

## **Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector?**

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### 1. Introduction

UK utility regulation initially aimed to avoid the perceived disadvantages of the US approach. The typical UK price control review now involves a substantial consultation process, led by the relevant regulator. Plans put forward by the utilities are analysed and discussed, including with other interested parties. The regulator then determines allowed revenue for the next period of years. This determination usually includes an explicit or implicit view on an efficient and appropriate future investment programme. In these respects, practice is more flexible and less legalistic than the traditional US regulatory approach. But there is also greater regulatory involvement.

In contrast, some jurisdictions in the US and Canada have effectively moved in the opposite direction. Utilities and interested parties, especially users and consumer representatives, seek to negotiate a settlement of some or all of these matters between themselves. The regulatory commission normally approves such a settlement provided that all interested parties have had an opportunity to be involved and are in support, and provided the settlement is consistent with the commission's statutory duties. The traditional regulatory process operates only in the event that the parties fail to agree.

Some UK regulators have expressed concerns about the UK regulatory process and indicated an interest in this alternative approach.<sup>1</sup> One UK regulator has already moved in that direction. To avoid the problems and acrimony of the previous price control review, the Civil Aviation Authority (CAA) encouraged the airports and airlines to engage in a process of 'constructive engagement' on a specified set of inputs to the price control review. They did so, and managed to agree substantially on quality of performance standards, traffic forecasts and the investment programme at Heathrow and Gatwick.

The All Party Parliamentary Water Group (APPWG) recently said that it "would like to explore these approaches in the UK and the possibility of a potential role for

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# I am grateful to many people for information, explanation and discussion on this topic, including Tony Smith, Deryck Hall and Andrea Cook (Consumer Council for Water), Phillip Mills, Janet Wright and Jeanne Golay (Water UK), Peter Antolik and Simon Oates (Thames Water), Graeme Sims (United Utilities), Jack Carnell (South Staffordshire Water), Hilary Aldridge (Environment Agency), Milo Purcell (DWI), Fiona Pethick and Mark Hann (Ofwat), and several others including Harry Bush, Sir Ian Byatt, Steve Smith, Jon Stern, Alan Sutherland and Mike Toms. None of the above is responsible for the views expressed in this paper.

<sup>1</sup> For example, Alistair Buchanan, "Ofgem's 'RPI at 20' Project", speech at SBGI, 6 March 2008, p. 7.

CCWater [the Consumer Council for Water] in representing consumer interests in this way”.<sup>2</sup>

This paper responds to the APPWG’s challenge. Part One examines recent and ongoing experience with price control reviews in the England and Wales water sector, particularly with the Quadripartite Working Groups set up by CCWater. In the light of APPWG’s interest, it gives particular weight to the views of CCWater. Part Two briefly reviews CAA experience with constructive engagement and some experience with negotiated settlements in the US and Canada. It then explores possible ways of applying and encouraging this approach in the water sector. The ideas discussed have implications for other utility sectors too, though there is not space to discuss that here.

For those not familiar with the England and Wales water sector, an Annex describes the roles of the main parties involved, including Ofwat, the Department for the Environment Food and Rural Affairs (Defra), the Environment Agency (EA), the Drinking Water Inspectorate (DWI), Natural England, the Consumer Council for Water (CCWater) and its predecessor WaterVoice.

## PART ONE

### 2. Ofwat price control reviews

Ofwat carries out price control reviews each five years. Each company submits a draft and then final business plan, which Ofwat scrutinises and challenges using consultants where appropriate.<sup>3</sup> There is provision for research into consumers’ views, and for receiving input and comments from interested parties including the quality regulators. Ofwat takes a view on the efficient level of operating costs for each company, an appropriate investment programme that meets specified quality standards, the cost of capital and other financial considerations. Ofwat then determines, for each company, an allowed level of revenue for the next five years.

Price control reviews of this kind were carried out in 1994, 1999 and 2004. The price control review process for 2009 (known as PR09) determines price limits to take effect in the period April 2010 to March 2015. PR09 was formally started in March 2007. It requires draft Business Plans in August 2008 and final Business Plans in April 2009. It will conclude with Ofwat’s final Determinations in November 2009, followed by any references to the Competition Commission if necessary, plus a period of implementation and evaluation until September 2010.

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<sup>2</sup> *The Future of the UK Water Sector*, April 2008, pp. 38-40.

<sup>3</sup> Ofwat uses the Reporter and company auditors to challenge the company business plans. (Each company must appoint a Reporter, who has a duty of care to Ofwat. This is usually a consulting engineer with a back up team. The Reporter’s duty is to scrutinise the historical data in the company’s annual returns and the forecast data in its price control submissions, and to carry out special investigations for Ofwat.) Ofwat may ask consultants to opine on specific questions (e.g. cost of capital, scope for future efficiency, customer consultation) and to evaluate some technical parts of the company submissions (e.g. the cost base). It has an external evaluation of its relative efficiency work. In Ofwat’s view these inputs are only a small part of the price review: Ofwat does most of the evaluation and takes all the decisions.

Successive price control reviews have increased familiarity with the process and incorporated various refinements in the light of experience. For example, a concern after PR04 was that utilities and environmental regulators are encouraged to put as much investment as possible into the forthcoming five year programme for fear of not having it allowed if it were deferred until a later period. In addition, the work programme tended to stop at the end of each period, with a delay after the charge determination was announced while the company re-evaluated and commissioned its investment programme within the allowed level of revenue.<sup>4</sup>

There has been an ongoing concern about the adequacy of research into consumer preferences. In 1999 the companies did research separately, not on a mutually consistent basis. In 2004 the research was coordinated by a joint stakeholder group, with a single contractor asking each company's customers the same questions. However, the complexity of the approach may have caused some confusion for customers.<sup>5</sup> The research findings were not unambiguous.<sup>6</sup> It was unclear how far the companies or Ofwat had used these research findings. There was also some difference of view (between Ofwat and EA rather than between WaterVoice and the companies) as to how far utilities were obliged to go ahead with schemes prescribed by the EA for which customers indicated they were not willing to pay.

Ofwat has sought to respond to these and other concerns in evolving the design of the price control process. Particular innovations in PR09, intended in part to meet the above two concerns, have been the 25 year Strategic Direction Statements, a more structured approach to consumer research and a greater emphasis on cost benefit analysis.<sup>7</sup> A further innovation, introduced by CCWater, has been the use of Quadripartite Working Groups. The next four sections examine these in turn. Despite the achievements, there are remaining concerns probably common to all utility price control reviews, associated with a perceived lack of regulatory responsiveness to views expressed by customers and companies, inflexibility to local circumstances and the burdensome nature of the process.

### 3. The 25 Year Strategic Direction Statements

For PR09, Ofwat required each company to prepare and publish a Strategic Direction Statement. In part this sought to address the phasing and 'stop-start' problem, by requiring utilities to formulate a strategy for 25 years ahead. It also had a broader purpose, to encourage more strategic thinking and more consideration of what customers really want. These Statements had to be submitted by 14 December 2007.

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<sup>4</sup> See for example the discussion by APPWG, 2 April 2008, pp. 21-2.

<sup>5</sup> There were two tranches of research. The Qualitative tranche asked about the principles underlying customers' willingness to pay, then the Quantitative tranche asked about customers' willingness to pay for specific investments or improvements in each company's area. Three separate business plans were put to customers: the utility's preferred plan, and two reference plans A and B proposed by Ofwat (a minimal one and a comprehensive one).

<sup>6</sup> The research showed that about 60% of customers were definitely or probably willing to pay the extra cost implied by the planned investment programme, but about 33% were not. This latter percentage varied by income level and by region. The existing level of water charges varies by region, being about twice the level in South West Water's area of supply than it is in the Thames region.

<sup>7</sup> See especially Setting price limits for 2010-15: Framework and approach – a consultation paper, Ofwat, 18 October 2007.

CCWater's view is that it was useful to require the utilities to publish 25 year Strategic Direction Statements.<sup>8</sup> CWater encouraged the utilities to do research with customers, to get their views about the proposed course of prices reflecting improvements, and to write the Statements from the perspective of customers. Although not all the companies indicated future price limits in their Statements, the companies eventually agreed to cooperate in these respects, some of the smaller ones being initially sceptical but the larger ones in particular being conscious of their reputation as an industry.<sup>9</sup>

In general CWater is pleased at the outcome: at least half the Statements are very solidly grounded in work with customers. But it was "rather disappointed that several companies, despite undertaking extensive consumer research, did not reflect the results of this research in their Strategic Direction Statements".<sup>10</sup> Some of the smaller companies are as yet stronger on engineering issues than on understanding customer viewpoints. Nevertheless, it finds all the Statements better than might otherwise have been expected, and the companies' communications strategies generally good. CWater has fed back its views to utilities individually so that the Business Plans can incorporate its thinking.

The companies seem to have welcomed the Strategic Direction Statements, some commenting that this is something they should have done anyway. The Statements have forced companies to talk to customers and consider the implications of their plans, and in some respects companies have changed their policies.

The quality regulators have welcomed the long term view that the Statements enable. They tend to see the actual Statements as rather a mixed bag, with some being tactical rather than strategic, and it remains to be seen how they are translated into Business Plans. The quality regulators say they are aware of affordability issues and seem to appreciate the scope for taking a more flexible, pragmatic and risk-based approach, although EA is widely seen as less flexible than DWI.<sup>11</sup>

Ofwat has discussed with each company its Strategic Direction Statement, but has not judged the Statements and does not intend to do so. Some therefore question what status the Statements have and how they might influence Ofwat's decisions. Ofwat sees them as enabling each company to define its own strategy and future, thereby

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<sup>8</sup> They would 'stretch the eyeline' of the industry, forcing companies to look ahead and, in particular, to appreciate the implications of their programmes and performance for their own reputations. The Statements should also enable a better recognition of the scope for adjusting the timing of investments, thereby allowing needed investment to be scheduled so as to avoid excessive price increases in the short term. This will facilitate identifying an investment package that customers are prepared to pay for.

