

THE WATER REPORT

POLICY | REGULATION | COMPETITION

JANUARY 2015



Quite a challenge

Good outcome, difficult process, lessons learned: CCG chairs Diane McCrea, Bernard Crump, Anna Bradley and Roger Darlington review the PR14 experience

COMPETITION WATCH

- | Open Water MAP points way to market opening but it's a winding road ahead
- | Gemserv's Ken McRae: April 2017 is feasible but don't expect perfection
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EDITOR'S COMMENT



Final determinations: a beginning not an end

It has been hard to see past 12 December – the day when decisions that will affect the industry in England and Wales for the next five years were published; the culmination of months of hard work. Purely in terms of forward visibility, enhanced status must have been worth its weight in gold.

However, with the price review for the most part over, we can expect attention to shift to the world beyond PR14. For Ofwat, that means closer focus on market reform. It has already indicated its thoughts are turning not just to retail competition but also to upstream issues. Its Water at 2020 project will consider making other parts of the value chain contestable; a consultation on vertical integration is anticipated.

But many of the choices that will dictate the future of the industry rest with companies. We should brace ourselves for extensive – and possibly imaginative – structural change.

First though will come familiar territory. There will be new AMP6 delivery arrangements aimed, in particular, at achieving the solid operating performance required by the new regulatory rewards package.

Companies will also be scrutinising the wider financial implications of the determination. High gearing, put in place before returns were cut, could hamstring companies now, so some deleveraging is likely. More broadly, investors will decide whether the risk/reward arrangements for 2015-20 suit their purposes. This could drive ownership changes, be it of minority stakes, majority interests or full buyouts.

But there is also a raft of new choices to consider. Most pressingly, companies will need to decide on a business retail market strategy. Crucially: should they exit the market? Exit could prove popular. Ironically given historic hurdles to mergers, horizontal consolidation in the business retail sector could follow fairly swiftly.

Upstream reform is as yet a little understood concept; it is variously defined, variously supported and complex. The industry has barely begun to explore what business changes this might necessitate or what opportunities it might present. But these are likely to include further catchment management initiatives, partnerships outside the sector and payments for ecosystem services – as well of course as greater competition for resources and treatment.

All in all, the industry as we know it could look very different by 2020. The regulator has expressed a hope that companies will proactively put forward structural change proposals – dynamic, innovative, possibly unprecedented in nature – for regulatory consideration. But that in itself will necessitate change – radical cultural

change from companies that are used to Ofwat making the first move. This cultural shift could prove the hardest thing of all.

Karma Ockenden, editor, The Water Report

Feedback, comments and suggestions very welcome.

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OFWAT HOLDS THE LINE IN FINAL DETERMINATIONS

It's swings and roundabouts for firms as totex gap narrows and retail costs improve but wholesale WACC trimmed to 3.6%. ODI policy stands.

Ofwat largely stuck to its draft determination (DD) guns last month when it published PR14 final determinations (FDs), though there were some noteworthy shifts. To some extent, adjustments negative for the industry were offset by concessions. The settlement should in the round be palatable but challenging to companies, with the notable exception of Bristol Water which is a real candidate for a Competition and Markets Authority referral.

Last issue, The Water Report identified four main areas of push-back in compa-

ny October representations on August's DDs: returns and financeability; totex costs; incentives; and household retail costs. How did Ofwat respond?

1. WACC and financeability

Unsurprisingly, many companies urged Ofwat not to do what it signalled it might in the DDs: cut returns below the 3.7% wholesale weighted average cost of capital (WACC) plus retail margin figure set out in its January 2014 Risk and Reward Guidance. Some said their DDs as they stood would not enable them to hold on to their target investment grade credit ratings; others took issue with Of-

wat's calculation methods and notional approach to financeability.

Ofwat in the event reduced the WACC marginally to 3.6% wholesale plus DD-level retail margins, on the grounds that the forward cost of debt had fallen since January. There were two exceptions: enhanced firms South West and Affinity got to keep the 3.7% figure under the "do no harm rule", while Portsmouth and Sembcorp Bournemouth secured company-specific uplifts of 0.15%, taking their wholesale WACC to 3.75%.

According to the regulator, its FD returns decisions will save custom-

ers £300m more than its DD position would have, and £2bn more than had companies' 4%-plus December business plan WACC proposals stood.

Moreover, in contrast to PR09 where a number of notified items to trigger interim determinations were permitted, Ofwat was rigid in allowing only one industry-wide item: if business rates adversely affect revenues above a certain threshold. This was on the grounds that it was beyond the industry's influence. In addition, it allowed a company specific uncertainty mechanism for Thames, should the procurement process for the Tideway Tunnel Infrastructure Provider be unsuccessful for a reason outside Thames' control.

The regulator showed flexibility in adjusting most FDs in line with company proposed pay-as-you-go (PAYG) and regulatory capital value (RCV) run-off rates, which determine the timing of cash flows and provide some financial flexibility. All but five companies secured the changes they wanted to ensure financeability on a notional capital structure. Moreover, 17 companies' bills were re-profiled to better reflect customer preferences.

Ofwat concluded: "We have confirmed that companies remain financeable on a notional basis following our interventions in their plans at final determination."

Ratings agency Moody's agreed. Stefanie Voelz, VP – senior analyst, said: "We expect the sector to maintain adequate financial flexibility following the cut in allowed returns by reducing dividends or leverage as necessary. Water companies may also be able to improve their cash flow through operational or financial outperformance."

In a report issued on 17 December, she added: "We maintain the view that highly-leveraged companies, such as Anglian Water, Southern Water, Thames Water and Yorkshire Water, as well as companies with higher embedded cost of debt, remain most at risk. However, we expect their management to consider the challenges of the final determination when updating their financial and dividend policies."

2. Totex

The FDs allow £40.4bn of expenditure for wholesale totex across the 18 water

BILLS AND ASSISTANCE

Average pre-inflationary water and sewerage bills will fall by 5% between 2015 and 2020, or by £20 from £396 to £376. This was widely well received by the mainstream media, where water customers have generally been seen as getting a rare break from rising household budget burdens.

The fall comes on the back of extensive company engagement with customers via Customer Challenge Groups (see feature p8-13) and the Consumer Council for Water, and Ofwat's £1.4bn price challenge to companies' proposed overall expenditure of £45.7bn. £44.3bn was allowed.

There is of course regional variety (see tables below). On combined bills, Anglian's customers get the biggest percentage reduction (10%) while Northumbrian's get the smallest (1%). However, in terms of the difference between requested and actual five-year change, Thames, Wessex and Southern

have been hardest hit. Of the water only companies, Bristol (21%) and Sembcorp Bournemouth (12%) customers stand to make the biggest percentage savings. Bristol (significantly) and Dee Valley have the greatest differences between requested and average five-year changes.

The number of customers who struggle to pay and receive some form of financial support from the industry will more than double in the 2015-20 period, too. Currently around 760,000 people benefit from some form of support from their water company. Over the next five years, companies will help an additional one million people.

Customers will see many service improvements, including: better bathing water quality at 50 beaches, 33% fewer properties flooded by sewage and a 32% reduction in the time lost to supply interruptions.

CHANGES TO THE AVERAGE ANNUAL COMBINED BILL FOR WATER AND SEWERAGE COMPANIES (£)

Ofwat's final determination	Companies' 2013 December requests		
	2014-15	2019-20	Requested changes
National average bill	£396	£376	-5%
Anglian	431	390	-10%
Dŵr Cymru	440	416	-5%
Northumbrian	388	382	-1%
Severn Trent	333	316	-5%
Southern	437	403	-8%
South West	545	506	-7%
Thames	370	353	-5%
United Utilities	410	398	-3%
Wessex	485	442	-9%
Yorkshire	373	361	-3%

Source: Ofwat

CHANGES TO THE AVERAGE ANNUAL WATER BILL FOR WATER ONLY COMPANIES (£)

Ofwat's final determination	Companies' 2013 December requests		
	2014-15	2019-20	Requested change
Affinity	176	163	-7%
Bristol	202	160	-21%
Dee Valley	152	149	-2%
Portsmouth	97	96	-1%
Sembcorp Bournemouth	153	134	-12%
South East	201	194	-3%
South Staffordshire	141	135	-4%
Sutton & East Surrey	186	180	-3%

Source: Ofwat



DIFFERENCES BETWEEN OFWAT FD ALLOWANCES AND BUSINESS PLAN FORECASTS OF TOTEX

Company	FD gap water (%)	Company	FD gap wastewater (%)
South West	-8	Severn Trent	-5
Affinity	-5	Dwr Cymru	-3
Thames	-5	Thames	-2
Yorkshire	-5	Anglian	-2
Portsmouth	-3	Northumbrian	-2
Dwr Cymru	0	Yorkshire	0
United Utilities	0	South West	0
Northumbrian	1	Southern	2
Sembcorp Bournemouth	1	Wessex	3
Severn Trent	3	United Utilities	6
Sutton & East Surrey	3		
South Staffs Cambridge	3		
Anglian	3		
South East	3		
Wessex	4		
Dee Valley	4		
Southern	6		
Bristol	32		

Source: Ofwat

and wastewater companies for 2015-20. This is just 1% shy of the £40.9bn companies proposed. However, this industry wide position masks significant differences at company level (see table).

Fast-tracked firms South West and Affinity, medium-tracked firms Dwr Cymru and Northumbrian, and companies whose business plan totex forecasts fell below Ofwat's assessments (Thames on wholesale water, and Severn Trent on wholesale wastewater), have had minimal differences to resolve with the regulator. In the case of Thames and Severn Trent, Ofwat signalled at the DD stage that it would cap the difference between company projections and its assessment

at 5% above the company's totex forecast.

Other companies had anything from major to minor gaps between their plans and Ofwat's view of efficient costs. At the DD stage, across all 14 slow track firms the regulator's DD view of wholesale water costs was £452m lower than companies proposed and £1.1bn lower for wholesale wastewater. These gaps have now for the most part been closed through what seems like a cooperative process of companies reconsidering business plans and Ofwat taking special cost factor claims into account. Companies with plans that remain above the FD totex levels will need to seek modest efficiencies.

Of the three companies highlighted at the DD stage as having major gaps, only Bristol Water remains significantly adrift (see box - Bristol totex gap persists)

United Utilities' £1bn DD wholesale totex gap had narrowed to £628m by the time the company submitted its representation in October following plan revisions. This has now narrowed to £188m. Among other adjustments, Ofwat agreed to fund water expenditure to pay for the contested Thirlmere link and wastewater expenditure to fund National Environment Programme phase 5 schemes.

Thames' issues were largely tied up with the thorny Tideway scheme. Voelz notes: "Thames Water's approximately £405m costs in relation to the Thames Tideway project have been fully accepted by the regulator at the final determination stage." The uncertainty mechanism detailed above has also been introduced. In addition, Ofwat increased Thames' allowance for west London sewer flood reduction programme, Counters Creek.

Other significant adjustments since

DDs include increased allowances for Dee Valley (reflecting better evidence on service reservoir exceptional costs) and Bristol (for enhancement spending), and an improvement for Southern in the legacy adjustment related to its 2010-15 performance.

3. ODIs

Company push-back in October was extensive on Ofwat's outcome incentives policy, both in relation to company-specific issues and the "horizontal checks" policy which surfaced at the DD stage. Essentially the regulator compared company proposals across the industry in six common areas: supply interruptions; customer contacts on water quality; water quality compliance; sewage pollution; sewer flooding; and leakage. It intervened in some companies' ODIs on the back of this, effectively to require them to aim higher because of other companies' plans.

Much of this protest fell on deaf ears. Ofwat stuck by the principle of its horizontal checks policy in the FDs and did not make company specific adjustments to performance commitment calculations on the grounds that "the factors presented by respondents were not sufficiently material, materially different for specific companies and outside their managements' control". It did however make a number of changes to the practical implementation arrangements for comparative analysis. It improved the definition of the sewer flooding and water quality contact measures and improved consistency in upper quartile calculations across all measures. It also introduced some deadbands (neutral zones where incentives won't apply) in recognition of the fact that "there may be an element of volatility of performance that lies outside the control of

TWO YEAR NON-HOUSEHOLD CONTROL

As trailed in last month's *The Water Report*, Ofwat has opted to set the non-household retail price control for two years instead of the usual five. Most companies showed support for flexibility beyond the standard five year period, either for shorter controls or to have re-openers built in to the settlement. This was to enable them to address cost and margin allocation issues closer to the time of market opening.

The regulator listened and has provided for a 2015-16 control. It also accepted updated cost and net margin allocations between different customer types for ten companies.

There will be a review in 2016 at which companies will be able to rethink

their cost and margin allocations and default tariffs for different customer types ahead of market opening in April 2017. The overall cost base determination will stand until 2020.

The FD allowed \$534 m of expenditure for non-household retail costs across the 18 companies for 2015-20. This is 11% lower than companies' revised business plans proposed in June, saving customers £68m over 2015-20. Companies will set default tariffs to give customers baseline terms.

In Wales, where switching will continue to be restricted to 50Ml-plus users, the regulator applied an efficiency challenge and included a non-household Service Incentive Mechanism.

BRISTOL TOTEX GAP PERSISTS

Bristol Water has had a difficult PR14 ride. It has had a degree of special treatment on the back of a yawning gap between it and Ofwat's opinion of efficient wholesale water costs, including early publication of Ofwat's assessment of its wholesale cost claims and engagement beyond the October representation deadline.

Ofwat notes (with a tone of mild irritation) that: "We did not receive final representations from Bristol Water in relation to these matters until 7 November, which has limited the amount of time that we have had to consider these late representations."

Despite some movement on both sides of the fence, a substantial totex gap remains. Ofwat commented: "It is notable that Bristol Water has not taken the opportunities provided by the price control process to substantially revisit and change the scope and costings associated with its December 2013 business plan, as has been the case with a number of other companies."

According to Moody's: "The gap between Bristol Water's proposed totex (£541m) versus Ofwat's final determination allowances (£409m) remains at 32%, making a referral to the Competition and Markets Authority likely." The alternative, according to Ofwat is: "(Bristol) will need to both reconsider the scope of its capital

programme and seek out further efficiencies, or its shareholders will need to fund a proportion of these costs."

Bristol made a number of other representations, including on company-specific uplift to WACC and legacy adjustments for 2010-15. Ofwat rejected the company's case for a 70 basis point WACC uplift but reduced the size of its downward adjustment for legacy performance, as well as increasing its retail cost allowance and adjusting its PAYG rate.

For customers, the FD means average bills in 2019-20 will be £154, 20% lower than currently.

Bristol's 12 December response was robust. It said: "We are very confident that our proposals for 2015-2020, combining service improvements and price reductions, meet our customers' requirements and expectations. Households and businesses have told us they support our proposals, with 92% of households surveyed indicating that our proposals were acceptable or very acceptable."

"We will therefore have to consider carefully whether Ofwat's FD will allow us sufficient expenditure to maintain levels of service and sufficient investment to deliver the enhancements needed to improve and protect the water supply for our customers."

even efficient management". In addition, it intervened to ensure concerns flagged up by the Environment Agency were addressed, including to ensure all companies committed to 100% compliance with discharge permits and to remove rewards for simply meeting statutory obligations.

