alan Sutherland extrapolated lessons for England from his experience of preparing the competitive market in Scotland and opening it in 2008.

MARGINS AND ENTRY, 2008-16



He recalled this was no mean feat, observing that when he first mooted the idea in 2001 "I had no idea what I was getting myself into and worse, what Scottish Water would have to do and what the Scottish Government would have to do". In the early days of competition, he said "loads of people benefitted" from better deals on price and service, but the going was slow on paper; observers were "obsessed" with asking about switching levels and by 2011, only 0.5% of customers had changed supplier (to one of only four new entrants).

That year, however, the market took off, with new entrant numbers climbing to the current 22 and switching activity accelerating to the point that incumbent Business Stream now has a market share of just over half.

On top of the fact that WICS had "prepared the ground" by setting up a market that worked efficiently and by ensuring the playing field was level, Sutherland said two key factors were in play in driving the uplift:

- **Margin expansion:** from 2010, as wholesale tariffs fell, the Commission allowed default tariffs to increase in line with inflation, as shown in the chart.

- **Water White Paper:** this was published in 2011 and set the course for the English market to open, thereby encouraging suppliers to try their hand in Scotland.

This course is also shown in the chart.

Neither of these igniting factors will be in play in England in 2017: Ofwat has indicated it plans to stick with a 2.5% net (c6% gross) margin (see report, p21) and there is no prospect of a neighbouring market opening galvanising interest. However, other factors are in play: the larger size of the market and, importantly, the likelihood of household switching shortly after 2020.

Sutherland observed that it was the "collective duty" of all involved parties to cooperate to ensure opening is successful: "Ironically, parties must collaborate in order to knock spots off each other." He set out a list of ten fundamental questions for incumbents and regulators to consider if market opening is to realise its full potential. These are detailed in the box. TWR

SUTHERLAND'S TEN KEY QUESTIONS

For incumbents

- How do you plan to organise your non household retail activity? How will you ensure the playing field is level and that your choices are consistent with the market code?
- Assuming exit, what is the opening balance sheet of the retail entity going to look like? How much new capital will be injected and from where?
- How will legacy assets be reflected in the balance sheet of the wholesale and retail businesses? How will assets be replaced at the end of their useful life?
- What is your expected rate of return on your retail business – at an aggregate level and at customer class level? Can you evidence that a profit can be made in serving each class of customer in your home area? Sutherland observed that the forecast margin of the combined United Utilities/Severn Trent NHH venture (pre tax profit of £9.7m on sales of £940.2m) didn't look too good, commenting "don't hold your breath for discounts".
- Do you have a retail strategy? What have you done to ensure that your retail pricing is consistent with: this strategy; in-area wholesale tariffs; out of area wholesale tariffs? A huge challenge here is understanding costs.
- Can you evidence that your retail business takes decisions on its merits not those of the wholesale business? How can you show there is no position of privilege for your retail business in its home area?
- What plans are in place to respond to data errors? Sutherland said this was one area "we didn't get right" in Scotland. He urged companies not to rely on fixing data before market opening only, as this would be insufficient.
- How much does your retail business expect to pay the market operator? Sutherland said the cost could not fall on the wholesale business as that would mean household customers paying, without standing to benefit. He added: what about the costs of fines and charges from the regulator for its market administration costs?

For regulators

- How should you/ the market operator evidence how much your market administration fees should be and how are these balanced between incumbents and new entrants? New entrants will likely be keen to know and households must have confidence they are not being disadvantaged.
- What would happen to a wholesaler and customers if a large retailer were to fail? How would you ensure the cost of capital for the wholesale business does not increase? A straight market response would give this result but that would mean household customers suffering so could have political and commercial consequences.

HOUSEHOLD RETAIL TO PUSH UP COUNTERPARTY CREDIT RISK

Mitigation must feature in domestic retail thinking, urges a study for Thames Water by FTI Consulting.

Opening the household retail market to competition could materially increase water company counterparty credit risks, and mitigation measures must be factored in to the decision making process around market opening (see box). That is the finding of a study conducted by FTI Consulting for Thames Water, published earlier this month.

