



Water Policy in Wales: Evidence to the Environment and Sustainable Development Committee

Introduction

Ofwat is the economic regulator of the water and sewerage sectors in England and Wales. Our primary duties are to:

- protect the interests of consumers, wherever appropriate by promoting effective competition; and
- enable efficient water and sewerage companies to carry out and finance their functions.

We also have a range of secondary duties. These include:

- contributing to sustainable development;
- promoting economy and efficiency;
- ensuring there is no undue discrimination against particular customers; and
- having regard to the principles of best regulatory practice.

We are accountable to the National Assembly for Wales when carrying out water policy set by the Welsh Government.

Since privatisation in 1989, our regulatory model has helped the water and sewerage sectors to deliver major improvements to customers and the environment while keeping customers' annual bills £120 lower than they would otherwise have been. This has included £8 billion of investment in Wales, which has delivered major service improvements to Welsh water customers and a cleaner, better water environment.

The sector now faces a different set of challenges from the chronic under-investment that was a problem at privatisation. The impacts of climate and demographic change, on water resources in particular, as well as changing expectations from customers, mean that we need a different approach.

While our historic, consistent model of economic regulation over the past two decades has been described as ‘the gold standard’ for attracting finance and dealing with under-investment after privatisation, there is some evidence that it has not always encouraged the most sustainable approaches from companies and the efficiency benefits we have gained for customers each price review have slowly decreased¹.

To meet the challenges of the future we are adjusting our regulatory model to ensure it supports the most sustainable outcomes and continues to drive efficiency improvements in the companies to keep bills affordable for customers. This reformed framework will include the use of new incentives.

We support the UK Government’s proposals to introduce choice for non-household customers and greater upstream trading of water. There is a wealth of both theoretical and empirical evidence suggesting that market-based approaches are more effective than regulation at driving efficiency². In particular, market mechanisms work well in allocating scarce resources as efficiently as possible – which is a key challenge that we are facing in water resources – and encouraging innovation.

We recognise entirely that decisions about whether or not to introduce market mechanisms and about how the legislative framework should be established and operate are rightly for Welsh Ministers and Government. We also recognise that these are significant decisions that are not without risk. Therefore, we welcome the opportunity to respond to the Committee to ensure that these decisions can be supported by the strongest evidence base.

We look forward to the Welsh Government’s forthcoming Water Strategy, building on the Ministerial Statement on Water of December 2011.

¹ In Future price limits – a consultation of the framework. Appendix 1: draft impact assessment, http://www.ofwat.gov.uk/consultations/pap_con201111fpl_app01.pdf (p.27), we showed that the relative efficiency gains that our regulatory model has gained for customers has historically been falling and during the last five-year asset management period (AMP 4) our efficiency challenge delivered a 1.6% efficiency gain on water operating costs and a 1.5% gain on sewerage operating costs compared with a 3.1% gain across both areas of operating costs in the previous AMP. Similarly, capital expenditure efficiency was 2.4% for water in AMP 4 and 2.7% for sewerage; again, these figures compare to 4.2% for water and 6.2% for sewerage respectively in AMP 3. This drop in efficiency gain is also part of the reason for a change in approach.

² See for example, Office of Fair Trading, Productivity and competition: an OFT perspective on the productivity debate, 2007, http://www.of.gov.uk/shared_of/economic_research/of887.pdf and Y Zhang, D, Parker and C Kirkpatrick, Assessing the effects of privatisation, competition and regulation on economic performance: the case of electricity sector reform. Department for Economics, SCAPE, Working Paper Series, 2005 Paper No. 2005/11, <http://ideas.repec.org/p/sca/scaewp/0511.html>

Assess the implications of the draft Water Bill for Wales, particularly with regard to competition in the non-household market

We welcomed the publication of the draft Water Bill in July 2012. We comment below on specific provisions in the draft Bill. However, a key feature of the overall draft Bill that we welcome is the package of changes that will bring about the introduction of choice for all non-household customers in England. Aside from the broad support for greater choice over their service provider among seven out of ten business customers³, these changes will help enable the water sector to respond to the challenges we have highlighted.

Reflecting experience in Scotland, the changes will encourage non-household customers to use water more sustainably and also drive efficiency, innovation and improvements in customer service, delivering economic growth. Taken together, these changes will help to support the sustainable outcomes.