In all, companies proposed 171 outcomes, 515 performance commitments and 312 financial outcome delivery incentives.

4. Household retail costs

The FDs saw considerable positive movement for the industry on household retail allowances from the DD position. The entire industry benefited from Ofwat's decision to move the price base for household retail cost allowances to 2013-14 from 2012-13. Moody's Voelz explained: "This increases cash flows from retail activities for all companies and largely offsets the additional 10bp reduction in allowed wholesale returns."

On top of that, Ofwat listened to company representations in a number of areas and allowed an extra £280m. This included higher bad debt costs borne of economic deprivation in Dwr Cymru and Northumbrian's areas. And Wessex, Bristol and Portsmouth joined Yorkshire in convincing the regulator they needed an adjustment for input price pressure.

In all, the FDs signed off £4bn of household retail cost expenditure across

the 18 water and wastewater companies for 2015-20. This was 7% lower than firms proposed in their December plans. Ofwat said the changes since then saved customers £300m.

It accepted all companies' allocations of costs between wholesale and retail and between household and non household retail. However it flagged it had concerns about the assurance provided by Dee Valley, South Staffs and Southern, and consequently that "we will take into consideration this lack of sufficient assurance in determining the company monitoring programme for these companies in the future".

Regroup...and restructure?

In the round, the FDs offer a good deal for today's customers (see box - Bills and assistance). For most companies, they should prove challenging but acceptable, though how they affect each company's thoughts on optimal structure going forward and what strategy to adopt in the competitive market is yet to be seen. Firms will be doing their sums on the FD numbers right now, not only to confirm the acceptance or rejection of the deal, but also to inform strategic direction. Fairly extensive exit from the non-household retail market after 2017 (see report, pages 26-28) is a possibility.

PR14 has also provided the industry with a taste of what to expect from Ofwat going forward. Its sector vision for trust and confidence will demand fur-

Ofwat stuck by the principle of its ODI horizontal checks policy and did not make company specific adjustments

ther customer engagement and stakeholder relationship building, as well as greater company "ownership" of those relationships. Regulation will in future take the same risk-based approach as the price review, and rely more on company assurance.

In the short term though, PR14 must be concluded. The remaining steps are:

- 16 January: menu choices and charge submissions due (for approval by 2 February)
- 9 February: Ofwat will set out its overall reporting framework and assurance requirements. This will include 2015-16 company assurance categorisations.
- 12 February: Deadline for company decisions on FD acceptance or request for a CMA referral (see report, page 14)
- Late March 2015: PR14 reconciliation rulebook due. This will explain how 2015-20 performance will be factored in at PR19 - in particular, how Ofwat will make revenue and RCV adjustments in relation to ODIs; menu selection, RPI and other specified factors. **TWR**

ALL'S WELL THAT ENDS WELL

The process was far from perfect, but CCGs made a positive contribution to PR14. A hybrid CCG/quadripartite model could be the best play for PR19.



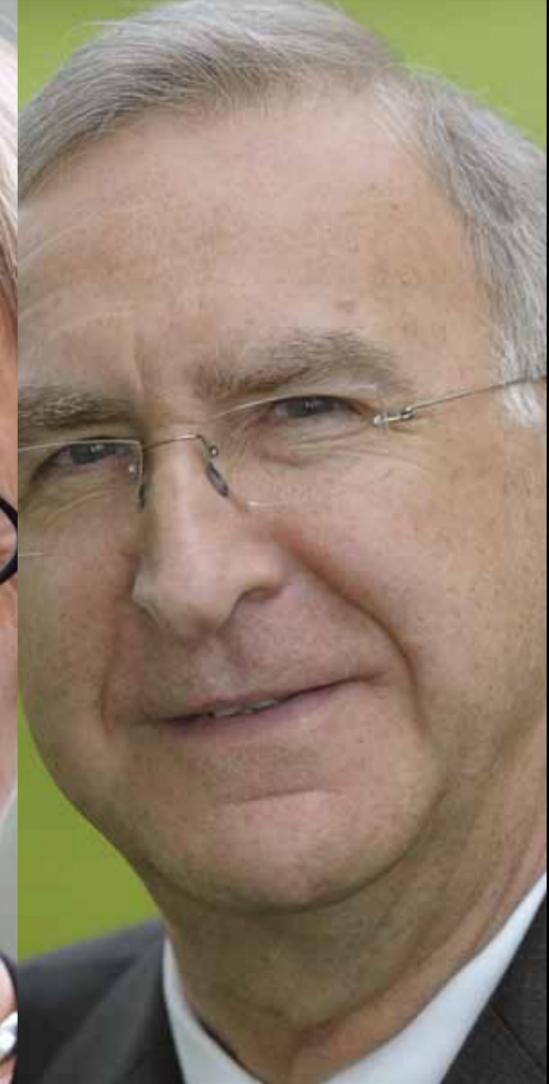
Diane McCrea, Dwr Cymru and Dee Valley CCGs



Bernard Crump, Anglian, Severn Trent, South Staffs/Cambridge, and Essex & Suffolk CCGs



Anna Bradley, Southern CCG



Roger Darlington, South East CCG

Now final PR14 determinations are out, the Customer Challenge Group (CCG) experiment – the innovative plan to use customers as partners in regulation – can broadly be deemed a success.

The customer voice was embedded in the regulatory process more thoroughly than ever before. Moreover this voice was broadened beyond the statutory consumer body the Consumer Council for Water (CCW) to include individual customers and other customer segment representatives.

Ofwat, meanwhile, praised the quality of the business plans that were developed with intense customer input. Consumers

will broadly see investment in the areas they prioritised while prices will fall. According to CCW research, nearly three-quarters of customers found Ofwat's pre-inflationary draft determinations for water and sewerage charges acceptable. We can expect the acceptability of final determinations to be at a similar or higher level.

Perhaps the greatest testament to success is the fact that virtually all companies intend to voluntarily institute some kind of CCG structure going forward to work with them on delivering business plans through to 2020.

These are good outcomes, of which everyone involved

should be proud. However, while we await the official dissection of PR14, even a cursory look at CCG arrangements reveals many practical imperfections. In fact, the model's overall success seems to be more down to the strength of the fundamental idea and the commitment of those who took part (see box Participants' performance, pg 12) than to the way the process was planned and managed.

For this article, The Water Report sought the views of four CCG chairs, between them responsible for the groups of around half the industry:

■ Roger Darlington, chair, South East Water CCG (independent) >

■ Bernard Crump, chair, Anglian, Severn Trent, South Staffs/ Cambridge and Essex and Suffolk CCGs (also chair, CCW central and eastern region)

■ Diane McCrea, chair, Dwr Cymru and Dee Valley Water CCGs (also chair of CCW's Welsh Committee)

■ Anna Bradley, chair, Southern Water CCG (independent).

We also requested interviews from some of the core members of all the groups – the Drinking Water Inspectorate and the Environment Agency – though they didn't take up the opportunity to comment.

Full of surprises

Chief among chairs' criticisms of the PR14 process is the fact that forward visibility was severely lacking. Very experienced consumer representative Darlington says, rather politely: "Moreso than any other appointment I've ever had, things clarified as we went along."

He accepts that the process was new and hence that there would be what he says Ofwat calls "learnings" along the way, but he believes there was too much unpredictability. He cites as an example the regulator's "horizontal checks" on company proposed outcomes and incentives in six common areas, and the requirement for firms to aim higher because of other companies' plans. The benchmark was set at the current upper quartile level, to be achieved by 2017/18. This only surfaced at the August draft determination stage. Darlington says: "Ofwat says it signalled this in April, but it was ambiguous. It should have been signalled earlier and more clearly."

Others agree that Ofwat's choice not to share its thinking with CCGs in a number of key areas early enough – crucially, on, upper quartile benchmarking and the cost models it used to judge the comparative efficiency of investment schemes – meant a lot of CCG time was wasted. Crump says: "It wasn't such a valuable use of our time to scrutinise individual investments companies proposed before they went into the plan, only for them to then be judged by Ofwat against a financial benchmark. The cost models should have been shared much earlier."



[Southern Water] embraced the need to change the way it engaged with customers, and embraced the CCG.



[The] historic argument about independence has melted away now... We've had six independent chairs. There has been no evidence of capture.

McCrea says Dwr Cymru's CCG was "caught out at the last moment" by the horizontal checks, particularly because the company had achieved semi fast track status. "We were very surprised the performance metrics were so far out," she says. "The horizontal checks should have been done much earlier."

Tight on time

Timing emerged as another key CCG sore point. The chairs found challenging and changing timelines frustrating and some suggest a bit of thought and minor adjustment could have improved things a lot – for example, if WOC and WASC report submission dates had been staggered, or if the whole process had started earlier.

Moreover, the chairs agree that the time commitment expected of group members far exceeded original expectations. McCrea explains: "We originally said work would be up to business plan submission in December 2013. Because that changed, it's been difficult. I really didn't know I'd have to ask people to keep working up to December 2014."

Most members worked on a voluntary basis or did the CCG work on top of their day jobs. Organisations that sat on multiple groups clearly felt the strain (see box – Participants' performance p12). To make matters worse, a lot of the work was incredibly complicated for those unfamiliar with the industry. Darlington wryly remarks: "ODIs [Outcome Delivery Incentives], RCV run-off rates and menu choices are an effort for many of us."

Research search

A natural corollary of companies owning the customer relationship is the variance that results. Ofwat views this as a strength which has allowed best practice to emerge. But by its very nature, it has also reduced comparability across the industry.

This is stark in the area of the research that underpinned everyone's understanding of customer priorities and willingness to pay (WTP). Darlington comments: "We need a debate about the WTP methodology. A cross company comparison

showed a wide range of WTP across the country. Why? Research is not an exact science and judgement is required in interpreting the figures."

He adds that different parties also found different customer appetites for ODIs. "CCW's research was very dismissive of rewards. Many in the industry including South East Water did fresh research after the Risk Based Review and got more customer buy-in. The benign interpretation is 'you give people more information, you get more acceptance'. The less benign interpretation is 'if you ask the right question, you get the right answer.'"

Crump comments that CCW "identified best practice around how research should be carried out and did its level best to ensure companies followed it". But he observes: "Sometimes results are thrown up that are somewhat surprising. Companies can ask the same set of questions and get different results...Market research is difficult. Results always need a bit of interpretation and are part of the answer, not the whole answer."

Heart of the matter

PR14 was touted as putting customers at the heart of regulation. It delivered on this promise, but there are questions around whether customers themselves were in driving seat, or whether Ofwat stole the show in the traditional way, albeit acting in customer interests.

Crump comments: "The experience of the last 12 months of the review, from December [2013], could give the impression the customer voice was more dilute that might have been expected. The customer voice was very influential in the early phase and definitely defined the shape, ambition and scale of business plans. But from December, most of the influential changes came from Ofwat, particularly in the application of cost models and in applying tests and requesting further information. It was more searching than you might expect from a light touch approach."

McCrea says: "The customer voice drove companies in their business planning. Once those plans were submitted to



The customer voice drove companies in their business planning. Once those plans were submitted to Ofwat, there were other forces at play.



The jury's out on whether they'd [the Environment Agency, DWI and Natural England] commit to CCGs again.

Ofwat, there were other forces at play." She cites the example of horizontal ODI checks and upper quartile benchmarking. Acknowledging that customers will benefit from more stretching targets, she nonetheless observes that there was little obvious customer support for outperformance incentives in general or for upper quartile performance specifically.

The chairs largely accept that posing a cost challenge was always going to be part of Ofwat's role. Darlington comments: "It was never the CCGs' job to make the cost challenge. If some CCGs thought they could agree the plan and that's it, done, they have misunderstood the nature of the regulation." For many, the Ofwat's cost challenge was welcome. Bradley says: "The downward pressure on prices that resulted was good news."

Nevertheless, as discussed earlier, some feel the process could have been better managed if Ofwat had shared its thinking earlier. Crump says: "Ofwat's intervention was inevitable, but it could have been done in a way that meant the customer had a voice right up to the end."

Perhaps the starkest example of Ofwat's dominance in the late months was its exclusion of investment schemes that had clear customer support from its draft determinations. Severn Trent's resilience scheme for Birmingham came to epitomise this issue, but there are many examples across the industry. Bradley, for example, says she was very disappointed that customers' bathing water improvement priorities were left out of Southern's draft determination because Ofwat didn't have confidence in company costings. She points out though that an innovative solution was found in time for the final determinations. Southern's Customer Advisory Panel, the successor body to its CCG, will "act as a gateway to the release of funds". Bradley adds: "It's a challenge to find a way to build in the cost of project delivery without complete confidence in costings."

CCG contribution?

Overall, the chairs had mixed feelings about the extent to which their CCG had a material effect on the PR14 outcome. >

Most agreed they had concertedly influenced the formation of the business plan, and could cite concrete examples of challenge and company response. McCrea for instance says the Dwr Cymru CCG rallied support to effectively challenge the company to scale back the £13 it originally wanted to cover private sewer transfer costs.

However, at the end of the day, McCrea says she would

like more clarity on what weight Ofwat attached to CCG work. "It's not been clear how much we influenced decisions. Ofwat has said we've been useful, but there is not really a clear measure of how. I'd like more considered feedback."

According to Darlington: "I believe the company [South East Water] thought differently and planned

better because of us. But it is very, very difficult to say this or that wouldn't have happened without us. Ofwat's cost challenge was at least as important as the CCG role. It's hard to separate out our achievements from Ofwat's achievements."

Either way, there's no denying the overall outcome of PR14 is good for customers: £44 billion of investment on

the back of bills down 5%. Darlington however has a reservation: that this short term, politically expedient win could come at a longer term cost. "Cost challenge has been a major theme of this price review," he mulls. "My reservation is, with all the emphasis on cost, I'm not sure medium term sustainability issues have had as big an emphasis as they should have." **TWR**

CCGS OF THE FUTURE

Thoughts are inevitably turning now to how the CCG model can be refined going forward. Most companies have expressed an interest in morphing their PR14 groups into customer groups that will oversee the delivery of business plans and perform

a monitoring function through to 2020. Then there is a related but separate issue of how PR19 groups should be structured and operate. A number of issues require thought.

Chair payment

There remains little agreement about whether chairs are compromised by being paid directly by the water company. CCW is adamant that at the very least, there is a risk that the public will frown upon its interests being represented by those in the pay of the industry.

Its research recommends, perhaps surprisingly,

that CCG successor groups are chaired not by the local CCW representative, but by an independent and that no individual chairs more than two groups. Crump explains experience has taught that chairing a group in a balanced, fair way "potentially risks customers not getting the advocacy they deserve" if that chair is also the statutory consumer representative.

However, crucially, CCW also stipulates that these new independent chairs, while answerable to the water company board, must be remunerated under CCW's auspices via an industry levy. McCrea comments: "I would not expect a chair to

be paid directly by a company. There is a potential conflict of interest. CCW's 'third way' proposal overcomes this difficulty."