The study explored two key issues:

- Whether a material amount of incremental counterparty risk could be introduced as a result of expanding retail competition to include household customers. This is because the current situation of integrated companies collecting revenues directly from households would be altered; wholesalers would need to collect revenues from retailers. FTI said this had the potential to affect credit ratings, because ratings are influenced by counterparty credit risk.
- If so, whether there are options available to address those risks which would be consistent with the water industry's objectives, including providing value for money services for customers.

Risk could rise

The report, *Counterparty credit risks in a future English household water retail market*, found "counterparty credit risks faced by English water companies are, in the absence of mitigating arrangements, likely to rise if the household water retail market is opened to competition". This is on the back of three key factors: some existing regulatory protections (for example, allowances for bad debt costs or price control reopeners) may be lost; there is a possibility that at least some household water retailers may not be (or may not be perceived to be by credit rating agencies) creditworthy counterparties; and losses in the event of a default could be material.

FTI said: "Since household retailers will collect around 80% of water companies' revenues (with the other 20% of revenues coming from non-household retailers), the revenues which would be lost in the event of a retailer default would be material…incumbent water companies would face counterparty credit risks in the household market approximately four times higher than the non-household market, all else equal."

Mitigation possibilities

The table shows the various mitigation measures FTI considered, together with how positively or negatively they would affect wholesalers and retailers.

Clearly certain options are more favourable than others for wholesalers, incumbent retailers and new entrant retailers. FTI concluded: "Overall, this suggests that bad debt true-ups, RCMs, SoLR obligations, minimum credit cover requirements and pre-payment by retailers would all be worth considering carefully as tools for mitigating counterparty credit risks" – though it cautioned that nothing at this stage should be ruled out. It added: "It may…be appropriate to adopt a suite of measures to mitigate counterparty credit risk."

Wholesale/retail credit terms are still being debated in the non household market (see p30). TWR

EVALUATION OF MITIGATION MEASURES

Measure	Wholesalers	Incumbent retailers	New entrant retailers
Test financial strength before allowing entry	Positive	Negative	Negative
Pre-pay	Strong positive	Negative	Strong negative
Minimum credit requirements	Positive	Negative	Strong negative
Joint liability among retailers for losses caused by a defaulting retailer	Positive	Negative	Negative
Supplier of last resort obligations	Positive	Neutral	Positive
Revenue correction mechanisms	Strong positive	Neutral	Neutral
Ex-ante bad debt allowances and price control reopeners	Positive	Neutral	Neutral
Bad debt true up or pass through	Strong positive	Neutral	Neutral
Fund the cost of alternative protections	Positive	Neutral	Neutral
Enable wholesalers to manage risk through commercial negotiations	Strong positive	Strong negative	Strong negative
Compensate additional risks through uplift to wholesale WACC	Positive	Neutral	Neutral

OFWAT STUDY TERMS OF REFERENCE

Ofwat has published the final terms of reference for its review of retail household markets. Under the terms, it will consider:

- The views and likely behaviours of customers
- Costs and benefits to customers, the water sector, the wider UK economy and the environment of introducing competition.
- The design of the competitive market and the approach that is taken to the implementation of reform.
- Potential models of competition that could be used.

In terms of scope, Ofwat will consider a range of competitive scenarios, including:

- A "thin" market (core retail activities only, such as billing and payment handling) v a "thick" market (one which includes a wider scope of activities, including resource procurement, local distribution networks, meter provision and metering, new connections and more customer interactions)
- A "wide" (all households) v "narrow" market (customers subsets only) market – the latter would allow different regions or segments of the market to be opened at different times.

It anticipates publishing draft findings in July and final findings in September, and to be able to factor the government's ultimate decisions into PR19.

Readiness condition: data doesn't have to be pristine

Ofwat has modified the demands of its market readiness licence condition to reflect the fact that the "achievement of 100% data accuracy may not be a realistic goal". The regulator has now proposed an amendment which "is targeted at the outcome that must be achieved, specifically that each company's data is sufficiently accurate to enable the effective functioning of the market".

