independent
Water Review
panel

Independent Water Review Panel

Strand Two Report

Management, Governance and Delivery

January 2008

PREFACE

In 2004, NIO Ministers announced far-reaching reforms in Northern Ireland's water and sewerage services. They proposed that the Water Service, which had been part of the Department of Regional Development, would become a government owned company (GoCo), and that all households would be required to pay a direct charge for its services.

These proposals encountered widespread popular opposition. Some people saw the creation of a GoCo as a step towards eventual privatisation. This hostility was reflected in the March 2007 Assembly election campaign, when all Northern Ireland's political parties expressed opposition to the NIO's reform proposals.

Once devolution had been restored, the Executive announced on 11 June 2007 that privatisation was no longer an option. The Minister for Regional Development set up the Independent Panel to review the reform process; make recommendations on the level of funding needed; and advise the Executive on how the services should be structured and paid for in future.

In our first report, published on 12 October 2007, we identified an urgent need to restore public confidence in the reform process. We set out our findings and recommendations on the level of funding required and where it should come from. We calculated that our recommendations, compared with direct rule Ministers' proposals, had the potential to achieve identifiable savings for households in Northern Ireland of at least £153m annually.

I would like to take this opportunity to correct some misunderstandings which have arisen in relation to our previous recommendations.

Metering

In our Strand One Report, we recommended that progress towards the introduction of domestic metering should be discontinued for the foreseeable future. Since optional metering is both less cost-effective and less equitable than universal metering, this means that no further action should be taken until and unless a policy of universal domestic metering is introduced. There should be no volumetric charging now, including meters already installed in new buildings. The installation of metering facilities in new buildings could continue to advance the provision of universal metering at some point in the future.

Farmers whose premises combine domestic and non-domestic usage should continue to pay volumetric charges as before. The domestic allowance previously payable to farmers should be discontinued but farmers will benefit from a reduction in rates.

We welcome the debate which our recommendation has stimulated and look forward to the Executive's conclusions. In concluding our contribution, we would point out that:

- because of the capital intensive nature of the water industry, the bulk of NIW's expenditure arises from the provision of infrastructure and is largely independent of how much water people use, which makes it completely different from electricity and gas

- Ofwat, the economic regulator for England and Wales, calculated some time ago that the installation and operation of a metering system costs the average user over £43 per year

- from a social perspective, metering is regressive and fails to prioritize those who need help most

- the burden of payment falls most heavily on families with low incomes and certain groups of people with disabilities

- the direct rule Ministers' proposed policy of optional metering for older people would both increase the average household bill substantially and create an unjustifiable inequity, in that any savings for those who chose to install a meter could increase the burden on others more disadvantaged

- metering in Britain has led to public health concerns

- from an environmental perspective, any impact on usage is both limited and short-lived

- there are more cost-effective conservation measures

- the NI Water Resource Strategy makes clear that with existing patterns of consumption Northern Ireland will not experience water stress before 2030

As far as the debate itself is concerned, the issues are complex and merit a full and open discussion informed by evidence on actual costs and benefits derived from experience in Britain and elsewhere. This is an important aspect of policy, which has significant social and environmental as well as economic dimensions. The debate should be led and owned by the Minister and Assembly on behalf of all the people of Northern Ireland.

Affordability

The Executive has supported our declaration that there should be robust arrangements to protect vulnerable people from hardship and water poverty. Many of those who responded to our first report have shared our concern over the issue of asset-rich but cash-poor individuals, especially pensioners living on fixed incomes in family homes. We will address this and other affordability issues in Chapter 7 of this Strand Two report.

Operating Efficiency

Some commentators questioned the feasibility of the enhanced operational efficiency target which we recommended for NIW. We agree that 40% by 2009/10 was a challenging target, and so it should be. What we perhaps did not make fully clear was that this was to be achieved against a baseline of performance in 2003/4, i.e. over a seven year period. The Water Service had already achieved 12.5% over the first 4 years, leaving a balance of 27.5% to be gained over the three years to March 2010.