Driving sustainable water use

We recognise the current policy position of the Welsh Government and its intention not to introduce further competition into the water and wastewater market at this time. However, we consider that if these changes were introduced in Wales they would deliver a range of positive benefits for Welsh customers. One of the key benefits of introducing choice over their retail supplier for non-household customers in Scotland has been reduced bills and water use through greater water efficiency.

The Scottish experience shows clearly that a stand-alone retail operator, competing for the business of non-household customers, is encouraged to offer more value-added services and water efficiency advice than they would have done under an integrated 'source to tap' water company model⁴.

³ Results based on two separate consumer research studies commissioned by CCWater and Ofwat between 2007 and 2010. Large business customer research was based on telephone surveys with 684 large businesses in England and Wales that MVA conducted in June 2007. This showed that 84% supported competition in principle. Small and medium business research was based on telephone surveys that Accent conducted in June 2010 with 1,515 businesses with fewer than 250 employees. This showed that 69% supported competition in principle. See www.ccwater.org.uk.

⁴ See Grant Thornton, Water Industry Commission for Scotland: Cost Benefit Assessment, May 2010, <http://www.watercommission.co.uk/UserFiles/Documents/Competition%20report%20-%20final.pdf>

A study into the Scottish market suggests that by 2020-21⁵ Scottish businesses will have saved £50–£55 million through saving water, compared with existing levels of water use. Furthermore, a recent public sector procurement exercise across Scotland resulted in a cost saving of up to £25 million. As part of the exercise the successful bidder also agreed to install free Automated Meter Reading technology in all of the public sector sites across Scotland – supporting significant water efficiency improvements. Retail competition is delivering a twin benefit of lower costs to Scottish businesses (which can help drive growth) and more sustainable use of a precious resource.

Beyond retail choice, the upstream reforms proposed in the draft Bill will sit alongside our own regulatory proposals to encourage companies to use scarce water supplies as efficiently as possible by trading more water and to build more interconnection between their networks. This will both ensure future resilience and avoid inefficient and unsustainable new supply investments wherever possible⁶.

The draft Water Bill will ensure that **all** water resources can be considered as part of a long-term approach to delivering resilience and ensuring the most efficient use of water in England. The proposals for upstream reform will ensure that where third parties hold water that can be used to ensure the future resilience of water supplies, and can provide those supplies more efficiently than the incumbent water company, they have the opportunity to do so. They will also give water companies a wider choice of how and where to take water from the environment to meet their customers' demands as part of their water resources management plans. With a greater choice of sources of water, companies will be able to choose the cheapest sources (keeping bills down) and those that are the most environmentally sustainable.

⁵ Ibid

⁶ Since 1997, levels of water trading between companies in England and Wales have remained static at 4–5% of volumes. This is despite the growing challenges around water scarcity in some parts of England and Wales and significant new investments within company networks. We consider that in order to ensure sustainable water supplies in the future companies must be encouraged to look beyond their own regions and build greater interconnection between their own networks and those of neighbouring companies.

The most comprehensive analysis of the impacts of these reforms available to date in England is the upstream impact assessment completed by the UK Government⁷, which suggests that some £2 billion of benefits would be gained from their introduction. Using the same methodology and assumptions as that impact assessment, we calculate that if these reforms were mirrored in Wales they could deliver a net benefit of £87 million over 30 years.

Efficiency, growth and reducing regulatory burdens

The draft Bill offers benefits beyond the £87 million of efficiencies from upstream reforms and the promotion of more sustainable water use. Applying the draft Water Bill in Wales, so that retail choice was available to non-household customers, would support further efficiency and growth in Wales, through:

- improved efficiency and lower bills;
- innovation in service delivery; and
- more tailored and improved services to customers.

Allowing business customers to choose their supplier will provide those customers with a much stronger say in the type and price of services they receive. This will enable them to control their own input costs and therefore be more competitive – helping drive growth in the economy by providing savings that can be reinvested in Welsh businesses. A Policy Exchange report in 2011 reported that a customer with 1,400 single sites could save £80,000–£200,000 by receiving one integrated water and sewerage bill from a single supplier instead of the 4,000 separate bills it receives at present⁸.

⁷ See <http://archive.defra.gov.uk/environment/quality/water/documents/wwp-ia-upstream-1347.pdf>

While there are always difficulties associated with forecasting future impacts and opportunities to improve the analysis, this analysis was independently quality assured by the Regulatory Policy Committee (RPC), which gave the impact assessment a 'green' rating, the highest rating they can give and one which is generally only achieved by c.1/3 of the IAs that the RPC review.

