

Ofwat's
Annual Report

2005-2006



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For the period 1 April 2005 to 31 March 2006

Presented to Parliament in pursuance of section 192B of the Water Industry Act 1991

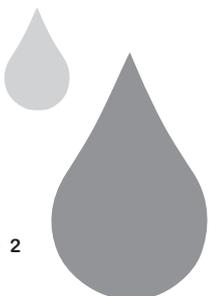
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Contents

Review of 2005-06	4
1. Paying for water	7
2. Preparing for the WSRA	10
3. Monitoring companies' activities	12
4. Regulatory information	19
5. Market competition	22
6. Protecting customers	26
7. Communicating with stakeholders	31
8. Managing Ofwat	35

Appendices

1. Forward programme milestones	41
2. Companies	43



To

Rt Hon David Miliband MP

Secretary of State for Environment, Food and Rural Affairs

and

Rt Hon Rhodri Morgan AM

First Minister

I am pleased to present my report on our work for the year ending 31 March 2006 and my last as Director General of Water Services.

Following the price review in 2004 the focus of our work in the early part of the year was on approving companies' charges schemes and explaining to customers why their bills had to rise. The level of the price limits meant that we saw a significant increase in the numbers and complexity of complaints about bills.

In the summer the independent steering group chaired by John Baker published its report. We were pleased that the group found a high level of satisfaction with the way we carried out the review and that by and large we had met our objective of being transparent and open. Where the group identified areas that we needed to improve we are following up on its recommendations.

The drought in the south-east of England that began in the winter of 2004-05 and has continued through 2005-06 presents a challenge to all those involved in the provision of water services to customers, including Ofwat. We welcomed the establishment of the Water Saving Group, by Elliot Morley, and look forward to playing our part in responding both to the short-term problems and the long-term implications of climate change.

Over the year we have investigated the allegations made about the way in which Severn Trent Water handled its accounting and regulatory returns. Southern Water notified us of irregularities in the reporting and handling of customer enquiries and complaints. We continue to investigate these irregularities. The quality of the information that companies supply is vital to our ability to regulate the industry. I expect the companies to operate high standards of corporate governance supported by rigorous standards of internal controls and I have been disappointed that we have had to undertake these investigations.

We have said goodbye to our colleagues who served WaterVoice and welcome the establishment of the new Consumer Council for Water.

This has been a year of change for Ofwat. I believe we are in a good position to meet future challenges under the direction of the Water Services Regulation Authority. I should like to record my gratitude to all Ofwat colleagues for their work in serving water consumers, and particularly to the non-executive directors on the Ofwat advisory Board.



Philip Fletcher



Review of 2005-06

Changing times

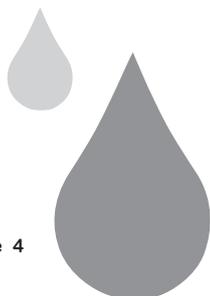
This is the last annual report that I will present as Director General of Water Services. From 1 April 2006 my duties as Director General became the responsibility of the Water Services Regulation Authority (Ofwat). As Chairman of the new Ofwat Board with my non-executive and executive colleagues I look forward to tackling in a corporate environment the challenges facing the economic water regulator for England and Wales.

We have been preparing the ground to enable the Board to take decisions on key issues in good time for the price review in 2009. For example, over the year we have been developing our thinking on how we meet our sustainable development duty. Following extensive investigative work by an in-house working group and an external workshop we issued our proposals for consultation in February 2006. We have also consulted on the time we should allow between price reviews from 2009 onwards. With Ofgem we issued 'Financing networks', which considers ideas for regulating the efficient financing of capital programmes.

2000-05

During the year we published our annual monitoring reports commenting on the progress that companies had made over the period. The industry continued to broadly deliver the outputs and outcomes we expected from it. Customers are now seeing the benefits of the large 2000-05 improvement programme.

Over the five years as a whole the industry outperformed the expenditure assumptions we made in price limits in 1999. Many companies said that these determinations were severe and too challenging. We are pleased that despite this the industry has been able to deliver on outputs and to outperform. For example, operating expenditure for 2000-05 was 2% or £255 million less than we had assumed in price limits. And total gross capital expenditure was £17.7 billion compared to the £19.4 billion we assumed, around 9% lower. This gives us confidence that the companies will deliver the outputs assumed in the price limits we set in December 2004.



Customers' bills

This was the first year of the price limits we set in December 2004. The average price limit for 2005-06 was 13.1% including inflation, an average increase in household bills of £29 (11.8% including inflation). The increase was higher than it will be in later years to adjust for past changes to companies' costs including energy and pensions. Such a steep rise in customers' bills is unwelcome. We made efforts to make sure that customers received good explanations as to why their bills had to rise and that we dealt carefully with the complaints that came to us. The bulk of customers' queries are appropriately handled by the companies and to a lesser extent by the Consumer Council for Water (CCWater). However, we did see a significant increase in the number that came to us.

The price limits we set meant that bills went up by no more than necessary following our scrutiny of each company's business plan. The price limits will allow each company to deliver the services customers require but only on the assumption that the company is efficient.

Market competition

The Water Industry Act 1991 (as amended by the Water Act 2003) also introduced a new competitive element to the industry. Since 1 December 2005, non-household customers likely to use at least 50 megalitres a year at eligible premises have been able to switch supplier to a water supply licensee.

We have worked closely with the industry to develop the new licensing regime. Companies and new entrants can apply for two types of licences. A retail licence authorises the holder to purchase a wholesale supply of water from an existing company and use its supply system to supply customers at eligible premises. A combined licence allows the holder to introduce water into an existing company's supply system and supply customers at eligible premises. There has been a lot of work over the year to develop a framework to allow this market to work properly. So far, four companies have been granted licences but none is supplying customers yet. We are pushing for progress on this.

Regulating the industry

We adopt the principles of good regulation in developing our policy and approach. We regulate at arm's length wherever possible. We provide incentives to companies to operate efficiently. It is for the companies to decide how they manage their activities and meet their obligations.

For us to regulate the industry the information that companies submit to us must be reliable, accurate and complete. We also expect every company to have high standards of corporate governance, including rigorous internal controls. We were therefore very disappointed by our preliminary findings for Severn Trent Water and Southern Water.

In our interim report into Severn Trent Water over the period 2000-04 we record that the company has agreed our findings and customers are being recompensed for the £42 million that they might otherwise have been overcharged by 2010. The company is improving its procedures and we expect to agree and place a penalty on the company once the Serious Fraud Office has completed its investigation into other issues. With Southern Water we continue to investigate jointly aspects of poor customer service at the company and have issued a financial penalty notice for one aspect of its failings. The company is committed to reimbursing any customers who have lost out.



Going forward

We are in a good position to meet the year ahead. Under the governance of the Board I look forward to continuing to develop the way in which the water industry is regulated. The water industry and its regulators face a challenging period. We are ready to play our full part in setting an appropriate regulatory framework for monopoly companies and new competitive entrants: demanding but not over-complex, and designed to promote a long-term constructive approach to the impact of climate change and our responsibility to contribute to the achievement of sustainable development. Our role is to provide the incentives for companies to deliver efficient services representing value for money for all their customers and consumers. In the immediate future we shall make our contribution to the challenge of drought in the south-east and contribute to the longer-term focus on water efficiency.

And looking back

I have very much enjoyed my time as Director General. Such success as Ofwat has had has been due to the professionalism and hard work of my colleagues, and to the essential contribution of stakeholders. I am grateful to all of them.

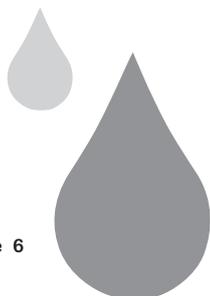
Over the past five years I have enjoyed the support of my non-executive advisory directors John Baker, Martin Cave, Jane May and Roger Munson. I am indebted to their unstinting commitment and challenge.

Bill Emery, a founder member of Ofwat, became Chief Executive of the Office of Rail Regulation in October 2005. I would like to pay tribute to the intellectual vigour that he brought to his role and to the immense contribution he made to the way Ofwat regulates.

This year saw the creation of CCWater in October 2005. We were sorry to see our colleagues from WaterVoice depart from Centre City Tower, but welcome the independence of CCWater. The year also saw the retirement of Roy Wardle, Head of Customer Representation, another of Ofwat's founder members, and I thank him for his work over the years. Thanks also go to Tony Smith, previously Director of Competition and Consumer Affairs, who is now Chief Executive of CCWater. We look forward to continuing to maintain a positive working relationship with CCWater whilst respecting its independence.



Philip Fletcher



Chapter 1 – Paying for water

Our price limits

In December 2004 we published our decisions on the price limits each company needed for each of the five years 2005-10. None of the companies asked us to refer their price limits to the Competition Commission for redetermination.