The data issue was one of a raft of concerns raised by water companies about the licence amendment designed to ensure the industry is fit and ready for April 2017. Among other issues that caused concern were that the condition required "an unbounded level of effort", would result in appointees being exposed to risks outside of management control, and was not specific enough.

Ofwat snubbed all the industry's arguments except the data point. It said: "The proposed condition already states that each company must only take steps or do such things as are within its power, and we consider that this adequately addresses the concerns regarding risks arising from external circumstances." It added: "We remind companies that one of the objectives of the readiness condition is to ensure that each company determines itself what is required to meet its obligations, rather than waiting to be being told what to do."

The regulator intends to conduct a targeted review of market readiness in the third quarter of 2016.

Separately, Ofwat has announced it will press on with removal of the in-area trading ban – another priority licence modification for market opening – despite the objections of new entrants. Some argued that removal of the ban, which prevents licensed water suppliers associated with appointees from trading in the appointee's area, raised the risk of appointees showing undue preference to their retail arms.

The regulator said its regulatory tool kit could deal with this, and published a note clarifying appointees' obligations regarding the relevant compliance codes.

WSSLs open for business

Applications for the new water supply and/or sewerage licences (WSSLs) opened on 5 April. One week on and Ofwat said it had received one application, and had a working assumption to expect 30-40 more.

Applications for a WSSL must contain a completed application form and a fee of £5,250. Ofwat will then follow the process set out in the table.

WICs will conduct its own assessment process and grant licences separately. WSSL licences will provide the holders with certain rights to provide services to non-household premises.

The two licences, one for water supply and one for sewerage, will each include one or more "authorisations" relating to the services that the holder wants to provide. The government has consulted on and published standard licence conditions for the WSSL regime common to all authorisations and specific conditions relating to retail and restricted authorisations. Standard licence conditions for wholesale, supplementary and disposal authorisations will be consulted on at a later date.

OFWAT'S WSSL APPLICATION ASSESSMENT PROCESS

Stage	Description	Time allocation
Initial screening	Check for completeness	5 working days
Public consultation	If the application is deemed valid, it will be publicly consulted on.	20 working days
Detailed assessment	Ofwat will consider responses to the public consultation and assess managerial, financial and technical competency.	40 working days to the point a licence is granted. May be longer if the application is to be rejected.
"Minded to grant"	Issue of a "minded to grant" decision if the application passes muster.	
Grant of WSSL	Licences will be granted upon the applicant passing MOSL's market accession tests.	
Issues & problems	If shortcomings are identified, Ofwat will inform applicants and provide information on the dispute process.	

Payment terms work goes on

Ofwat and companies continue work to pin down the details of appropriate credit and payment terms between wholesalers and retailers.

The codes provide for a variety of different forms of credit to be posted, depending on the financial standing and credit risk of the retailer:

- cash deposit
- letter of credit
- parent company guarantee
- insurance
- prepayment

Details remain up for discussion, particularly concerning the precise amounts of credit that will need to be agreed and formally defined in the codes (taking into account provisions for severe credit events, as seen in the energy market), as well as the transitional arrangements for retailers to move between the different forms of credit should their financial standing change.

Wholesale charges

Water companies must publish indicative wholesale access charges for 2017-18 by October 2016.

Ofwat flagged that it recognised the trade-off between early information on charges and the reliability of such information. As such, it will require companies to provide assurance that charges published in October are those companies expect to set for 2017-18.

Ofwat said publishing indicative wholesale access charges would allow retailers sufficient time to develop their retail pricing proposals ahead of the beginning of the charging year. It added that publishing would facilitate a level playing field and provide an opportunity for any changes to wholesale access charges to be reflected in central market systems.

The regulator said it would consult later this year on requirements for the publication of wholesale access charges, including indicative charges, from 2017 onwards.