This target is no more demanding than what was achieved after restructuring in England, Wales and Scotland, even though the services there entered the transformation process with less scope for improvement.

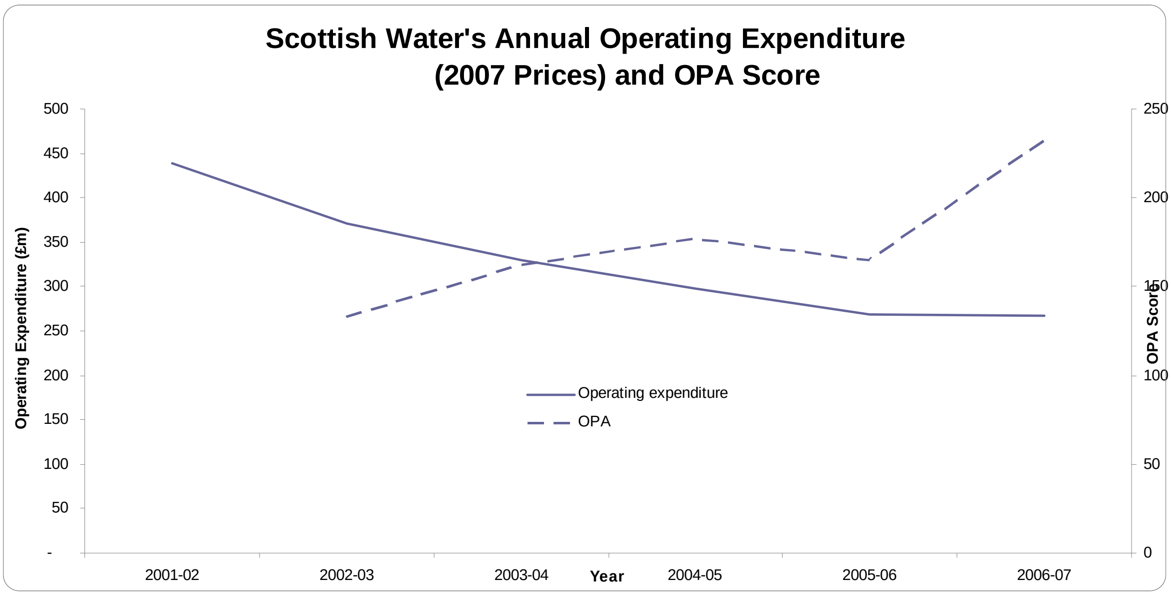
It might be helpful if we explained our reasoning in more detail. It is important to remember that our purpose is to review the various aspects of reform process, not to redo them. In respect of the operating efficiency targets, we noted that the Financial and Strategic Review Team in 2005 assessed the relative efficiency of the Water Service against comparators in Britain and concluded that the scope for operating efficiencies ranged between 20% and 40% by 2010. At a more detailed level, the UBS team found that there was, on average, a unit cost gap of 20% on water and sewerage services – and that the true gap was likely to be higher after taking into account the higher level of service quality in England and Wales. UBS concluded that given the performance of the companies in England and Wales since privatisation and Scotland since 2001 there was scope for annual operating efficiencies of between 3% and 7% by 2009/10 - a range of 20% to 40% cumulative.

UBS also concluded that the GoCo model was the most likely model in the state sector to be able to achieve the highest level of operating efficiency, but that this would depend on many factors not least the capabilities and commitment of the senior management team. The logic behind this conclusion was supported by DRD in its letter of 7 February 2006 to NIW, which stated that an operating efficiency target over the period 2003/04 to 2009/10 of 35% was achievable and that the Department would not expect the final operating efficiency target to be less than this.

In the course of our work we were unable to identify any audit trail or other evidence to justify the subsequent reduction in the 35% figure to 22%.