The average price limit for 2005-06 was 13.1% including inflation. This led to an average increase in household customers' water and sewerage bills of £29. With most household customers facing increases to their bills, our priority in the early part of the year was to support the work the companies do to explain why bills had to rise.

Independent review

We commissioned an independent steering group in December 2004 to examine the way in which we carried out the price review and to consider recommendations to improve the process. John Baker chaired the steering group. The other members were John Neilson, Gill Owen, John Smith and Peter Vass.

The review focused on the process we followed in setting price limits, not the actual decisions we made. The group appointed Accent to carry out market research on its behalf and the members of the steering group also met and interviewed a wide range of stakeholders. The group also sought the views of Ofwat staff and commissioned an independent audit of our processes.

The group published its findings in its 'Report into the conduct of the 2004 Ofwat periodic review'. It found a high level of satisfaction with the way we carried out the 2004 review, with most external contributors agreeing that it was a major improvement on previous reviews in terms of its transparency and our openness. We have examined the group's principal recommendations and have set out our responses in MD214. The Board will wish to examine these recommendations further and will take them into account in preparing for the next price review in 2009.

Informing customers about the level of their bills

To help customers understand why their bills were going up during 2005-10, and in particular why they were going up by more in the first year of the price limit period, we published a range of material. This included updating our bills leaflet, preparing a series of company-specific briefing sheets and developing the frequently asked questions section on our website. We also handled more than 650 written enquiries and complaints and 500 telephone calls about the increases.



Customers were unhappy about the level of the increases, but largely wanted either confirmation that their bill was correct or an explanation of why the increase was needed. Unmetered customers mostly contacted us before the summer but metered customers continued to contact us throughout the year, depending on when they received their first bill after the new price limits came into effect. We have asked the companies to warn customers in a timely way about price increases. We made sure that we had sufficient resources to handle queries from customers.

We set positive price limits to reflect the higher day-to-day running costs of delivering water and sewerage services, and the build-up of costs since the last review in 1999. The companies will deliver a substantial capital investment programme of around £16.8 billion over the five years to 2010 to:

- provide safe, reliable water supplies and sewage disposal;
- make the further improvements to drinking water quality and the environment sought by Ministers; and
- achieve significant reductions in sewer flooding.

Approving charges schemes

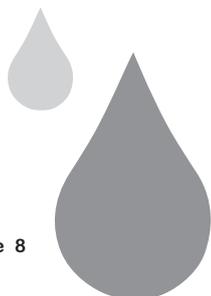
Within its overall price limit, each company sets its charges and publishes these in a charges scheme each year. To protect customers, we check and approve each scheme before it is published. Companies submit drafts of their charges schemes with their principal statements which set out their charges in detail. We scrutinise these to make sure that each company's charges:

- comply with its price limit;
- reflect its costs; and
- are consistent with guidance from the Secretary of State.

We consulted the CCWater regional committees on companies' charging proposals. We approved each company's 2006-07 charges scheme in February 2006.

Charges to vacant properties

We consulted water companies and customer groups on charges for customers with vacant properties. We wanted companies to find an appropriate balance between the costs of billing vacant properties and the principle that customers should pay for the services they receive. We concluded (in RD02/06, March 2006) that companies were already taking a broadly sensible approach, although there was still room for improvement in some cases. We described best practice and encourage companies to follow this.



Interim determinations

We can reassess a company's price limits between price reviews if its costs or revenues change materially in specific areas, an interim determination. Either we or the company may initiate an interim determination by following the criteria in the company's licence.

We wrote to the companies in May 2005 (MD203) setting out our approach to interim determination applications. In the event, none were triggered during the year.

Cambridge Water agreed a voluntary abatement of 1.3% of its price limits for 2006-07. This represents a share of the proceeds of land that the company sold during the year. Effectively, the voluntary abatement returned the same amount of money to customers, through lower charges in 2006-07 to 2009-10, as would have happened if we had initiated an interim determination.

Company rebates

Pennon Group plc, the owner of South West Water, announced its decision to increase the level of gearing in the regulated water and sewerage business to increase the efficiency of the Group's capital structure. As a consequence, the board returned £200 million to shareholders and gave a one-off rebate of £20 to each South West Water customer. Each customer's 2006-07 bill has been reduced by £20.

Dŵr Cymru Welsh Water is owned by Glas Cymru Cyfyngedig, which is a company limited by guarantee and not owned by shareholders. All financial surpluses are retained in the business for the benefit of customers. Instead of paying a dividend to shareholders, the company paid a rebate or customer dividend worth £18 to each of its customers in the 2005-06 billing year.



Chapter 2 – Preparing for the WSRA

Our corporate governance and leadership changed on 1 April 2006 when the Water Services Regulation Authority took over the statutory functions of the Director General of Water Services. In future, decisions will be taken by the Board.

We have been preparing for this change for some time. The first step was the transfer of responsibility for representing customers from WaterVoice, part of Ofwat, to the new and fully independent CCWater.

New duties

The Water Act 2003 has given us new duties effective from 1 April 2005. A new primary duty is to further the consumer objective by protecting the interests of consumers, wherever appropriate by promoting effective competition.

Throughout the year we have been finalising the development and implementation of the new water supply licensing regime. This was launched on 1 December 2005. Stakeholders worked closely with us at each stage of the process and we value their input. Our work is covered in more detail in chapter 5.

Other changes have included a new duty when exercising our functions to contribute to the achievement of sustainable development, on which we have launched a public consultation.

Ofwat Board

Philip Fletcher was appointed Chairman on 3 February 2006. This will be a non-executive part-time role once a Chief Executive has been appointed. The Board includes a majority of non-executive members.

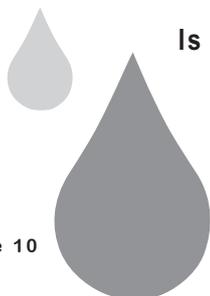
The Board members are Jane May, Lord Whitty, Penny Boys and Peter Bucks, who are all non-executive directors; Keith Mason, Director of Regulatory Finance and Competition and Melinda Acutt, Director of Network Regulation, and our Chief Executive when appointed.

We established a project team to help make the transition as smooth as possible. Our preparatory work has involved developing procedures to ensure good corporate governance and to keep our stakeholders informed about our decisions. We worked with the other economic regulators in developing our approach.

Our forward programme workshop for 2006-07 took place in April. We will publish our first forward programme by July 2006. In preparation for early decisions by the Board we have initiated the following consultation exercises.

Is five years right?

Although it has only been a year since we set price limits we are beginning to prepare for the next review. In the early stages of the last review we promised to consult later on whether we should continue to set price limits for five-year periods.



We believe that five-yearly reviews have worked well. In January 2006 we issued a consultation paper, 'Setting water and sewerage price limits: Is five years right?'. This considered the implications of moving away from five-yearly reviews. Two workshops were held in March for representatives of companies, consumers and other interested parties. The debate focused on the advantages and disadvantages of staying with five-year price limits. We will review the responses to this consultation before setting out our decisions.

Sustainable development

Since our new duty to contribute to the achievement of sustainable development began last April we have thought about what this should mean for us. We held a workshop involving stakeholders, including sustainable development specialists, representatives from the water industry, customer representatives and environmental groups to consider our contribution to sustainable development. We are consulting on our new duty, with responses due in May. The consultation sets out:

- our interpretation of sustainable development;
- how we think we can contribute to it; and
- what we think the key issues are for the next price review and beyond.

The Board will consider the responses and reach conclusions on its approach. We have also reviewed our own housekeeping to encourage more recycling and cut energy use.

Financing networks

We have a duty to ensure that companies are able to finance the proper carrying out of their functions and that efficient companies are able to earn a return at least equal to their cost of capital and are financeable. This means that companies' revenues, profits and cash flows allow them to raise finance on reasonable terms in the capital markets.

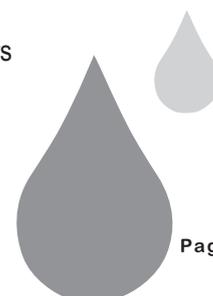
The continuing large capital investment programmes and the associated financing strain on the companies made our approach to the cost of capital and financeability a critical issue at the 2004 price review.

In February 2006 we published a discussion paper 'Financing networks' with Ofgem, which considers ideas for regulating the efficient financing of utility companies' capital investment programmes. The paper also looks at the ways companies and regulators could deal with the financial constraints arising from the need to deliver large capital programmes.

We held a joint seminar in April. In light of the views expressed we will set out with Ofgem how we intend to take this work forward.

Water industry forward look

We launched a new series of occasional 'Viewpoints' written by members of staff in March with a paper titled 'Water industry forward look 2010-30: Some possible views of the future'. This paper discusses possible future levels of investment, financing and household bills over the next 25 years using four scenarios. It is based on our current understanding of issues facing the water industry in the medium to long term. The paper is not a statement of policy or in any way a prejudgement of the outcome of the 2009 price review.



