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Neil Parish MP
Chair, Environment, Food, and Rural Affairs Select Committee
House of Commons
London
SW1A 0AA

7 December 2018

Dear Mr Parish

**Response to Environment, Food, and Rural Affairs Select Committee
report on regulation of the water industry.**

This letter provides Ofwat's response to the recommendations in the above report. We are grateful for the Committee's considered report, and for the opportunity to provide written and oral evidence to the Committee.

We recognise that it is for Defra to provide a formal Government response to the report. We have therefore provided responses only to those recommendations which were aimed wholly or partly at Ofwat. We have shared our response with Defra to inform the completion of the Government's response.

Over the last 30 years, regulation has helped the sector deliver significant investment, more reliable services, and environmental improvements. However, we recognise that more needs to be done, especially in the face of future challenges such as climate change, population growth and changing customer expectations.

Many of the conclusions reached by the Committee are in line with Ofwat's view of the issues which we and other regulators, as well as water companies, must address. Our response therefore sets out what action is already underway, as well as what future action Ofwat intends to take.

Finally, it is worth mentioning that we are currently in the process of reviewing our strategy in order to ensure that Ofwat is in the best shape to deal with future challenges. The Committee's recommendations will be taken into account as we progress our strategic thinking.

Our response to individual recommendations is set out in an Annex to this letter.

I will be happy to provide further information if that is of assistance to the Committee and, as recommended, I will provide a further update on companies' responses to our requirements on financial structures, dividend policies, and executive performance pay in 2019.

Yours Sincerely

Rachel Fletcher

Chief Executive

Annexe: Response to recommendations

Leakage

Recommendation: *“Ofwat’s target for water companies to reduce leakage by 15% by 2025 is not ambitious enough and Ofwat should set a long-term target for water companies to reduce leakage. This would help focus efforts beyond the five-year period of PR19. We consider that continuing the trajectory set by the target of 15% by 2025, the water industry should collectively be aiming to reduce leakage by 50% by 2040, rather than 2050.”*

Ofwat response:

We welcome the Committee’s focus on leakage and recognise that reducing leakage will play an integral part of the “twin-track” approach to achieving resilience across the sector. At future price reviews, we intend to continue to review the leakage challenge we set companies to ensure that targets stay in line with advances in technology and the best available evidence on driving leakage reduction.

We have challenged companies to reduce leakage by 15% over the five-year price review period from 2020 (PR19). The 15% figure represents an improvement on the most ambitious company’s leakage performance commitment in PR14. We are pleased that companies have responded positively to this challenge and we are reviewing the proposals in their plans for PR19 to ensure that each company is facing a genuinely stretching performance commitment on leakage. We will be happy to provide an update to the Committee as the process of finalising companies’ leakage commitments progresses.

We note that water companies have, via the trade body Water UK, committed to reduce leakage by at least half by 2050 “at the latest”¹. We also note the National Infrastructure Commission’s recent recommendation to the sector of reducing leakage by half by 2050. However, we also believe that a significant increase in industry collaboration and innovation is likely to be necessary to achieve continued improvements in leakage performance. As part of our review of our regulatory strategy, we will consider the appropriate role for Ofwat in relation to collaboration and innovation.

¹ <https://www.water.org.uk/news-water-uk/latest-news/letter-secretary-state>

Water transfers

Recommendation: *“Defra and Ofwat should make a strategic assessment of the need for water transfer infrastructure and confirm a long-term target for water transfers. We are concerned that existing incentives in PR19 are not strong enough to incentivise water companies to invest in water transfers.”*

Ofwat response:

We agree that water transfers have an important role to play in securing a resilient and efficient water supply. We have made it clear to water companies that we are disappointed in the progress in this area and believe that there is are economic, environmental and a resilience benefits to be achieved from planning more effectively across company borders.

Financial incentives to trade water between companies were introduced at PR14. In developing our methodology for the 2019 price review, we considered carefully, including through consultation with water companies and others, whether any changes to our existing incentives were merited and concluded that, whilst we would retain them, there was no justification for strengthening the incentives at this time. We consider that the principal remaining barriers to trading water relate to coordination problems, environmental and water quality constraints, and commercial practice, rather than the level of direct financial incentive.

Earlier this year, the National Infrastructure Commission, in its first National Infrastructure Assessment, made recommendations to increase the volume of water transferred between company areas. Building on these recommendations, Ofwat, together with Defra and the Environment Agency, has challenged companies to step up regional coordination in water resource planning. Three companies are in active discussions about establishing a joint venture to develop proposals for a major north-south transfer, and we are exploring a regulatory alliance to assess multi-company infrastructure options and drive regulatory alignment and cooperation where possible. We will progress discussions with Government in the coming months.

A further component of the joint efforts to increase effective coordination within and across regions is the National Framework for Water Resources Planning which is currently being led by the Environment Agency. This will provide an important source of shared intelligence to inform effective planning by water companies, and we look forward to continuing to work with the Environment Agency to develop the framework.