A more detailed relative efficiency analysis was later done by Ernest for DRD using the OFWAT methodology. This study concluded that water and sewerage operating efficiency improvements over 5 years should be at least 37% to 42% with room for more. In Scotland, again using the OFWAT methodology, the Regulator estimated that Scottish Water should be able to achieve operating efficiencies excluding any merger benefits of 37% in the shorter period 2001-2005. In the event the company achieved efficiencies of 39% and improved service quality over the same period (see figure 1).

Figure 1: Scottish Water Operating Efficiencies



Finally, it has been argued that increased efficiency means job losses and that this leads to lower service quality. This is not necessarily so. Although some job losses may be inevitable, operating efficiencies are largely about areas such as better procurement processes and better project design, i.e. better management.

The Panel is firmly of the view that operating efficiencies which we have recommended are soundly based and achievable along with better service quality. We note that the limited progress to date – i.e. 2.5% per annum since 2003 – will make the task more difficult. However, this means that there is still a great deal of scope for improvement. NIW must now make further major progress quickly if it is to achieve its stated aim of being the best water company in the UK by 2014.

Strand Two

In this, our second and final report, we deal with the important outstanding issues of legal structure, governance, capital investment and affordability. We look forward to the full public consultation which the Executive will now be arranging on our recommendations, and we would encourage you to engage in the debate.

I have been fortunate to have as colleagues on the Panel Charles Coulthard, Professor John Fitzgerald and Joan Whiteside. Once again, I would like to thank them for their dedication and support, and for fitting the demanding additional workload into their heavy schedules.

I would also like on behalf of the Panel publicly to acknowledge the work of our Secretary Bill Smith, who captured the essence of our arguments from numerous discussions and drew them together in this report; and the other members of our staff team.

Finally, our special thanks go to everyone who wrote to us or met us with evidence: without their contributions our task would have been impossible.

Professor Paddy Hillyard
Chair of the Independent Review Panel

16 January 2008

CONTENTS

EXECUTIVE SUMMARY

The restoration of the devolved administration and the Executive's decision to rule out privatisation as an option have transformed the context for the development of Northern Ireland's water and sewerage services. The future arrangements must both deliver high quality services cost-effectively and satisfy the new requirements of full and transparent accountability to the people of Northern Ireland through their Executive and Assembly.

Strand One

In our Strand One Report, published in October 2007, we recommended that:

- Direct rule Ministers' proposals for water charges should be abandoned, saving householders around £153 million annually
- Households should not have to pay twice for water and sewerage services: they are already paying some £109m towards water and sewerage services through their rates bills
- Plans for optional household metering should be dropped for the foreseeable future
- There should be no standing charge. Domestic payments should be based on property values and supported by an improved affordability scheme – the most generous in the UK - for those who can least afford to pay

- There should be one single household bill identifying separately contributions towards rates, water and sewerage services

- Bills should be kept as low as possible, and steps to reduce them should include:

    - Removing road drainage costs, saving householders £15m in 2009/10

    - Increasing NI Water’s operating efficiency target to 40%, saving £23m

    - Reducing NI Water’s required dividend, saving £4m

    - Discontinuing domestic metering, saving over £1m

    - Rationalising billing and debt recovery systems

Our main Strand One findings and recommendations are reprinted at Appendix 2.

Strand Two

Further to the publication of our Strand One Report, we have examined the issue of affordability in greater detail. We have also covered the areas of governance, management, and delivery.

It has been clear to us from the start that for various historical reasons the reform process under direct rule Ministers failed to secure public confidence. Action is now urgently needed to ensure that we have not only an effective and efficient system, but one which the public and its elected representatives can trust. That has been our overarching goal.

Our Strand Two conclusions and recommendations may be summarised as follows.

Affordability

In principle, we take the view that everyone should contribute towards the cost of investing in high quality, sustainable and safe water and sewerage services: and that there should be generous support in place for those who can least afford to pay. As a result of the Executive's acceptance of our Strand One recommendations, households here will save over £153m annually relative to the direct rule proposals: that is the equivalent of £160 for the average home.