Chapter 3 – Monitoring companies' activities

Incentive-based regulation

Every five years when we set prices we put in place incentives to encourage the companies to:

- deliver an excellent level of service to their customers;
- outperform regulatory assumptions and thereby reward shareholders with eventual benefits for customers; and
- deter companies from failing to deliver agreed outputs in any area.

Now, at the end of the 2000-05 price review period, we can see the benefits of this approach. Companies have provided customers with the service they expected and have put in place schemes to protect and improve the environment. They have ensured continuity of water supplies in demanding circumstances, have delivered efficiency savings and are well placed to meet the demands of the future.

Customer service improvements

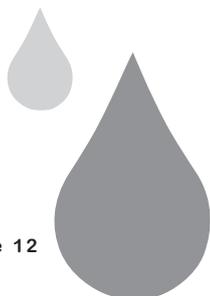
The companies continue to monitor services to customers. Research suggests that customers are still generally satisfied with the levels of service and value for money delivered. The overall performance assessment demonstrates the high levels of service delivered, with scores approaching the maximum and little variation between companies.

Comparative competition

Every year, we assess each company's progress in delivering the outputs and efficiencies we expect from it. Comparing performance and setting challenging improvement assumptions forms part of our five-yearly price setting process. This year we were able to assess performance over the whole of the 2000-05 period.

International comparisons

We undertake work to place the performance of the companies in England and Wales in a wider context. There is increased European awareness of the value of comparisons and we have made important new contacts. We are pleased to be working with the Scandinavian 6-Cities benchmarking group. Evidence continues to show that customers in England and Wales receive world-class value and service. We published our 'International comparison of water and sewerage service 2006 report' in February 2006.



Operating costs

Operating expenditure for the industry over the five-year period 2000-05 was 2% less than our 1999 price limit assumptions. Most of the outperformance came in the earlier years of the period. In later years expenditure rose, reflecting higher input prices and the need to provide increased levels of water and sewage treatment. At the same time, operating efficiency has continued to improve as the poorer performing companies close the gap on the best.

Capital maintenance

In the 2004 price review we assessed the quality of companies' work to apply risk-based planning principles in developing forward looking capital maintenance plans. This was a new development, based on UKWIR's 'Common framework for capital maintenance planning'.

In 2005-06 we fed back to companies our assessment of their application of the common framework planning principles. This should ensure that further improvements can be made to companies' plans and the assessment process at the next review. With UKWIR we reviewed the common framework and serviceability indicators.

We monitor and report on each company's service to its customers every year. We also assess the trends for key measures to ensure that assets can continue to provide good service for the foreseeable future – serviceability. This assessment relates to the broad asset groups (or sub-services) for water and sewerage, underground and above ground assets.

At the industry level the trends in serviceability are assessed as stable for water and sewerage underground assets and for water treatment assets. However, the performance of sewage treatment works is judged to be marginal, in line with the 2004-05 assessment.

Where a company's performance for a sub-service is assessed as deteriorating, we require it to prepare a detailed action plan to restore stable serviceability before the next price review. We have discussed these in depth with companies and their reporters, and will monitor delivery closely.

Leakage

The industry reported an overall reduction in the amount of water lost to leaks in 2004-05 and was well placed to respond to the dry summer in 2005. However, Thames Water and United Utilities fell short of their targets. This year companies began their 2005-10 leakage strategies with the aim of contributing to the resolution of all supply security problems. The colder and dryer winter makes it more difficult to keep leakage levels low, and it is even more important to preserve water by reducing leakage. Overall, companies have the skills base and assets to meet this challenge. We are prepared to take appropriate action if any company persistently fails to meet its targets.



Security of supply

The ability to maintain supplies is essential. The extended dry period that started in winter 2004-05 remains a significant test for companies in the south-east. They made use of drought orders and permits, and introduced some restrictions on non-essential use such as hosepipe and sprinkler bans for some customers.

Winter rainfall has been well below the long-term average, and we expect that maintaining supplies in summer 2006 will be challenging. We will continue to work with the Environment Agency and companies on modelling shared water resources for the south-east.

Efficient use of water

Companies have a duty to promote the efficient use of water by customers. We continue to monitor their work in this area.

Elliot Morley launched the Water Saving Group in October 2005. It aims to reduce the current level of water consumption in households by encouraging the efficient use of water. We are members of this group and are leading a sub-group on developing best practice in promoting water efficiency.

We are actively involved with and sit as an observer on the board of waterwise. This is a new body funded by the UK water industry, which aims to develop a model framework for sustained water efficiency in the UK.

We are again sponsoring the economic research category in the Environment Agency's 2006 Water Efficiency Awards. We have widened the scope of the award to recognise non-household as well as household initiatives on water efficiency and reuse.

Investing in the environment

The price limits we set for 2005-10 assumed investment of £3.5 billion for the sewerage service with improvements at more than 4,000 sites. In addition, there is a £2 billion programme for the water service to improve and protect drinking water quality, with 227 water treatment works to be upgraded, and more than 13,000 km of distribution mains to be relined or replaced in 2005-10. We have worked with the Environment Agency, Drinking Water Inspectorate (DWI) and companies to clarify and confirm the outputs to be delivered.

During the summer we assessed with the DWI and the Environment Agency the progress companies had made in completing the programme for 2000-05. We are working with the Environment Agency and the companies to make sure that any outstanding projects are completed as soon as practicable.



Water Framework Directive

The Secretary of State for Environment, Food and Rural Affairs and the Welsh Assembly Government will confirm the river basin management plans and programmes of measures to achieve environmental objectives under the Water Framework Directive in December 2009. The Environment Agency is the competent authority for the implementation of the Directive in England and Wales and the Government is taking the lead on the economic analysis. We have continued to contribute to the collaborative research programme and, with the Department for Environment, Food and Rural Affairs (Defra), commissioned analysis on the costs of removing phosphorus from sewage effluents.

We also belong to a number of Defra-chaired stakeholder groups and have responded to a number of consultations over the year. We welcome the Directive, with its focus on costs. We would like the objectives of this Directive to be delivered in a fair and proportionate way, with all investment by the water companies giving value for money for customers and the environment. We encourage sound economic analysis, taking account of benefits as well as costs.

Adoption of private sewers

We helped the Government develop its policy on private sewers and drains. We produced detailed estimates of the costs at a company and regional level and consequent bill impacts of transferring responsibility for private sewers and drains to the water companies and the options for implementing this. We also contributed to Defra's discussion papers on how pilot transfer schemes could operate and on the benefits of voluntary transfer options.

Sustainable drainage systems (SUDs)

We participated in the National SUDs Working Group. This seeks to develop the further use of SUDs in England and Wales.

Odour from sewage treatment works

We worked with Defra on developing its 'Code of practice on odour nuisance from sewage treatment works'. We will monitor the effectiveness of the programme to alleviate nuisance from odour at some sewerage installations.

Thames Tideway

Work continues on finding a solution to the water quality problems caused by intermittent discharges of storm sewage to the Thames Tideway. The Thames Tideway strategic study steering group submitted its report to Ministers in November 2005. In February 2006 we placed an independent review by Jacobs Babbie that we had jointly commissioned with Thames Water on our website.

The success of the London bid for the 2012 Olympic Games has lent a new urgency to resolving the problems. We are currently participating in a Defra-led working group to develop an action plan to address pollution concerns in the River Lee which may affect the Olympic Games site.



Reporters

The reporters and their teams scrutinise and comment on the regulatory information that each company submits to us. We assessed their work on the June returns and shared our findings with the water companies. We made awards to the top performers for the 2005 June returns:

- Ben Haywood Smith and the team from Strategic Management Consultants (Yorkshire Water); and
- Keith Hall and the team from Strategic Management Consultants (South East Water).

All but two of the reporters' appointments with the water companies ended during the year. We approved new appointments, which took effect after the reporters had completed their work on the 2005 June returns. A full list of current reporters is on our website.

Regulatory accounts

We require companies to publish their annual regulatory accounts in accordance with our regulatory accounting guidelines (RAGs) 1 to 4.

In RD08/05 (April 2005) we set out a summary of the responses we received to our consultation on the adoption of International Financial Reporting Standards (IFRS). We said that we would retain UK Generally Accepted Accounting Practice as the basis for the regulatory accounts. We asked companies for further views on some specific areas affected by IFRS and their likely impact on statutory reporting.

A full list of the companies' auditors is on our website.

Transfer pricing

Water companies have a duty to prevent cross-subsidy by trading at arm's length from associate companies and by keeping their regulated and non-regulated businesses separate.

Maintaining transparency of water companies' costs helps ensure that the financial ring fence around the regulated business is effective. This protects water customers from bills inflated by inappropriate costs that are not associated with the proper delivery of water and sewerage services.