The independent chairs who have been paid directly by the industry hitherto feel this is an unnecessary complication. Bradley says: "I don't feel I have to be paid differently to ensure my independence. I have been independent anyway." Darlington argues: "This historic argument about independence has melted away now. A third of companies went their own way and we've had six independent chairs. There has been no evidence of capture."

"All six companies are looking to continue now with their current chairs. I think few if any CCW chairs will stay on. So I hope we can get more collaboration nationwide as opposed to just the six of us, geographically close, collaborating."

Watchdogs off duty?

There is also a question as to whether regulators the Environment Agency/Natural Resources Wales, the DWI and Natural England should in future participate in successor groups. On a practical level, they struggled with the commitment level demanded by the CCG process, but there is also the ideological issue of whether these regulators should sit on, or be external to, consumer groups. Darlington proposes they are excluded and work in partnership with rather than as part of CCG successor bodies, certainly for the monitoring phase. This would make space for more actual customers and their representatives too.

Bradley agrees, arguing that these regulators have separate, statutory responsibilities anyway – for instance, they report to Ofwat on whether company plans meet statutory quality obligations – so it is more appropriate for them to engage outside the consumer group.

There is some difference of opinion, too, around whether greater consistency across the industry would be desirable. McCrea compares and contrasts the two groups she chairs: "My two companies couldn't be more different. There needs to be a consistent approach to challenge if that is to be part of the regulatory process." Crump suggests that perhaps the demands placed on WASCs and WOCs should take their size and resources more into account.

In terms of the structure of successor groups, there is more agreement that practicalities must be factored in. CCW recommends around 15 members is optimal, and that these must be well inducted and provided with clear expectations regarding

their role, remit, duties and the process. Moreover, to keep workloads manageable, subgroups are recommended, along with greater use of experts who can dip in and out of the process when relevant. CCW adds that Ofwat should set out its criteria for evaluating business plans clearly at the outset, should stick to hard deadlines and should feed back thoroughly to CCG members at the end.

Bigger picture

Darlington would also like to see Ofwat's Customer Advisory Panel (CAP) – a group set up in 2011 and disbanded last year, to advise the regulator on sector wide consumer issues – play a more prominent role and engage more with CCG successor bodies. "The notion of a CAP is good but hardly anyone has heard of it," he comments. He remarks that its interaction with CCGs over its lifetime has been minimal; he finally met the CAP at its final 2014 meeting.

Darlington believes a CAP-type body would be ideally placed to comment on sector wide issues for which individual CCGs are not qualified – for instance, the appropriate cost of capital and the horizontal incentive checks/upper quartile performance issue. "They are sector wide issues that should have been discussed with the CAP," he says, adding: "I would like to see Ofwat create a standing consumer advisory soon, to consult on things like its annual plan, its future strategy and so on. By the next price review, this body would be up to speed and ready to play its part."

Quadripartite plus?

In the round, the CCG experience worked and was worthwhile, despite the bumpy ride. It will be interesting to see how individual companies choose to structure and operate their monitoring groups (some are already well on the way). The enthusiasm with which the industry is planning to take the model forward speaks volumes about its value.

But for PR19, all the signs are pointing towards some kind of hybrid CCG/quadripartite model, under which each company thrashes out its plan as part of the regulatory process with customers and, as separate entities, the quality regulators. Only "customers" would no longer mean CCW alone but independently-chaired, multi-customer bodies featuring strong input from CCW.

Ofwat will inevitably have to challenge the plans that result, and in doing so will simply be doing its duty. But sharing its financial models and broader thinking about the process earlier could only lead to an even better result.

CCGS – THE BASICS

CCGs are an development of the "quadripartite" process of PR09 (and in Wales, of the Wales Water Industry Forum). At the 2009 price review, a group consisting of four main stakeholders – the company, CCWater, the Environment Agency and the Drinking Water Inspectorate – was set up in each water company area to discuss investment requirements, service packages and costs ahead of company business planning and throughout the price setting process. This was widely regarded to have been a success, resulting in a better deal for customers than at PR04.

Research ahead of PR14 suggested customers would be happy to be more directly involved in price setting. Consequently, CCGs were suggested and each company given responsibility for establishing one. They comprised a core group of members – the old quadripartite stakeholders – plus many other customer voices – for example local businesses, local authorities and community leaders. The exact composition and size of the groups varied according to company discretion; some opted for large groups of around 30 members on a "more the merrier" basis, while others kept their groups tight, to around nine or ten members, in a bid to prevent unwieldiness. Some groups merged during the course of the approximately two year long process.

According to research by CCW, some CCG members felt certain interests were overrepresented on groups – CCW itself for instance, where there was both a CCW chair and a representative, or local authorities – while other segments, particularly the private sector, were underrepresented.

Most companies chose to ask a senior CCW representative – commonly the regional chair – to chair their groups, though some opted for independent chairs, who were usually sourced through recruitment agencies or adverts. Some groups followed very formal processes; others were less formal.

The groups' objectives were to: review company engagement with customers and challenge companies to base plans on customer opinions; challenge the phasing and scale of work to deliver customer preferred outcomes; and advise Ofwat on company business plan performance and proposed bill acceptability.

PARTICIPANTS' PERFORMANCE

Water companies

The industry comes up smelling of roses, with the CCG chairs universally impressed by the way companies threw themselves into the process and treated the customer groups as a priority.

Crump says: "All the companies I worked with stated and lived their support for this process. They weren't grudging in their engagement. The details varied a bit company to company but there was always very senior engagement from the executive team... Overall I was very impressed with the companies. They didn't take a narrow view in which investors and owners were their primary concern. They had real interest in customers and the environment."

Bradley says of Southern Water: "It embraced the need to change the way it engaged with customers, and embraced the CCG."

Where there is criticism, it is either minor or felt to be to some extent beyond company control. Crump notes, for instance, that regulatory expectations were in no way tailored to company size or capacity to cope. "Sometimes it was all a bit last minute with the small companies," he says, "but it was a very demanding process for them. Their internal capacity and their capacity to employ external support was inevitably lower than at larger companies."

McCrea says: "Both companies in Wales were very willing to engage. There was never any kickback, they were both brilliant, but approached things differently. Dee Valley struggled to respond at times. Initially it proposed putting bills up significantly to fund a major treatment works investment programme. We challenged that and it did reduce its prices but it was still only one of two companies to put in for price rises in its business plan. Ofwat disallowed that."

"Dwr Cymru undertook an enormous customer consultation programme. It consulted very widely, had roadshows and everything. It had so much information that we felt it wasn't clear that every customer recommendation had been sieved out and made use of. We would have liked to see a clearer audit trail – its "golden thread" could have been thicker."

Ofwat

The regulator is to be congratulated for taking the bold step in the first place of allowing customers to have such an extensive say in the PR14 process. But its conduct along the way is deemed less impressive. While its policy of not issuing extensive guidance to CCGs was deliberate, according to research by CCW this left some group members feeling unsure of their remit

and scope and consequently of unnecessary work being done. There was a general view that better visibility of the whole process would have benefited everyone (see body copy).

Crump adds that in stark contrast to the senior level commitment shown by companies, "several members were surprised they didn't get to meet anyone from Ofwat" (though the chair did) and would have liked to be able to present their reports in person rather than just submit them from a distance.

The wider turmoil at Ofwat that formed a backdrop to the process, particularly the fact that as one chair put it "half the senior management team changed, including the chair and chief executive" was also felt to have disruptive knock-on effects for CCGs.

CCG members

General: The chairs praise the tenacity and commitment of the members of their groups, particularly given the complex subject matter and the fact that for most, the duration and level of commitment demanded by membership was longer and deeper than anyone had expected. Crump says: "I have been deeply impressed by the willingness of people, particularly those with a relatively tangential interest in water, to make such big contributions. I've seen a real public service ethos."

EA, DWI, Natural England: However there is widespread acknowledgement that aside from CCW, the members who had a place on every group (see box, CCGs – The basics) struggled with the time and resource commitment. Darlington comments: "It was hard for them to sustain membership. The DWI dropped out (of my group). Others were clearly under pressure and didn't attend all meetings." Another chair remarks that because of major reorganisations at their home organisations "some weren't even sure if they'd have a job to keep doing". Crump comments: "The jury's out on whether they'd (the Environment Agency, DWI and Natural England) commit to CCGs again."

CCW/non-CCW chairs: According to Darlington, collaboration between groups chaired by CCW regional chairs and those chaired by independents paid directly by the host water company has been lacking. He says: "CCW wrote opposing the appointment of independent chairs and has kept us at a distance." While not questioning the integrity of any individual, CCW believes direct payment by a water company could jeopardise the independence with which a chair can act (see body copy).

If any water company opts to appeal its PR14 determination, or if merger plans surface in the wake of the price settlement, the industry will get its first taste of dealing with the Competition and Markets Authority (CMA). The Competition Commission (CC) performed appeal and merger functions until its duties were fused with those of the Office of Fair Trading on 1 April 2014 under the CMA banner. So what might water companies encounter in dealing with the new body? What issues should they be aware of? And how has the CMA's inaugural year been so far?

According to competition experts, the risk of further political interference in markets is high and a CMA priority must be to robustly demonstrate its independence – or risk losing market confidence.

Political risk

Matthew Fell, director for competitive markets at the CBI, told a Westminster Business Forum seminar on UK competition reform that this year's general election, twinned with pressures around devolution and EU membership, "gives rise to increased political intervention in markets". He explained "politicians are putting regulators and competition authorities in a pretty tricky spot right now" and said the danger is the government will decide on solutions for companies or markets before regulators or competition authorities get a look in. Fell said this heightened political threat "reinforces the need for strong, independent-minded leadership" at the CMA.

Bruce Lyons, professor of economics at the University of East Anglia and member of the Economic Advisory Group for Competition Policy to the European Commission, raised the issue of the CMA's independence as an



The risk of further political interference in markets is high and a CMA priority must be to robustly demonstrate its independence

CMA: WHAT TO EXPECT

After PR09, the Competition Commission was in the appeals and mergers driving seat. What's the heads up after PR14 on the infant CMA?

appeals body in light of its membership of the UK Competition Network. This is an alliance of the CMA and sector regulators the Civil Aviation Authority, the Financial Conduct Authority, Ofcom, Ofgem, Ofwat, the Office of Rail Regulation and the Utility Regulator for Northern Ireland. Members share a common interest in having a duty to promote competition, and the network operates on a collegiate basis. Lyons hinted this co-working could make it more uncomfortable for the CMA to overturn a sectoral regulator's ruling than it was for the CC in the past.

So far, so good?

More broadly, however, there was considerable support from speakers at the Westminster Business Forum event for the formation of the CMA. Though born of the "bonfire of the quangos" policy, the single body was said to offer the real benefits of a smoother process, earlier senior level dialogue and more robust decision making.

Moreover, many felt early experience had been promising, albeit limited. Sonya Branch, the CMA's executive director of enforcement, explained the organisation had "not blossomed fully formed" and that integrating staff from "two very different cultures" had

occupied considerable attention. Nevertheless, Branch said the CMA was committed to making markets work. She explained enforcement activity was a priority, and that the CMA would be robust – for instance, it anticipated frequent use of its compulsory interviewing powers.

Challenging times

At the time of speaking, Branch said the organisation was dealing with 14 "in-flight" cases (those predating its launch) and since April had: closed one Competition Act investigation, accepted commitments in two other cases, and opened four new Competition Act investigations. It had also stepped up its criminal enforcement work, recruiting three new directors and taking a more intelligence-led approach. In the round, Branch viewed the CMA as having got off to a good start, but with plenty more to do.

Lyons, however, highlighted some of the challenges: the CMA's "abysmal" website; the "worrying loss of the middle order" despite some "excellent senior appointments"; the OFT/CC culture clash; and the need to ensure decisions are evidence-based not knee-jerk reactions to political or public pressure.

Gunnar Niels, managing director, Oxera, added to the list of challenges the need for the CMA to find its place in relation to other competition authorities such as sectoral regulators, courts and Europe's DG Competition. "Are they complements, substitutes or rivals?" he questioned. Another issue would be reconciling the CMA's two very different functions: the teeth-baring, adversarial enforcer on one hand, and the wise expert panel on the other.

Fell pointed out that on top of all of these issues, there were some big picture challenges facing the CMA too: the need to deal with the blurring of market boundaries borne of technological development; the globalisation of business; and the impact of social media on cases and outcomes.

So should a water company appeal its price settlement, or propose a merger that will inevitably prompt a referral, it should be mindful of the broader context in which the CMA is operating as well as of the specifics of its individual circumstances. **TWR**

NI WATER TOTAL REVENUE CUT £89M TO £2.3BN

Utility Regulator cuts prices for all except unmetered customers in 2015-21

Northern Ireland's Utility Regulator (UR) has coupled a soft landing on operational expenditure with a greater challenge on capital spending in its final price control determination for Northern Ireland Water, running 2015-21 (PC15). Overall the final determination (FD) is not a huge stretch from the company's business plan. But hanging over it is the prospect of significant reductions in public expenditure.

The targets on which the price controls are based were set by the Department of Regional Development assuming no change in current levels of public expenditure which is arguably unlikely. The regulator has warned that a reduction in public spending in Northern Ireland will be detrimental to the service NI Water will provide: "In the event of public expenditure reductions for water and sewerage services, it is likely that there will be an impact on the level of [NI Water's] services and outputs."

In the FD, the regulator told NI Water to reduce its total revenue by £89.3 million from its business plan figure of £2.43 billion – a 3.7% cut. Caps on the percentage point increases or decreases to inflation (K factors) have been applied separately to each of five tariff baskets – measured and unmeasured water and sewerage, and trade effluent – "so that the correct revenue is raised from each customer group." Most customers will see cost decreases over the PC15 period. For the average notional household, the 2014-15 price of £410 will fall to £365 by 2020-21, which is £35 less than the NI Water proposed figure of £400.

Only unmetered customers – 11% of all consumers – will see an increase in their charges, typically of about 14% to

£285 by 2020-21. According to the regulator: "The main reason for this increase is down to more accurate information about the consumption levels of this group of consumers."

The UR's allowed rate of return was marginally greater than NI Water's view (see table).

Operations

NI Water is 22% less efficient than similar companies in England and Wales. According to the UR: "NI Water spends £1.27 for every £1 spent by the more efficient companies."

It has told the company to reduce this efficiency gap and deliver 2.3% per

WEIGHTED AVERAGE COST OF CAPITAL		
	NI Water	UR
Cost of debt	1.22%	1.41%
Cost of equity	5.70%	5.65%
Gearing	50%	50%
WACC	3.46%	3.53%

PENSIONS EMERGENCY

Trade union protest over pensions reform hit NI Water over the Christmas period, where industrial action limited the staff available to respond to emergency situations. The situation continued at the time of writing.

NI Water warned the possible consequences included water quality deterioration, supply interruptions, pressure problems, wastewater discharge problems and customer response delays.