⁸ Policy Exchange, 2011, Still Hobson's Choice, The case for water retail services market reform in England and Wales, p.2-3,

<http://www.policyexchange.org.uk/images/publications/water%20retail%20services%20competition%20in%20england%20and%20wales%20-%20jul%2011.pdf>

There have been various studies into the costs and benefits of introducing non-household retail choice in England and Wales or England only. These include work completed by the Cave review⁹, Oxera¹⁰, Policy Exchange¹¹, the Water Industry Commission for Scotland¹², Ofwat¹³ and Deloitte¹⁴, and the UK Government's retail impact assessment¹⁵. These studies offer a range of figures for the likely total costs and benefits of introducing non-household retail choice, with some providing quantitative results and others looking at specific aspects of the cost/benefit case. As is the case with the upstream reforms, we are not aware of any Wales-specific studies.

⁹ Cave, M, Independent Review: of competition and innovation in Water Markets: Interim Report, November 2008, <http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/documents/cavereview-report.pdf> and Cave, M, Independent Review: of competition and innovation in Water Markets: Final Report, April 2009, <http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/documents/cavereview-finalreport.pdf>

¹⁰ Oxera, Competition in the Water Sector: a review of the cost-benefit analysis knowledge base, 2011, <http://www.oxera.com/main.aspx?id=9560> see also Cave, M, Comment on Oxera report on 'Competition in the water sector: a review of the cost-benefit analysis knowledge base', April 2011.

¹¹ Policy Exchange, 2011, Still Hobson's Choice, The case for water retail services market reform in England and Wales, <http://www.policyexchange.org.uk/images/publications/water%20retail%20services%20competition%20in%20england%20and%20wales%20-%20jul%2011.pdf>

¹² See <http://www.watercommission.co.uk/Blogs/post/Costs-and-savings-of-retail-competition.aspx> and also Water Industry Commission for Scotland, Retail Competition in Scotland: An audit trail of the costs incurred and the savings achieved, 2011, [http://www.watercommission.co.uk/UserFiles/Documents/WICSAuditTrail\(B\)%20\(2\).pdf](http://www.watercommission.co.uk/UserFiles/Documents/WICSAuditTrail(B)%20(2).pdf)

¹³ Ofwat, Review of the evidence base for retail competition and separation, 2011

¹⁴ Deloitte, Lessons for the water and sewerage industry from retail competition in the utility sector, 2011, http://www.deloitte.com/view/en_GB/uk/industries/eiu/water/24dca3dd6f90e210VgnVCM2000001b56f00aRCRD.htm

¹⁵ The UK Government's impact assessment ('Introducing retail competition in the water sector', HM Government, 2011, <http://archive.defra.gov.uk/environment/quality/water/documents/www-ia-retail-1346.pdf>

Table 1 Studies into non-household retail choice and results

Study	Results	Notes
Cave review retail impact assessment	£617 million net benefit (NPV over 30 years)	Results cover England and Wales and are based on proposals to legally separate retailing activities. Evidence largely based on a conservative application of the Scottish experience and with limited data on the true retail cost base.
Deloitte working on behalf of Water UK	£1,351 million net benefit (NPV over 30 years)	Results cover England and Wales and are based on direct application of Cave review proposals (including legal separation of retail). Despite the overall result, the report provides some sceptical narrative around the achievement of some of the benefits cited, particularly ‘spillover’ benefits to household retail and the ‘wholesale’ business.
Water Industry Commission for Scotland	£750 million–£2 billion net benefit (NPV over 30 years)	Results cover England and Wales and are essentially based on direct application of the Scottish experience to England and Wales (including separation of retail services).
UK Government retail competition Impact Assessment	£190 million net benefit (NPV over 30 years)	Results cover England only and are based on no separation of retail of any kind. Based on a range of evidence and sources.
Policy Exchange	N/A	Results based on a series of case studies with business customers and desk review of other studies.
Oxera	N/A	Provides some critical discussion of the Cave review analysis and underlying assumptions.

Collectively, these studies suggest that across England and Wales the net result of introducing retail choice for non-households could deliver somewhere between £190 million and £2 billion of net benefits. They also highlight a range of key risks such as the need to maintain investor confidence – which the UK Government has cited as a key reason for not taking forward the Cave review’s recommendation to require the separation of water companies’ retail operations.