We monitor the companies to make sure that cross-subsidy does not take place and that companies are complying with their licence requirements. Guidance on transfer pricing (RAG 5) assists companies in meeting this duty.

In 2005-06 we reviewed in detail trading arrangements at Anglian Water Services Ltd, Northumbrian Water Limited, Severn Trent Water Ltd, Thames Water Utilities Limited, United Utilities plc, Wessex Water Services Ltd, Yorkshire Water Services Ltd, Mid Kent Water Ltd and Three Valleys Water plc.

The auditors and reporters help us monitor arm's length trading.

Corporate activity

Bristol Water plc

In July 2005 Bristol Water Group plc (the owner of Bristol Water plc) returned £30 million to its shareholders, including £22 million funded from new debt raised by the regulated water business. We reviewed the company's financial projections and took no further regulatory action, having previously modified the company's licence.

Mid Kent Water Limited

In April 2005 we consulted on the regulatory issues arising from the Utilities Trust of Australia and Hastings Diversified Utilities Fund joint acquisition of Swan Group plc, the owner of Mid Kent Water Ltd. In June 2005 we published a position note and proposed appointment modifications for Mid Kent Water Limited. The company's appointment was modified in August 2005 to reflect the new ownership structure.

Portsmouth Water plc

In June 2005 we published a consultation paper on the regulatory issues arising from the completed acquisition by Secondary Market Infrastructure Fund UK LP (SMIF) of a 36% shareholding in South Downs Capital Ltd, the ultimate holding company of Portsmouth Water Ltd (Portsmouth Water). We invited views on:

- the capacity of SMIF to be the owner of a regulated water business; and
- the need for any changes to Portsmouth Water's appointment to protect customers' interests.

We published our intention to modify the company's appointment in October 2005. These changes were made in December 2005.

South Staffordshire Water plc

In April 2005 we published a position note on the regulatory issues arising from the acquisition of South Staffordshire plc – the owner of South Staffordshire Water plc (SST) – by First Islamic Investment Bank E.C. (FIIB), through its acquisition vehicle AqualInvest Acquisitions Limited. At the same time we also published our intention to make modifications to SST's appointment. These modifications were agreed and made in August 2005 to reflect its new ownership structure and to bring SST's appointment into line with other water companies that have become part of larger groups.

SST announced on 18 November 2005 its proposal to exchange its existing 2025 bond for one issued out of Artesian Finance III plc. SST believes that the exchange will allow it to improve its financial flexibility, enhance the financial ring fence around the issuer, increase its allowable debt levels to a more optimum level for its sector, and lengthen its debt maturity profile. We reviewed the company's proposals and took no further regulatory action.



South West Water Ltd

In December 2005 Pennon Group plc – the owner of South West Water Ltd – announced a proposed capital return of £200 million and a proposed increase in gearing for the regulated business to about 65% (from about 55%). Pennon also announced the one-off payment of £20 by South West Water Ltd to its customers arising from this balance sheet restructuring.

On 23 January 2006 Pennon announced further details of its proposal and held an extraordinary general meeting on 15 February 2006 to obtain all necessary shareholder approvals. We reviewed the company's proposals and took no further regulatory action.

Sutton & East Surrey Water plc

In the course of the year Sutton & East Surrey Water plc changed hands twice.

We issued a consultation paper on the regulatory issues arising from the proposed acquisition of East Surrey Holdings plc, the parent company of Sutton & East Surrey Water, by Kellen Acquisitions Limited (a subsidiary of Terra Firma Investments GP (2) Limited) in May 2005. We published a position note on the proposed acquisition in July 2005. The acquisition was completed on 28 October 2005 and in November 2005 we published our intention to modify Sutton & East Surrey Water's appointment. Sutton & East Surrey Water has agreed in principle to these modifications and is acting as if they were already in place.

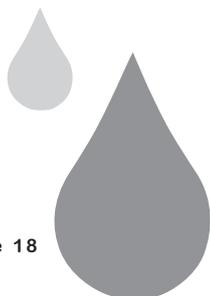
On 16 December 2005, Deutsche Bank AG London announced that Aqueduct Capital (UK) Limited, a company owned by Deutsche Bank AG, had agreed to buy the East Surrey Holdings Group (ESH) from Kellen Acquisitions Limited. Aqueduct Capital (UK) Limited subsequently acquired ESH on 27 January 2006. We issued a consultation paper into the regulatory issues arising from the acquisition inviting views on:

- the capacity of Deutsche Bank AG London and Aqueduct Capital (UK) Limited to be the owners of a regulated water business; and
- the need for any changes to Sutton & East Surrey Water's appointment to protect customers' interests.

We are considering responses.

Mergers

There were no proposals for mergers between water companies during 2005-06. Any proposal for such a merger must be automatically referred by the Office of Fair Trading to the Competition Commission for review. Our position on mergers remains that the loss of an independently owned company potentially weakens our ability to make comparisons. In our view, any merger would require an appropriate remedy or countervailing benefit to offset any detriment to our ability to make comparisons. We will consider with an open mind each individual merger proposition that arises before offering our advice to the Competition Commission.



Chapter 4 – Regulatory information

Review of the June return

Our main source of information is the June return, in which each company sets out its levels of service to customers, the investment it has made and the outputs it has delivered. We place most of this information on our website.

The Environment Agency and the DWI also provide us with annual reports on each company's progress in delivering its required improvements.

After each price review we carry out a complete review of our June return information requirements. Our aim is to make sure that we have the information we need to regulate what is essentially a monopoly industry, but that the burden is kept to a minimum.

In July 2005 we issued a consultation on our June return information requirements. It not only focused on our information needs for the next price limit period, but also embraced the principles of better regulation.

In September 2005 we held a seminar for the industry and other stakeholders to explore issues raised by the consultation. We presented the results of our internal review of the June return and also our proposals for developing our information management systems. We published our decisions in December 2005. We reduced the number of different data items we need and the requirement for written commentaries.

We now collect data in the June return on behalf of the quality regulators. The Environment Agency uses this information to report on water supply and the work companies have been carrying out on their water resource plans.

We have also established an industry-wide information requirements consultative group. The group will help us achieve a balance between our need for information to regulate and managing the regulatory burden we place on companies.

Going forward, we will work with CCWater on its information requirements. CCWater is represented on the information requirements consultative group. By co-operating in this way, we aim to avoid duplication of effort.

Simpler, smarter, better

A member of staff undertook a secondment with Defra to prepare a programme initiation document pulling together a number of activities that the regulators are undertaking to reduce the administrative burden on companies. We continue to work with Water UK and others to develop better regulation for the industry.



As part of its work to cost the burden of regulation PricewaterhouseCoopers asked us to participate in the expert panel to determine the financial burden on the industry of the Water Industry Act 1991. We hosted the expert panel and a preliminary discussion. With the industry, we helped establish the broad categories of information the companies must report and the cost to the industry.

Water UK also published its consultation paper and response, 'Simpler, smarter, better: Water UK's response to its consultation on the future regulation of the water industry July-October 2005'. We look forward to working with Water UK as it takes this work forward.

Regulatory information

We take extremely seriously the quality of the information that companies submit to us. We expect this information to be reliable, accurate and complete. We also expect high standards of corporate governance including rigorous systems of internal controls to operate throughout each company. We issued MD209 in November 2005 reminding companies of their obligations.

Investigation into Severn Trent Water

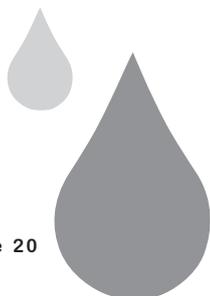
In 2004 a Severn Trent Water employee made a number of allegations to the company and to us about the handling of accounting and regulatory returns.

The board of Severn Trent plc (the holding company) appointed external forensic accountants from PricewaterhouseCoopers (PwC) to investigate these allegations. The board concluded in the light of PwC's report that its water customers had not been overcharged. We have conducted our own inquiry into the issues raised on behalf of customers. We referred our concerns about the reliability of certain regulatory information, especially for leakage, to the Serious Fraud Office (SFO) in May 2005. The SFO concluded that the matter was sufficiently serious to warrant a separate investigation. It began its investigation in October 2005.

In March 2006 we published our report setting out our interim conclusions on matters other than leakage.

We have concluded that Severn Trent Water's failure to meet its obligations in respect of the provision of information has led to price limits being set for Severn Trent that were higher than necessary. This would have resulted in customers being overcharged by £42 million over the period 2004-05 to 2009-10.

Before beginning our investigation we obtained written assurance from the company that if it were ever found that customers had been overcharged, any necessary corrections would be made. Severn Trent has agreed to do so promptly.



We consider that there should also be an additional penalty over and above any adjustment to return the amount overcharged to customers. We will consider this element in more detail once the SFO's investigation is complete.