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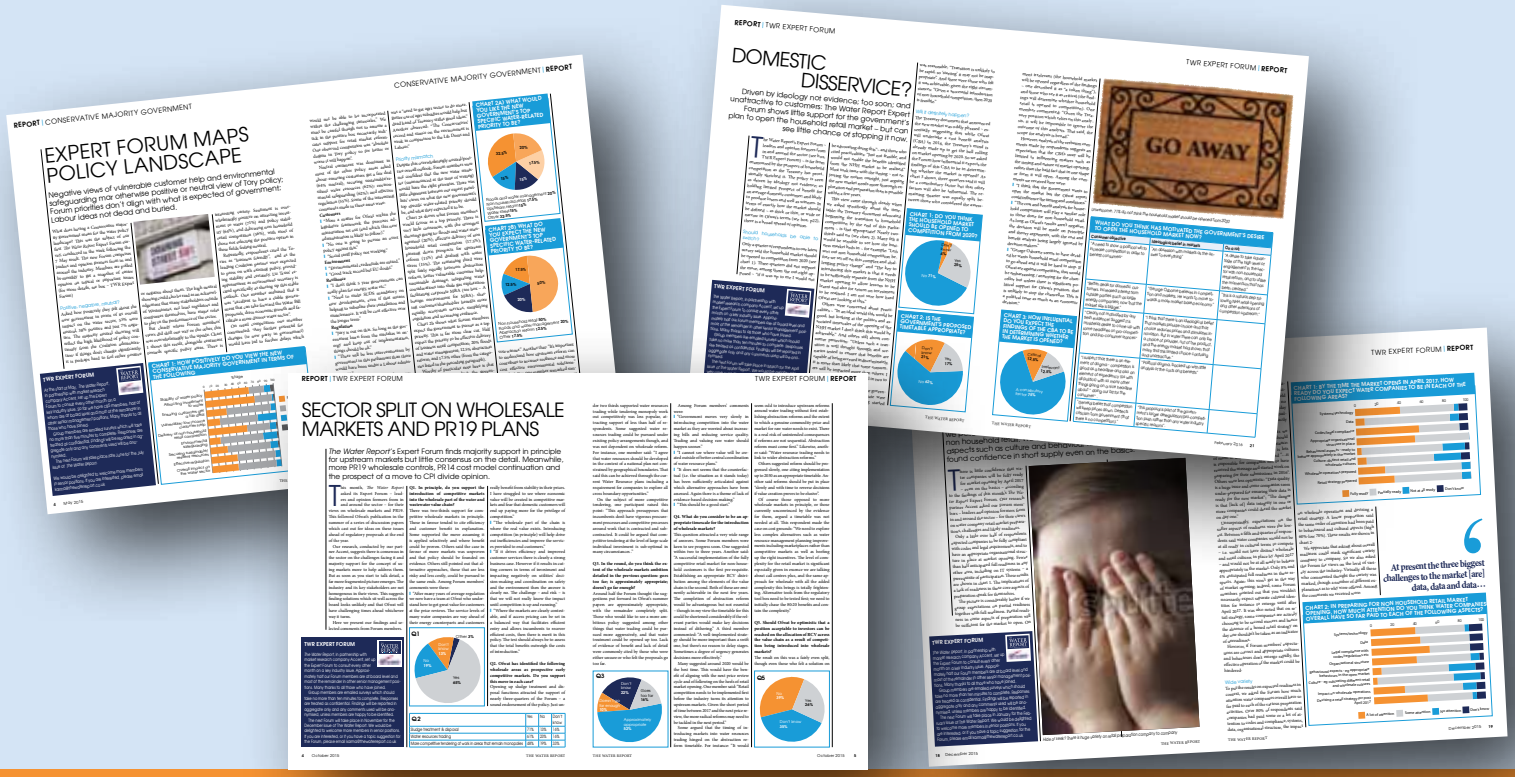

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Marketforce's 6th Annual Conference