<sup>9</sup> CWater indicated that it would declare publicly whether or not it supported the Business Plans that would follow from these Statements. It expected that the utilities would see the merit of being able to present their proposals as supported by the consumer body.

<sup>10</sup> CWater response, February 2008, para 4. For their part, some companies may have felt that there was some confusion as to which research was supposed to inform the Statements and which the Business Plans.

<sup>11</sup> EA has traditionally given proposals to companies whereas DWI gives guidance to companies and invites them to make proposals to meet its conditions. The EU regulations that the EA implements may now (with the Water Framework Directive) be a little less prescriptive and more flexible than previously, and in future other considerations (e.g. climate change) may reduce the weight attached to water standards. Some see personalities as important too.

differentiating the companies. It expects that a company's Business Plan will be consistent with its Strategic Direction Statement and with its consumer research. It does not seek to determine the company's strategy. To that end, Ofwat has prescribed a set of tabular data for all Business Plans, but left it to the companies to determine the text format, which will result in variations between companies.

#### 4. Consumer research

Ofwat has required companies to carry out joint research with stakeholders into consumers' views and priorities during Phases 1 (March 2007 – March 2008) and Phase 2 (April 2008 to January 2009) of PR09. Most companies have already carried out stated preference research to inform the Strategic Direction Statements and draft Business Plans. Ofwat will feed back comments to each company in October/November 2008. During the period August 2008 to January 2009 there will be joint stakeholder research into consumers' views on issues arising from these draft Business Plans. The companies will issue final Business Plans in April 2009.

Given the central role of customer research, steps have been taken to determine an agreed approach. A steering group with representatives of all parties involved has defined the tender for the research contract and ensured that there is a valid sample in each utility's area. It is open to any utility to do further sampling or research if it wishes to do so, but during the last review no party disagreed with the joint research. Having said that, companies find it helpful to do their own research with their own customers, which can be of a more technical nature and more company-specific than the joint research. Some companies perhaps feel that the research is more relevant in informing their own plans than for regulatory purposes, where it is unclear what use will be made of it. (Will each party simply choose those results that suit its own purpose?)

CCWater attaches particular importance to customer research.<sup>12</sup> Each year it conducts tracking research to gauge consumers' views about the performance of the companies and itself.<sup>13</sup> It finds that customers are generally satisfied with the level of service (water is safe and reliable and sewage is effectively disposed of), but they are less satisfied with value for money, especially in the high price areas, and there is a question about their receptiveness to further price increases.<sup>14</sup> Whereas in early years

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<sup>12</sup> It currently spends about £250k per year on this. Over time it has investigated some 15 different topics since 2005 to add something to the industry's knowledge. Research to date includes customers' use of water, fair charging, what customers think, views of business customers on competition, etc.

<sup>13</sup> The 2007 research shows that over 7 in 10 customers are satisfied with the service they receive, two thirds agree that charges are fair, and three quarters agree that charges are affordable, but one quarter would switch supplier if given the chance. See CCWater website.

<sup>14</sup> "Our own deliberative and quantitative work, which pre-dates the PR09 research, shows consumers are generally satisfied with the services received but question whether this represents value for money. In these circumstances, we have real concerns about consumers' lack of receptiveness to further price increases. As a reflection of this growing resentment the industry and its regulators have come under close scrutiny in the media and politically over the past two years. Customers have vented their frustration and impatience when things go 'wrong' (hosepipe bans, leakage, regulatory data inaccuracies). In these circumstances we think it is critical to the future of the industry that the outcome of the review is driven by what consumers want and think." CCWater response, February 2008, paras 5, 6.

there were tangible benefits such as more Blue Flag beaches<sup>15</sup>, in recent years it is less obvious what benefits the increased prices bring.

CCWater has therefore sought to work with the companies, so as to increase the understanding of and responsiveness to the views of their local customers, and more generally to attempt to regain customer trust in the industry. For PR09 CCWater project-managed so-called “deliberative research” on behalf of a wide stakeholder network.<sup>16</sup> The results were published in June 2008 although the key findings had been sent to the companies prior to publication to assist them in developing their draft business plans. CCWater considers that the process yielded better information about the underlying issues and customer concerns, and about how best to communicate with customers.

In commenting on the draft Business Plans, CCWater will look (inter alia) at the impact of the investment plans on prices. It will attach particular importance to consumer research: does it suggest that customers support the proposed plans and would they be willing to pay for the proposed investment programmes? If not, what options are there to ‘square the circle’ and establish a revised investment plan for each utility that is consistent with its customers’ preferences?

## 5. Cost Benefit Analysis

Ofwat has explicitly required that companies should justify their Business Plans in terms of cost benefit analysis (CBA).<sup>17</sup> It attaches great importance to CBA, both at a high level and in detail, because the approach pushes companies to think more thoroughly about the costs and benefits of their proposed investments. CBA also highlights the implications of quality regulations. Whether there is a conflict between willingness to pay and required standards remains to be seen, but in this review the

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<sup>15</sup> The Blue Flag is a voluntary eco-label awarded to over 3200 beaches and marinas in 37 countries. The Blue Flag Programme is owned and run by the independent non-profit organisation Foundation for Environmental Education.

<sup>16</sup> Defra, WAG, Ofwat, EA, DWI, Natural England, Water UK and CCWater. This research involved 40 groups of 8 individuals meeting in 20 locations across England and Wales (i.e. two per water and sewerage company region). (This small sample size caused companies some concerns about the validity of this research.) Each group met for two hours and initially were allowed to discuss whatever concerned them about living in Britain today. Discussion then moved on to utility services and then narrowed to water. Comments were off the cuff but generally revealed that water companies were not generally trusted – because of high profits / dividends linked to year on year real terms increases in prices, drought, leakage, flooding, pollution incidents, and company fines. Groups were then given a folder with a series of very general questions or statements and asked to undertake further research by scouring the internet, searching newspapers for water stories, canvassing opinion from friends, family and colleagues, and writing their findings in the folder. For each location the two groups were brought together, again for two hours, and asked to discuss their findings and participate in a series of exercises. These covered: general views about their company, other players in the water industry, satisfaction with services, value for money, priorities for investment and willingness to pay. Participants received £100 each.

<sup>17</sup> “Each company should use its business plan to present and explain investment plans that are an affordable aggregation of programmes that customers are prepared to pay for. Each company must demonstrate that, in the long-term context, its business plan is the optimal level of investment, with the benefits of each investment proposal exceeding the costs. Each company should carry out an appraisal of the costs and benefits of its proposals using CBA appropriate to the scale and nature of its investment programmes. This is a significant development in our expectations from companies.”  
Setting price limits for 2010-15, Ofwat 2007, p. 17.

evidence will be more soundly based whereas in PR04 it was more conjecture. There will also be more scope for companies as well as Ofwat to challenge the quality regulators. And Ofwat may be more willing to accept arguments for additional investment if there is sounder evidence for this.

Other parties seem cautiously positive about CBA, but they have reservations. Companies generally accept the case for quantifying benefits where possible, though some question whether it is as appropriate to apply this to asset replacement schemes as to new investment projects.

While defending its own process on quality regulation,<sup>18</sup> DWI is a keen supporter of the use of CBA but regards it as a useful tool amongst many in any business planning process, and advocates a more balanced approach. It has concerns about the methodologies employed by the water industry to generate willingness to pay data, about the focus on enhancements rather than fundamentals, and about the difficulty for consumers in assessing the bundles of service attributes. It would like to see a combination of methods used.<sup>19</sup>

While supporting CBA, CCWater has some concerns about how it might be applied. Where costs far exceed benefits, CCWater urges the need to look at alternative ways to deliver the statutory programme. Seeking a more holistic and innovative approach (e.g. catchment-wide rather than site-specific) might be more sustainable than the solutions that have characterised previous price control reviews. Some scheme delivery dates might thereby be deferred to enable a more cost-effective solution to be developed, while perhaps advancing lower cost schemes with higher cost-benefit ratios. CCWater is also concerned that some projects might be assessed in isolation, without sufficient reference to the benefits derived from other projects, or that benefits might be derived using mean rather than median willingness to pay.

Yet others have expressed concern about the selective use of CBA, by companies and/or by Ofwat, to justify or reject proposed schemes or price increases.<sup>20</sup>

## 6. Quadripartite Working Groups

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<sup>18</sup> “We use a transparent challenge process for companies to justify need, select options, and demonstrate benefits; improvement schemes supported by us are consulted on before implementation. The value of the outcomes achieved is not a matter of conjecture, and the processes employed are generally recognised as far forward of any other regulatory area of the business planning process.”

<sup>19</sup> “Is it completely unrealistic to advocate research into combining the positives of SPCE with the fundamental value explored through revealed preference methods, using cost of mortality/morbidity approaches or averting behaviour approaches? Consumers signal their need for clean safe drinking water as a top priority when asked, but that is not what comes through willingness-to-pay outcomes consistently. The precautionary approach necessary to deliver consumer expectations is undervalued as most consumers have no experience of significant failure, and companies have no experience or reliable benchmark for measuring the benefits of public health protection and maintaining public confidence.”