In addition to measures aimed at directly increasing transfers between water companies, we also note the potential for other measures to increase the scope for

water trades. The Water Act 2014 contained provisions to create bilateral markets in water resources, which would allow third parties which own water resources to sell water directly to retailers. This should bring efficiencies and may lead to an increase in levels of water trading between water companies by increasing the amount of water available to trade. Decisions on implementing the provisions in the 2014 Act are for the Government.

Complaints process

Recommendation: *"Ofwat should review how the complaints process within water companies could be streamlined. This could include a mechanism whereby water companies either automatically pay complainants a fixed sum or escalate complaints to CCWater if the complaint is not resolved by the company within 15 days".*

Ofwat response:

We share the Committee's interest in ensuring that companies' complaint handling processes deliver the right outcomes for customers in a timely and effective way. The process for handling complaints within water companies is at variance with those in comparable sectors in a number of ways, including in the absence of a "deadlock" mechanism for automatic payments or referral to a third party where a complaint is not resolved within a given time. We believe there is scope to make the overall complaint handling process much more streamlined and accessible for customers and for the intelligence coming from customer complaints to be used more powerfully to drive real change in the way water customers treat their customers.

We want companies to take ownership of issues which affect their customers and have been pushing companies to ensure that the complaints handling process (both within company and the post-company stages) is fit for purpose. Our current Service Incentive Mechanism (SIM) provides a direct incentive to companies to manage customer contacts, including complaints, appropriately, while the Customer Measure of Experience which is to replace SIM in PR19, will ensure that companies' customer service, including complaints handling, is compared with the best companies from other sectors. As part of our ongoing strategy review, we will be considering how we can best use our existing powers to protect customers and ensure they receive excellent customer service.

Earlier this year, at Ofwat's urging, Water UK commissioned an independent review of the post-company complaints handling process. The scope of the review is to examine the effectiveness of the current processes for delivering the right outcomes for customers and to provide recommendations to improve the customer experience.

In the short term, the review will inform the re-tendering of the contract for the alternative dispute resolution scheme (WATRS) set up by the sector. The conclusion of this review, and how the sector takes this forward, will provide important evidence which will help determine whether we should take further action. We encourage the sector to be swift and ambitious in taking forward the recommendations from the review. We will closely monitor the sector's progress.

Business retail market

Recommendation: *“Ofwat should consider ways to incentivise water retailers to attract more SME customers.”*

Ofwat response:

We agree with the Committee that SMEs are not yet experiencing the same benefits that larger customers receive from the retail market. We have identified a number of frictions which are hindering the market from reaching its full potential, and these include:

- a lack of complete, accurate and timely market data;
- poor aggregate performance of wholesalers against the industry standards; and
- poor interaction between wholesalers and retailers which has sometimes made it hard for retailers to operate and offer services in the market.

These frictions can raise retailers' costs and hinder their incentives to engage with certain customer groups, particularly small businesses.

All parties in the market have a role to play to ensure that customers can engage. We have been engaging with stakeholders to identify the drivers behind the frictions and will look to ensure that initiatives to improve interactions between wholesalers and retailers are taken forwards. In November 2018, we published a call for inputs looking at issues affecting wholesaler performance in the business retail market and the quality of service received by retailers. We will follow this up in 2019 in the light of views received.

We are also working with market participants, including the Market Operator, MOSL, to address these market frictions. MOSL is currently undertaking a scheme of work in order to improve the data in the Central Markets Operating System.

We will continue to closely monitor and regulate the new business retail market and will step in to protect customers where required.

Recommendation: *“Ofwat should undertake annual reviews until the market is shown to be delivering real competition and water efficiency”.*

Ofwat response:

We acknowledge that there is untapped potential in the market. Currently, the business retail market is not delivering the benefits which we would expect from a mature market.

We will continue to issue annual reviews and plan to publish our next annual report, concerning the second year of the market, in early summer 2019.

Financial and corporate reform

Recommendation: *“Ofwat should review the changes implemented by water companies on financial engineering, dividend policies and linking executive bonuses to delivering for customers and publish a written update to us by April 2019.”*

Ofwat response:

The changes we made as part of our [Putting the sector back in balance](#) package which we finalised July 2018, set out our expectations for how companies’ business plans for PR19 should set out clear approaches to dividend policies and executive performance pay, and address the need to share with customers the financial gains of adopting highly geared structures. We are currently scrutinising these business plans as part of our price review process.

We will be taking forward discussions with companies on a range of these issues following our initial assessments of business plans. We will be pleased to provide the Committee with a written update on the progress of our ‘back in balance’ policy when we have concluded these discussions later in 2019.

We will, of course, continue to push companies to deliver the outcomes that benefit customers and will use our regulatory tools to ensure that customers’ interests are protected.