We recommended in Strand One that households should pay an amount based on the capital value of their property. This will allow the water and sewerage payment system to be aligned with the rating system. Our recommendation to abolish the standing charge will mean lower bills for around 60% of households, those with a capital value of £110,000 or less. And Northern Ireland will be the only region in the United Kingdom which has introduced a comprehensive income-related Affordability Tariff to protect vulnerable people.

In our Strand One report we identified targeting and take-up problems with the proposed Affordability Tariff. In Strand Two, we have considered how best to tackle them. We have concluded that the proposed Affordability Tariff will be effective and should be extended beyond its present limit of 2010; and that all those who are eligible for the recently enhanced Rate Relief Scheme should continue automatically to qualify for it. This will benefit those low income households who are receiving no or only partial help with their rates through Housing Benefit, pensioner households which are asset rich and income poor, and everyone aged over 70 who is not otherwise eligible.

As with the revised Rate Relief Scheme, better-off pensioners who are not eligible for the Affordability Tariff should be able to defer their payments at a concessionary rate of interest for the rest of their life or until their house is sold. To maintain consistency with the rating system, the reduced capital value ceiling of £400,000 should also be applied in calculating water service payments.

Finally, an effective and properly resourced campaign should begin urgently to ensure that all those who qualify for Rate Relief or other passport benefits get them.

Towards Better Governance

That the direct rule Ministers’ reform process failed to secure public confidence is due largely to a lack of openness and transparency in their decision-making and accountability processes. We have also discovered four substantial flaws in the arrangements which they put in place for accountability and regulation: they lack public confidence; clarity about roles and responsibilities; openness and inclusion; and specialised expertise. These deficiencies should be rectified immediately in order to create firm foundations for future stability. The respective roles and responsibilities of the different agencies in the governance system should be clarified and overlap minimised. Overall, the system needs positive leadership, and it must be clear to all concerned who is accountable to whom and for what.

The Minister for Regional Development should assume overall authority and responsibility for the entire water policy development process and for the political oversight of the system's performance. He should continue to be supported by the Department for Regional Development's (DRD's) Water Policy Division and a separate Shareholder Unit, also in DRD.

An independent Water Advisory Panel should be established to report publicly to the Minister on the services' strategic objectives and priorities. The Panel's membership should comprise nominees from the business and voluntary sectors, the regulators, consumer representatives, and independent experts. It should be disbanded as soon as it has reported.

A Business Advisory Panel should also be established with the narrow and specific purpose of supporting the Minister as Shareholder in setting NI Water's business objectives and monitoring its financial performance. This Panel should remain in existence for as long as the Minister is the majority shareholder.

We propose that the 2006 Order should be amended to clarify the powers, roles and responsibilities of the Department, the Utility Regulator and the Consumer Council, and to bring them into line with the Energy Order 2003. The future legislation should give the Consumer Council equal status with the Utility Regulator as the statutory representative of consumers' interests. Both should be able jointly to make regulations setting out guaranteed service standards for NIW's domestic customers. Given that privatisation is no longer an option, the Utility Regulator should no longer have to secure reasonable returns on capital from NI Water.

Finally, the desirable criteria for selection to Board level positions in NI Water and the Utility Regulator should include demonstrable knowledge, experience and understanding of the political, economic and social context in Northern Ireland.

Future Business and Financial Model

The choice of business model should secure public confidence; ensure that good services are delivered at the lowest possible cost to Northern Ireland's users and ratepayers; and minimise any negative impacts on other areas of public expenditure.

It would be neither appropriate nor practicable to reverse the water reform process and reinstate NI Water as an executive agency within DRD. To do so would cost our public expenditure budget over £90 million per year and increasing.

We have concluded that NI Water should continue to be a government-owned company at least for the next five years, subject to the improved governance and accountability arrangements outlined above.