Chief executive Sara Venning said: "I do recognise the right of employees to participate in action, but I have made it clear to unions that it is not in the gift of NI Water to defer pension reform."

annum efficiency savings over PC15, which will save the consumer £47 million in 2012-13 prices.

In arriving at its decision, the UR acknowledged NI Water's successive and significant improvements in its operational efficiency, adding: "It is important to recognise such reductions in opex have been achieved at the same time as improving levels of service for consumers." However, it added: "There remains scope for further reductions in operational spend."

By the end of PC15 the UR expected opex to fall £170 million a year from £193 million in 2015-16 – a real terms reduction of about 11.5%.

Capital spending

The FD provided for £1 billion in capital investment which "aligns with current guidance on public expenditure available for investment in water and sewerage services". Of this investment, £556 million is allocated to the repair and replacement of assets while £446 million is allocated to deliver new and upgraded treatment works and other "clearly defined and prioritised outputs which will enhance service".

The regulator has set a 7% target for increased capital efficiency. That will add £56 million worth of service improvements within the current budget. Added to this, NI Water will be expected to keep up with a 0.6% a year rising efficiency target applied to improving works and capital maintenance.

In its assessment of capital maintenance investment, NI Water concluded that an increase to an annual average of £122 million was needed. The UR said such a hike would have "an immediate impact on costs to customers and taxpayers," and would use 87% of the capital budget. "Once investment to meet growth was considered, there would be no room for improvements to water quality, the environment or consumer service."

The regulator has proposed a constrained budget of £80.3 million which NI Water warned would add risk to serviceability and possibly increase expenditure even further to address a backlog. The company proposed that any mid-term review of PC15 should include capital maintenance investment. **TWR**

NEWS
IN BRIEF

Tideway own way: Ofwat has modified Condition B of Thames Water's licence, to enable its Tideway Tunnel activities to be regulated under a separate price control.

Linked in: The government has published *Better Connected*, a new guide to utilities for homebuilders. It flags up the new connection charging rules Ofwat is due to develop following guidance from DEFRA, due this summer.

Hythe and seek: Independent Water Networks applied for two variations in its appointment in December, to supply to Martello Lakes in Hythe and Forge-wood NES Crawley.

Yorkshire more: Yorkshire Water has committed to pay all staff a "living wage" of £7.85 an hour. South East Water was the first water company to join the Living Wage movement in November.

Coming of age: Ondo Industrial Solutions has become the 18th licensed provider to join the Scottish water retail market.

Credit where credit's due: Dwr Cymru has agreed a £230m loan facility with the European Investment Bank on the back of its industry-leading credit rating. The loan will help finance its £1.5bn capital investment programme for 2015-20.

Going up market: Northumbrian Water customer director Ian Donald is to take up the new role of market reform director, to lead the company towards retail market opening in 2017. He is replaced as customer director by current distribution manager Claire Sharp.

DEFRA mulls a 'third way' on abstraction reform

The government is considering a new option for abstraction reform which would combine the two options originally set out in its *Making the most of every drop* consultation.

Speaking at an Anglian Water event, DEFRA policy advisor Henry Leveson-Gower explained the hybrid option would implement "Water Shares" arrangements in enhanced catchments where the need for reform is most pressing, while most catchments would start off with "Current System Plus" arrangements. These could transition to Water Shares over time.

Under "Current System Plus" plans, annual and daily volumetric constraints would continue,

while under "Water Shares", abstractors would be given a share of the water available in a catchment, rather than an absolute amount.

Leveson-Gower said rolling Water Shares out in a limited number of catchments rather than widely would reduce implementation risk and provide learning opportunities. In the meantime, Current System Plus would improve on existing practice in basic catchments – for instance, by facilitating water trading.

The Anglian Water event was to launch a research report on lessons from Australia's experience of introducing a market system based on water shares (see feature, page 34-35). Author Alice Piure found introducing

reform there had been complex, difficult and time-consuming. She said a limited initial rollout could be practical, both to help iron out difficulties in a manageable way and in light of the tight timetable for reform.

Leveson-Gower said the government would produce a strategic decision on the way forward this year and would aim for primary legislation in the next parliament, with a view to implementing reform in the early 2020s. He added though that there was "a level of uncertainty on how this will play out in future" in view of May's general election.

The EFRA committee has put pressure on DEFRA to deliver reform urgently.

Irish Government legislates to cut new water charges after widespread protest

The Irish Government has bowed to widespread public demonstration and slashed the prices Irish Water can charge. A new Water Services Bill was rushed into law on 28 December, allowing the revised water prices to come into effect.

Annual water and sewerage charges, metered or unmetered, have been capped (see table) until 2018, with legislative provision for this arrangement to continue

after 2019. Children remain free of charge. Prices are halved if only one service is taken.

Those on meters can beat the capped rate through efficient consumption; the metered rate for each water and sewerage service was cut by a quarter from €2.44 to €1.85 per 1,000 litres.

In addition, all eligible households that respond to Irish Water's customer application campaign by the extended deadline

of 2 February will receive a "water conservation grant" of €100 per year from the Department of Social Protection. This will take capped annual combined bills down to €60 per single adult household and €160 for larger households.

The starting date for water charges was also put back from 1 October 2014 to 1 January 2015, with first bills to be issued from April 2015.

REVISED COMBINED CHARGES FROM 1 JANUARY 2015

Household type	Capped annual water and sewerage bill to 2018	Water conservation grant	Net cost
Single adult (with or without children)	€160	€100	€60
Multi adult (with or without children)	€260	€100	€160
Dwellings not permanently occupied	Minimum of €125; where usage exceeds this amount in metered properties, charges capped at €260 max	N/A	€125 (min) - €260 (max)

Source: Irish Government

CHALLENGE ON THE CHEAP

The Consumer Rights Bill will make it a whole lot easier for retailers to mount competition law challenges against incumbents if they don't play fair.

Legislation making its way through Parliament could make it easier for competitive retailers to bring competition law challenges against incumbent water companies if they believe they aren't acting fairly.

The Consumer Rights Bill, which had its third reading in the House of Lords on 8 December, seeks to make anti-competitive behaviour quicker and cheaper to challenge and hence to galvanise more individuals and businesses, particularly SMEs, to take action. At present, the complexity, long timescales and the need for costly expert economic input deter all but the biggest businesses from taking cases on.

Once the English water retail market is opened to competition, a change in the law of this nature would mean out of area incumbent retailers and new entrants could feasibly take action if they suspected an uneven playing field or other competition law breach on the part of the local water company. Many of the retailers operating in the Scottish water market are SMEs, and if this pattern is followed in England, the Consumer Rights Bill could open legal options to them that they would not normally be able to shoulder.

In particular, the Bill proposes:

■ Allowing the Competition Appeal Tribunal (CAT) to hear cases, with a special cost-capped, fast-track route for SMEs.

■ Alternative dispute resolution options, so courts become a last resort. These options include: collective settlement powers for the CAT, under which it could agree a level of damages if approached by any representative consumer group or trade association and a business which has broken competition law; and a redress certification role for the Competition and Markets Authority, enabling it

to approve a consumer compensation scheme put forward by a business which had broken competition law.

■ An "opt-out" collective action regime, under which any representative consumer group or trade association could take action and any eligible consumer automatically benefit unless they actively opted-out. At present, only Which? can bring such actions and only on an opt-in basis.

Private paucity

Speaking at a Westminster Business Forum event on UK competition reform late last year, CAT president Mr Justice Roth said there was "total underdevelopment" of private actions, but that the government had acknowledged their potential value and that private actions had steadily increased since the Enterprise Act 2002. In terms of abuse of dominance specifically, he highlighted two key cases: Purple Parking v Heathrow Airport over the location of valet parking in 2011, and Arriva the Shires v Luton Airport over an express bus service from London in 2014.

Roth described cost and complexity as "very real obstacles to victims seeking redress" and said the CMA and regulators don't have the resources to take up every bona fide case brought to them. Consequently, he explained there has been a gap where there should have been individuals and SMEs bringing cases.

However, Roth said the Consumer Rights Bill should go some way to plugging this gap. Because consumers retained the option to go through the courts should they wish, the CAT would have to "justify itself through shorter wait times and so on"; it would aim to hear SME cases within six months. The CAT would also have to manage collective proceedings and settlements very

carefully, though he said fears of US-style class action excesses were "misinformed" because safeguards had been built in to the new system.

These safeguards include no jury trials; no treble damages awards (where courts grant victors three times the damages awarded in the case); and making losers liable for winners' costs,

Out of area incumbent retailers or new entrants could feasibly take action if they suspected a competition law breach on the part of the local water company

which should deter "bad claims" being brought forward.

Roth noted, though, that a number of amendments proposed in the Lords would dilute the intention of the legislation if they stood – for instance, one amendment sought to prevent third party funders assisting private claimants in bringing action, while another sought to emasculate the opt-out rule.

The House of Commons will consider the amendments sent back from the House of Lords on a date to be announced. **TWR**

BROADER AIMS OF THE CONSUMER RIGHTS BILL

- Streamline key consumer rights covering contracts for goods, services, and digital content;
- Clarify the law where it is confusing, or written in legal jargon;
- Modernise the framework for the digital age;
- Deregulate to reduce business burdens and costs; and
- Enhance measures to protect consumers, where it is appropriate to do so.

MARKET OPERATOR STATUS REMAINS THE GAP IN AN OTHERWISE SOLID MAP

Incumbents have their work cut out now Open Water has published the wholesale retail code and baseline documents for the competitive retail market. But MO classification and central systems procurement delays are becoming urgent.

Open Water's second Market Architecture Plan (MAP2) was published in December, for the first time giving the water industry something to really get its teeth into in terms of planning for the competitive retail market. The plan sets out all the activities that need to be completed for the market to be opened successfully in April 2017 and provides baseline market documents. Chief among these is the statutory wholesale-retail code which defines among other things operating procedures, terms of trade, and registration and settlement processes.

MAP2 is a major achievement. It provides a comprehensive work plan for key stakeholders to take forward and is the product of five months of hard labour from incumbents and new entrants after the first MAP was published in July 2014. It is hoped this momentum can be maintained and the time Open Water lost in 2014 to setbacks of various sorts made up. Open Water says: "While the programme is still behind where we would like it to be...it is hoped that by late spring 2015 the Open Water programme will have recovered from earlier delays."

Risks

However there is no hiding the fact, as Open Water freely admits in the MAP2 document, that market opening on time is far from a done deal. It hinges on a number of important assumptions, including:

- Classification of the market operator (MO) as a private entity. This would

chiefly enable central systems to be procured more quickly and easily than under public procurement rules.

- Open Water can pursue work on the detailed specification of the market and operational terms and conditions as a revenue, not a capital, expenditure. "This is not unreasonable," the programme says. Open Water already has approval for revenue spending but would not be allowed to commit to any capital expenditure without prior HM Treasury approval. MAP2 adds that in the event that capital expenditure and budget approvals do prove necessary, these must have been granted by mid-April 2015 so the central

systems build contract can be tendered.

- The budget for the next financial year is approved and is available in a timely fashion.

- No external factors get in the way. Political risk could be significant given this year's general election.

Each of these assumptions carries considerable risk but of immediate concern is the classification of the MO. This is an issue that has dragged on far longer than anyone would want and if left unresolved for much longer could jeopardise on-time opening (see box – MAP gap).

MO aside, MAP2 pretty much spells action stations for incumbents. The publication of the wholesale-retail code, particularly now PR14 is in its final throes, should set them on a path of intense activity.

Wholesale retail code

The proposed wholesale retail code performs the functions of the Scottish retail system's market code, operating code, and wholesale agreement. Open Water has recommended a different legal form be followed from that in the Scottish market on the back of legal counsel. This advised use of the statutory code mechanism for the English market. The resulting wholesale retail code will create a set of standardised terms and conditions that will apply to all wholesalers and all licensed retailers.

Legal form aside, the code contains broadly the same rules, processes and procedures as those in the Scottish market. It took the Scottish arrangements as a starting point and aims to offer customers a seamless experience across the border. The operating rules cover, among other things, new connections, metering, customer contacts and complaints, procedures for planned and unplanned activities, trade effluent control and disconnections/reconnections. The market rules set out matters including how market information will be accessed, customers registered and information sent to and received from the MO.

Most of the proposed arrangements for England are consistent with those already in place in Scotland, albeit in some cases adapted to the larger market. There are a few exceptions.

tions, most notably around payment terms. Unlike in Scotland where wholesaler Scottish Water is paid by licensed providers up front, in England, retailers will pay wholesalers 30 days after the end of the billing period or 15 days after the issue of an invoice, whichever is later.

Scottish Water has in the past spoken up for payment in advance, saying it values the protection from risk this provides. So how retail-wholesale payment pans out in England is yet to be seen. Risk protection in the English market will be delivered via an escrow account system. The code requires each licensed retailer to establish an escrow account with each wholesaler with whom it wants to trade. The minimum balance in an escrow account will be £50,000, until 75 days' wholesale charges exceeds that amount. At that point, the account should be topped up such that its balance is consistent with 75 days of wholesale charges.

It is important to note that the wholesale retail code only governs relationships between wholesalers and external retailers, not relationships between the wholesale and retail arms of vertically integrated companies. Open Water says: "It follows that a separate arrangement will need to be made to ensure that the interactions between [a] legally integrated company's wholesale and retail arms will take place on the same basis as a transaction between that company's wholesale arm and a licensed retailer operating in that area." This arrangement could take the form of a company-requested or Ofwat-imposed licence condition requiring the terms of the statutory wholesale retail code to be applied to internal dealings.

The fact that the code doesn't govern internal relationships should be an influential consideration as companies deliberate how to structure themselves for the competitive market.

Stick together or separate?

Incumbents are free to choose how they organise themselves for competition. They can remain fully vertically integrated; take a middle path of some kind – for instance through functional separation or by outsourcing their business retail operations within their existing licence; or take up the exit option (see report p26-

28) and transfer non household retail responsibility to another legally licensed entity, either within the parent group or completely external to it.

Those that choose to remain legally integrated will face more issues in demonstrating compliance with the level playing field demanded by competition law, because their internal wholesale/retail dealings won't be governed by the statutory code. These issues will include:

- Practical challenges** – for instance, how to handle operational matters or how to deploy internal communications systems

- Governance challenges** – how can a single board take independent decisions on wholesale and retail matters?

- Financial challenges** – how can integrated organisations demonstrate the standalone creditworthiness of their retail operations?

Vertically integrated companies will need to take steps to reassure the market that the retail business is not getting any preferential treatment from the wholesale business. This could be through a licence condition as mentioned above, new governance arrangements, or by transferring customers into a separate licensed entity within the group via the exit route. Exit to an associated licensee would mean that both the retail and the wholesale activities of the previously vertically integrated incumbent would be subject to the statutory wholesale retail code. Alternatively, they could outsource retail functions to a third party.