<sup>20</sup> “As the economic downturn bites, we are being told that customers have ‘agreed’ to price increases of £75 over 5 years when this is clearly not the case. They have prioritised and expressed preferences but the actual appetite for such increases is influenced by a number of factors and should not be considered as an unequivocal endorsement.” “Despite Ofwat’s claim of not being prescriptive, it strikes me that, de facto, there has been a lot of prescription and a very large scope for cherrypicking by the regulator on this aspect.”

CCWater has sought the most effective way to incorporate the views of customers into the price control. Experience suggested that this could best be done locally since national pressure was not always effective.<sup>21</sup> In PR04, local consumer views had had an impact in two specific instances.

In the northeast, water discolouration and sewer flooding were issues of particular local concern. The regional chairman of WaterVoice Northumbria organised meetings between the utility (Northumbrian Water) and other interested parties to discuss this. One of the requirements of WaterVoice Northumbria and the DWI was to have agreed objectives and targets.<sup>22</sup> They persuaded Ofwat to increase the revenue allowance for the utility in order to address this problem.

The Welsh Assembly was normally very concerned about price and affordability issues.<sup>23</sup> But it also wished to reschedule some of the water quality improvement schemes of Welsh Water (Dwr Cymru) so as to enable its regeneration programme to proceed in certain critical areas. In addition it wished to increase investment in some of the sewerage systems so as to accommodate local development in those areas. It was willing to accept a higher revenue allowance for the utility in order to achieve these ends. It sought the views of WaterVoice Wales, which carried out an analysis of this issue and sought assurance that developers should not benefit at customers' expense if extensions and upgrades to water and sewerage networks were advanced to aid economic regeneration. Again Ofwat was agreeable to the proposed outcome.

This experience suggested to CCWater that there was merit in a 'bottom up' approach to customer involvement rather than just a 'top down' approach. The previous approach could be 'turned on its head'. Instead of making representations from local customers at the end of the price control review, CCWater would try to ensure that the informed concerns of local customers were represented in the 2009 review from the very beginning, particularly in the utilities' strategic thinking and business planning.

In August 2007 CCWater set out its expectations for PR09. It began by noting its concerns about consumer perceptions.<sup>24</sup> It explained that it was crucial to "place consumers at the heart of the price review".<sup>25</sup> To this end, CCWater agreed to take the

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<sup>21</sup> For example, in the 1999 review the Customer Service Committees had wanted the companies to carry out some extra maintenance but Ofwat had given priority to cutting prices. In the 2004 review, Ofwat had initially cut back on the companies' plans to deal with sewer flooding, though in the light of arguments from WaterVoice it agreed to reinstate some of that investment.

<sup>22</sup> For example, the targets included the number of properties that would be removed from the sewer flooding register and a specified reduction in the number of complaints over a given timeframe.

<sup>23</sup> In this context the Welsh Assembly Government (WAG) is also the standard setter. I am told that in order to keep prices down WAG decided not to pursue as many environmental improvements as Defra did in England and Wales.

<sup>24</sup> "It is important to improve consumer perception and support for the water industry and the way it is overseen by Government and the regulators. Recent negative publicity on leakage, drought, profits and takeovers is harming the industry and leading to erosion of the goodwill that still characterises the general relationship water companies have with their customers."

<sup>25</sup> "Price Review 2009 – CCWater's Expectations", CCWater, Position Paper 1, October 2007. CCWater expanded on these ideas in "CCWater Response" to "Setting price limits for 2010-15 Framework and Approach: a consultation paper by Ofwat", February 2008.



lead in coordinating the qualitative research on general willingness to pay. CCWater also stressed the need for improved provision of information.<sup>26</sup>

CCWater therefore proposed partnership at the regional level to complement the arrangements that Ofwat was initiating at the national level.<sup>27</sup> Building on its successful experiences in the 2004 review, CCWater set up a Quadripartite Working Group for each of the 20 companies in England. Each Group comprises the water company, EA, DWI and CCWater, and in some cases Natural England.<sup>28</sup> The general aim was to refine each company's business plans, and in particular to bring the views of local customers to bear on the price control review process. There would also be more localised research into consumer attitudes to help companies draft their Strategic Direction Statements.

Each Group sets its own objective and arrangements – for example, the United Utilities Group has the objective of “Working in partnership to actively seek, facilitate and ensure the best possible outcome from PR09 for all relevant stakeholders across the region”. The emphasis is on knowledge sharing rather than reaching agreement. Each Group meets approximately quarterly, the local utility provides secretarial support, members take it in turns to host meetings, and they meet their own expenses.

In general, other parties involved seem to have welcomed the creation of these Groups and early experience has been encouraging. Participants see the advantage of coordinated research, getting all the stakeholders together, and raising awareness of the broader issues. They get earlier and improved understanding of the company plans, and are less likely to be ‘bounced’ at the end. The Groups bring a better bottom-up regional focus to the review process, to complement the previous top-down national focus. Face to face meetings give parties a better understanding of other parties’ positions. This has the potential to reduce and remove tensions and differences between parties (which can be between company and customers, between customers and quality regulators, between quality regulators themselves, etc.). The other parties perceive less pressure and burden on Ofwat to resolve all the issues.

On the downside, the time needed to participate can be demanding, particularly for the smaller regulatory bodies. The meetings are not presently coordinated with other meetings in the review process. Seniority of representation, quality of input, chairing and effectiveness are all variable, hence so are the benefits of the meetings. Where there are few issues at stake, some question the net benefit of the process.

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<sup>26</sup> PR04 was “the most open and transparent review to date”, and also “the most information intensive”. “Yet most of what was placed in the public domain was of little help to consumers and others in deciding whether the Final Determinations represented good value for money.” To remedy this CCWater proposed full disclosure of relevant data, more user-friendly presentations, and clearer communication with customers.

<sup>27</sup> Ofwat has initiated coordination between the chief executives of the various organisations involved (excluding the companies). There is also a general sharing of information on some other issues. For example, in PR04 EA organised workshops on its Benefits Assessment Guidance to determine whether discretionary environmental schemes should be added to the National Environment Programme. Ofwat commissioned research into efficiencies and incentives and invited WaterVoice and others to join the steering group.

<sup>28</sup> Natural England has joined the Group where nature conservation issues are relevant (particularly in the south and east), though its attendance tends to be rather ad hoc and dependent on the particular agenda items. In Wales there is a single meeting, organised by WAG, involving the two Welsh water companies, EA, DWI, CCWater, the Countryside Council for Wales and Ofwat.

Some regret the absence of Ofwat, Defra, local government and regional planning offices and (where they are not involved) Natural England. However, Ofwat's participation could constrain discussion and be a strain on its resources. One view is that the Welsh Group, chaired by WAG, is more effective because it is more focused and with a stronger regional rather than company scope. An opposite view is that this Group is too large and too political. Some feel that there would be advantage in considering certain issues from a regional rather than company perspective. This is particularly the case in the southeast, where there are several water companies in the same water basin.

## 7. Achievements and remaining concerns about the review process

In many respects the picture that emerges from the foregoing discussion is an encouraging one. It exhibits goodwill and learning from experience. There are differences of view, but all parties acknowledge the importance of better understanding the views of customers and of incorporating this into the companies' Business Plans and Ofwat's Final Determinations. To this end Ofwat has introduced Strategic Direction Statements and emphasised customer research and cost benefit analysis; CCWater has introduced Quadripartite Working Groups. Despite some limitations and reservations, these arrangements seem to provide better prospects than in previous reviews for informed and effective discussion between the parties. The final outcome seems likely to reflect the views of customers in each area more clearly than in the past.

And yet, despite the numerous achievements, there are some continuing limitations and reservations that seem to be common to the UK utility price control process in general.

1. It remains to be seen whether and how far the Business Plans and Determinations turn out to reflect the views of consumers. It is ultimately a matter for each company as to what final Business Plan to propose, and a matter for Ofwat to decide what Determination to make. EA and DWI have a formal input into environmental constraints on Ofwat's decision. The official representative of consumers, namely CCWater, can comment and discuss but does not have a formal role in the process.
2. Customers themselves – the people and organisations who actually pay the water and sewerage bills that will result from the price control – are only indirectly involved in the process. There is commendable emphasis on customer research, but the extent of that is necessarily limited and the results are open to interpretation by each interested party.
3. The lack of a formal role for customers in the process means that agreement with customers falls into the “nice to have” rather than “must have” box. This can be expected to reduce the interest in exploring possible options and services that might be of particular interest to customers. It means less flexibility and innovation in this direction than might otherwise be the case.
4. Ofwat has to present, implement and defend a uniform and consistent policy on a national basis. There is a limit to how far each company's price control can be tailored to the particular circumstances of that company and its customers. This makes it more difficult to explore and allow local and

regional variations and tradeoffs that might be of interest to customers and companies in each area.

5. The fact that Ofwat makes the ultimate decisions on the price control tends to devalue the relationship between a company and its customers. Companies have to orient themselves primarily to what Ofwat and the quality regulators want, rather than what customers want. Regulation may indeed limit a company's scope to respond to what it perceives as customers' priorities.<sup>29</sup> Customers, for their part, ultimately have to appeal to regulators rather than to companies.
6. All price control processes impose a burden. The water sector one is perhaps heavier than most, whether it be in terms of duration (three and a half years for each five year control), or in terms of the time, cost and complexity of data-gathering, cleaning, scrutiny, challenge, debate and decision. The process is no doubt generally transparent, accountable and consistent, as the Better Regulation principles require. It is more challenging to demonstrate convincingly that the approach is proportionate and targeted only at cases where action is needed. There is increased questioning as to whether this is the most productive use of so much effort.

These concerns are not a specific criticism of Ofwat. They are also applicable to other utility regulators, who have begun to acknowledge their force.<sup>30</sup> Other regulators too have sought to increase the role of customers in the price control process.<sup>31</sup> But the limitations just mentioned are as yet still applicable in these other sectors.