For beyond 2013, the Minister should consider what potential there might be for reducing bills by restructuring NI Water as a company limited by guarantee working in the interest of its customers, a model which we have called the “Customers’ Company”. We believe that such a restructuring could in the right circumstances have the potential both to reduce financing costs and to strengthen customers’ sense of community ownership. The transformation could be implemented with relatively little disruption by retaining NI Water as fully as practicable as it is but establishing the Customers’ Company with the specific purpose of taking over the Minister’s shareholding interest.

In the interim, the dividend extracted from NI Water by DRD as shareholder should be no higher than what customers would pay under a debt-financed model, and this should continue to be the case for as long as DRD retains an equity stake. The amounts received by DRD should be returned to NI Water as a contribution to its capital investment programme, thus lowering customers’ bills.

Investment Planning

The Minister should give immediate and high priority to preparing guidance on social and environmental matters which will clearly define the expected outputs of NI Water’s investment programme over the period to 2013 and beyond. NIW’s current investment priorities should be completely reviewed in the light of this guidance. The new independent Water Advisory Panel should support the Minister in producing this guidance, through a process which is inclusive, open and evidence-based.

Once the Water Advisory Panel has completed its report, it should cease to exist and an Output Monitoring Group should be established, including representation from the Consumer Council. Its role would be to advise the Minister on the company's progress towards meeting the targets in the investment programme.

Sustainability

In line with the Executive's Investment Strategy, investment in the water and sewerage services of the future needs to promote sustainability along three dimensions: economic, societal and environmental.

An independent Environmental Protection Agency (EPA) should be established as a non-Ministerial Department similar to the Utility Regulator. It should discharge the current environmental protection roles of the Environment and Heritage Service, the Rivers Agency, the Fisheries Conservancy Board, the Drainage Council and the Loughs Agency. It should also have a specific responsibility to oversee the production of a Water Demand Management Strategy for Northern Ireland.

OFMDFM should include NI Water in its list of public bodies required to act to promote sustainable development. All NIW's major capital investment projects should in future be subject to a full cost-benefit analysis which takes account of environmental and resource costs, to be undertaken jointly between the new EPA and the Utility Regulator.

The DOE should produce as a matter of urgency a Planning Statement on water sustainability in spatial planning and building design. This should include proposals for legal duties to be followed in making planning decisions.

Building Regulations should be changed to encourage water conservation measures in new buildings. For existing homes, consideration should be given to the possibility of offering cuts in water service bills as an incentive to conservation. These actions could be supported by a comprehensive public education programme.

1. INTRODUCTION

1.1 In order to restore public confidence in the future of our water and sewerage services, the new Northern Ireland Executive announced on 11 June 2007 that privatisation was no longer an option. The Minister for Regional Development set out the terms of reference for a comprehensive review of the water reform process: they are reprinted at Appendix 1.

1.2 We published our first report on 12 October 2007, covering the level of funding needed and where it should come from: our main recommendations are summarised at Appendix 2. The Executive has agreed that our Strand One Report provides the best way forward for achieving sustainable delivery of services at the lowest possible cost to users and taxpayers.

Scope

1.3 This, our second and final report, comprises five sections covering:

- improvements in the present structure of governance
- possible alternative structures
- investment planning
- sustainability
- affordability

1.4 The questions we have tackled are complex and we have found few obvious answers. We have reviewed a considerable volume of documentation and have taken evidence from those listed at Appendix 3.

1.5 We were disappointed that the DFP officials from whom we took evidence were unable to respond more proactively to our requests for information on the wider public expenditure implications of the future business models, which we consider in Chapter 4. As a consequence we have been unable to resolve as fully as we would have wished some uncertainties about the best business model for the future beyond 2013.