We have also identified a number of actions that Severn Trent must take to ensure we can have confidence in its data in future.

Investigation into Southern Water

In October 2005, Southern Water notified us of irregularities in the reporting and handling of its responses to customers' enquiries and complaints.

We are investigating these irregularities and, with Southern Water, have appointed independent forensic accountants KPMG LLP to work on our behalf. We have obtained an undertaking from the company that it will not benefit to the detriment of its customers from any irregularities found by the investigation.

The issues this raises are complex and it is likely to take some time to investigate the irregularities thoroughly. Meanwhile, in March we gave notice of our intention to penalise Southern Water for its failure to achieve customer performance standards under the Guaranteed Standards of Service Regulations.



Chapter 5 – Market competition

Water supply licensing

On 1 December 2005 the new water supply licensing (WSL) regime went live. Customers who are likely to use at least 50 megalitres of water a year at eligible premises may now purchase water from either their existing appointed water company or from a water supply licensee. We estimate that there are around 2,200 potentially eligible customers, who in total spend approximately £200 million on water each year.

Implementation

Together with Defra and the Welsh Assembly Government, we worked closely with the industry to deliver the WSL regime. An extremely valuable aspect of this process was the use of expert industry advisory groups whose membership comprised representatives of each of the key stakeholders. We will continue to involve the industry through these advisory groups as we monitor and review the operation of the WSL regime.

Access codes and indicative prices

Under the WSL regime, appointed water companies have a duty to provide access to their supply systems (for either combined or wholesale supplies), on reasonable terms.

On 31 August 2005 appointed water companies published their indicative access prices, followed on 15 September 2005 by their access codes, which set out how they will allow licensees access to their water supply systems.

Licence applications and new licensees

To supply an eligible customer, a company needs to apply to us for either a retail or a combined licence.

- A retail licence entitles the holder to purchase water from an appointed water company (called a wholesale supply) and to sell it to eligible customers.
- A combined licence authorises the holder to introduce water into an appointed water company's supply system and sell it to eligible customers (a combined supply).

Companies have been able to apply to us for a licence since 1 August 2005. So far, we have granted four licences and are currently working on one licence application for a combined licence. Three of the licences we have granted are to associates of existing appointed water companies.

Progress in WSL competition to date has been slow. Although the new WSL regime may suffer from some teething troubles in its early stages, we encourage companies (appointed water companies and licensees) to make a genuine and reasonable effort to co-operate. We will not tolerate behaviour by companies that amounts to deliberate delay or obstruction.

WSL bulletin

To keep stakeholders informed about progress in implementing the WSL regime, we issue regular bulletins explaining the key stages in the process and the next steps.

Complaints and queries

We receive a variety of complaints and queries each year. Some are about competition law, others about the new water supply licensing regime, and some are general enquiries about competitive opportunities in the water industry. We received more than 100 enquiries in 2005-06. Most of these were about the new water supply licensing regime and eligibility for the new opportunities. In handling enquiries we apply the relevant regulatory or competition powers as appropriate. This can result in guidance and/or a determination.

Competition law developments

We have concurrent powers with the Office of Fair Trading (and certain other sectoral regulators) to enforce the Competition Act 1998 (CA98) and European competition law in the water and sewerage industry in England and Wales.

We published a decision under the CA98 about our investigation into charges for the treatment of tankered landfill leachate by United Utilities plc following a complaint made by Quantum Waste Management Limited. We opened the investigation on 18 January 2002 and following a thorough examination we concluded that there were insufficient grounds for action against United Utilities. A copy of our decision is available on our website.

Appeals

This year we have spent a lot of time and resources defending appeals to the Competition Appeal Tribunal (CAT). During 2005-06 the CAT considered the following appeals against the Director's decisions or actions. A short description of progress on each follows.

Albion Water Limited v Director General of Water Services (Dŵr Cymru/Shotton Paper)

In December 2000 Albion Water made a CA98 complaint to us about, among other things, the allegedly excessive access charge Dŵr Cymru Welsh Water offered to Albion Water to use its system to supply the Shotton paper mill. The Director published his decision on this case in May 2004. Albion Water lodged an appeal against the decision in July 2004. The first hearing took place in May 2005. On 22 December 2005, the CAT handed down an interim judgement which requested further information on three main issues – bulk distribution costs of non-potable water, the stand-alone costs of supplying the Shotton paper mill, and the efficient component pricing rule. A second hearing is scheduled for May 2006.



Albion Water Limited v Director General of Water Services (Thames Water/Bath House)

In January 2001, Enviro-Logic Ltd, now Peninsula Water Ltd, complained to us about Thames Water Utilities Ltd's conduct in providing a price for access to its network. Enviro-Logic wished to supply customers from boreholes at New Bath House and Albion Yard using Thames Water's network.

After we closed the file on the complaint, Enviro-Logic made an application under the original section 47 of CA98 in relation to one point of the complaint. We concluded that the views put forward in two letters amounted to a decision that the Chapter II prohibition had not been infringed. We published the letters in March 2003. Enviro-Logic subsequently asked the Director under the original section 47 of CA98 to withdraw or vary his decision in relation to other points of the complaint. In May 2004, the Director informed Enviro-Logic that he would not withdraw or vary his decision.

Albion Water (a former subsidiary of Enviro-Logic) appealed the decision not to vary or withdraw the original decision to the CAT in July 2004. The main hearing took place in June 2005. Judgement was handed down on 31 March 2006.

Aqua Resources Limited v Director General of Water Services

In April 2005 Aqua Resources lodged an appeal with the CAT relating to the Director's decision not to investigate Aqua Resources' complaint about the terms on which Severn Trent Water was prepared to grant access to its network to a new entrant who was seeking to enter into a common carriage agreement. Aqua Resources withdrew its appeal in July 2005.

Independent Water Company Limited v Director General of Water Services

On 12 January 2006 Independent Water Company Limited (IWC) lodged an appeal with the CAT against the Director's decision not to investigate IWC's complaint about the alleged behaviour of Bristol Water plc in relation to an inset proposal by IWC. The appeal continues and the question of admissibility will be dealt with as a preliminary issue.

European competition law

In our role as a National Competition Authority for the purposes of applying European competition law (Articles 81 and 82 of the EC Treaty) we monitor competition law developments in the European Union and in the UK, particularly those that may have an impact on the water industry in England and Wales. We work through the Concurrency Working Party and the European Competition Network to contribute to the development of competition policy and procedures.



Inset appointments

An inset appointment allows one company to replace another as the appointed water undertaker for a specific area.

We continue to work with applicants on a variety of inset proposals. The inset regime exists in parallel with that for water supply licensing. The existing large user inset threshold in England was reduced to 50 megalitres a year on 1 April 2005, in line with the water supply licensing eligibility threshold. The threshold remains at 250 megalitres in Wales.

Self-lay

We updated our guidance on 'Competition in providing new water mains and service pipes' in August 2005. We first published guidance in 2002 but have revised it to reflect the new self-lay provisions introduced by the Water Act 2003 and developments in the market place. We continue to work with the self-lay advisory group to make sure that the legislation is implemented fairly and the market continues to develop.



Chapter 6 – Protecting customers

Working with CCWater

CCWater was launched on 1 October 2005. We welcome its establishment and maintain regular contact. We keep each other informed about our priorities and activities, and look for opportunities to work collaboratively where appropriate. We are currently working with CCWater to develop a memorandum of understanding to guide how we will work together in future.

CCWater committees carry out audits at the companies. They provide us with reports on complaint handling and debt, along with a wider assessment of each company's debt recovery performance. The debt assessments and complaint audits feed into the customer service element of our overall performance assessment. The committees examine a selection of complaints and cases involving customers in debt (a minimum of 25 in a report year), assess them against specific criteria and award them a good, acceptable or unacceptable marking.

Performance against DG indicators

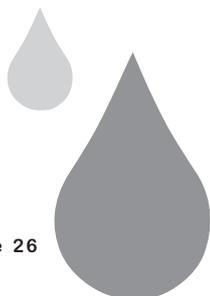
Each year companies provide us with information on their performance for various aspects of their service – DG indicators. We review their performance and report this in our 'Levels of service for the water industry in England and Wales' report.

Affordability

Following the cross-government review of water affordability (December 2004) we have worked with Defra and other stakeholders to take forward the recommendations set out in the report.

- We participate in the steering group to co-ordinate the pilot study in the south-west to assess the benefits of targeting assistance to low-income customers. Households have been selected to take part in the study and the fieldwork began in January 2006. Results are expected by mid-2007.
- We worked with Defra and other industry stakeholders to review the effects on various customer groups of different ways of charging. Progress has been slower than we expected and work will continue during 2006-07.
- We worked with water companies and consumer groups to encourage use of the 'Water Direct' third party deduction scheme. We wrote to the Department for Work and Pensions to set out our views on the scheme's potential to help the least well off and customers as a whole by holding down bad debt.

