

26th March 2012

Our ref:

Your ref: Setting Price Controls Consultation



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BY EMAIL ONLY

Dear Ofwat

Ofwat – Consultation on ‘*Setting price controls for 2015-20 - Framework and approach*’.

Please find attached Natural England’s response to the above consultation. We have restricted our comments to the issues where Natural England’s advice is most relevant.

If you have further questions regarding our response to this consultation, please contact Tim Collins, Principal Specialist – Water & Coasts on 0300 060 0754 or at tim.collins@naturalengland.org.uk ; or Glen Cooper, Senior Specialist- Freshwater Programmes at glen.cooper@naturalengland.org.uk or on 01323 721037

Yours sincerely

A handwritten signature in black ink, appearing to read "Tim Collins". The signature is written in a cursive style with a horizontal line underneath.

Tim Collins
Principal Specialist – Water & Coasts

Ofwat: a consultation on ‘Setting price controls for 2015-20 framework and approach’.

Natural England’s Response – March 2012

Introduction

Natural England works for people, places and nature to conserve and enhance biodiversity, landscapes and wildlife in rural, urban, coastal and marine areas. We conserve and enhance the natural environment for its intrinsic value, the well-being and enjoyment of people, and the economic prosperity it brings. We promote access and recreation and contribute to the sustainable management of our natural resources.

We welcome the opportunity to respond to this consultation on *Setting price controls for 2015-20*. Due to the length and complexity of the consultation document, we have responded only to specific topics where Natural England’s advice is most relevant.

Key points in our response:

- The unambiguous policy direction set by the Government around catchment management, habitats and Biodiversity 2020 obligations does not appear to be clearly conveyed within the main consultation. In particular, the catchment based approach is central to the thinking around delivery of the Water Framework Directive, has ministerial support, and the potential contribution that holistic catchment approaches could make to water companies outcomes need to be made clearer by Ofwat.
- Due to the crucial role CCG’s play in the process it is important that CCG’s have representative membership, and the necessary guidance, information and support from Ofwat to carry out their role.
- Ensuring that willingness to pay (WTP) studies follow best practice, is also crucial to the process. Ofwat may wish to consider requiring appropriate quality assurance of WTP surveys to ensure they are fit for purpose.
- Natural England are encouraged that Ofwat is proposing to employ AIM as a mechanism to reduce pressure on environmentally sensitive sites. Further clarity on how the AIM is proposed to operate would be useful, and Natural England would welcome the opportunity to participate with Ofwat and the Environment Agency in discussions about the design and development of the AIM.
- With water trading it is important that the necessary regulation of trades and connections between networks are established in a way that avoids unintended environmental consequences.
- We welcome the requirement that companies take account of legislative responsibilities and suggest more could be done to demonstrate compliance.

Our comments on specific topics:

1. Clarity on statutory requirements and Government policy direction for biodiversity and the environment:

Natural England expects companies to comply with existing statutory requirements; we are pleased to see this is recognised by the “take account of them” instruction on page 15 of the consultation document. We suggest that the role of companies (section 2.2.1) also includes companies demonstrating compliance with statutory requirements, as laid out in the Statement of Obligations (Defra 2012). We don’t think this is simply semantics and believe that reminding companies of their statutory responsibilities is important; so that there is no doubt in the expectation that they should meet these obligations.

The consultation document explains that Ofwat proposes to make greater use of incentives in future pricing reviews to enable an outcome-focussed approach. As part of its adoption of good practice, we encourage Ofwat to employ incentives or encourage companies to propose incentives that reward companies only for environmental delivery that exceeds statutory responsibilities (as opposed to incentives for securing compliance). We appreciate that this will only be appropriate where it can be demonstrated that there is customer support for delivery that exceeds statutory requirements.

Companies will also be aware of the Strategic Policy Statement and Social and Environmental Guidance (SPS/SEG) from Defra to Ofwat. The clear policy direction within the SPS/SEG around catchment management, habitats and Biodiversity 2020 obligations does not appear to be conveyed within the main consultation, other than a single mention of catchments in the additional “briefing note for environmental stakeholders”.