At least three other types of approach have been used to address these kinds of issues. Under the Public Contest method in Argentina, decisions on transmission investment are made by users rather than by the incumbent transmission company or by the regulator.<sup>32</sup> Despite an initial controversy, this method has worked well in Argentina

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<sup>29</sup> For example, one correspondent refers to Ofwat's "national service standards that do not vary or differ across companies or regions. Given the different levels of customer bills, leakage, sewer treatment works and odour nuisance across the country, I struggle to accept the idea that there is a single set of customer preferences. If instead companies had incentives to establish what the specific priorities were for their regional customer base and then receive a financial incentive for improving service in those areas I believe companies and customers alike would be better off."

<sup>30</sup> E.g. "A few years ago I spoke at the Institute of Economic Affairs, on Better Regulation ["Facing up to the better regulation challenge", 29 November 2005], and in that speech I referred to my worries over the increasing complexity of price controls. Arguably the current approach to price controls struggles to meet the Better Regulation Commission's call for simplicity. For example, it takes two years of extensive consultation to complete a price control. This – even after 20 years experience when arguably the most debatable aspects of price controls have been thoroughly debated. While undoubtedly very clever, some schemes in our price controls, such as the IQI sliding scale, are virtually unfathomable to those outside the cognoscenti." Alistair Buchanan, Ofgem, op cit pp. 5, 6.

<sup>31</sup> In the last distribution price control review, Ofgem changed its stance on undergrounding on the back of detailed willingness-to-pay studies with 10,000 customers across the country, who clearly said that they were willing to pay for limited undergrounding in some areas of natural beauty. In the present review, Ofgem is encouraging network operators to engage with local customers and indicating that company plans with good evidence of local customer support will necessitate less scrutiny and challenge. It has also set up a consumer panel for domestic and business customers.

<sup>32</sup> The transmission network existing at privatisation was subject to a conventional RPI-X constraint, to be revised periodically by the regulator. Any major new transmission expansion (with an associated fee) has to be proposed by users and approved by a majority in a public vote. Number of votes is proportional to potential use of the proposed expansion, using a method defined in the regulatory framework. Any expansion that attracts sufficient support is then put out to tender, and the winning

(until the macroeconomic crisis). It is not pursued here because it would require a change in the statutory framework. Whether or how to incorporate smaller and domestic customers would also need consideration.<sup>33</sup>

The two methods examined here are constructive engagement, as practised by the CAA since 2005, and negotiated settlements as practised in the US and Canada over many years, particularly in the last couple of decades.

## PART TWO

### 8. Constructive engagement and the CAA

The CAA appraised the 2004 airport price control review at some length.<sup>34</sup> It had several concerns about the process.<sup>35</sup> Looking forward, airlines wanted more focus on (airline) customers, mainstream consultation and a real input into decisions. Airports wanted greater consensus on plans, more structured information on airline requirements and more recognition of realities. The CAA wanted improved information and inputs, less intrusion on commercial issues, a more focussed role and better decisions.

In May 2005 the CAA made the following proposal.

“The CAA envisages that for the next airport price control reviews, some of the work usually carried out by the regulator will instead be taken forward by the airports and their airline customers through a process of ‘constructive engagement’. These are

- volume and capacity requirements
- the nature and level of service outputs
- the nature and level of quality outputs [added in later paragraphs]
- the nature and scale of the investment programme
- the efficient level of future capital expenditure associated with that programme
- the revenues from non-regulated charges by the airport to airlines over the next price control period, and

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tender price determines the price to be paid by all users over a defined asset life (maximum 15 years, typically much less). S C Littlechild, “Symposium on electricity reform in Argentina: Preface”, *Energy Economics*, 30 (2008), 1279-1283, and articles therein.

<sup>33</sup> The method was originally designed for the regulation of the national transmission network. The number of users/voters for any expansion has varied from 1 to 65 with a median of 5. Experience with the provincial sub-transmission grid is more limited but the approach accommodates some 200 regional and municipal distributors (who coordinate their actions via an association) plus directly connected industrial consumers.

<sup>34</sup> Airport Regulation: Looking to the future, learning from the past, CAA May 2004, and Airport Regulation: Looking to the future, learning from the past: Review of responses to the CAA’s consultation document, CAA December 2004.

<sup>35</sup> “The process encouraged influencing the regulator rather than customers, airlines did not buy into it, it was adversarial and at odds with underlying business relationships.” Harry Bush, *Some Issues in Airport Regulation*, presentation at Hertford Seminars in Regulation, 11 May 2007 slide 17.

- the elements of service quality and investment to which specific financial incentives should be attached and – depending on what progress can be made – the details of such financial incentives.

In this way, the normal business of commercial airport/airline interaction should be reinforced by the regulatory process, rather than interrupted by it.

The CAA also envisages that work on benchmarking aspects of airports' operating costs will be regulator-led, but in close co-operation with the airports and the airlines, with remaining work – principally the financing inputs of the price control and the financial trade-offs that underpin them – being taken forward by the regulator in its traditional role.”<sup>36</sup>

The key responsibilities that the CAA would retain included analysis of market power and opex efficiencies, addition of past investment costs to the RAB, proportion of future capex to be recovered in the next price control period, assessing the cost of capital, determining any price profile adjustment, establishing a revenue requirement (including allowance for non-regulated revenue), assessing options for the structure of the control, and developing proposals for financial incentives.<sup>37</sup>

The CAA gave some general guidance on working arrangements and set a timetable. It also responded to concerns about how “the interests of passengers and small, new entrant (or future) airlines would be safeguarded in negotiations between airports and airlines”. It would be looking to see explanation and evidence on how the agreements took account of these interests, and to that end set out some general guiding principles and basic questions that would be considered in looking at whether the agreements met the CAA's statutory objectives. Importantly, the CAA committed to respecting the agreements that were made.

“Final decisions and responsibility in a legal sense will continue to rest with the regulator. But if an agreement can be better reached by the parties, the regulator is likely to have a preference for it, provided the regulator is satisfied that the agreement meets user interests overall and is consistent with its statutory obligations.”<sup>38</sup>

No change in the statutory framework was involved.

Appraising the situation in May 2007, the CAA considered that the outcome so far had generally been satisfactory, indeed better than expected, at least at Heathrow and Gatwick. (The approach had reached impasse at Stansted and was still ongoing at Manchester.) There were still some business uncertainties, and some issues still to play for before the scheduled end of the process in June 2007. However, achievements include agreement on base capex, treatment of non-regulatory charges, the broad scope for capex efficiency, and traffic evolution at Gatwick. There was also an improvement in consultation and ‘the quality of regulatory discourse’.<sup>39</sup>

<sup>36</sup> Airport regulation: the process for constructive engagement, CAA, May 2005.

<sup>37</sup> Airlines initially wanted to discuss cost of capital as well, but realised that there was already a large workload with the assigned tasks. In future, with experience of the assigned tasks, it might be more straightforward for them to take on additional issues.

<sup>38</sup> CAA, May 2004, para 37, p. xii.

<sup>39</sup> Harry Bush, op. cit. slide 21.

The Competition Commission was more critical.<sup>40</sup> It saw substantial merits in the process, and noted that the airlines did too.<sup>41</sup> But it had some concerns about the process of consultation, though these also related to BAA's own planning processes. It was particularly concerned about the significant increase in BAA's capex programme during the course of its inquiry. Among its other concerns (para 4.19) were

- a) significant information and resource asymmetry between BAA and the airlines
- b) inadequate information to support estimated project costs
- c) very limited information on the implication of the capex for operating costs
- d) little discussion of the implications for airport charges, with a risk of excessive investment<sup>42</sup>
- e) difficulty for airlines in judging the impact of investment on commercial (non-regulated) revenues that offset airport charges
- f) risk of voices of non-participating airlines not sufficiently taken into account and too much weight attached to well-resourced airlines
- g) absence of a dispute resolution/arbitration mechanism at each stage, with CAA acting only as an observer
- h) lack of clarity in how BAA arbitrates between airlines' views and how apparent consensus was reached in previously hotly contested areas.

The Competition Commission did not conclude from this that constructive engagement should be abandoned. On the contrary, it concluded that constructive engagement should be a continuous process not confined to the periods approaching a quinquennial review. It recommended that the CAA address the above matters in further developing the constructive engagement process.

The views of BAA and the airlines (generally supportive of constructive engagement but with some reservations) are available, as are the responses of CAA to these points.<sup>43</sup> Others too are making spirited contributions to the debate.<sup>44</sup> A full discussion will have to await a later occasion.<sup>45</sup>

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<sup>40</sup> BAA Ltd. (*Heathrow and Gatwick Quinquennial Review, Final Report*), published 3 October 2007.

<sup>41</sup> "Constructive Engagement between BAA and the airlines is clearly an important process in resolving uncertainty as to the projects to be undertaken ... Agreement between BAA and the airlines is a far preferable way to decide the investment programme than relying on the judgement of ourselves or the CAA. Most of the airlines to whom we spoke also regarded Constructive Engagement as a significant improvement on previous levels of consultation, or consultation at other airports." (para 4.15)

<sup>42</sup> "It is in consequence likely that each airline will want the particular projects from which it will benefit, but to which it will only pay a fairly small proportion of the cost; but not wish to pay its share of the costs of projects from which other airlines will benefit but not themselves. Even though airlines are clearly best placed to scrutinize BAA's capex plans, there is a risk that any CIP [Capital Investment Programme] agreed through Constructive Engagement will be inflated by the airlines' mixed incentives, and BAA's incentive to grow the RAB."