We have maintained contact and working relationships with stakeholders such as Public Utilities Access Forum, Water UK and the National Consumer Council.



Customers in need of special assistance

Companies have procedures in place to make sure that assistance is available to customers who require additional help, such as the disabled or elderly. In September 2005 we published details on our website of the number of customers registered for special assistance in each water company area.

Additionally, under government regulations, metered customers who receive specific benefits and are members of large families or have certain medical conditions can opt for a capped charge. The regulations were drawn up to help households who might otherwise worry about turning on their taps – possibly compromising their health and the health of others – because of their concerns about paying their bills.

We collect information each year on the number of households applying for, and successfully receiving help under the regulations. For the first time we published this information on our website, along with a note setting out details of the scheme, 'Customers applying for help under the Vulnerable Group Regulations: 2003-04 and 2004-05'.

We also encourage companies to make sure that customers who could benefit are aware of the scheme.

Customers in debt

We published information from companies on the number of commercial water disconnections and the level of debt recovery actions for household customers.

Levels of outstanding household revenue have risen since the ban on household disconnection was introduced in July 1999. RD15/05 sets out industry revenue outstanding and associated costs in 2004-05, and a comparison with 1998-99 and 2003-04. In recent years the revenue outstanding figure has stabilised.

We continue to work with the Water UK debt focus group. We were also a member of the project steering group for Water UK's research into the socio-economic characteristics of customers in debt.

Telephone call handling

In 2005-06 we improved the levels of service indicator we use to monitor how well companies handle telephone calls from their customers. It now combines customer satisfaction with quantitative measures of how easy it is to contact companies by telephone (including the number of occasions when all telephone lines are busy). Customer satisfaction is measured by a qualitative customer satisfaction survey, which has been developed and tested over the last few years in conjunction with Water UK and CCWater.



Guidance to customers about sewer blockages

Following recommendations from the National Audit Office ('Out of sight – not out of mind', NAO 2004), we are looking at how companies tell their customers about sewer blockages. We have asked companies to provide examples of how they let customers know about the common causes of blockages and how to avoid them. We are looking at the information they have sent us and will share best practice with the industry.

Guaranteed standards scheme

During the year we issued a consultation document about the GSS and, in particular, how to deal with customers who have been affected by sewer flooding. Our consultation proposals would improve the current guaranteed standards and introduce industry guidelines for dealing with customers that suffer sewer flooding. The consultation closed in February 2006 and we are analysing the responses.

Water Resale Order

This protects customers from being overcharged where they pay a third party, such as their landlord or a managing agent, for their water and sewerage services.

We issued a consultation paper setting out our proposals on how our new powers, introduced in the Water Act 2003, should be used. We received more than 200 responses to the consultation which broadly supported our proposals. We published our conclusions in December 2005.

The Water Resale Order 2006 came into force on 31 March 2006, accompanied by a revised guidance leaflet.

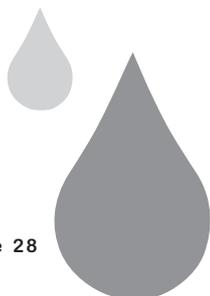
During the year, we also responded to more than 150 queries on how the Order operates.

Complaints and disputes

Before 1 October 2005, we could be asked by WaterVoice to review some of the complaints it handled.

During that period, WaterVoice referred three complaints to us that it had been unable to resolve with the companies. We supported WaterVoice's recommendations in one of those cases. We also dealt with 31 complaints from customers who were not satisfied with WaterVoice's investigations. We upheld two and partially upheld one of these cases.

We received eight requests to review the handling of complaints made to us. The Head of Corporate Affairs examines internal review cases. We upheld six of these and suggested a different approach on two.



We held a complaints workshop in May for WaterVoice members and staff to promote best practice in complaint handling.

CCWater, which took over from WaterVoice, now deals with the majority of complaints from customers and has established its own arrangements for reviewing complaints. We will, however, continue to support the development of complaint handling by contributing to workshops.

We also dealt with more than 600 complaints and disputes in 2005-06. We obtained compensation and rebates for customers of almost £170,000.

During the year we have reviewed our performance standards for complaint and dispute handling, comparing them to standards for other sector regulators and we are considering how to take this forward. We have reviewed our complaint recording, working practices and standards of service to make sure that our complaint handling process is clear to customers and meets their expectations.

Connection charge disputes

Companies are entitled to recover the reasonable costs of making connections to water mains. Disputes may be referred to us for determination.

Of the eight disputes closed, all were settled in favour of the customer. We required companies to make refunds to customers ranging from 11% to 45% of the original charge (an average refund of 25%).

Of the 12 cases we referred to the companies to review their charges informally, 11 resulted in refunds to the customer.

Sewer adoption appeals

If a company refuses to adopt a customer's sewer as a public sewer, the customer can appeal to us. Customers can also appeal against the adoption. We dealt with ten appeals and 29 enquiries during the year.

Trade effluent appeals

Traders can appeal to us if a company refuses permission to discharge effluent into a public sewer, or changes the terms of an existing consent. Ten cases were brought forward from last year. Nine of these cases were resolved informally or withdrawn.

Complaints about pipe laying in streets

We received six complaints, none of which required formal arbitration.



Complaints about pipe laying in private land

We resolved 34 cases informally, usually by the company agreeing additional compensation, or doing further reinstatement work.

GSS disputes

Customers are entitled to guaranteed standards of service, as laid down by the Government. If a company fails to meet any of the guaranteed standards, customers can claim a compensation payment.

We settled one dispute under the GSS, but not in favour of the customer. We resolved a further eight cases informally, four in the customer's favour.

Free meters

Household customers are entitled to free meters. Where a company finds it is impractical or unduly costly to install meters we require it to offer customers an assessed charge based on what they would have paid if metered. If there is a dispute about whether a meter should be fitted, we will make the final decision.

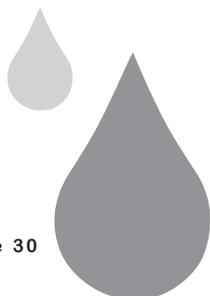
This year, we dealt with 52 disputes. Meters were installed in 15 cases, in nine the company applied an assessed charge and four disputes were withdrawn.

Installation of new water and sewerage infrastructure

The Water Act 2003 gave us powers to determine disputes relating to:

- the terms and financial conditions of water, main sewer and lateral drain requisitions;
- the terms and financial conditions of self-lay agreements; and
- refusals by water companies to adopt self-laid pipes supplying water for domestic purposes.

We received three formal disputes during 2005-06, two are outstanding and the other was concluded in the customer's favour.



Chapter 7 – Communicating with stakeholders

Working with elected representatives

We are accountable to Parliament and the National Assembly for Wales. We work hard to keep MPs, AMs and other elected representatives informed about our activities. We provide clear and prompt responses to queries and questions from elected representatives. Bill increases for constituents have dominated our postbag.

The House of Lords Science and Technology Committee set up a sub-committee to examine water management. We provided written evidence and appeared before the sub-committee to discuss current water management issues. Philip Fletcher also made a presentation to the Committee at a preliminary seminar.

The Environment, Food and Rural Affairs Committee undertook an inquiry into the Environment Agency. We provided a memorandum of evidence to the Committee detailing our work with the Environment Agency. Additionally, we contributed to the Public Accounts Committee's inquiry into 'Governing the future'.

Consultation responses

Over the year we have responded to a number of consultation papers issued by Defra, CCWater, the Office of the Deputy Prime Minister, the Department for Transport, the Environment Agency, the Greater London Authority and the Better Regulation Executive. These have covered a wide range of areas such as river basin planning guidance; the code for sustainable homes; penalties available to regulators; and the implications of the Traffic Management Act.

We place our responses to each of these consultations on our website and by and large these responses will also appear on the websites of those issuing the consultations. Over the year we have responded to around 18 consultations. Although responding to consultations can be a time-consuming activity we consider it an important aspect of our work. It allows us to pass on our views to other departments as they develop their policy and provides an opportunity for them to consider the implications of their proposals on the companies and their customers.

Informing stakeholders

We are committed to openness and transparency when dealing with our many audiences and try to achieve this through our publications. These are all produced in hard copy and electronic form.

We published a comprehensive glossary of the terms and phrases we use and this is available on our website.



We have also improved the look and feel of our publications over the past 12 months. We continue to follow the rules of plain English and try to apply them to our work.

In the past year we have published:

- 25 reports;
- 35 consultations and consultation responses;
- 7 guidance documents;
- 5 leaflets;
- 46 press notices; and
- 38 RD/MD letters.

*H₂O*fwat

We launched *H₂O*fwat, a quarterly on-line newsletter. It summarises our activities and is aimed at people who are interested in our work, but do not want detail on everything. Links are provided within *H₂O*fwat to more detailed information.