Open Water formally says corporate structure is a matter for companies to decide and that "there is no single correct option". But reading between the lines, it clearly suspects demonstrating compliance within vertical integration will be tough. It points out there is a need to demonstrate beyond doubt that the integrated retailer doesn't have any form of advantage. "When the incumbent starts with all of the customers and all of the most recent knowledge of these customers, this could be quite a difficult case to make." It adds in reference to mitigation actions: "There is, of course, no particular set of arrangements that will be fully effective. This is because it is the actual behaviour of an incumbent's staff and contractors that will determine whether or not the level playing field has been safeguarded. Accordingly, an

GOVERNANCE: WICS' EXPERIENCE SOUGHT

The Water Industry Commission for Scotland will deploy its experience of opening up the Scottish Water market in England in acting as Ofwat's delivery partner on Open Water, now the regulator has taken this work in house. WICS chief executive Alan Sutherland is rapidly becoming the face of the programme. At the time of writing, the deal was yet to be signed and sealed but is expected to see WICS delivering:

- design of codes, processes and procedures
- establishment of the MO including managing the procurement and delivery of central systems

- the communication and engagement programme with non household customers
- management of work plans and contracts
- design and management of the assurance process.

Ofwat retains overall responsibility for the delivery of those elements of the programme that impact on regulatory policy. These include:

- developing the licence framework
- charging and the levels of tariffs
- all matters connected with the price review.

incumbent company should consider carefully how its competitors in the market may perceive its organisation and how it functions."

This is particularly the case in light of incoming consumer legislation which will make it easier to mount competition challenges (see report, p17) and Ofwat's concurrency powers under the Competition Act 1998. Non compliance could have financial as well as operational implications.

MAP2 lists as things an integrated company will need to think about in demonstrating compliance to the regulator:

- that it has lived within the four discrete revenue caps that Ofwat set in PR14;

- that its retail arm receives no preferential treatment in terms of its "stand-alone" creditworthiness;

- that its retail arm pays the wholesaler in a timely way (and on the same basis) as competing retailers; and

- that the retail and wholesale arms handle shared costs and services equitably.

However, it is important to note, as Open Water points out, that exit is not a panacea for these complex and difficult issues, even if customers are transferred to an independent third party. "A company that chooses not to participate in the non-household retail market need only ensure that it treats, and is seen to treat,

all of the retailers that are operating within its wholesale area equally. In so doing, it would need to do nothing that might show, or appear to show, any preference to former colleagues and, through them, its former retail business."

Wholesale tariffs

MAP2 also sounds a note of caution for incumbents in their choices around wholesale tariff setting. Different types of non-household customer cost different amounts to serve. These costs relate to matters such as payment and debt profile, service needs, meter arrangements, billing arrangements and so on. But at present retail prices do not reflect these differences.

In setting wholesale tariffs – those wholesalers will charge retailers – wholesalers need to understand what it costs to serve each type of customer. Set the tariff too low for a customer type, and there will be a high retail gross margin which could lead to cherry picking (with retailers practised in Scotland sure to spot it). Set the tariff too high and incumbents could leave themselves open to accusations of margin squeeze where attractive customers are concerned. Unattractive customers would be stuck with an insufficiently resourced incumbent, jeopardising the credibility of the market.

"Setting appropriate wholesale charges is a major exercise if a company is to get it right," Open Water points out, adding the exercise took around 18 months in Scotland. It suggests companies consider:

- the financial and operational costs of different classes of customer;
- how the network and treatment works costs are allocated to different classes of customer; and
- how 'collective' benefits such as the availability of firefighting water might be allocated across customers.

On the plus side, in its final determinations for PR14 Ofwat set a two year non household price control, allowing companies more time to explore such issues and to revisit cost and margin allocations for different customer groups ahead of market opening.

Data

The final major gauntlet thrown down by MAP2 to the industry is to get its data in order ahead of market opening. Open

MAP GAP: MO CLASSIFICATION

MAP 2 was published without provisions relating to the establishment and governance of the MO, despite the issue having been an important focus area for Open Water stakeholders since the publication of MAP1. At stake is whether the MO is classified and structured as a public or a private entity. All other MOs, including Scottish water market operator the Central Markets Agency, have private classifications. But the rules have changed recently, leaving the English set up in limbo.

The first entity established by stakeholders in early 2014, ultimately with a view to it performing MO functions, was Open Water Markets Limited (OWML). By July it was clear the company was likely to be classified as a public entity, so Ofwat announced it would bring Open Water in-house as a ring-fenced programme. This is now expected to happen on 1 February.

Since the decision to wind down OWML, Open Water has pursued a twin-track approach to the MO: working with DEFRA so it is covered should a public route prove necessary; while hoping to procure privately through MOSL, a new entity set up by water companies. MOSL has secured private entity status, which is good news and will enable it to get on with useful tasks including data prioritisation and assurance planning. However, at the time of writing, the enduring status of the MO and the consequent nature of central systems procurement remained unresolved.

Private classification will be essential if the April 2017 deadline is to be securely hit. Open Water hopes the MO will be established by a licence change, potentially brought about under Section 55 of the Water Act 2014, requiring companies to make arrangements for its set up and membership, including the voting rights of each class of members, and the size, structure and composition of the board.

MAP2 argues: "It is consistent with the needs of the market that market participants set up and run the entity to meet the needs of the market." It provides an example: "If, at any stage, the entity is failing in that duty, it

would be important to ensure that it can be replaced by a successor body." Such a 'shipwreck clause' would offer protection for market participants and non-household customers and would be consistent with a private classification.

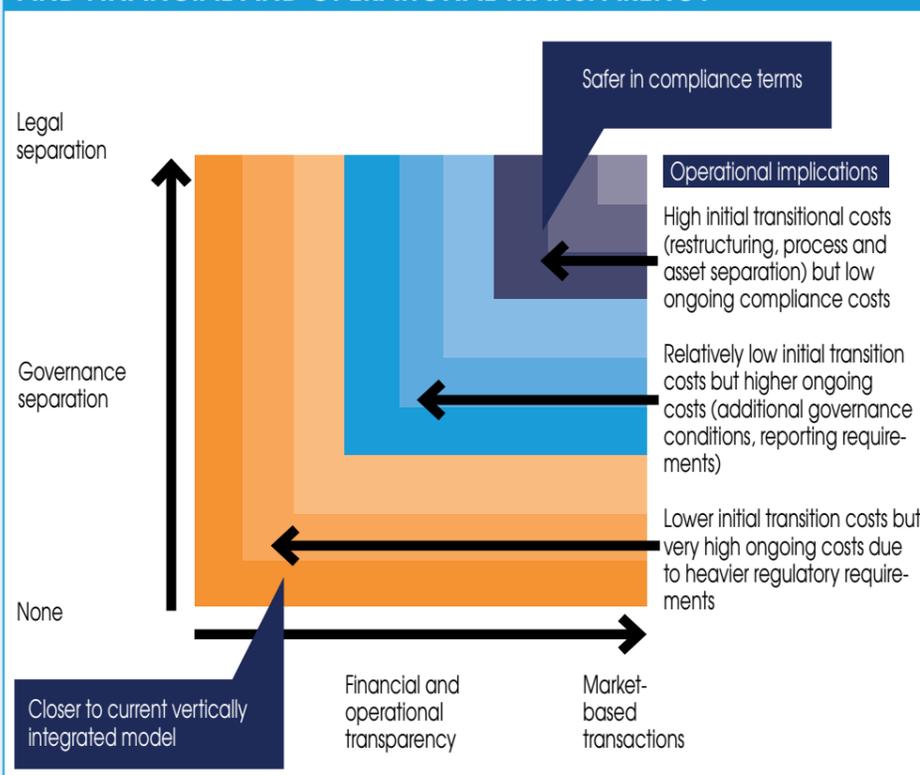
Perhaps the biggest concern at this stage, though, relating to the classification of the MO is whether central systems can be procured in time for market opening. The aim is to have a working system available in April 2016, which would allow time for testing and data transfer. Open Water notes in the MAP2 conclusion: "Final preparations will...only be possible when the central systems are sufficiently developed to allow the interfaces between company systems and the market operator to be designed, implemented and tested."

A private MO would be able to follow a private procurement path which would be smoother, quicker and cheaper than the public route.

Open Water will continue to strive for this outcome, though reaching agreement is clearly proving thornier than was hoped. Speaking at a meeting of the Major Energy Users' Council water group, Open Water lead Alan Sutherland urged business customers to help by keeping up the pressure for competition. He said: "There's a very real need for customers to continue to push for market opening to happen." He commented that private procurement of central systems would be "infinitely preferable" and added: "We've got to find a way that everyone can live with. This requires a MO that's classified as a private body, otherwise we'll be trooping to Horse Guards Parade every time we need to make a change. We can't let classification rules get in the way of a sensible outcome for customers."

A minor consolation is that companies can continue to progress some IT and data preparations without full clarity around the design and build of central systems. According to MAP2: "It should be possible to make IT system changes in areas that do not interact directly with the central systems."

POTENTIAL TRADE-OFFS BETWEEN SEPARATION OF GOVERNANCE AND FINANCIAL AND OPERATIONAL TRANSPARENCY



Water published a baseline version of the full data catalogue as an appendix to the main MAP2 document. This provides welcome clarity on precise data requirements. Having the appropriate data in the right format is crucial if companies are to participate in the market and avoid costs and penalties. A final data catalogue is expected in late spring.

But data cleansing and preparation for interaction with central systems is notoriously difficult, fiddly and time consuming. Data quality was and continues to be an issue in the Scottish market. English incumbents had 16 months from when MAP2 was published to get ready. Gemserv chief operating officer Ken McRae, veteran of preparing the Scottish market, says the best that can be hoped for is progress not perfection (see interview, p22-25).

Open Water advises the following steps:

- Ensure all names, contact details, services and meter information are complete.
- Ensure data for central systems is properly formatted and complete.

"Making progress in this area will take time and will likely require a company

to commit substantial effort to updating and reformatting the necessary information.

- Update and correct data issues that are identified after market opening. "There will inevitably be errors in the data that is uploaded into the central systems... Customer confidence in the new market arrangements will require that any such information errors are addressed promptly."

Assurance and awareness

Among other areas of work identified by MAP2 is the need to provide assurance that all parties are ready to successfully implement and operate the market. An assurance framework built on stakeholder engagement is due in the first quarter of this year. Building awareness of market opening in the non-household customer community will be a further strand of activity. This is viewed as "quite different from the promotional activities of incumbent and new entrant retailers who will want to convince customers to switch to them".

All round, incumbents specifically but all stakeholders generally are look-

ing at a hectic schedule in a tight timescale. Open Water itself is barely taking a breath after publishing MAP2 and is pressing ahead now with the various strands of its activities. It will begin more detailed specification of how the market rules will be implemented in February. The results of this will be used to support the further detailed development of the code subsidiary documents and procurement of central systems.

A Workplan Review Group comprising programme managers from DEFRA and Ofwat as well as market participants has been set up (superceding the previous Programme Delivery Board) and an updated work plan will be published each month. From this summer, the terms of trade will be frozen and any further changes proposed will be collected for possible implementation after market opening.

However, the most pressing issues of concern to the whole market are MO classification and central systems procurement. If these aren't sorted soon, whispers in corners of the industry that market opening could be delayed could become more audible. **TWR**



Post December's MAP from Open Water, market design expert and Genserv COO Ken McRae says water market opening in April 2017 is a realistic prospect – but don't expect perfection.

OPEN

When Open Water published its updated Market Architecture Plan in December, real detail became available for the first time on how the retail water market in England will be opened, and what needs to be done, when and by whom. It wasn't a complete picture – crucially, detail around the market operator and central systems procurement remained to be decided – but the plan put flesh on the bones in most other important areas and set the timer for 28 months to market opening in April 2017 (see report, p18-21).

So is a functioning water market achievable in that timeframe? Very few people outside of those bound up with Open Water have much in the way of hands-on experience upon which to base a sound judgement. But Ken McRae, chief operations officer at Genserv, was personally involved in designing and developing the Scottish water market (see box, page 25) and the design and operation of the GB electricity market. He believes we ignore those treasure troves of information at our peril: their transferable design features; the solutions they have found to problems; and latest developments in more mature markets.

So what says McRae about England's prospects for April 2017? "It's tight, it's challenging, but with a fair wind behind it, it's do-able."

Genserv's contract in Scotland started in November 2006 with a go-live date of April 2008. Acknowledging things were simpler because of the single wholesaler and single major retailer, McRae comments: "Eighteen months was quite a short window to do everything, but at the end of the day, we got there."

He politely says of England's progress to date: "It's taken a little bit of time to get on track." But that "from a slowish start, there's been fairly rapid progress over the past few months" as Open Water activity has ramped up ahead of the December document publication.

"Outside looking in, it feels like it's getting back on track. The building blocks are there to make April 2017 an achievable target. But there will be lots of challenges and it will require a big effort from all the water companies and other stakeholders to make it happen."

Pragmatic and realistic

But if you are expecting a perfectly-formed market in that relatively short space of time, think again. McRae is a believer in having a fixed opening date because it focuses the mind and provides clarity for all stakeholders. But inevitably this comes at the price of perfection. The solution? Pragmatism. Establish baseline requirements to launch with. Be prepared to make changes down the line once go-live arrangements have bedded in. Be practical about stakeholder involvement.

On the latter point, McRae says: "You do need to provide stakeholders with an opportunity to get involved and influence, but there are various ways of doing that. You don't have to have every water company sitting around the table debating every single point." He cites the example of the 1996/97 work programme ahead of domestic electricity market opening in 1998. Some companies sat on some groups; others on others; but everyone did not sit on all. The key factor is "making sure you have enough people on the working groups so it's not just one company driving it".

On baseline launch requirements, McRae explains: "We need clear success criteria at the outset so you know that if arrangements aren't 100% there, is there enough to go with? That happened in Scotland. We did go live regardless on 1 April 2008. There was an IT release within three months of go live because there were still some aspects of functionality to implement, but with the right cooperative attitude of stakeholders we were still able to go live. The volume of switching in Scotland was always likely to be low in the first few months so there was a fairly low risk."

Open Water should also be prepared to make changes – both along the way and after go-live, McRae asserts. In Scotland, when Genserv started systems design, Scottish Water was assigned to produce settlement calculations. Halfway through the build, the strategy changed and the central system took on the settlement function. McRae explains: "I think it was partly because Scottish Water had some concerns about whether they could deliver the settlement function on time or whether they could deliver it at the cost that was allowed

MINDED

in the price control. It made most sense for the central system to undertake settlement, so we added that in to the design...In reality, the central system had all the information: meter readings were going in, wholesale charges were there, you knew which SPID [supply point] was being supplied or which wastewater SPID was being serviced by which water company. So all the building blocks were there.”

Changes after go-live are standard practice too. For instance, the regime around testing new entrants’ fitness to interact with central systems was altered from a clipboard-style pass/fail approach to a more supportive, consultative approach very swiftly because it was felt the bar had been set too high. “There was an early departure from the high-level testing regime. But it was appropriate. There’s a difference between market readiness – that’s about existing market participants being able to operate under the new regime – and market entry – which is about new organisations choosing to operate in the market and ensuring they can inter-operate with all the other market participants, conforming with the central code.”