<sup>43</sup> Appendix D paras 52 and 53.

<sup>44</sup> Former BAA executive Mike Toms expresses a critical view in a forthcoming lecture "Airports regulation: a case of destructive engagement?" Beesley Lectures on Regulation, Series XVIII, 9 October 2008. He argues that constructive engagement is unlikely to produce agreement (because of the differing commercial interests of the airlines) and is unlikely to be optimal if it does (because the airlines do not fully reflect the interests of present and future passengers, and because of the dangers of collusion between airlines). He therefore suggests that the CAA should determine the parameters of an optimal outcome against which to evaluate proposed capex programmes, and recommends Ofwat's requirements for cost benefit analysis and willingness-to-pay studies.

<sup>45</sup> Briefly, I agree that the limitations of constructive engagement need to be considered, and it is important for the regulator to consider the interests of those not at the table. As noted, the CAA

In a subsequent report, the Competition Commission reiterated its concerns but also indicated that it envisaged a greater role for such processes rather than a return to traditional regulation.

“Nor, specifically, do we advocate a greater involvement by the regulator in the taking of decisions on investment, service quality or similar issues, but a greater involvement in facilitating agreement between BAA and the airlines by providing an appropriate framework for consultation. In essence we would expect in a well functioning system of regulation processes and procedures to be in place for all relevant information to be made available by the airport operator to airlines and the regulator and on a timely basis to enable:

(a) airlines to engage in constructive dialogue with the airport operator on investment (overall and on a project by project basis), on levels and quality of service and on other areas of mutual interest; and

(b) the regulator to ‘monitor what is going on’ and act as arbitrator when necessary though within an established protocol/framework.”<sup>46</sup>

It is difficult to believe that airlines did not know the price control implications of their preferred capex programmes for airport charges, or were unable to finance an effective level of participation. And the Commission’s part (b) proposal is questionable.<sup>47</sup> However, to enable the “constructive dialogue” envisaged by the Commission in part (a), it may well be helpful to ensure that airlines and the airport clarify and agree at the outset what information is needed and when it should be provided, including the implications for commercial revenues. If necessary the CAA could ensure that this information is provided. There is also a case for extending constructive engagement to include the level of charges or revenue implied by the agreed investment programme.

#### 9. Constructive engagement in the water sector?

How could Ofwat encourage constructive engagement in the water sector? Following CAA’s precedent, it would presumably propose an analogous set of issues to be discussed and where possible agreed by the main parties involved. These would be the company, EA, DWI and CCWater, and where relevant Natural England. It would set a timetable for this consistent with the price control review process (which arguably could still be consistent with PR09). Ofwat would retain responsibility for

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explicitly acknowledged this in advance, and to reflect the interests of passengers it in fact introduced a positive incentive for BAA to improve quality of service, beyond what the airlines considered necessary for their own purposes. My argument in the present paper is that the concept of a regulatory optimal outcome has limitations too.

<sup>46</sup> *BAA Airports Market Investigation, Provisional Findings Report*, Competition Commission, 20 August 2008, para 7.40. See also “We regard an active involvement of the regulator as necessary, not principally as a decision maker/arbitrator but in order to ensure there are processes and procedures for consultation and the necessary two-way flow of information between the airport operators and the airlines.” (para 26)

<sup>47</sup> The CAA emphasised that “if it were to have been drawn into individual disputes, during the process of negotiation, its involvement would have undermined that process and risked unravelling a complex set of compromises and agreements.” (*BAA Airports Market Investigation*, para 7.30) My impression is that in the US and Canadian jurisdictions where negotiated settlements work well, there is a clear view that it is *not* considered helpful for the regulator to ‘monitor what is going on’ and act as arbitrator.

determining the financial issues itself (including opex efficiency, cost of capital, RAB and the price control itself).

The Quadripartite Working Groups might be a useful vehicle for such discussion and agreements. The Groups are designed to incorporate the four main interested parties (plus WAG in Wales) and to involve other parties as appropriate (such as Natural England). It is for consideration whether the precise membership and constitution of the Groups would need some revision if there were a clear target of constructive engagement, but the Groups already exist and they may be a sensible place from which to start the evaluation.

The price control review process incorporates provision for Government guidance.<sup>48</sup> The local representatives of EA and DWI would obviously need to ensure that proposals to which they signed up would be acceptable to their relevant national authorities. This could be an organisational challenge for them initially, but their present internal processes already need to ensure that their ultimate position combines both local and national views.

Would Ofwat wish to encourage constructive engagement in this way? The CAA saw advantage in encouraging it because it meant “improved information and inputs, less intrusion on commercial issues, a more focused regulatory role and better decisions”.<sup>49</sup> Ofwat has previously encouraged parties to agree on plans to deal with sewer flooding and has indicated an openness to new approaches in future. This precedent might be extended. Investment plans generally could be better tailored to local conditions and there could be greater innovation. Getting prior agreement of quality regulators to company Business Plans could shorten the regulatory process and reduce uncertainty. The general approach seems consistent with the Better Regulation precepts of reducing regulation where appropriate. To the extent that customer groups and quality regulators agreed investment programmes this could reduce the presentational burden on Ofwat. Importantly, Ofwat would retain control over the process.

There could be a resource advantage to Ofwat. Although Ofwat itself considers it has enough resources available to it, several parties seem less convinced. Any reduction in Ofwat’s regulatory burden with respect to the price control review could free up resources for other tasks, notably the increasingly important competition issues.

Ofwat would obviously need to satisfy itself that the contents of each company’s Final Business Plan (or such part of it as is covered by constructive engagement) is consistent with Ofwat’s statutory duties and with any Guidelines laid down by Government, Ofwat or other relevant regulatory authorities. Ofwat would want to assure itself that all or most relevant parties had participated in the negotiation and had accepted the agreement. In view of the Competition Commission’s concerns, it would want to ensure that all parties had access to all relevant information, and perhaps the agreement should extend to price. Ofwat would want to take into account any comments or opposition expressed by others not party to the agreement. It would

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<sup>48</sup> Notably the Water Strategy and Social and Environmental Guidance issued in February 2008 for PR09.

<sup>49</sup> Harry Bush, presentation op. cit. slide 18.



of course retain the ability (and the duty) not to accept any agreement that it considered inconsistent with its statutory duties or declared policy in any area.

Would the various other parties be interested to participate in this way? Experience in the UK and overseas is that they generally welcome the chance to do so. Parties are thereby better able to ensure that their objectives are better achieved and with less vulnerability to regulatory and other risks. There is increased certainty about the investment programme because it is negotiated and agreed, compared to the relative uncertainty of the company Business Plans and regulatory Determinations. There is also the advantage – to companies and to quality regulators - of being able to demonstrate wide and committed support for the proposed investment programme and associated service provisions.

Constructive engagement could help to resolve issues where views might differ. For example, while endorsing CBA in general, all parties have expressed some reservations about its detailed or mechanical application. If the parties in the Quadripartite Groups were able to discuss these aspects and explore alternative options together then a more flexible and rounded approach would seem to emerge naturally.

Is it plausible that the parties would reach agreement on all or most of these issues? Are there what one correspondent called “overlapping zones of comfort” between the parties? Put another way, are there gains from trade between them?

The issues identified by CAA seem to correspond closely to the kinds of issues that the parties are discussing in the Quadripartite Groups at present.<sup>50</sup> Some correspondents have suggested, indeed, that this is nearly where the present arrangements lead, or could do so relatively easily. Ofwat has already indicated its expectation that the companies will consult with the other parties.<sup>51</sup> It has yet to add a commitment to heeding this in its Determinations, as the CAA has done.

## 10. Negotiated settlements in US and Canada

In proposing constructive engagement, the CAA allocated certain tasks to the parties and retained others for itself, using both processes as inputs to its final decision. Such an approach only partly addresses the regulatory concerns mentioned above. For example, the regulatory assessments of opex, cost of capital and financing considerations, and the setting of the overall price control, remain largely as before.

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<sup>50</sup> More specifically, the Groups are discussing factors determining the growth of the water and sewerage networks, the DG indicators of service levels, the scale and pace of delivery of drinking water quality and environmental improvement programmes and whether cost benefit shows that these deliver value for money or could be modified to facilitate this, and the nature and scale of the investment programme including the above plus routine maintenance. The Groups are not discussing efficiencies and incentives associated with the investment programmes, or non-regulated revenues, or opex benchmarking.

<sup>51</sup> “We expect each company to put forward a consumer-focused and consumer-supported strategy. Each company must demonstrate this through consulting with consumers and discussing their priorities with the Consumer Council for Water (CCWater), the Environment Agency, Drinking Water Inspectorate (DWI), Natural England or the Countryside Council for Wales, and other stakeholders.” Ofwat, Setting price limits 2010-15, 2007, p. 9.

And, as the CAA noted, the lack of focus on the implications for price seems to have inflated the capex programme.

In the US and Canada, by contrast, user groups and utilities have taken the initiative. They typically (though not always) begin negotiations during the course of a rate hearing, after the written statements have been presented and cross-examined but before the formal hearings begin. The settlements usually cover pricing and may also cover investment and other issues.<sup>52</sup> Typically the settlements are accepted, obviating the need for a formal hearing and regulatory decision other than to adopt the terms of the settlement.<sup>53</sup>

This has been the normal approach for some years for some issues at the Federal Energy Regulatory Commission.<sup>54</sup> Gas pipelines and a wide range of interested parties typically negotiate a variety of issues including cost of service, rate design, capacity turnback and service restructuring.<sup>55</sup> The process is more flexible and innovative than traditional litigation. The settlements typically include rate moratoria and/or must-file provisions (not available to the regulatory commission), thereby providing efficiency incentives coupled with the ability to reassess the issues after a specified period of years.