1.6 In the course of our work we have:

- analysed the current legal status of Northern Ireland Water in depth, including its statutory relationships with Departments and other bodies and its responsibilities to the people who use and pay for its services

- evaluated the present arrangements for accountability and regulation in light of the restoration of the devolved administration and the Executive's decision that the services should not be privatised

- examined the corresponding statutory frameworks in other jurisdictions, looking in depth at those in Scotland and Wales

- assessed the extent of past underinvestment, including the level of spending needed to meet current European standards

- searched for ways of reducing the cost of the capital needed to finance infrastructure investments

- tested the impact of a range of tariff systems on different household types

- considered all these issues within an overarching commitment to sustainable development.

The Water Reform Process

1.7 We have outlined the main events in the direct rule Ministers' water reform process at Appendix 4. They considered a range of options, including the models currently in place in Scotland, England, Wales and Northern Ireland, before deciding in favour of the Government Owned Company (GoCo) model. This change was implemented in April 2007 with the creation of Northern Ireland Water (NIW).

1.8 In considering the review team's recommendations, the direct rule Minister was required to act within a framework of financial policies determined by HM Treasury. In October 2005 he reached an agreement with the Treasury that the GoCo should become self financing by 2009/10; and that private sector control options should not be ruled out in the longer term – in effect re-opening the door to eventual privatisation. This agreement was the basis for the financial framework for Northern Ireland Water's first Strategic Business Plan (SBP), which was published in May 2007.

1.9 All Northern Ireland's political parties had expressed reservations about the NIO water reform process, and one of the first decisions of the new Northern Ireland Executive was that it should be subjected to the current independent review. The Executive also made clear that it ruled out privatisation as an option.

1.10 The restoration of devolution and the Executive's decision against privatisation have created a new context for the development of water service policy. In preparing this report, we have not been constrained by any of the decisions taken during the NIO reform process. We have focussed on designing a clear and effective governance framework which will fully meet the needs of this welcome new political reality. We have reviewed the fundamental issues with a critical eye, taking into account the social and environmental dimensions as well as the economic objectives of cost-effectiveness and efficiency. We have produced a series of findings and recommendations – some for immediate improvement, others for consideration over a longer time span. We intend these to inform a full and open public debate, during which the people of Northern Ireland and their elected representatives will have the opportunity for the first time to determine what arrangements best meet their needs as service users and taxpayers.

Principles

1.11 In addressing our remit we have adopted the following essential objectives:

- public confidence
- effective delivery of high quality services
- maximum cost-effectiveness for customers
- affordability
- sustainability

1.12 We have recognised the need for balances and tradeoffs between them: for example there is an obvious tension between the pursuit of ever higher water quality standards and affordability.

1.13 In addition to these core objectives, the governance arrangements for our water and sewerage services must ensure:

- Clear priorities and targets
- Financial stability, with security of funding for at least 5 years
- Access to finance on favourable terms
- Full accountability to elected representatives
- Full and independent regulation covering economic, environmental and social dimensions

- Clear roles, powers and responsibilities
- Openness and transparency in decision-making
- Operational autonomy for the services' management
- Ability to attract and retain personnel with knowledge and experience of the water industry
- Alignment of management and workforce incentives with customers' needs
- Minimizing costs and disruption of any transition from present arrangements

2. TOWARDS BETTER GOVERNANCE

2.1 In this chapter we will assess the present structure of governance and make recommendations for improvements. There is a summary of the present structure at Appendix 5.

2.2 We concluded at an earlier stage in our work that NIO Ministers tended to rely on models and practices based on experience in England whether or not they were appropriate for circumstances here, and despite the opposition of our political parties. One of the drivers for the 2004 reform package was the Treasury's desire to keep the door open for eventual privatisation. The 2006 Order was based on the corresponding legislation in England, where it was intended to produce multiple private sector providers. Given the restoration of the Executive and its prompt decision not to proceed with privatisation, we have sought to establish whether these existing arrangements are still appropriate.

2.3 What we are addressing in this chapter is the incremental improvements which could be made within the present broad governance framework. We will consider the case for a completely different business model in Chapters 3 and 4.