At the recent CIWEM ‘Catchment Based Approach’ conference, the Minister Richard Benyon MP said that he was “Especially keen that water companies develop their role in funding catchment schemes.” As the catchment based approach is central to the thinking around delivery of the Water Framework Directive, it is disappointing not to see (even brief) reference in the main consultation document regarding the potential contribution that holistic catchment approaches could make to addressing these issues (and others such as climate change adaptation) along with the potential economic benefits of such solutions. We suggest these policy directions are reflected and made clear to water companies in the business planning consultation, and final methodology.

We are aware some companies are striving to deliver their statutory environmental obligations, and with customer support, additional environmental outcomes, and we fully support such approaches. Nevertheless we have concerns that with clear pressures on the economy, an instinctive response for some may be to assume that delivery of non-statutory biodiversity outcomes is a ‘luxury’. Through our work with water companies and the CCG’s we can and do highlight the statutory requirements under the NERC Act for biodiversity and the policy outcomes in Biodiversity 2020, along with the wider socio-economic benefits for customers. A clear direction from Ofwat to Water companies that sustainable outcomes must properly include the environment, along with socio-economic considerations, will ensure these biodiversity outcomes are delivered.

2. Clarity over the role of Ofwat and others in assessing statutory environmental requirements:

Our understanding is that Ofwat will not themselves be assessing whether statutory environmental requirements have been met, as there is an expectation that companies will do this in order to make their business plan fit for purpose; Ofwat are thus apparently reliant on other regulators, authorities and the CCG's to highlight where this may not be the case. It would be useful to clarify this role to the regulators, to ensure that proper scrutiny takes place.

3. The role and views of customers:

Ofwat state (section 2.1) that “to give companies more ownership of what they deliver, we want *them* to develop and propose in their business plans outcomes and outcome delivery incentives that reflect their customers' views and priorities”. This is a laudable approach for those outcomes that go beyond statutory obligations (which need to be delivered even if they may not always represent customer priorities) and it would be useful to make this distinction clear to companies.

We appreciate that Ofwat want companies to deliver for customers in the long term. However, in the information that customers provide to water companies (eg through Willingness to Pay surveys), there are risks that customers will focus on what they want in the short term. This could be driven by immediate economic pressures or current conditions (eg drought or floods), for example. These short term needs may not be compatible with customers expressed priorities for the long term. How will the risks arising from this be managed and how will companies be incentivised to address the long-term needs for the sustainable management of water?

4. Cost benefit and cost effectiveness

The consultation document specifies that commitment performance levels should be cost-beneficial (page 34). In the cases of outcomes for which it is difficult to assess the benefits, this requirement may prove problematic. For statutory requirements for which it is difficult to assess the benefits we suggest it is more appropriate for companies to demonstrate that they are proposing the most cost-effective solution. We believe it would be appropriate to make this clear through the framework.

5. Incentives and assessment of water company plans:

In its assessment of the outcome-based delivery and incentives proposed by water companies, how will Ofwat check that unintended negative impacts on the environment will not arise? For example, where Ofwat is reliant on using information on past performance of water companies to assess likely outcomes, there are risks that this information will not predict undesirable outcomes that could arise in the future.

Given the diversity in analyses that are likely to be provided by companies under the revised approach, will it be feasible for Ofwat to compare whether companies are providing value for money (as indicated on page 35)? The importance of having suitable and comparable metrics such as KPI's is important for Ofwat to

ensure this (a point we previously raised in our response to the regulatory change consultation).

6. Customer Challenge Groups

There is considerable reliance on the effective operation of customer challenge groups in the process set out in the consultation document. Ofwat have previously stated that they have not prescribed how these groups are set up or run, other than asking for an independent chair. In order to fulfil their role (set out in Section 2.2.2), it is important that Customer Challenge Groups have a membership that properly reflects the wishes of customers and other legitimate stakeholders, and are able to operate effectively. Given this is a new process we suggest that Ofwat put in place a suitable mechanism to ensure this is so and remains the case. ?