Champion and manager

Beyond pragmatism, opening the English water market on time will require really robust programme management, according to McRae. You can’t rely on incumbents alone. A champion to continually push forward is crucial, and working closely with Defra and Ofwat, in WICS chief executive Alan Sutherland, now acting as Ofwat’s delivery partner, England has found its man. Says McRae: “There have been a number of false starts, programme managers have come and gone. But now Alan has a strong continuing involvement, that’s really good. Together with Defra and Ofwat, Alan will provide that leadership. In Scotland, he really did drive it forward and make sure everyone did what they were supposed to do.”

“Our contract was a fairly simple one. It was just a case of ‘this is what we will pay you and you will make sure the market is open on 1 April 2008’. But it was a very strong direction we were given, and Alan lived by that.”

The programme manager must set out deliverables and timescales clearly and communicate changes transparently along the way. It must ensure also that all relevant parties are able to input into development – particularly customers. “It is a fine line between direct customer involvement on the programme and organisations out there that are influencing it,” McRae mulls. “In energy, under the Smart Energy Code, for instance, Citizens Advice has a seat on the panel if they choose to take it up. One of the things the water programme should consider is that level of customer representation. There is also a high degree of lobbying going on at the moment, as organisations like the MEUC have re-established their water competition groups.”

“The customer journey is one of the key learning points for me from energy. When you develop a market, bear the customer in mind throughout – otherwise it just becomes a theoretical exercise in terms of putting new processes and new systems in place. We need to make the customer journey as smooth as it possibly can be. In energy, there have been issues around customer switching, erroneous transfers and the like. Examples from other markets can provide learning and be applied in water so we make sure those things don’t happen in this sector.”

Pic ‘n’ mix

As much as he advocates drawing on the experience of other markets, McRae is absolutely clear that learning lessons does not mean carbon copying – even from the Scottish water market that the English market is to effectively harmonise with. He says: “The fundamental building blocks in Scotland are applicable to England. But I wouldn’t advocate that you slavishly follow it; you shouldn’t just try to take that and put it here.” After all, England faces challenges that were not a factor when the Scottish design was modelled ahead of 2008 – chiefly those of scale, complexity and available technology; plus upstream reform was not a factor north of the border.

McRae observes however: “The government has clearly set out the idea of an Anglo-Scottish market model. I do believe you need a high degree of harmonisation. There is a question that says ‘how quickly do those two markets come together?’ The important thing is that the two of them need to be on a convergent path – even if it’s not for April 2017. If it’s a couple of years later, that’s fine as long as the policy goals converge.”

Indeed, says McRae, it is likely that the Scottish market may be able to learn some tricks from the new English market as well as vice versa. “It’s going to be like playing leapfrog a little bit,” he says. “You’ve got Scottish systems that have been developed already. England hopefully will look at what happened in Scotland, look at energy and other markets, and come up with something that’s slightly better. But then Scotland probably needs to look at those slightly different design aspects for England, and say ‘do we now embrace those as well?’ That’s where convergence and harmonisation will come from, as they continue to learn from each other.”

In terms of specifics of the market, McRae highlights the following as key issues.

Water company structure and culture. Clearly the roles and responsibilities of wholesalers and retailers must be separated to ensure the playing field is level, but an important issue is not exactly how this is done, but how companies cope with the cultural shift required. Says McRae: “The fundamentals around separation, be it accounting separation, legal separation or physical separation, is very much about processes, people and the overall culture of the organisation. If you’re a water company, yes you’ve got a wholesale department, but you’ve got a retail wing as well [assuming no exit]. The new entrant is one of your customers; they will be paying your wholesale charges. It’s about recognising they are both your competitor and your wholesale customer – and that’s a cultural shift.”

McRae says of Scotland: “One of the things I was most impressed by was Business Stream – it really embraced this idea of being a retailer and of dealing with customers as opposed to dealing with consumers.” He adds that the market – its codes, legal framework and governance structures – must recognise the differences between wholesalers and retailers and support their separation. Under the electricity sector’s Master Registration Agreement (MRA), for instance, network firms and supply businesses fund and vote separately, even if they are part of vertically integrated companies.

GEMSERV IN THE SCOTTISH WATER MARKET

There were three key aspects to the design of the Scottish water market: central market arrangements; operational services; and wholesale charging. Gemserv was one of three key stakeholders (external to the main parties) that was integral to the development. Its work fell into two phases:

Phase 1: Design

Review and development of WICS’ high level market design. This included compiling data structures to support the wholesale charges scheme; defining the supply point as the traceable entity (it developed the SPID or Service Point Identification number, a unique reference number per supply point); basing settlement runs on existing meter reading cycles; and design of high and low volume interface arrangements.

Detailed market design definition in the market code and code subsidiary documents.

Phase 2: Implementation

Design and build of central systems and full systems testing. This drew on but simplified Gemserv’s work on the MRA in electricity. For instance, the MRA’s 300 data flows were rationalised to ten. Meanwhile the electricity market’s “hub, spoke and rim” interface arrangements (whereby participants share information both via central systems (the hub) and from participant to participant (the rim) was simplified to just a “hub and spoke” interface, so central market information only ever goes via central systems.

Assurance services - market readiness assessment of both central systems and individual participants.

Development of the market code.

Establishment of the CMA, which succeeded Gemserv as the market operator.

Data. While companies will be ultimately responsible for the quality of their data, the market has a role to play too in defining the data model to be used and in specifying data provision requirements – for instance, the format of address data central systems will accept. Of particular importance will be the definition, eligibility and configuration of supply points.

The experience of other markets suggests data quality could be a big problem and could act as a barrier to switching, especially as early switchers are likely to be multi-site customers looking for a single supplier. “You don’t want to be in a position where you’ve got 20 sites in 20 different water company areas, and the customer finds it can’t switch them on the same day, or within a reasonable period of each other, or that it can only switch 18 because you’ve got data quality issues. That’s not good for the reputation of the new market.”

Again McRae counsels a pragmatic approach for companies: start data cleansing now, even though it is unlikely data will be 100% by 2017. “As long as you’re setting key objectives and achievable timescales, not everything has to be perfect by April 2017 but there must have been an improvement in the quality of the data.”

He adds that cross referencing from other data sources could have a role to play too. “In electricity we have a database with 29,000,000-plus records. I’m sure every water customer that is going to be in this new competitive market is on that database. It’s not a complete answer, but these are opportunities that need to be looked at – to cross reference, or maybe to assist in some aspect.”

Market design. Key aspects that should be transferred from the Scottish water market include central registration and a settlement function within a Central Market Agency-style market operator. Market arrangements should be transparent and legacy issues acknowledged. Wholesale charges schemes must be based on agreed principles.

Moreover, the market must be designed with the experience and expectation of the new entrant in mind, to ensure there are as few obstacles to entry as possible. In Scotland, some of the early licensed retailers were small, niche players without the luxury of extensive IT infrastructures. “So we had the idea of the high-volume interface – put simply, a big computer speaking to another big computer and bulk exchange of information – and the low-volume interface, so if you are a

small supplier who is only going to pick up 20 or 30 customers, there is a means by which you can effectively sit in front of a computer terminal, enter in the relevant information and that could be communicated via web interfaces into the central system.”

Governance. This is what McRae describes as Gemserv’s “sweet spot”. He urges market-makers not to treat governance as an afterthought. “Design it upfront and make it an integral part of the way in which the market will develop and operate as you go forward. It’s a key building block.” He advises the use of shadow governance arrangements ahead of market opening.

Gemserv has previously argued that governance should be separated out from the provision of central IT services, rather than the market operator doing both. The CMA does perform both functions, but that is in the absence of upstream competition concerns. IT systems and governance are provided separately in both the gas and electricity markets, and under the national smart metering programme.

Systems development. Systems should be developed from a firm and detailed market baseline design with extensive stakeholder participation and with robust change management practices in place. Gemserv counsels using an established architecture and open access to avoid technical barriers, and to build in scalability and adaptability from the outset.

Market readiness and assurance. It is essential to check existing market participants can operate under the new regime before it goes live, to reassure customers the market will work; to give new entrants confidence incumbents have separated to an acceptable degree; and to provide comfort to water company boards that they are compliant with the rules and won’t run the risk of a regulatory fine or competition challenge.

McRae declares Gemserv’s interest in bidding for market operator, governance and other work once the factors holding up these tenders are resolved. But whether it ultimately secures a formal role or not, Gemserv’s rare experience of designing and operating a competitive water market and other utility markets suggests its opinions are valuable and should be heeded. **TWR**

CUSTOMERS TO KEEP PRICE AND SERVICE TERMS WHEN INCUMBENTS QUIT RETAIL

Government retail exit plans will safeguard customers' supply terms should they be transferred to a new retailer.

Non-household customers concerned by the prospect of their water supplier leaving the retail market after 2017 should take comfort from DEFRA's exit consultation, published on 10 December. The government has prioritised reassuring customers, many of whom did not support the exit policy, that they will be protected should their supplier opt-out and that actively participating in the market will be safe.

DEFRA's entire exit policy (see box – Exit recap p28) is underpinned by a "principle of equivalence": that non-household customers should have access to the same safeguards regardless of whether their undertaker quits or stays. The crucial protective element will be the "deemed contract", which will spell out the price and non price terms customers can expect should their undertaker exit and should subsequent transfers take place.

Speaking at a meeting of the Major Energy Users' Council's water group, Holly Yates, from DEFRA's water regulation and consumer protection team, explained deemed contracts would be designed to "plug the gap" created by the exit policy. Most customers' essential supply terms are currently governed

by legislation not contracts, the exception being the few very large users who would have negotiated a contract when switching. Incumbent undertaker exit would leave customers with neither statutory protection nor a contractual relationship – which is where the deemed contract will kick in.

According to the consultation, deemed contracts will apply in all instances where a non-household customer is served by a licensee but has not negotiated a contract. This would cover not only the transferred customers of an exited undertaker but also, for example, new customers arising in an area where an undertaker has exited and customers whose premises need to be reconnected.

Ofwat has been charged with developing a template deemed contract. This is expected to be issued for initial consultation this summer and finalised by March 2016 (see timeline). Retail licensees are expected to beat deemed contract conditions in most cases, but these baseline arrangements would provide customers with minimum price and service terms.

Price terms

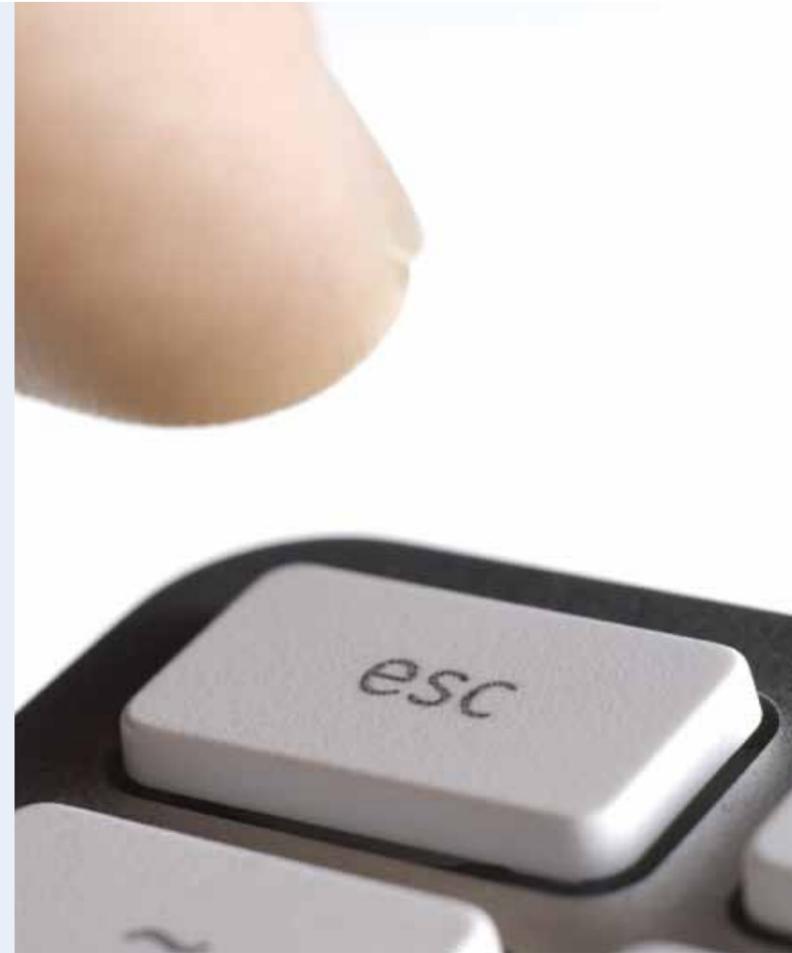
Price terms in deemed contracts must be transparent, "fair" and perpetual unless a customer switches and negotiates new contractual terms. Two fair pricing options were considered: requiring licensees to set default tariffs using an equivalent process to that used by the exiting undertaker; or price terms in deemed

contracts identical to those the customer received from its undertaker at the time of exit, for two years following market opening. DEFRA proposes adopting the second option (unless undertaker prices are found to be unsustainably low) on the grounds of simplicity and because this would protect customers from licensees reapportioning costs between customer groups and hence some facing price rises after an exit.

The government has charged Ofwat with reviewing whether this sort of price protection will be necessary after 2020. This will depend on how the market has developed by then and could mean different levels of protection come to apply to different customer types. The consultation says: "For example, the evidence from other markets suggests that some SMEs... may find it more difficult to negotiate advantageous terms than some larger businesses."

Non price terms

To ensure customers continue to receive good service after an exit – for instance, on billing, payment management, debt and metering – DEFRA proposes any pre-existing contractual arrangements between the customer and the undertaker "should be passported across as part of the transfer arrangement". Beyond that, Ofwat will be required to develop a revised set of Guaranteed Service Standards (GSS) reflective of acceptable practice in the sector to be applied to licensees. The Water Act 2014



made provision for GSS to be applied to licensees as well as undertakers. Ofwat is expected to consult on this summer/autumn 2015 with a view to new GSS regulations being ready for April 2016.

First and last resort

DEFRA has also acted to ensure customers are never left without a retailer as the result of an exit. Incumbents have always acted as suppliers of last resort (SoLR), should a licensee depart from the market – for instance, due to insolvency. If that incumbent has exited, they clearly won't be able to perform that role. The Water Act 2014 permitted licensees as well as incumbents to act as last resort suppliers. The exit regulations propose that at least one acquiring licensee opts in to the SoLR regime when an undertaker exits and customers are transferred. Licensees will be able to request being excused from opting in

and this will be judged against criteria expected to be published by Ofwat by February 2016.

Provision has also been made for the first time for a supplier of first resort (SoFR) regime, for new connections or reconnections. Both retail and wholesale connections services have historically been performed by the incumbent undertaker. While wholesale services will continue to be so, an exited incumbent won't be able to provide a retail service. Customers in most instances will choose a retailer, but where this doesn't happen, DEFRA has proposed a SoFR panel – a "pool of licensees that will be available to take on new customers following an exit". Opt outs will be available for special circumstances (again these will be judged against criteria Ofwat will publish by February 2016), but most acquiring licensees will be expected to join.