2.4 The current structure came into operation in April 2007, and its performance cannot yet be evaluated fully on the basis of experience. In making our assessment, we have taken into account the fact that a substantial programme of reform and restructuring is still in progress, and that relationships between the various agencies in the new structure are still in the process of bedding down.

2.5 Overall, we have concluded that the current governance structure goes some way towards opening up the potential for better services and greater efficiency: it is not predicated upon eventual privatisation. However, it is already clear from the evidence we have seen and heard that *the system suffers from four serious deficiencies which must be remedied urgently: in public confidence; clarity about roles and responsibilities; openness and inclusion; and specialised expertise.*

2.6 Some of the changes which we recommend will require legislation: others can and should be made immediately. Until this is done, we would not expect the public to be satisfied that their interests are sufficiently protected and promoted relative to those of the state, the service provider, and the regulators themselves.

Public Confidence

2.7 In our Strand One report, we traced public mistrust in the reform process back to its origins in direct rule Ministers' attempts (a) to pave the way for privatisation by stealth and (b) to charge people for water twice. The restoration of the Assembly and the Executive's prompt decision against privatisation have provided an opportunity to rebuild the public confidence which their predecessors lost.

2.8 In this section we will focus on the roles of the Minister and the Assembly, both acting on behalf of the people as their elected representatives; the Board members who represent the public interest at the apex of NIW and the Utility Regulator; and the Consumer Council as the statutory representatives of consumers' interests.

Minister

2.9 The key to success in restoring public confidence lies in the authority of the Minister as the political head of the Department of Regional Development; and in his accountability to the Assembly. The Minister must have ultimate political responsibility for the successful operation of the entire governance system. It follows that he must have the authority and statutory powers required to make the system work. As illustrated in Appendix 5, the system is complex and responsibilities are distributed across a number of Departments and agencies. An important element in the Minister's leadership role is to co-ordinate activity across Departments and their agencies, working in co-operation with his Executive colleagues.

2.10 The Departments (NI) Order 1999 establishes that the Department must operate under the direction and control of the Minister. We take this as given. *However if there is any residual ambiguity about the Minister's powers, we recommend that amending legislation should be introduced to remove it.*

Assembly

2.11 It was put to us in evidence that the restoration of public confidence requires a strengthening of the Assembly's powers in relation to the approval of secondary legislation. At present regulations on issues such as water quality and performance standards and charging arrangements may be passed automatically without debate unless the Assembly acts to prevent it. It was suggested instead that all such regulations should instead require positive approval after full debate and a formal vote.

2.12 We note that the proactive approval of the Assembly is currently a requirement under the 2006 Order only for such politically salient issues as the appointment of a new service provider; fluoridation; the classification of trade effluents; the safety of reservoirs; and some categories of vesting order. Nevertheless, it would be misleading to suggest that the Minister can make secondary legislation without the Assembly's knowledge or against its wishes. The Assembly's procedures provide for Members to debate any draft regulation at their discretion. Indeed, we understand that every draft regulation on water and sewerage service issues is subjected to detailed scrutiny by the Regional Development Committee.

2.13 Clearly, under direct rule there was a substantial democratic deficit: with the restoration of the devolved administration it appears that this has been fully rectified. *We are satisfied that no legislation can be enacted without exposure to the scrutiny and endorsement of the Assembly or its Regional Development Committee.*

2.14 Moving from the Assembly's role as legislator to that of performance monitor, several witnesses identified deficiencies in

NIW's accountability to the Assembly. It was put to us that the current structure could encourage the development of a closed circle of regulation, in which DRD officials, NIW executives and the Utility Regulator would run the system to the exclusion of service users and elected representatives.

2.15 It seems to us that this argument confuses accountability with regulation. By accountability, we mean the arrangements whereby NIW as a publicly owned company reports to the Assembly through the Minister and Department: by regulation, the arrangements where specialised agencies set targets and parameters for NIW, monitor its compliance, and have statutory powers of enforcement.