In Florida, the Office of Public Counsel (the state-established consumer advocate) has taken the lead in negotiating settlements (often called stipulations) on behalf of consumers, often in conjunction with user groups. Utilities range from larger ones such as Florida Power and Light and Southern Bell to many smaller ones. The settlements typically provide one-off refunds or rate reductions and rate freezes for a specified period of years. Several four-year settlements have been repeated. Provisions have also included approval of new generation plant. Settlements have effectively replaced traditional rate of return regulation, and superceded later earnings sharing schemes with profits caps, by 'revenue-sharing incentive plans': agreements that fix prices for specified periods of time with stronger and more enforceable revenue-sharing arrangements in the event of (e.g.) unexpected demand increases.

At the Canadian National Energy Board (NEB) participants include all eight oil and gas pipelines plus relevant producers, shippers and consumers.<sup>56</sup> Settlements have been used to determine prices, operating and capital cost projections, return on equity,

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<sup>52</sup> The parties are not called upon separately to comment on or evaluate this agreement. The settlement agreement may indicate why the agreement meets the needs of the present situation and/or is in the interest of customers and the parties involved.

<sup>53</sup> For a short overview of these approaches, see my article "Let's talk", *Utility Week*, 2 May 2009, pp. 20-21. More extensive summaries are forthcoming in "Some alternative approaches to utility regulation", *Economic Affairs*, September 2008, and "Some applied economics of utility regulation", *Energy Journal*, September 2008. My research papers on experience in Argentina, Florida and Canada are available at <http://www.electricitypolicy.org.uk/pubs/index.html>.

<sup>54</sup> Zhongmin Wang "Settling utility rate cases: an alternative ratemaking procedure", *Journal of Regulatory Economics*, 26 (2), September 2004, 141-163.

<sup>55</sup> The interested parties or intervenors include ratepayers (direct and indirect customers including local natural gas distribution companies, industrial, electric and commercial gas users, and gas marketing companies) and non-ratepayers (including state public utility commissions, competing pipelines and potential customers).

<sup>56</sup> Doucet, J and S C Littlechild. "Negotiated settlements and the National Energy Board in Canada", Electricity Policy Research Group Working Papers, No. EPRG 06/29, November 2006. Cambridge: University of Cambridge at <http://www.electricitypolicy.org.uk/pubs/index.html>.

service quality improvements and information requirements. Settlements were the vehicle by which multi-year incentive agreements developed rapidly for all pipelines. In addition, from 1996 to 2001 parties have settled about one quarter of the 120 electricity and gas rate cases at the Alberta Energy and Utilities Board. Some of these settlements have been quite innovative: for example, a regulated rate option to encourage efficient purchasing and pricing by an electricity utility as the market opened to competition.

#### 11. Negotiated settlements in the water sector?

Reflecting practice in the US and Canada, it would be open to the parties to begin discussions at any stage during Ofwat's price control review process. A natural time might be after the companies had published their Strategic Direction Statements and Draft Business Plans (in PR09 the latter would be in August 2008), although one correspondent suggests that a main advantage of settlements would be a more collegiate approach to the development and assessment of the Draft Plans. It would be prudent to take into account Ofwat's comments to each company (scheduled for October/November 2008). The aim would be for all parties to discuss the Draft Business Plans and comments, and attempt to agree a Final Business Plan to put to Ofwat in April 2009.

The attitude of Ofwat will of course be critical. If Ofwat were able to indicate that it would normally expect to be able to accept an agreed settlement put to it by the Quadripartite Group, this would considerably facilitate the development of settlements. If Ofwat were not interested or even hostile, the parties would have little or no incentive to seek such agreements, and greater incentive to target their arguments and complaints at Ofwat.

Experience suggests that 'cherrypicking' by the regulator is fatal. The Canadian NEB accepted all the elements of two initial settlements except the agreed rate of return, and this delayed the further development of negotiated settlements in the Canadian energy sector by nearly a decade. The deadlock was broken by the NEB issuing a revised set of Guidelines. These declared, in essence, that if all interested parties had an opportunity to be involved in a settlement, if there was no opposition to the settlement, and if it was not inconsistent with the relevant Act, then the NEB would normally be able to conclude that the settlement was acceptable. As noted, the CAA has used a comparable form of wording to encourage constructive engagement, albeit only on prescribed issues so far.

It may seem ambitious to attempt to negotiate the whole of a price control. Against that, the Competition Commission identified a lack of focus on price as a concern about constructive engagement. Looking at the whole picture would reduce the scope for subsequent complaint and provide additional 'degrees of freedom' to facilitate agreement on other issues. The main issues that would require to be dealt with, over and above those involved in constructive engagement, would be the companies' operating costs and scope for efficiency improvements, the allowed return on capital, and the tailoring of the price control to reflect the financial and other needs of the companies. These would seem to be issues of prime concern to CCWater and the companies, rather than to EA and DWI and Natural England. It would be for the parties to decide whether the Quadripartite Working Group would be the most

appropriate vehicle for discussions and agreement on all these issues. Perhaps they might establish sub-groups working in parallel on the two sets of issues.

Would CCWater have the staff and expertise adequately to challenge the companies (and for that matter the quality regulators) on opex, cost of capital and other financial issues? Could it properly appraise the implications for companies and customers? Would it have the same degree of overview as Ofwat has? Could it take fully informed decisions on behalf of customers?

Elsewhere, various different ways have been established to ensure that the parties have the necessary expertise, including in-house resources, consultancy, information-sharing, etc.<sup>57</sup> I understand that EA is already assisting Ofwat in the appraisal of company plans, so could similarly assist the other parties. CCWater is already engaging with the water companies' Reporters to better understand their scrutiny and challenge of the companies' business plans. If necessary Ofwat could be obliged to make its data available under the Freedom of Information Act, but Ofwat's presumption already is that it will publish most of the data it receives from companies. It also makes some of its consultancy research available to the parties. Access to this information might need to be speeded up in order for it to be helpful in a negotiation process.

In this way CCWater could seek to attain an overview of companies across the whole sector, and could engage in the kind of efficiency comparisons that Ofwat presently does, without an overlap or duplication of costs and preparation on the part of companies or other parties. If necessary the interested parties could jointly fund additional consultancy appraisals.

Whether CCWater would want to approach the issue in the same way as Ofwat is another matter. Negotiations elsewhere tend to be more company-specific, with less weight on detailed analysis and comparisons, and with more emphasis on finding a mutually agreeable package of outputs, services and prices in the particular circumstances of each company. Traditionally, CCWater has asked different questions than Ofwat has, and questions whether the approach would need to be as information-intensive as at present.<sup>58</sup>

This is an important issue. Many parties expressed a worry that an alternative approach might be more resource-intensive rather than less.<sup>59</sup> For this reason, consistent with the precepts of Better Regulation, a key aim should be a net reduction in the burden of the price control process and a withdrawal by Ofwat from detailed involvement.

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<sup>57</sup> In Florida the Office of Public Counsel has built up the necessary in-house expertise plus a consultancy budget. In Alberta and New York the regulator allows intervenor parties to claim for their expenses in providing relevant evidence. As part of the CAA's constructive engagement process, BAA found it helpful to pay for the airlines to have technical consultants, to facilitate informed discussion on the cost of the elements of an airport expansion programme.

<sup>58</sup> "Does the package of proposals on offer satisfy customers' priorities and requirements and meet their willingness to pay? Could we introduce new mechanisms that would smooth the process, enable companies to take a much longer term view yet ensure that consumers' interests are protected by appropriate mid-term reviews?"

<sup>59</sup> "Is there a danger of simply creating a local bureaucracy and a multiplicity of mini-Ofwats?"

Cost of capital is sometimes cited as an issue where even well-informed parties might find it difficult to agree.<sup>60</sup> There are different ways of handling this. In Florida the settlements agree rates (prices) or annual revenues for a forthcoming period of time but they do not require the parties to determine and agree a cost of capital or allowed return on equity.<sup>61</sup> In Canada the NEB has determined a formula applicable to all the pipelines (with some adjustment for company size and capital structure). Each year the NEB announces the parameters of the formula, so that the parties know what cost of capital the NEB will use in the event that they are unable to agree a settlement. In practice, the users sometimes agree a small margin over this base rate in return for exceptional quality of service or other provisions. In the UK, it has been suggested that cost of capital be determined independently of the individual sector regulators, perhaps under the auspices of the Competition Commission.

Any of these approaches could be applied in the water sector. Or the parties might agree the revenue for the new assets without explicit reference to cost of capital. Or they might choose to use a cost of capital that Ofwat determines for the existing assets (whether this is set ex ante or ex post). They might agree a slightly higher rate in return for various products or services provided by the utility (see below), or a slightly lower rate in order to make affordable a larger new investment programme.<sup>62</sup>

What about monitoring and enforcement of any agreements made between the parties? In general this has not been a problem elsewhere. Once accepted, the agreements are simply adopted by the regulatory bodies.<sup>63</sup> It would be open to the parties to agree how to treat (e.g.) disputes over revenue-sharing or the implementation of agreed investments. Ofwat would not need to commit to anything with which it would feel uncomfortable.

## 12. Settlement of other issues

A typical price control covers a wide variety of issues on which opinions differ. For the most part, Ofwat has to take a view and prescribe a uniform approach for all companies. Negotiated settlements would enable the parties to agree different approaches if that seemed to them more appropriate for their particular circumstances. We may illustrate with some of the options in the present review process.