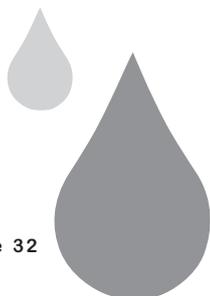
Media relations

Media activity is an integral part of our communications work. The Director and senior staff took part in interviews with TV, radio and the print media on both national and regional issues.

We held two media briefings and issued nearly 50 press notices and information bulletins to explain our policy and decisions. We also contributed articles to business, consumer and water industry publications, and our work received regular coverage in 'Utility Week'.

Handling enquiries

The Library responds to enquiries from the public. In 2005-06 we dealt with more than 3,700 telephone enquiries and replied to more than 1,700 written enquiries. The number of written enquiries increased by 13% over the previous year. We do our best to answer enquiries quickly and during 2005-06 we answered 84% within five working days and more than 95% within ten working days. We updated the frequently asked questions section on our website and continually monitor it to make sure that it meets consumers' needs.



www.ofwat.gov.uk

We have seen a continuing increase in the number of visitors to our website during 2005-06. It is our prime communications tool, and we try to keep it up-to-date and accurate. We launched a survey on its use and welcome feedback.

During the year we raised the profile of our e-mail subscription service. This notifies users automatically by e-mail whenever we add to the website. More than 800 users have subscribed to this service.

Overseas visitors

We work with Defra's International Water and Sanitation Team on hosting overseas visits. We also meet visitors who want to learn more about regulation of the water and sewerage industry in England and Wales.

Our overseas visitors this year have included:

- government delegations from Bulgaria, China, Israel, Italy, Malaysia, Mexico and Turkey;
- water companies from Australia and Italy; and
- academics from Japan, Korea and Italy.

Members of Ofwat staff have also visited Australia, Italy and Portugal to make presentations and discuss how regulation operates in England and Wales.

We are also a member of Partners for Water and Sanitation, and look forward to working further with this group.

Freedom of Information Act 2000

We continue to respond to requests under the Freedom of Information Act 2000 (FOIA). We monitor and record FOIA requests to make sure that we handle them properly and meet the deadline for responses. We also submit quarterly reports to the Department for Constitutional Affairs (DCA).

We keep up to date with all developments and guidance from the DCA and the Information Commissioner.



Handling requests

We handle any request on the presumption of disclosure, whilst paying due regard to the public interest and information provided by third parties.

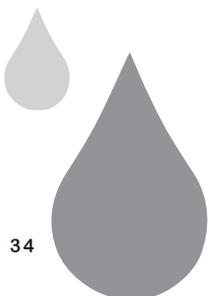
In 2005, the first year of the Act, we received 84 FOIA requests. The deadline for answering a request is 20 working days, although the legislation allows extensions in certain circumstances. We met this deadline in 96% of cases. Of the 84 requests received, 65% have received a response with full disclosure of the information requested. In 4% of cases we disclosed part of the information. In 13% of cases we did not hold the information. In only 6% of cases did we refuse to disclose the information requested. In one case we neither confirmed nor denied holding the information requested.

In 2005-06 we received 77 FOIA requests. So far, we have answered all complaints within the 20-day deadline.

Releasing information

Where we release new information to an individual under the FOIA we also place it in the disclosure log on our website, if it is of interest to the general public.

We review our publication scheme each year. The Information Commissioner initially approved our publication scheme in 2002. Following review in 2005, the Information Commissioner's Office approved the scheme for a period from 29 July 2005 to 30 November 2006.



Chapter 8 – Managing Ofwat

Staff recruitment and development

Staff are recruited on merit through fair and open competition providing opportunities for employment regardless of race, sex, physical disability or marital status. Our recruitment activities are subject to external audit by the Civil Service Commissioners to make sure that we comply with the guidance set out in its recruitment code.

During the year we undertook 17 separate recruitments. The results are summarised in the table below.

Table 1: Staff recruitment 2005-06

Level	Number appointed	Proportion of women (%)	Proportion from ethnic minorities (%)
Head of division	1	100	0
Middle management	12	58	33
Clerical and secretarial	4	100	50
Total	17	71	35

Everyone was recruited through open competition, with the exception of three staff on short-term casual appointments.

Ofwat has a total staff of 182 (full-time equivalent, as at 31 March 2006) of whom:

- 60% are women;
- 18% are from ethnic minority groups;
- 5 are members of the Senior Civil Service (3 men and 2 women);
- 11 are employed on fixed-term and casual contracts; and
- 13% work part-time.

Staff turnover is currently running at 10%.

During the year we supported the establishment of CCWater. On 1 October 2005, 61 staff transferred to CCWater. We provide a number of services to CCWater.



Senior staff changes

Dr Bill Emery, Director of Costs and Performance and Chief Engineer, left in September 2005 to join the Office of Rail Regulation as Chief Executive. Tony Smith, Director of Competition and Consumer Affairs, left in November 2005, to join CCWater as Chief Executive. Bill Emery has been replaced by Melinda Acutt, Director of Network Regulation. Keith Mason is now responsible for Competition as well as Regulatory Finance. Sue Cox is acting Head of Consumer Affairs.

Remuneration

Philip Fletcher's salary for 2005-06 was £158,831.

Salaries for members of the Senior Civil Service (as at 31 March 2006):

£90,000 – £94,999	2
£85,000 – £89,999	1
£75,000 – £79,999	2

Race equality scheme

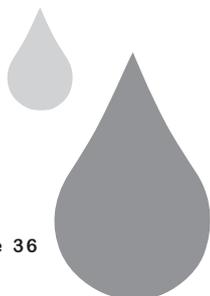
As part of our race equality scheme we take steps to make sure that no member of our staff receives less favourable treatment because of their race or ethnic background. During the year no member of staff from an ethnic group was involved in a disciplinary procedure and no grievance cases were brought due to race or ethnic background. No diversity issues were mentioned by staff during their exit interviews.

Table 2: Staff training attendance 2005-06 (by ethnic group)

Ethnic group	Number of days training*	%**
White	452	90
Other ethnic groups	53	10
Total number of days	505	100

* Number of days has been rounded up.

** Percentage has been rounded to the nearest whole number.



Providing safe and secure workplaces

We supported the establishment of CCWater in its new premises and prepared the transfer scheme. Over the year we undertook an accommodation review, examined health and safety procedures and strengthened office security.

Our contingency plans were updated to reflect the formation of CCWater.

Finance

The financial information provided is the latest available forecast and is subject to external audit by the NAO. We prepare the accounts in accordance with HM Treasury's Resource Accounting requirements.

The financial details provided for 2005-06 and comparative years are for Ofwat only. WaterVoice's assets and liabilities were transferred on 1 October 2005 to CCWater and it is now responsible for its financial reporting.

In order to secure economies of scale we provide a shared service to CCWater for a range of functions including IT, library and information services, facilities management, human resources and finance. These are provided under a service level agreement that started on 1 October 2005. Our budget was increased during the year to £12.1 million. This was required to meet cost pressures associated with the formation of CCWater and Competition Appeal Tribunal casework. In practice, as a result of slippage or underspend on a number of projects we expect an underspend of around £1.2 million when our accounts are completed. Much of this will be required in 2006-07, and offset against licence fees.

We will carry forward an estimated £0.8 million of previous years' licence fees to offset against future fees charged to the water companies.

Table 3: Estimated income and expenditure 2005-06*

	£000s	£000s
Income		
Licence fees recovered	10,959	
Other income	281	
Licence fees unused to carry forward	(379)	
Total income		10,861
Expenditure		
Permanent staff	7,109	
Personal overheads	356	
Consultancy projects	800	
Accommodation	1,201	
Non-cash costs, eg depreciation	554	
Other	841	
Total expenditure		10,861

* Excluding WaterVoice and CCWater.



Table 4: Administration costs – by activity group

	2005-06 estimated outturn £000s
Regulatory action	7,001
External relations and legal services	1,747
Finance, human resources, facilities management and operations	1,438*
IT services and information management	675*
Total expenditure	10,861

* Excluding support to WaterVoice and CCWater.

Table 5: Ofwat's administration costs

	£000s		
	2004-05 outturn	2005-06 estimated outturn	2006-07 plans
Gross administration costs:			
Staff	7,233	7,109	7,702
Other	3,963	3,752	4,698
Total gross administration costs	11,196	10,861	12,400
Related administrative receipts from licence fees and other minor receipts	(11,196)	(10,861)	(12,400)
Total net administration costs	–	–	–

Notes:

1. This table is included as a requirement stipulated by HM Treasury. Outturn figures are taken from our resource accounts. We operate on the basis that licence fees recovered from the industry should cover our costs.
2. 2005-06 gross administration costs are based on estimated outturn and are subject to review by audit.
3. Other administration costs for 2005-06 include non-recurring set-up costs for CCWater and Water Services Regulation Authority reorganisation costs.