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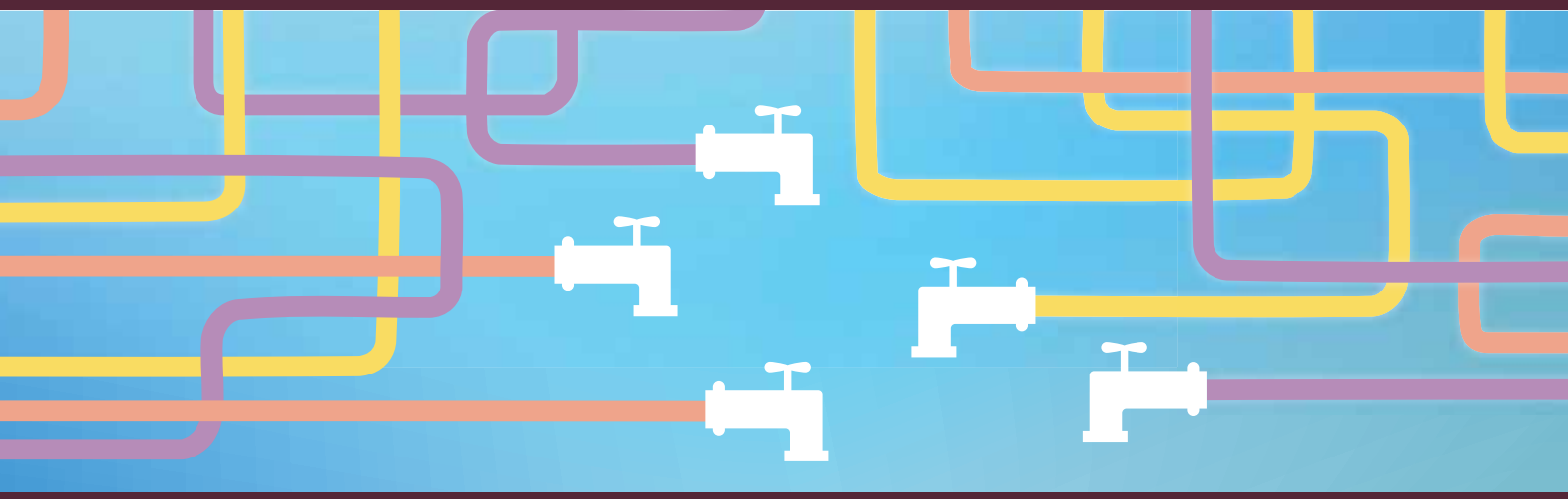

Water Market Reform

4th July 2016
The Waldorf Hilton, London

Laying firm foundations for the new market

Water Market Reform will bring together over 100 senior stakeholders from water companies, Ofwat, the Government, and the supply chain ahead of major legislative changes coming into force in 2017 and beyond.

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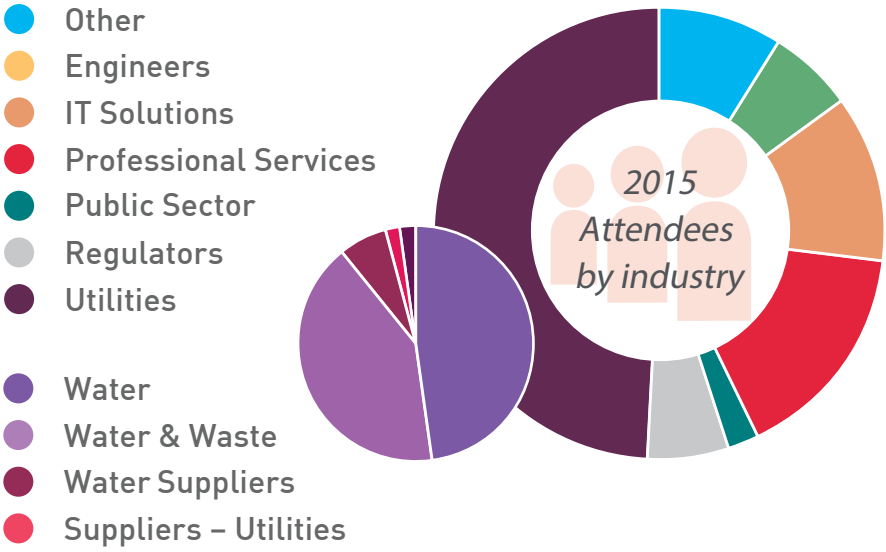
Northumbrian Water

"A very good day, insightful and good relationship opportunities."

Business Strategy Manager
Severn Trent Water



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