Taken together, these price and non

price provisions in deemed contracts and supplier of first and last resort arrangements offer customers a good level of protection. Businesses will be able to retain any advantageous price or service terms despite transfer to a new supplier, continue to benefit from baseline protections elsewhere and be assured they will always have a retail supplier.

The only area where protection is limited is that customers' rights to switch back to deemed contract terms with a previous supplier will be limited to two years. Customers switching to a licensee have always had the right to return to the incumbent if they wish, so it follows under the principle of equivalence that customers should be able to switch back to an acquiring licensee on deemed contract terms should they at any point switch away from it. The consultation notes: "The attraction of this approach is that it would ensure that all customers could be encouraged to engage in the market, knowing that they could return to the terms and conditions set out in the deemed contract if they were unhappy with their choice of retailer. The risk of this approach is that it would increase the levels of complexity and bureaucracy associated with the market, which could ultimately have a chilling effect. While it is easy to see how this protection could

DEFRA has proposed a SoFR panel – a "pool of licensees that will be available to take on new customers following an exit

be extended to a customer following a single transfer, it is much harder to see how this could be maintained many years down the line, potentially following multiple transfers and switches."

DEFRA considers the best approach therefore to be granting the return right for two years following a transfer, for customers transferred directly as a result of an exit or as a result of a subsequent deal. After the two year period, the right to return on deemed contract terms will cease. The consultation says: "The aim here is to encourage transferred customers to engage in the market by extending some of the protections that they would

FEBRUARY 2015:	SUMMER 2015:	AUTUMN 2015:	FEBRUARY 2016:	MARCH 2016:	APRIL 2016:	MAY 2016:	OCTOBER 2016:	DECEMBER 2016:	APRIL 2017:
Ofwat to consult on the removal of the in-area trading ban	Defra to consult on draft exit regulations, draft licence (produced by Ofwat) and draft exit applications process; Ofwat to consult on content of deemed contract	Ofwat to consult on revised content of GSS; Defra to publish final licence (produced by Ofwat) and exit applications process and criteria	Ofwat to publish criteria for opt-in/out of SoLR and SoFR	Ofwat to publish draft deemed contract	Defra to lay revised GSS regulations	Licence applications to open	Ofwat to issue licences ahead of market opening; Defra to open exits applications process	SoFR announces exits decisions ahead of market opening	Retail market opens

TIME LINE

CONSUMER PROTECTION BEYOND EXIT

Consumer Council for Water (CCW) senior policy manager Steve Hobbs told business customers at the MEUC meeting that his organisation was working to ensure the retail market worked for customers across the board. According to CCW's Uncharted Waters research into what protections customers want in the market, cold calling, hard sell marketing, contract lock-ins, auto-rollovers and poor billing were top of the list of features to avoid. Among features considered desirable were: cooling off periods, notification ahead of contract expiry, clear tariffs, 24/7 customer service, better service and prompt response to leaks/supply interruptions. "Regulation needs to address all these issues," said Hobbs. Further CCW research sought lessons

from other sectors on how such issues had been dealt with. This found: misselling and poor contract conditions had been dealt with using codes of practice; misleading information about price and service terms had been addressed by some standardisation of contract terms; regulated price controls and the use of default tariffs had helped tackle differential pricing issues; and cumbersome switching processes had been simplified and shortened. Consumer protection arrangements in the Scottish water market are not differentiated by customer size or type, but this is a possibility for England. Hobbs concluded: "This is an ongoing process, we still have some way to go on all of this."

have had with the undertaker for a time-limited period. However, the government also wishes to place reasonable limits on any long-term legacy of different requirements applying to different customers."

Retail licences

So despite its focus on customer protection, DEFRA has also had an eye on making the market work for retailers. The detail of some key elements are yet to surface. Crucially, licences setting out retailers' roles and responsibilities need to be designed by Ofwat; specifically, these will set out to what extent licensees need to take on the powers and duties

stripped from the undertaker.

Ofwat has been told to develop a flexible licensing system capable of catering for all types of retailer – from those looking for large scale customer transfers to niche players and self-supply licensees. A balance needs to be struck between ensuring licensees are capable of delivering for all transferred customers and not creating barriers to entry for small players. The government will consult on licence conditions this summer and publish the final licence in December.

Exit applications

For incumbent undertakers, DEFRA has committed to a "simple, light-touch [exit] applications process", which it appreciates must be available as soon as possible. To promote predictability and transparency for all parties, it has proposed a framework of requirements that apply equally to all parties, rather than bespoke conditions that are specific to individual companies or exits. It notes: "This will mean that safeguards will primarily be secured through the wider regulatory framework—for example, codes, licences, GSS etc."

The light touch is evident in the policy that, when granting an exit, the secretary of state will rely on assurances from companies that they meet certain criteria, rather than on bureaucratic tests. Applicants can expect to provide assurance that:

- exit is being undertaken voluntarily
- both parties to the transfer have taken appropriate steps to ensure compliance with the regulations
- there will be a continuous retail (and wholesale) service following the exit
- the new licensee(s) will meet certain

standards in terms of service and price ■ both parties will take appropriate actions to ensure that customers are kept informed. Before the transfer, the exiting undertaker will be required to contact customers to explain what is happening and why; that customers have a choice about whether to switch their supplier; and to direct customers to further information about the market. After the transfer, the acquiring licensee will be expected to contact the customer to confirm that the transfer has occurred and lay out billing information, service levels etc for the coming period.

In-area trading ban

Ofwat has also committed to consult next month on the removal of measures designed to prevent undertakers showing undue preference to licensees they are associated with. The in-area trading ban prevents associate licensees providing services in their undertaker's area, while licence condition R limits transactions between the two parties. Water reform will reduce the likelihood of discriminatory behaviour and the restrictions could mean associate licensees are actually disadvantaged. Removal of the restrictions could help smooth exit transitions: exiting undertakers could outsource preparations for engaging in the retail market to their licensee ahead of being granted leave to quit; while undertakers that do not wish to exit but do wish to outsource their in-area non-household retail activities to an associated licensee could do so.

Making regulatory provision for exit is a complex business. Commenting on why companies have to wait until 2017 to exit, Yates said: "All the legislation is predicated on the assumption that water companies are integrated. Unpicking that legislation is a bit of a challenge."

But DEFRA seems so far to be on the right track in prioritising consumer protection while keeping an eye on ensuring the exit regime is tolerable for incumbents and retailers. The question remains of course: will practice live up to policy? **TWR**

■ The consultation is open until 18 February, and responses are invited via www.gov.uk/defra or by email to RetailExitsConsultation@defra.gsi.gov.uk.



A NEW LEAF?

What could water companies do to grow on salad producers?

The water needs of the UK's salad growers are pretty simple: they need absolutely secure access to a sufficient quantity of suitable quality water. As one put it: "Without water, we have no business."

Most growers self-supply the majority of their water: many have abstraction rights, and virtually all have onsite reservoirs which hold harvested rainwater. Such sources supply the average grower with around 70 per cent of his needs. Many also have a cap – a maximum day demand – on the amount they can draw from mains supplies.

So what can the water industry do for growers? What might turn growers' heads in the competitive market? The Water Report spoke to salad specialists from around the country to find out.

More control: growers were interested in reducing their reliance on mains water and increasing self-supply. A few said they would be very keen to sink boreholes on their land and draw directly from aquifers currently used by water companies. One said this would be entirely feasible environmentally if the water company in question would agree to reduce its abstraction by an equivalent amount. He argued abstracting water where salad crops are actually growing would be "more economical, more efficient and more logical" than pumping water over long distances and losing some to leakage along the way.

More visibility: some growers' estates are vast and water can be drawn from a number of on- and off-site sources. One said he would welcome help to optimise use of these resources. This could involve an audit, management advice and consumption analysis.

Water efficiency: growers said they would welcome suggestions on how to make better use of the resources they have. One reported a good experience of working with his local water company to improve his estate's pipe infrastructure to

minimise leakage, and to install more meters on the network so any future leaks are more readily identifiable. Another pointed out that if an estate could reduce how much water it took from mains supplies, this would have knock on benefits for the water company and leave more resource available for other local water users.

Innovation: according to one grower, the sector would welcome suggestions for innovative solutions to the practical challenges it faces. "We face a lot of challenges," he said, "particularly around climatic change, environmental policies, cost pressures. For instance, if it is too hot, some varieties, like iceberg lettuce, go to seed. I would consider anything from technical solutions – we now widely use soil moisture probes for instance, so we only apply water when it is really necessary – to new ways of funding more traditional options like rainwater harvesting or storage."

Another said he would welcome advice on the water implications should his company want to expand or alter its crop growing choices.

Keep costs down: while water security is the primary concern of the salad grower, many of those who supply major supermarkets are finding costs squeezed and will welcome any cost reduction available. One explained: "Our company has supplied one of the major supermarkets for over 40 years but because of price wars with the discount retailers, they are now selling cucumbers for less than 50p. This cost has been passed through to us. I have told them how this will hit us and they have just shrugged." **TWR**

GROWING BUSINESS

■ For outdoor grown salads such as most lettuce varieties, the growing season runs from mid March to late October. Leafy crops typically take six to ten weeks to grow, depending on the temperature, and require around six applications of water during their lifecycle. The growing season for glasshouse grown crops such as tomatoes, peppers and cucumbers – those that require temperature control – can be longer.

UNIVERSAL CREDIT CRUNCH

The industry is expecting customer hardship and bad debt to worsen as welfare reform bites. Collaborating with housing associations could offer a lifeline in coping with affordability problems among social tenants.

Ofwat's December ruling that water bills will fall by an average £20 to £376 in 2015-20 was a welcome Christmas present for customers. But water companies are under no illusion that it will be a universally happy new year.

In fact, for those on low incomes, 2015 is looking pretty bleak. While inflation will take the sparkle off the numbers for everyone, companies are expecting welfare reform to bite the poor and to lead to growing payment problems and water bill debt. This is a particularly grim prospect for those directly affected, but also a problem for customers in the round who already stomach a £15 a year charge to cover unpaid bills.

This situation, together with possible responses to it, was explored in late 2014 at a workshop for water companies and

housing associations hosted by Accent Market Research. One water company presenter said his employer was well aware of the looming problem: 42% of social tenants and 32% of private tenants are already spending more than 3% of their income on water bills; meanwhile debt is climbing, living costs are rising, welfare support is being cut, and people are staring down the barrel of stress, isolation and despair as well as actual financial hardship.

According to research for housing association The Hyde Group, the introduction of Universal Credit, now set for national rollout (see box – Universal Credit), is a “terrifying” prospect for tenants. The concept of having to budget for a month is expected to prove too much for many of those who struggle to make weekly payments last all seven days. They fear that as rising utility bills further reduce their income, they could fall into debt or in some cases even more debt, despite efforts to keep up their monthly payments. Moreover, the fact that Universal Credit will be paid in arrears will leave a gaping chasm in household budgets. Borrowing from high interest payday lenders is expected to rise, compounding existing financial problems.

Bad to worse

For water bill affordability and debt, welfare reform looks set to make an already bad situation a lot worse. The water company presenter mentioned above explained his company segments struggling customers into three groups:

- non-payers – can't or won't pay
- help-seekers – those who have approached the company for assistance

UNIVERSAL CREDIT

Universal Credit is a new type of financial support for people of working age who are looking for work or on a low income. It replaces and will merge together many existing benefits and tax credits, namely: income based jobseeker's allowance, income-related employment and support allowance, income support, child tax credit, working tax credit and housing benefit. The government argues this will make the system easier and simpler.

Universal Credit will be a single, monthly payment into a bank account. Partners will get one payment for the household. Recipients will be responsible for paying their landlords themselves.

It is being introduced in stages. Until now it has only affected claimants in certain areas earmarked for pilots, including Ashton-under-Lyne, Wigan, Warrington, Oldham, Hammersmith, Rugby, Inverness, Harrogate, Bath and Shotton. It is now due to be extended to the rest of the country by 2017.

SOCIAL TARIFF RESEARCH

Accent director Rachel Risely reviewed the social tariff research undertaken by the industry. Among her key observations were:

- A large proportion of companies have undertaken dedicated research on social tariffs.
- Mostly this has been focused on the willingness of benefactors (the broad customer base) to support a social tariff scheme, with little work done among potential recipients on how to reach out to them and help them to pay.
- Discussions proved “highly complex”. In the majority of areas, support was established for a tariff after extensive dialogue; in the minority, finding a consensus proved impossible. It was “just too complex to introduce a fair system”.
- In terms of identifying recipients, it was “an obvious solution from a customer perspective” for water companies to work with the DWP. Respondents

were concerned involvement from other parties may just complicate the situation.

- A minority expressed a desire to be able to opt-out of cross subsidising others, though the majority felt this would be unfair and problematic.
- The majority supported match funding, under which the water company would match the funds raised through the customer cross subsidy. Some however were suspicious that this would lead to customers paying twice.
- The type and level of support tested varied considerably company to company.
- Receipt of benefits as an eligibility qualifier was unpopular – it was found to be tied up with the whole ‘state scrounging while spending on fags and flat screen TVs’ argument. An ability to pay assessment was preferred, though would be more complex to administer.



making-doers – those unlikely to ask for help, who pay their water bills even though it is a struggle.

Going forward, the company is planning to proactively help those in the latter category who don't currently present it with a problem, because it knows they will find it harder to make ends meet. "We are expecting the third group, the strugglers, to tip into either the non-payment or asking for help categories," the presenter said. "Our challenge going forward is to identify and reach this third group."

Available schemes

The industry's hardship schemes are numerous and well-meaning but patchy and imperfect. Currently around 760,000 people benefit from some form of financial support from their water company. As well as the national WaterSure scheme (and Welsh Water Assist), initiatives include debt write-off, bill capping, charitable trusts, single occupier discounts, low use discounts, grants and special tariffs, as well as more holistic assistance such as funding money advice services, training or charities. Some initiatives are linked with reducing water consumption; others aren't.

The most recent addition to this armoury is the social tariff. Due to a protracted and difficult process, few firms have as yet rolled these out in earnest, though this will kick into gear from April. According to Ofwat, the number of people benefiting from financial support will more than double to around 1.8 million by 2020, with social tariffs forecast to help an additional one million people.

Nonetheless, eligibility criteria and assistance levels will vary company to company, contributing to the patchy national assistance picture. Social tariff research conducted by the industry underlines the thorny and complex na-

ture of this new help mechanism (see box – Social tariff research p31)

Can't give it away

However, the biggest problem facing water companies is not the type or amount of assistance available to vulnerable customers, it is quite simply finding the right people to give it to. As one workshop participant put it: "We've got a host of different schemes, if only we could get them to customers."

Ofwat updated its debt guidelines in July 2014 covering how it expects firms to approach debt and those who find themselves in it. But there is no direction from government on who specifically should receive assistance outside of WaterSure, and no accessible central repository of information about those in hardship.