Although many water companies endeavour to operate in a way that is environmentally sustainable there could be the potential for a water company to deliver no environmental improvements beyond statutory requirements, especially if the company's customers were not aware of the potential for the company to deliver such improvements. Such a situation could arise, for example if environmental non-government organisations were not represented on the company's customer challenge group, and environmental sustainability was not a priority for the company. Natural England suggests safeguards are put in place to prevent such a situation arising.

In the event that the challenge provided by a Customer Challenge Group deems that a company has not adequately engaged with customers, or its proposals do not reflect the balance of customers' views, what course of action will be taken to ensure that the necessary changes are made? We suggest this part of the process is explained.

Customer Challenge Groups for different companies may benefit from sharing material and best practice ways of working (for example some CCG chairs ensure that for part of CCG meetings, members have an opportunity to discuss issues without a water company representative being present). If it has not done so already, it would be helpful if Ofwat established:

- (i) the information that it expects Groups to be able to share with each other allowing for restrictions on commercially sensitive information, and
- (ii) the mechanisms for sharing best practice.

It is also important that participants in the CCG's have the necessary guidance, information and support from Ofwat to carry out their role. Is Ofwat planning to provide this?

Natural England has been fully engaged in the Customer Challenge Groups where our resources allow, and we support the aims of the process. However, it is clear that the process can be very demanding in terms of groups' and individuals' time. Overall for most water companies we believe it represents an increased demand on our staff time compared to PR09. We would look to Ofwat

to review with CCG's this approach during and after PR14, to understand how the process can be improved and the level of input by individuals and organisations kept at appropriate levels.

7. Willingness to pay surveys and valuation of benefits

The consultation document establishes that Ofwat expects companies to carry out willingness to pay (WTP) surveys and to use other evidence to inform their assessments of the benefits of their proposals to customers. What mechanism will be employed to ensure that the WTP studies and other evidence are of adequate quality? CCGs are charged with the responsibility to challenge "the quality of customer engagement". If Ofwat is expecting CCGs to advise on the methodologies and content of WTP studies, the necessary expertise needs to be made available to the CCG. Because WTP surveys are a specialist area of work, quality assurance might be more effectively provided by a third party with the necessary expertise. We are aware that some companies already adopt this approach by employing an appropriate peer reviewer (an independent expert in WTP surveys) for their surveys. To manage the risks of a survey being deemed to be inadequate after completion (which would be very costly), quality assurance is needed at key stages in the work. Peer review of willingness to pay studies (reported back directly to the CCG) at these stages would be a way to ensure this.

The quality of willingness to pay surveys and other stakeholder research data is paramount to ensure that if customers express a strong preference for improvements beyond statutory requirements that these preferences can be reflected in business plans.).

In the event that a CCG advised Ofwat that the findings of WTP survey did not reflect the priorities of customers, what action would Ofwat take to ensure that the necessary information was used to inform the water company's plans? We suggest that this point is addressed in the framework. If the main benefits to customers are not correctly identified during the design of the WTP survey (through focus group discussions and testing of the questionnaire), there is a significant risk that the findings would not reflect customers priorities.

It will be important that a water company's plans for its wholesale services are informed by the views and preferences of its wholesale customers (who may be different to its retail customers). Does Ofwat propose to put checks in place to ensure that the appropriate customers inform the different components of a company's plan?

Some of the benefits of water companies' interventions are enjoyed by society as a whole, not only water company customers. Examples include interventions that maintain or improve the environment in areas that are of national or European importance for nature conservation or provide wider ecosystem services. If only benefits to specific water company customers are employed in the cost-benefit analysis of proposals, these wider benefits will not be included. How will the risks of under-investment that that could arise from this be managed? We suggest Ofwat provides guidance on how such wider societal benefits should be reflected.

8. Trade in water

We are encouraged that Ofwat plans to keep under review the use of incentives for importers and exporters to trade water. This review would usefully develop the evidence base on barriers to trade and interventions that are effective at overcoming these. Though financial incentives may encourage water companies to consider trading, they not be the most effective mechanism for overcoming barriers that are behavioural or cultural.