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<sup>60</sup> This is as true in the water sector as elsewhere. For example, CCWater has been concerned about the unduly high cost of capital in PR04 while the companies, in contrast, are concerned that Ofwat envisages a considerably lower cost of capital in PR09. Philip Fletcher, City Briefing, 6 November 2007. Some have observed that Ofwat itself is not to be regarded as infallible in price control matters (e.g. with respect to cost of capital and information reporting) and therefore an alternative approach is not to be judged against a standard of perfection.

<sup>61</sup> In Florida, the later agreements typically provide for a reopener if the company's achieved return on capital falls below a specified minimum level, but they explicitly state that there is no maximum return on capital, and that any concerns on that score are dealt with by an agreed and specified revenue-sharing arrangement with customers.

<sup>62</sup> It is for consideration whether the agreement provides for the new investment to become part of the existing asset base at the end of the five year period, and is henceforth subject to charge determination by Ofwat unless otherwise agreed. (This is analogous to the procedure in Florida.) An alternative is that the agreement could determine the revenue associated with the new assets until the end of the new asset lives. (This is analogous to the procedure in Argentina, where the cost of the proposed new investment is determined by putting it out to tender with repayment over a specified period of years.)

<sup>63</sup> The precise process in the UK would of course need to take account of the duties and responsibilities of the regulators, and the statutory instruments available for implementation.

(a) Indexation of the cost of debt

Ofwat has mooted indexation of the cost of debt.<sup>64</sup> Companies may be apprehensive because historically they have benefited from falling cost of debt. CCWater is concerned because customers might not always benefit from it, they might not understand the principle, and many customers value stability in pricing as it allows them to budget.<sup>65</sup>

This seems the kind of issue that companies and customer representatives could usefully explore. Indexation may reduce the risk to both parties. It should be possible to separate the impact on total allowed revenue from the impact on individual customers. In recent years electricity and gas suppliers have offered a choice of terms: some prices vary at a few weeks' notice, others reflect 'price guarantee' tariffs that cap the prices for several months or years ahead.<sup>66</sup> It would be open to the parties to examine and agree more stable tariff options for (e.g.) vulnerable tariff customers. Settlement would allow the parties to come to potentially different views from one company to another rather than have Ofwat determine one uniform approach.

(b) Menu regulation and benefit sharing

Ofwat has tended to favour an RPI-X approach in order to provide strong incentives to operate efficiently. The resulting level of profits depends critically on the assumptions made in setting the control. Ofwat seeks to incentivise companies to submit accurate business plans (and not to 'game' the process). To that end it proposed a form of 'menu regulation'. Several parties felt that the proposal lacked clarity and might be problematic. Since then Ofwat has revised its proposal and rebranded it as the Capital Incentive Scheme.

CCWater argues that "regulators tend to err on the side of caution, with the result that the balance between risk and reward is usually in the companies' favour. It is for this reason that we continue to question whether there should be a mechanism for customers to share early the benefits from outperforming regulatory assumptions."<sup>67</sup> Companies might respond that there are fewer financial incentives for water companies and more financial penalties.<sup>68</sup> Ofwat might argue that any sharing of benefits would need to be in both directions: if companies have to share unexpected profits or revenues then customers would have to share unexpected losses or costs.

Negotiated settlements between companies and other parties including consumer representatives would provide an alternative approach. It would be possible for the

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<sup>64</sup> Ofwat, Setting price limits, p. 50; Regina Finn, City Briefing, 6 November 2007.

<sup>65</sup> CCWater response, February 2008, para 79.

<sup>66</sup> Domestic Market Retail Report June 2007, Ofgem 169/07, 4 July 2007, pp. 13-14. As of March 2007 over 6 million product accounts, around 13 per cent of the residential gas and electricity market, were on such 'price guarantee' tariffs.

<sup>67</sup> CCWater response, February 2008, para 25, also paras 74-77.

<sup>68</sup> In reply, CCWater would note the favourable cost of capital assumptions, argue that companies always out-perform under the rolling incentives mechanism re opex efficiency and that at PR04 17 out of 22 companies achieved a positive adjustment under the overall performance assessment. It would see Ofwat's proposed policies for PR09 (e.g. revenue correction mechanism and capital incentive scheme) as geared to maintaining water companies as low risk investments.

parties to agree, inter alia, how any benefits are to be shared in the event that the costs of a particular project can be reduced or deferred. Rather than simply fix allowed revenue for the whole period, the parties might agree some trade-off between allowed revenue and sharing any benefits that are higher than expected. This has been a common component of negotiated settlements in Florida. Indeed, settlements provided a vehicle whereby different methods of benefit-sharing were tested out over time. The presently-preferred arrangement there (revenue-sharing) evolved from the one that the regulatory body initially chose (earnings or profit-sharing), which Public Counsel found to be problematic with respect to allocation of costs and calculation of profits. Importantly, the preferred solution might differ from one company and consumer group to another. Over time, the different experiences could be drawn on in setting future controls.

#### (c) Renewable energy

Ofwat takes the view that, if a renewable energy scheme is economic but not a direct by-product of its core business, a company should be willing to adopt it outside the regulated business.<sup>69</sup> CCWater suggests that wherever possible energy used in treatment processes should be obtained from renewable sources, and that Ofwat should remain open to proposals from companies and should treat each case on its individual merits.<sup>70</sup> This is an issue on which companies and CCWater could seek to agree, with possibly different outcomes from one company to another. The inclusion of commercial consumers in the negotiating team could help to reassure those concerned about the economic nature of such investments.

#### (d) Tariffs

Views on tariffs seem to vary from one region and one company and one individual to another. In responding to Ofwat's Framework and Approach document, CCWater has noted a variety of concerns about the proposed approach. Many of these focus on the way in which the allowed revenue might be translated into prices to customers, rather than (or as well as) on the aggregate level of allowed revenue. Examples include

- the affordability and distributional impact of price increases
- the potential impact of metering on unwinding historic cross-subsidies that might impact adversely on lower income customers
- the need for innovative tariff structures as part of demand management strategies.

At present, Ofwat does not prescribe the tariff structure. Rather, companies make a case to Ofwat, and may be allowed to proceed depending on the strength of the case and any general concerns that Ofwat has (e.g. about avoiding cross-subsidy). CCWater argues that consumer research suggests that any social tariffs should be financed by government rather than by other customers. Some companies, at least, are conscious of the need to avoid complex tariffs and wish to work closely with CCWater to develop tariffs that consumers will find acceptable in what will be a rapidly changing environment.

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<sup>69</sup> See Ofwat's recent letter PR09/14

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/ltr\\_pr0914\\_tmtrenewenerg](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/ltr_pr0914_tmtrenewenerg)

<sup>70</sup> CCWater op cit, Paras 35-38.

Agreements between the parties may provide a way ahead here. It would be open to the parties to discuss such issues and agree solutions, either separately from the investment programme and allowed revenue or as an integral part of these aspects. Flexibility or innovation by the company with respect to tariffs could also be traded off against approval of other projects or services of particular importance to one party or another, within the general framework set by Ofwat and the quality regulators.

#### (e) Competition

Ofwat's present policy is to facilitate competition, including by vertical separation. Does this preclude constructive engagement and negotiated settlements? It should not do so. There will need to be regulation of the constituent separate businesses, and a wider range of vertically separate businesses means that a wider variety of regulatory approaches will be appropriate. In addition, with more players involved including customers and competitors, the greater is the advantage from enabling them to participate in negotiations rather than leaving all the decisions to Ofwat.<sup>71</sup> It has also been put to me that competing retailers are likely to have better knowledge of customer preferences than is a regulator of a monopoly business.

Experience elsewhere shows that negotiated settlements are viable at many different stages of the vertical chain. In Florida, the settlements have typically been with respect to 'base rates', including network investment and excluding fuel costs that are treated on a pass-through basis. In Alberta, by contrast, the innovative settlement mentioned above effectively covered such 'non-base' costs in the supply business.

It is not impossible that the parties themselves could help to negotiate the transition to competition. There is a precedent insofar as users of a British Columbia pipeline designed a whole framework of light-handed regulation and negotiated a shift to that framework as the market there became more competitive. However, it may be premature to expect this in the water sector if competitors have not yet emerged, and without prior experience of negotiated settlements.

Would all this mean unacceptable variation in price controls and subsequent outcomes from one company or region to another? In general there would be more variation in outcome than with the present process, but this would be by mutual agreement and would be a benefit. It would better reflect local circumstances and concerns, and it would be conducive to more innovation and learning in terms of technologies, policies and regulatory ideas.

### 13. Concerns about customer representation and CCWater

One central concern has been frequently expressed. Are there appropriate counterparties in the UK regulated sectors to negotiate with each regulated company?

<sup>72</sup> Specifically, in the present case, does CCWater adequately represent all water

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<sup>71</sup> C.f. the recent argument for competition as a discovery process in the water sector. Competition in the Provision of Water Services, by George Yarrow and colleagues, Regulatory Policy Institute, April 2008.

<sup>72</sup> "The most obvious problem with the 'negotiated settlement' or 'constructive engagement' models ... is that there is no obvious counterparty with which the network operator can conduct the negotiation.



customers and does it know what they want? Does it have the necessary legitimacy and expertise? Are its incentives sufficiently aligned to those of the final customer that negotiations with the companies can safely be delegated to it?

In favour of CCWater is that it is the body established by statute to represent customers. In one form or another it has done so in practice for many years and continues to do so. It would be willing to discharge its statutory remit by participating in the kinds of constructive engagement or negotiated settlement under discussion here. Its proposal of Quadripartite Working Groups reflects its experience of a limited but successful foray in that direction in PR04. It is keen to discover and represent the views of customers, and has always stressed the need for consumer research, and for its representatives to be guided by that research. In my experience, the members of such consumer bodies are generally honest, conscientious, diligent and fair-minded.