Using the same approach and assumptions as the UK Government's retail impact assessment, which is among the most conservative pieces of analysis and considers all of the studies listed above, we calculate that the potential benefit to Wales of extending choice of supplier to business customers is in the order of £18 million over 30 years¹⁶.

Where choice is effective at delivering efficiency for customers, we will also be able to regulate the provision of retail water services to businesses in a more light-touch way than we do currently and could potentially de-regulate these activities completely at some point in the future. This will reduce the burden of regulation on the existing water companies' retail businesses, allowing them greater freedom to respond to their customers.

Overall implications for Wales

If the Welsh Government were to implement the provisions of the draft Bill that give non-household customers a choice of supplier, we consider that this would lead to benefits to Welsh business customers from the efficiency and service improvements described above, more sustainable water use and reduced bills.

We recognise that this is a complex set of decisions that carry some risks and that the Welsh Government may therefore choose not to apply these provisions in Wales. In this case, we will continue to regulate the provision of retail services to business customers differently in Wales to ensure that those customers as far as possible gain any benefits from changes in England. We will not be able to reduce the burden of regulation on Welsh companies because in the absence of choice these customers will continue to need the protection of the regulatory framework to drive efficiency in Welsh companies.

For example, to ensure that Welsh companies continue to improve in a way that is comparable to the English companies it is likely that we would need to collect more information from Dŵr Cymru and Dee Valley to ensure we could compare them with the best performing companies in the competitive market in England. This would be an added cost for the Welsh companies and their customers.

We stand ready to work with the Welsh Government on any research on the potential development of markets in the Welsh water sector.

¹⁶ This impact assessment was also reviewed by the RPC and received an 'amber' rating (the RPC reviews all impact assessments coming out of the UK Government and gives each of them a 'green', 'amber' or 'red' rating).

Assess the progress made by the Welsh Government in addressing water affordability

The Welsh Government's Strategic Policy Statement on Water confirmed that:

“Keeping water bills at affordable levels is a priority for the Assembly Government. We want customers to have a choice of charging options that will drive up efficiencies, reduce debt issues and deliver benefits for all customers while protecting vulnerable groups.”

We have supported the Welsh Government as it formulates its preferred policy in this area by providing the results of our research and investigations into some of the options for addressing water affordability in Wales.

This work was designed to inform, assess and provide potential options for consideration by policy makers, and it is for the Welsh Government to take decisions on the appropriate policies to adopt. It set out a three-part package for assisting customers, which would replace Welsh Water's 'Assist' tariff (for Dŵr Cymru) and WaterSure (for Dee Valley), and which would most effectively target support on those customers who need it most. This package comprised:

- a targeted metering campaign for single occupants on benefits and/or tax credits or a bill cap based on a realistic assessment of consumption for households unwilling or unable to be metered;
- free blocks of water for metered families on benefits or a discounted assessed bill for unmetered families on benefits; and
- a bill cap for customers with medical conditions on benefits requiring above average consumption of water.

These three strands are designed to be delivered as a package of support to customers on benefits and (or) tax credits. Together they could maximise signals for efficient use of water, deliver support in a manner that is fair and tackle water affordability risks.