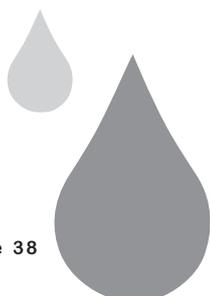


Table 6: Consultancy and professional services expenditure summary 2005-06 (company contracts costing more than £50,000 excluding VAT)

Project	Supplier
Review of water company capital maintenance submissions	Mott MacDonald
Thames Tideway project – review of economic solutions to storm discharges	Jacobs Baktie
Water Framework Directive Economic analysis of water industry costs	Arup (sub-contractor Oxera)
Severn Trent Water financial investigation study	RSM Robson Rhodes LLP
Shaping the Consumer Council for Water	COI (sub-contractor Opinion Leader Research)
Competition Appeal Tribunal – Aqua Resources	Pinsent Masons

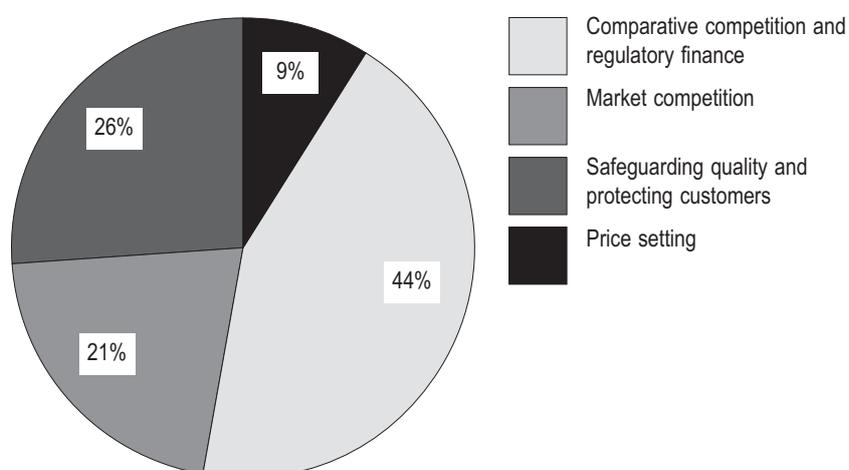
Resource accounts

We published our resource accounts for 2004-05 in July 2005 (HC313). The accounts received an unqualified audit certificate from the Comptroller and Auditor General. The resource accounts are prepared in accordance with the Government Resources and Accounts Act 2000 and directions issued by HM Treasury.

Resource allocation

Our expenditure is apportioned to the outputs planned in our forward programme. A summary of resource allocation against our main outputs is shown in figure 1.

Figure 1: Resource allocation



Audit

Our financial and risk management systems and reports are scrutinised by the Audit Committee. Members of the committee in 2005-06 were John Baker (Chairman) and Roger Munson, both non-executive advisory directors. The NAO, internal audit (KPMG Audit PLC), the Director and senior finance staff attend the committee. The committee met three times during the year.

Consulting on licence condition N

In preparation for changes to our structure and the introduction of water supply licensing, we consulted on the necessary licence changes to recover costs. Licence changes will be made in early 2006-07.

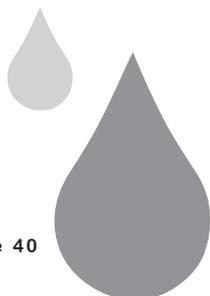
Risk management

Our assessment of risks underlies each policy area. Every six months the Board, Management Committee and Audit Committee examine and assess the risks we face.

Information management and technology

We rely on a range of computer-based tools to collect, process and store regulatory information. These have successfully delivered the requirements of the office over the past 15 years, but need to be updated ahead of the next price review in 2009.

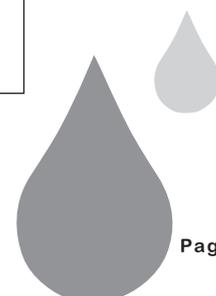
We are now developing our systems to improve effectiveness and help the office to work in a smarter way. We initiated a long-term project to restructure our entire software suite – Project Reservoir – in the summer of 2005 and work will continue throughout 2006 and 2007.



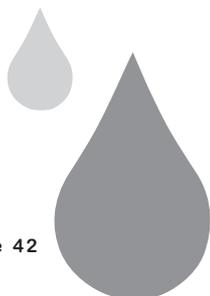
Appendix 1: Forward programme milestones

In 'Ofwat forward programme 2005-06 to 2007-08' we set out our priorities for this year. These outputs and the dates we achieved them are given below.

Milestones	Achieved date
Key developments 2005-08	
Setting up the Water Services Regulation Authority	Ongoing
Developing our approach to sustainable development	Ongoing
Develop MoUs with Defra, Welsh Assembly Government, Environment Agency and CCWater	Ongoing
Implement powers on financial penalties	April 2005
Contributing to the set-up of CCWater	1 October 2005
Safeguarding customers	
Implementing a revised measure for telephone call handling	April 2005
Publish 'Tariff structure and charges 2005-06 report'	May 2005
Hold complaints workshops for WaterVoice and CCWater	May 2005
Workshop on possible changes to the current provisions for compensating those suffering sewer flooding	June 2005
Publish companies' leakage performance for 2004-05	July 2005
Publish data on debt levels and debt recovery procedures	August 2005
Publish 'Financial performance and expenditure of the water companies in England and Wales 2004-05 report'	September 2005
Publish 'Levels of service for the water industry in England and Wales 2004-05 report'	September 2005
Publish the numbers of customers registered with companies as requiring special services	September 2005
Publish 'Security of supply, leakage and the efficient use of water 2004-05 report'	October 2005
Review the guaranteed standards scheme with stakeholders	November 2005
Publish 'Water and sewerage service unit costs and relative efficiency 2004-05 report'	December 2005
Commence review of 'Guidelines on dealing with customers in debt'	April 2006
Approve companies' charges schemes	February 2006
Publish 2006-07 average bills leaflet	March 2006



Milestones	Achieved date
Review how security of supply is reflected in the OPA	March 2006
Implement powers to require water sellers to provide information to purchasers	March 2006
Contribute to Defra's review of household charging	Ongoing
Develop sludge disposal OPA measure	Ongoing
Comparative competition, industry structure and companies' finance	
Hold reporters' and auditors' joint workshops	April 2005
	December 2005
Make awards for the best reporters for their reports on the 2005 June returns	December 2005
Publish international comparisons report	February 2006
Market competition	
Publish report on Competition Act 1998 complaints	April 2005
Publish updated self-lay guidance	August 2005
Publish WSL guidance documents and regulations	December 2005
Follow up to the 2004 price review	
Review of the price review	August 2005
Place PR04 submissions in the public domain	August 2005
Consult on the length of the next price review period	January 2006
Resources and other issues	
Publish number and details of FOIA requests in annual report	June 2005
Publish annual report	June 2005
Publish resource accounts for 2004-05	July 2005
Write to companies with estimates of CCWater set-up costs	August 2005
Modify licence condition for fee recovery	September 2005
Publish information requirements for June return 2006	December 2005
Publish draft forward programme for consultation	April 2006



Appendix 2: Companies

The water and sewerage companies

Anglian Water Services Ltd

www.anglianwater.co.uk

Dŵr Cymru Welsh Water

www.dwrcymru.co.uk

Northumbrian Water Limited

www.nwl.co.uk

Severn Trent Water Ltd

www.stwater.co.uk

Southern Water

www.southernwater.co.uk

South West Water Ltd

www.southwestwater.co.uk

Thames Water Utilities Limited

www.thameswater.co.uk

United Utilities plc

www.unitedutilities.com

Wessex Water Services Ltd

www.wessexwater.co.uk

Yorkshire Water Services Ltd

www.yorkshirewater.com

The water only companies

Albion Water Ltd

www.albionwater.co.uk

Bournemouth & West Hampshire Water plc

www.bwhwater.co.uk

Bristol Water plc

www.bristol-water.co.uk

Cambridge Water plc

www.cambridge-water.co.uk

Cholderton & District

01980 629203

Dee Valley Water plc

www.deevalleygroup.com

Folkestone & Dover Water Services Ltd

www.fdws.co.uk

Mid Kent Water Ltd

www.midkentwater.co.uk

Portsmouth Water Ltd

www.portsmouthwater.co.uk

South East Water Ltd

www.southeastwater.co.uk

South Staffordshire Water plc

www.south-staffs-water.co.uk

Sutton & East Surrey Water plc

www.waterplc.com

Tendring Hundred

www.thws.co.uk

Three Valleys Water plc

www.3valleys.co.uk

Water supply licensees

Aquavitae (UK) Limited

www.aquavitae-uk.co.uk

WaterCall Limited

Severn Trent Water Select Limited

YorWater Limited



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