Having said all this, there nevertheless seems a strong case for inviting the participation, in tandem with CCWater, of actual customers who pay water bills. These might be individual large consumers, or representatives of business and commercial users (such as the Major Energy Users Council or local Chambers of Commerce). In addition, APPWG has suggested (p. 39) that the Government look at how local authorities can have a meaningful role in the development and determination of the price review, which could include their role as major consumers.

Some have questioned whether CCWater would accept that companies have to make reasonable profits. Would it be willing to accept the level of profits that might follow from an incentive regulation scheme designed to improve efficiency over the longer term? CCWater has emphasised that it is not against companies making reasonable profits but is against them making excessive profits (e.g. as a result of windfalls) and not sharing these with customers. Experience elsewhere is positive: the Office of Public Counsel in Florida and the companies together designed revenue-sharing incentive schemes to overcome concerns about excessive and windfall profits.

Would CCWater be willing to agree to price increases, which the Office of Public Counsel has admittedly found difficult? In this respect the UK situation may be easier than in Florida. UK water prices have been increasing for the last two decades in order to maintain and improve quality, and customer research shows that a majority of customers accept this.

With respect to both prices and profits, it is always open to a company or any other party to decline to enter an agreement if it is unable to agree a settlement. In that case Ofwat would make its determination as at present. So there is no point in any party taking an unrealistic approach that would be inconsistent with the likely thinking of Ofwat and ultimately the Competition Commission (which resolves the issue in the event of the company not accepting Ofwat's final Determination).

Airlines and shippers have been negotiating with airports and pipelines for many years. Would non-commercial parties and public bodies have the same ability and incentive to negotiate realistic agreements in a timely way as commercial parties

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... It is not clear who the counterparty is whose incentives are sufficiently aligned to the final customer." Philip Burns, *The X factor*, *Utility Week*, 2 May 2008, pp. 18-19.

have? As one party put it, would representatives of water customers have enough skin in the game? This remains to be seen, but the fact is that the Office of Public Counsel in Florida has repeatedly negotiated tough and timely agreements over the last two decades. And the inclusion of commercial customers should facilitate the negotiating process in the water sector here.

#### 14. Conclusions

In many respects, price control reviews in the England and Wales water sector have learned from experience and evolved to address the concerns of the parties involved. There is widespread support for putting the interests of consumers at the heart of the present price control review. Ofwat has taken steps to encourage a dialogue between interested parties at various stages of the review, not least with respect to Strategic Direction Statements, consumer research and CBA. CCWater has initiated Quadripartite Groups to coordinate discussions locally and to help to integrate the views of customers. Companies themselves are carrying out and analysing their own consumer research. These steps all promise more informed discussion and more customer-sensitive approaches.

Nonetheless, despite its many advantages and achievements, UK regulation has both advantages and limitations. Though flexible in some respects it is inflexible in others. It has difficulty understanding and responding to differences in local conditions. It does not allow real consumers or their representatives to make critical decisions. It devalues the relationship between companies and customers. It has become rather burdensome particularly with respect to price control processes. And even with the sophisticated process of consumer research and discussion in PR09, it is ultimately for the companies to propose Business Plans and then for Ofwat alone (within the constraints of quality regulation) to make the Determinations for all the companies.

Experience elsewhere suggests that there is advantage in encouraging consumer groups and other parties involved to enter into discussion, and where possible to come to agreement with companies that as far as practicable meet all their legitimate requirements. The elements of a few such agreements seem to have been reached in PR04, on a few relatively small issues, which persuaded Ofwat to take a different view in its final Determinations compared to its draft Determination. Ofwat has also indicated its openness to new approaches. The time now seems ripe to enable such agreements to emerge on a larger scale, and to play a more explicit role in influencing all Ofwat's Determinations.

Several reservations have been expressed, and need to be addressed. The first is whether CCWater adequately represents the interests of all customers. This could be remedied by seeking the involvement of actual customers or their direct representatives. Arguably that might be a prerequisite for proceeding. A second concern is the ability of consumer groups to appraise, analyse and challenge the costs and benefits involved. In practice, various ways have been used to provide the necessary information or resources, so this should not be an obstacle. A third concern is to reduce rather than increase the resources consumed by the price control review process. This may need some commitment by Ofwat and the other parties involved. A fourth concern, expressed by the Competition Commission, is to ensure that the parties have adequate information on which to base their negotiations.

Ofwat could encourage a greater involvement of customers, if it wished to do so. Following the approach of the CAA, it could express its support for constructive engagement in the water sector, indicating those issues where it would hope the parties would discuss and agree, and those other issues where Ofwat itself would expect to take decisions. Alternatively, or as well, it could indicate its willingness normally to accept settlements of price control issues agreed by the parties, perhaps under specified conditions. In doing either of these, Ofwat would not and indeed should not abandon its statutory duties.

There is a wide spectrum of issues on which agreement might be encouraged or sought, some of which will be more conducive to agreement than others. And agreement might be easier in certain regions or with certain companies than with others. But the success of the approach does not depend on achieving agreement on every issue or with every company. Nor does it depend on any change in legislation, although it would be straightforward for the government to encourage such approaches if it wished to do so.<sup>73</sup>

Some fear that Ofwat would be reluctant to relinquish control. However, Ofwat has indicated its openness to doing things differently in future. There also seems to be a preference for a more responsible role for companies and customers and a correspondingly reduced role for regulation.<sup>74</sup> The prize for Ofwat, and for others, would include a significant step in this direction. It would facilitate deregulation, the better tailoring of regulation to local conditions, greater certainty yet greater flexibility and innovation, the freeing up of regulatory resources for other tasks, greater responsibility on the part of companies, and the prospect of improved relations within the industry, its customers and its several regulatory bodies. It therefore seems worth exploring further the possibility of constructive engagement and/or negotiated settlements in the England and Wales water sector. And, for that matter, in the other utility sectors too.

## **Annex The regulatory structure of the water sector in England and Wales**

The water sector in England and Wales presently consists of 10 relatively large combined water and sewerage companies and 11 smaller water-only companies, the latter mainly in the south-east. (Mergers have reduced the number of companies from a total of 39 at the time of privatisation in 1989.) The industry body is Water UK.

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<sup>73</sup> The Alberta Energy and Utilities Board has a statutory duty to “recognize or establish rules, practices and procedures that facilitate negotiated settlement”. It would be straightforward to add such a duty to the existing duties of the utility regulators in the UK. It seems eminently consistent with the concept of Better Regulation.

<sup>74</sup> See the recent interview with Ofwat chief executive Regina Finn. “Question: If you could change one thing in the financial and commercial environment, what would it be? Answer: To see companies take responsibility for delivering excellence for their customers, instead of looking to regulators and government to tell them what to do.” *The Times*, Business: Monday Manifesto, July 21 2008, p. 45.

The Water Services Regulation Authority (WSRA, still known as Ofwat) is the economic regulator of the water and sewerage sector in England and Wales. Its current ‘strapline’ summarises its role as “protecting consumers, promoting value and safeguarding the future”. It directs the price control review and consultation process and determines the allowed revenues of each company (subject to appeal to the Competition Commission). It also has other responsibilities, including encouraging competition where appropriate. It has nearly 190 staff and a budget of nearly £18m.

Throughout the review process, Ofwat must work with quality regulators, namely the Environment Agency (EA) and the Drinking Water Inspectorate (DWI), and government, principally the Department for the Environment Food and Rural Affairs (Defra) and the Welsh Assembly Government (WAG). Government ministers determine the policy framework for the sector and make final decisions on the drinking water quality and environmental quality standards.<sup>75</sup> DWI and EA make submissions to ministers on the scale, scope and pace of the quality programme. Ministers take advice from Ofwat on whether the proposed programme is affordable. There is a separate but parallel exercise with WAG and the two Welsh companies. Other contributors to the review process include the Cabinet Office, Treasury, Natural England<sup>76</sup> and the Consumer Council for Water (CCWater).

The Environment Agency (EA) is “the leading public body for protecting and improving the environment in England and Wales”. It has about 12,000 staff and a budget of almost £900m. Around 60 per cent of its funding comes from government, most of the rest from various charges schemes. It has a head office split between London and Bristol, 8 regional offices and 22 area offices.

The Drinking Water Inspectorate (DWI), set up in 1990, is responsible for assessing and enforcing the quality of drinking water. It has about 35 staff and a budget of £2.4m. It works closely with Defra (Water Services Regulation) and WAG who provide the policy on drinking water quality and co-ordinate departmental and government input to the process in that area.

From privatisation, consumers were represented by Customer Service Committees appointed by the Director General of Water Services (the head of Ofwat). In response to the Water Bill 2001, Ofwat reconstituted the committees in April 2002 as a transitional and autonomous part of Ofwat known as WaterVoice. In October 2005, following the Water Act 2003, WaterVoice formally became the Consumer Council for Water (CCWater). CCWater’s duty is to represent customers of water and sewerage companies in England and Wales and provide a strong national voice for customers. It has four regional committees in England and a committee for Wales. It has seven local offices across England plus one in Wales. It has about 80 staff and a budget of just under £6m. BERR has indicated an intention to consult on whether CCWater should be subsumed into the new National Consumers’ Council, recently rebranded as Consumer Focus.

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<sup>75</sup> Statement of Obligations. Defra, December 2007.

<sup>76</sup> Natural England was formed by bringing together English Nature, the landscape, access and recreation elements of the Countryside Agency, and the environmental land management functions of the Rural Development Service. It has about 2320 staff and a budget of about £233m. The corresponding organisation in Wales is the Countryside Council for Wales (CCW).