The industry has long argued for access to Department of Work and Pensions (DWP) data, but to little avail. Water UK is understood to have renewed its efforts in light of social tariff expectations, but few are holding their breath. One housing association representative who had worked with the DWP on information sharing hinted the department's data might not be a panacea anyway. He was distinctly non-plussed by the nature of the data, reporting the department initially referenced individuals solely by national insurance number (though it was now progressing to use name and address details too).

Likewise industry efforts to force landlords to hand over tenant contact details have hitherto fallen on deaf ears in England. There is a more positive picture in Wales, where the policy is expected to be implemented this year.

But for now, companies are pretty much left to their own devices to decide who to help, and how to source and assess the eligibility of potential beneficiaries. This is nightmarishly difficult.

Who you know

Collectively, the Accent workshop concluded companies' best bet for finding the right people to help in the absence of government assistance and in the face of imminent welfare reform is to get to know their customers better. Quite simply, to begin to understand individual circumstances – who needs help, when, why, how and how much.

The Hyde Group research mentioned earlier is instructive here. It found, as might be expected, genuine hardship: falling incomes, rising costs, heating curtailed, luxuries gone – a picture of social tenants just about holding it together, propped up by "secret support" from family and friends, one step away from being tipped into serious trouble.

But it also turned up some lessons useful for water companies. For instance, that any form of digital approach – for example, emailed bills/reminders or online account management – would be a waste of time for many. There was reluctance to use to online channels (often from older people); ignorance of how to use devices and websites; and repeated incidence of broadband self-disconnection to save money.

Moreover, the research suggested that helping customers to pay would require more intimate knowledge of individual circumstances. This would enable vital early diagnosis when payment problems arose; an appropriate approach to inter-

vention; and an understanding of how different customers might react in different circumstances.

Ofwat made a good start in looking at the human-side of water bill payment in 2012 when it commissioned a study from Accent to improve its understanding of behavioural responses to charging practices in the water industry among groups at risk of affordability problems (see box – Bill behaviour). This recommended some practical solutions and remains relevant for companies today.

However, the avenue explored in detail at the workshop was how water companies might get to know their customers better through working more closely with third parties – for example, local authorities, community groups, care agencies and in particular housing associations. Many such groups will be trusted by customers and have established relationships with them. They could help to identify those in need of water company assistance; encourage customers to trust rather than be suspicious of the company's motives; administer help; and take account of each individual's broader economic situation.

Most water companies already enlist third party help to one extent or another but again the picture is patchy. On social tariffs, for instance, some schemes are or will be administered by trusted third parties including Citizens Advice and expert relief administrator Charis. Others are or will be administered by water companies directly. There is no right or wrong answer, but some going it alone are already finding it hard going. One participant reported his company's social tariff scheme had been designed to cope with demand from around 70,000 customers but that so far only around 200 had been signed up. He questioned: "Is our [application] form wrong? Is our eligibility criteria [3% of household income spent on water] too strict?" The company is conducting a full strategic review of its practices, with a view to taking a new direction this year.

House mates

Housing associations could prove especially valuable partners for water companies grappling with affordability and debt problems among social tenants. The housing representatives at the workshop highlighted a number of extremely useful roles they could perform, including:

- Data sharing (see below).
- Using their knowledge of their tenants to flag up households where bill reductions are likely to be either welcome – for instance, those hit with the bedroom tax – or fair – for instance, single occupants in flats where metering is impossible could be suggested for assessed charge reductions.
- Using their expertise to analyse, interpret and add meaning to water company customer data.
- Acting as a channel for water company communications – for instance, carrying information leaflets in tenants' welcome packs or at six-week follow up visits. They could also provide tenants with ongoing advice on water relief offerings, if companies keep them up to date (one water delegate said her company had trained housing officers to this end).
- Applying for assistance schemes on tenants' behalf if the company permits this (some already do).
- Comparing and contrasting water company behaviour to help pin down and enhance industry best practice.

Partnering to deliver specific initiatives. One water company, for instance, reported it had held a special event at a housing estate to promote keeping bills down through water efficiency, metering and appropriate charging. This featured, among other elements, community engagement and education, knocking on doors, and leafleting as well as post event customer engagement. A year on, debt levels on the estate had risen only 1% compared to 10% on a control estate, while metering was up 11% compared to a control 3%.

Assist with relief reapplication procedures. Affordability is a dynamic concept. Some companies insist on full reapplication after 12 months. Others opt to minimise the administrative burden by automatically re-enrolling beneficiaries but auditing a set percentage. Housing associations could advise on whether tenants' financial situations had changed.

Data sharing

If housing associations shared their tenant data with water companies, "it would give us a fighting change of understanding the customer," said one workshop participant. He gave the example of two customers who on paper look to be in the same financial situation but one pays and the other doesn't. Richer tenant data could help establish why. Meanwhile, if water companies reciprocated and shared their data, this could enrich housing association knowledge and understanding of tenants' circumstances.

At present, data sharing of this sort is hit and miss. At the workshop, participants had different understandings of what data they could legally share, with one for instance advocating there was no obstacle to sharing as long as both parties agreed, while another said he had been advised to the contrary.

So it falls to each company and housing association to decide how much they share with the other – if at all. A participant remarked it simply "depends on your lawyer". One water company said it willingly shares data with all HAs in its area, regardless of whether or not they reciprocate. Another that it has access to data from around a quarter of associations in its area, but that its policy is not to share anything.

Beggars can't be choosers

It is a crying shame that helping the most vulnerable members of society afford as essential a service as water and sewerage should be left to companies who themselves struggle to deliver that help. It is incredible that ad-hoc partnerships with third parties should be deemed progressive.

But in the absence of an alternative, and with welfare reform looming, it is more important than ever for companies to do what they can to get closer to their customers, understand their situations, anticipate their behaviours, communicate effectively and respond appropriately.

Working more closely with trusted third parties is part of the solution, with housing associations an obvious first choice on the social tenancy side. At the very least, both parties would benefit from the rules on data sharing being clarified and best practice pinned down. **TWR**

For more information about The Hyde Group research, contact Yvonne.pick@hyde-housing.co.uk

BILL BEHAVIOUR

Accent's research for Ofwat among customers in debt or struggling to pay their water bills aimed to provide companies with a greater understanding of how behavioural economics can be deployed to develop effective charging practices and improve debt and revenue collection. Among the key findings were:

- Carrots are better than sticks: encouraging people to pay on time is far more sensible than penalising them for paying late, except for won't pay.
- Participants felt there was little understanding of – or attempt to understand – individual circumstances, which resulted in a generalised approach and communications which were often wide of the mark in terms of content and tone.
- The most popular charging schemes were ones which empowered struggling customers to make payments – for instance, via debt write off, substantial discounts, trust funds, social tariffs, Water Direct and payment holidays.
- There was widespread lack of awareness about existing assistance schemes, which fuelled suspicion of water company motives. Respondents felt schemes should be widely publicised and it be absolutely clear who is eligible to apply.
- While customers falling into difficulty should contact their supplier, in reality people often bury their heads in the sand. Therefore it is imperative for companies to proactively contact such customers, ideally within two months of them falling into debt.
- Schemes allowing regular payments were preferred over gimmicks such as prizes or discounts for encouraging others to sign up to special schemes.

The study recommended companies: review their communications with struggling customers (what is sent? at what point in the debt timeline? what is the tone? etc); scrutinise debt-related complaints to establish where they are going wrong; accept different strategies work for different types of customer and develop alternative payment schemes based on behavioural biases; and share evidence across the industry.



Branching out: national water reform has been dominated by events in the Murray-Darling Basin in south eastern Australia

GOING WALKABOUT

Anglian Water's Alice Piure went to Australia where a Water Shares based abstraction system is already in place to learn lessons for water companies facing reform in England and Wales.

An abstraction system based on "Water Shares", where abstractors have rights to a proportion rather than an absolute amount of water in a catchment, looks increasingly likely to be introduced here – at least in "enhanced" catchments where the need for reform is greatest (see news, page 16). However, exactly how water companies would operate within a shares system is a great unknown and a cause of concern for the industry. Specifically, there is nervousness about meeting demand when the amount of water available for abstraction is uncertain, and about how short term (DEFRA suggests fortnightly) allocations would sit with an industry that is by its very nature long term.

Anglian Water strategy and policy analyst Alice Piure sought to inform this debate by exploring Australian experiences of water reform – especially how public water supply has been affected.

Australia operates a water shares based system (see box). Its experiences are not directly transferable to England and Wales but it provides what Anglian chief executive Peter Simpson described at the launch of Piure's research as "a rich evidence base". He added: "There is no one model to adopt, nothing to pick up and copy, but plenty to learn."

Piure spent four weeks conducting fieldwork in Australia and reviewed relevant literature extensively. Her resulting report makes a number of recommendations for the government and Environment Agency as they progress abstraction reform here.

Design recommendations

Reform should be proactive. Piure recommends action ahead of a trigger situation – "given that there is likely to be a permanent decline in the availability of water resources in the future". She cites the foresight of the state of Victoria to reform bulk entitlements with a view to defining water rights and agreeing how water should be shared in a severe drought situation – before the Millennium Drought hit. This was so severe it lasted for the 13 years from 1997 and affected most of the continent. Proactive reform stood Victoria in good stead. Without it, says Piure, there could have been a "chaotic bun fight" as competing abstractors sought to secure water access.

Markets and trading should be promoted. The theory that trading results in more efficient water allocation because it allows high value users to gain access to water and encourages low value users to release their water has been borne out in practice in Australia. All the Victorian water authorities that took part in Piure's research "agreed unanimously that the market was critical in maintaining supplies to customers during an unprecedented drought". It enabled them to buy both permanent and temporary allocations from other abstractors and sectors when need was greatest; permanent entitlements could be traded as temporary

allocations after the drought and the profit reinvested for customers.

Public water supplies should be prioritised over other abstraction in drought conditions only. All of the Australian states studied give priority to essential domestic use in drought conditions. In normal conditions, different states take different approaches: New South Wales gives priority whereas Victoria doesn't. Victoria is consequently a far more active trader.

"Carryover" should be explored. DEFRA's abstraction reform consultation does not currently propose a feature that has proved useful in Australia: carryover. This allows an abstractor who has been unable to take a full year's share because of hands-off flow conditions to carry its entitlement over to the following year. This could work particularly well for abstractors with access to storage.

Strategic planning is still needed. While abstraction reform is vital to secure sustainable water resources, the fact that Australia was taken by surprise by the record-breaking Millennium Drought suggests effective strategic planning is also necessary. According to Piure, the English and Welsh water sector needs to build on traditional Water Resources Management Planning techniques, using new scenario modelling and multi-sector approaches. She says: "The Australian experience suggests that the WRMP process, that is deterministic, reliant on historic climate change data and has a narrow focus on least-cost does not allow the water industry to best manage future uncertainty. It also demonstrates that failure is possible and that the cost of failure is high."

Implementation recommendations

Over-allocations must be resolved before markets are introduced. This is part of DEFRA's plan. Piure though sounds a note of caution: "The Australian experience demonstrates that dealing with over-allocation is difficult and contentious. In most cases, Australian governments have chosen to grandfather unused volumes into reformed systems, and to deal with over abstraction by buying back water for the environment."

One size fits all entitlement definition is inappropriate: DEFRA's consultation proposes calculating "recent use" using a single formula that will be applied to all licences in a catchment undergoing transition to new arrangements. However Australia's experience is that a committee-style approach where stakeholders are represented and can have their say works best. For water companies this would offer reassurance that deployable output will be protected and that unplanned investment won't be triggered. Others could be reassured water companies don't dominate the market. Piure says: "A key advantage of the catchment based committee approach to transition is that it allows abstractors to agree an approach to transition that is perceived to be fair and legitimate."

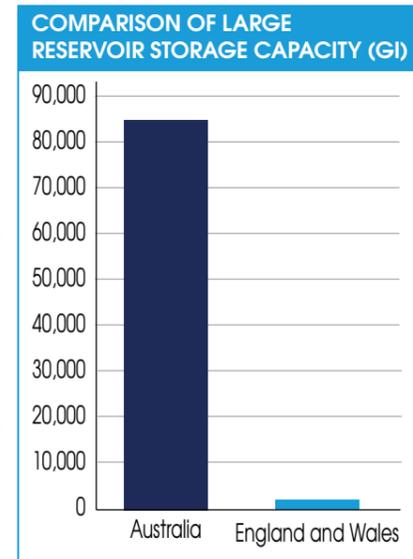
Markets should be introduced incrementally. Introducing Water Shares would be innovative and hence would carry risk, especially because experiences from elsewhere cannot be read directly over to England and Wales. It would make

THE AUSTRALIAN CONTEXT

The development of water markets in Australia dates to the late 1980s when New South Wales, Victoria and South Australia permitted limited trading. By 1994, the Council of Australia Governments Water Reform Framework demanded a market based system of water allocation be introduced by 2005. The Millennium Drought of 1997-2010 was of unprecedented severity, duration and geographical extent, affecting most of the continent for over a decade. It accelerated reform that was already underway and drove additional change.

State governments are responsible for water management and consequently reforms have developed at both state and national level. Different states have unbundled different elements of water rights but common to all are tradeable water access entitlements, for conversion to water shares.

There are many differences between the water situations of Australia and England/Wales. Australia's climate is highly variable and susceptible to multi-seasonal drought. Consequently it has vastly greater reservoir capacity (see chart). Public water supply accounts for only 11% of abstraction, whereas here half the water abstracted goes into public supply. The industry in Australia is not privatised and is owned by a mixture of state owned water companies and local authorities.



sense therefore for shares to be trialled in selected catchments before being implemented across the board. Moreover, if the committee approach described in the previous point is adopted, it will be time consuming. DEFRA is working to a tight implementation timetable. Introducing reform to selected catchments only at first would be a practical choice.

In addition, trading could prove particularly contentious so an incremental approach on that would be wise. Piure advises: "In Australia, there has been significant public debate about the potential for 'water barons' and foreign investors to buy up water rights, and the loss of water from some regions and sectors as a result of intersectoral or interstate trading. As a result, Australia has taken an incremental approach to the introduction of water markets."

In the round, the Anglian project suggests England and Wales would be missing a trick if they opted not to pursue abstraction reform based on Water Shares. But equally that trying to implement such an innovative system across the two countries – particularly as more water trading is encouraged – would be unachievable by the suggested timescale of the early 2020s, given the obvious complexities, provocations and difficulties it would entail. In light of the Australian evidence, introducing Water Shares in enhanced catchments first seems a sensible option. [TWR](#)

Alice Piure's report *Markets, water shares and drought – lessons from Australia* is available at <http://bit.ly/1FQMWo4>

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Quite a challenge

Good outcome, difficult process, lessons learned: CCG chairs Diane McCrea, Bernard Crump, Anna Bradley and Roger Darlington review the PR14 experience

COMPETITION WATCH

Open Water MAP points way to market opening but it's a winding road ahead

INSIDE

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