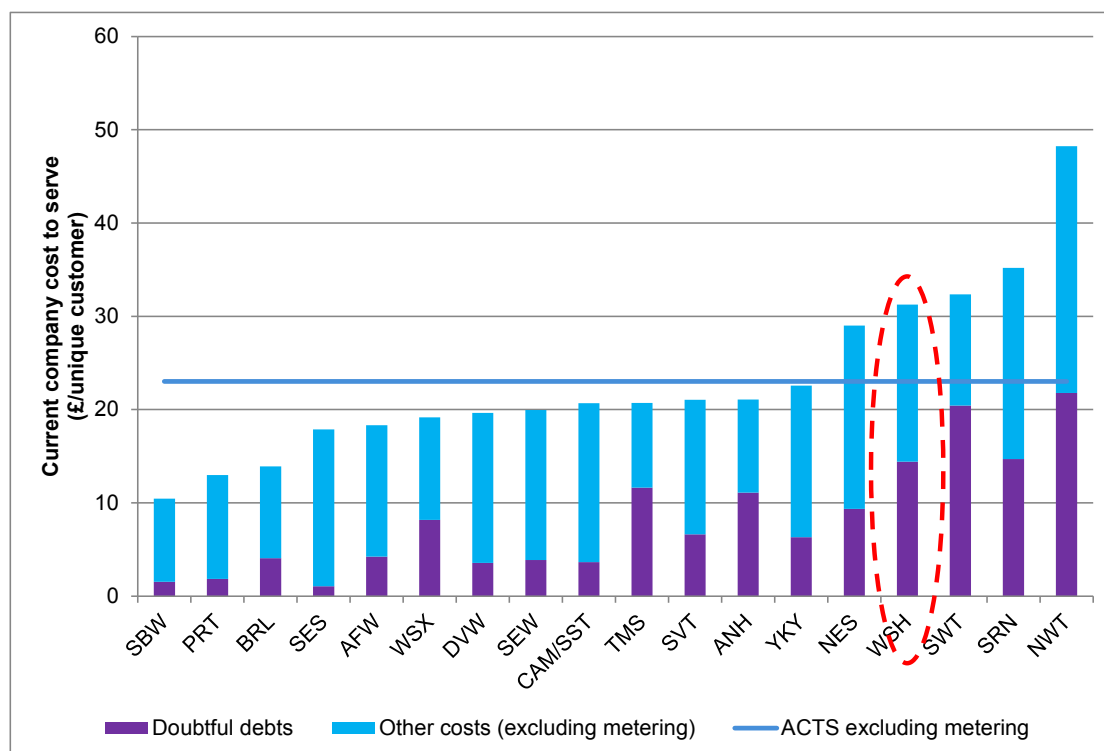
We are happy to share this research and package of measures with the Committee.

We look forward to the Welsh Government's publication of its social tariff guidance, which we expect will provide policy clarity in this area, and we will continue to work to implement that policy.

We are also keen to ensure that our regulatory framework helps address the significant affordability challenge we are facing. The level of bad debt that currently exists in the sector is a key affordability issue. This has been a growing problem in the sector and we estimate that bad debt now accounts for about £15 on each customer’s bill. Dŵr Cymru has particularly high bad debt costs compared with other companies in the sector¹⁷.

The graph below shows the differences between companies’ bad debt levels and overall retail ‘cost to serve’ each customer. Dŵr Cymru (labelled ‘WSH’) has both retail costs above the industry average and relatively high levels of bad debt. In our recent consultation on the methodology for the 2014 price review, we proposed to introduce separate price controls around wholesale and retail services. We consider that a separate retail price control will provide a stronger challenge on companies with high bad debt costs to address them and in doing so help address issues of affordability.

Figure 1 Retail and bad debt costs across the sector¹⁸



¹⁷ We note that there could be different reasons for this beyond inefficiency and the company has argued that, among other factors, its level of bad debt is influenced by the local customer base and the level of deprivation in its area.

¹⁸ Source: Ofwat analysis of companies’ most recent published household retail cost data, adjusted to reflect differing levels of meter penetration.

We responded to the Welsh Government's consultation on the Walker review. Our response can be viewed on our [website](#)¹⁹.

We also responded to the Welsh Government's consultation on social tariffs. This can also be viewed on our [website](#)²⁰.

Conclusion

If the Welsh Government were to implement the provisions of the draft Bill that give non-household customers a choice of supplier, this would encourage more sustainable water use and economic growth. Benefits from introducing retail competition could amount to £18 million in Wales over 30 years. If these provisions were not to be taken forward, in order to protect customers, we will have to regulate water companies operating wholly or mainly in Wales differently to how we will regulate in England and this could impose additional burden and costs on the Welsh companies.

If the Welsh Government were to take forward the upstream reforms in Wales, this would drive the more sustainable allocation of scarce resources, and further innovation. Benefits from the upstream reforms could amount to £87 million over 30 years.

Whether or not to take forward the provisions in the draft Water Bill is a matter for the Welsh Government. We are committed to continuing to protect Welsh customers, and ensuring that the water companies in Wales improve their services for them.

We have worked with the Welsh Government to develop a package to support their work in addressing water affordability, which includes targeted metering, free blocks of water and a bill cap for certain customer groups. We look forward to the publication of its social tariff guidance.

Ofwat
March 2013

¹⁹ See http://www.ofwat.gov.uk/regulating/charges/res_ofw20110704wgwalker.pdf

²⁰ See http://www.ofwat.gov.uk/future/customers/metering/affordability/res_ofw201102wagsocial.pdf