As we highlighted in our previous Ofwat consultation responses, we can see that there is potential for water trading to address over-abstraction and low flows, and meet customers' needs more effectively. However, it is important that the necessary regulation of trades and connection of networks is established to avoid un-intended environmental consequences. In particular the unintended transfer of Non-Native Invasive Species and impacts on water quality must be taken into account, and this is particularly pertinent to sites designated for their nature conservation interest. Natural England seeks Ofwat's re-assurance that they have considered how any new system will ensure that these risks are avoided or mitigated.

9. AIM (Abstraction Incentive Mechanism)

We are encouraged that Ofwat is proposing to employ AIM as a short term mechanism to reduce pressure on environmentally sensitive sites. In the medium term, reforms to abstraction licensing will ideally provide the necessary changes to manage over-abstraction and AIM will no longer be required.

Ofwat proposes that AIM will apply only to sites that are designated by the Environment Agency as Water Framework Directive 'Band 3' sites. Whilst we understand from our discussions that the AIM mechanism is intended to operate both on sites that are not covered by existing statutory requirements and those that are (eg obligations to meet the conservation objectives of Natura sites) it would be useful to clarify this in subsequent documents (see our previous response to the Wholesale incentives consultation). Note also that sites that are not classified as 'water bodies', eg many groundwater dependent wetlands, may in fact be very sensitive to abstraction pressure and should not be excluded from this mechanism.

In addition to this, measures should be employed to prevent displacement of environmental impacts of abstraction from these sites to other sites that are vulnerable to over-abstraction, which could arise as a result of AIM itself. For example, unintended effects could arise from increased abstraction (in response to AIM) at sites where the impacts of over abstraction may be less certain, but potentially damaging nonetheless, or where there may be 'in combination' impacts. Similarly, Ofwat may wish to consider applying AIM to licenses that are traded, to manage the risks of environmental impacts arising as a result of the trade increasing levels of abstraction from the licence.

Ofwat is proposing to use estimates of willingness to pay for improvements in flow levels derived for the Environment Agency from the National Water Environment Benefit Survey. We understand that Ofwat is proposing to use these

data in the absence of better information at this time. It would be helpful if Ofwat explained that this is the case and that if in the event that improved evidence on the benefits is available in future, this may be used instead.

In the consultation document Ofwat explains that it is anticipating that the AIM flow threshold will be a percentage of the Environment Agency's Environmental Flow Indicator (EFI) at the relevant site. This requires more clarity as EFIs vary across the flow regime. Will there be scope for this percentage to be adjusted to reflect the situation at specific sites where necessary, for example if the site is a protected area and has specific flow objectives? In addition, it is not clear over what range of flows the AIM will apply. Is it targeted simply at low flows (eg Q95) or at protecting environmental flows across the whole flow regime?

The consultation refers to "historic average abstractions" as a baseline for assessing AIM. It should be noted that these levels of abstraction may have been causing environmental damage, and that this baseline may not therefore be appropriate. Such abstractions should be on the Environment Agency's Restoring Sustainable Abstractions list.

Natural England would welcome the opportunity to participate with Ofwat and the Environment Agency in discussions about the design and development of AIM, including the appropriate level for the AIM flow threshold, the baseline levels of abstraction used for each company and appropriate incentives to employ.

Ofwat's proposal to run a shadow AIM will provide a useful opportunity to test the processes and sources of information that will be used in AIM. Because of the impacts of weather, we would expect that data from several years will be needed to assess the performance of the mechanism itself.

10. Deciding on the nature of the incentives (non-financial, one- or two-sided or for allowing trade-offs where appropriate)

The suggested process seems sensible. For the approach adopted for trade-offs, we suggest that the net impact on outcomes is subject to review, given that the outcomes cannot be substituted for each other.

11. Water Efficiency and Leakage

Given the experiences from last year's drought, climate change predictions and the pressure on water resources (particularly in the south-east) we believe there is a need to offer clear encouragement to the water companies to adopt a progressive approach to these issues.

We hope the above comments are helpful and would be happy to discuss and clarify any of the issues that we have raised.

Natural England, March 2013.