2.16 We acknowledge the validity of the concern about a closed circle of regulation, which we will consider later in this chapter. *As regards accountability, we are satisfied that the Assembly and its Committees already have sufficient powers to hold the Department and NIW to account in the public interest on the same basis as any other public sector agency in Northern Ireland.*

Board membership

2.17 It was put to us in evidence that NIO Ministers in making public appointments emphasised experience in the privatised utility sector in England at the expense of local knowledge and understanding. We agree, and we believe that this has contributed to the failure of the new system to attract public support.

2.18 *We recommend that in future public appointments to the boards of and senior positions in NIW and the Utility Regulator the desirable criteria should include demonstrable knowledge, experience and understanding of the political, economic and social context in Northern Ireland.*

<u>Consumer representation</u>

2.19 In the context which we described in our Strand One report of widespread popular alienation from the reform process, we consider that it is essential quickly to restore a strong representative consumer voice, which (a) must be independent of DRD, NIW and the Utility Regulator, and (b) capable of bringing adequate resources to the negotiating table on behalf of consumers.

2.20 In preparing this report, we discovered variations for which we could find no clear explanation in the remit of the Consumer Council, depending on whether they were dealing with water or energy issues. In particular, we did not find any convincing rationale for granting weaker powers to the Consumer Council in the 2006 Order than those in the Energy (Northern Ireland) Order 2003.

2.21 *We recommend that the statutory powers and responsibilities of the Consumer Council should be enhanced to bring them into line with those which apply to the regulation of the electricity and gas industries. This will require legislative amendments to the 2006 Order*.

2.22 *We further recommend that the 2006 Order should be amended to give the Consumer Council equal status with the Utility Regulator as the statutory representative of consumers' interests. This would include*:

- *equal access to commercial and environmental information*
- *the right to participate and be consulted at all stages in the policy formulation process on equal terms with other statutory stakeholders*
- *primacy in the function of addressing complaints and resolving disputes between NIW and its customers*
- *stronger statutory duties on NIAUR and NIW to consult the Council on issues of concern to service users, including charging policies and schemes*
- *the power to audit NIW's complaints and customer care procedures*

Openness and Inclusion

2.23 One of the factors sustaining public mistrust in the system is a perceived lack of openness and inclusion in decision-making. The changes which we have recommended in the previous section in the criteria for Board membership and the powers of the Consumer Council will go some way towards opening the system up and making it more inclusive. Two obvious sources of public disquiet remain: the fact that the environmental regulator is embedded in the Civil Service, and the lack of an independent source of advice to the Minister on the services' strategic objectives and priorities. We will return to the value and importance of independent environmental regulation in Chapter 7.

2.24 The 2006 Order empowers the Minister to give directions to the Utility Regulator on social and environmental matters. This parallels similar provisions in the English legislation. However, we do not consider that the English model is necessarily appropriate for Northern Ireland. There, it was necessary to overcome the governance issues associated with a Minister giving policy directions to private companies: here this is not the case. *We recommend that Article 7 of the 2006 Order be amended to the effect that the Department's guidance be issued directly to NIW rather than to the Utility Regulator.*

2.25 In Scotland, where like here the water company is publicly owned, the Minister gives it a list of detailed policy objectives to be achieved over the forthcoming price control period. The economic regulator is required to set prices at a level such that these objectives can be met at the lowest reasonable cost. To advise him on objectives and priorities for the 2006-2010 price control period, the Minister commissioned an advisory group, the Water Quality and Standards Board (QSB). Its membership included the company, the regulators, the consumer body and a range of voluntary and business representatives. Papers produced by the QSB were published. Once it had given its advice, the QSB was disbanded.

2.26 We are reluctant to add further complexity to an already dense network of policymaking and regulation. However we see the following advantages in introducing a similar advisory body here:

- access for the Minister to a wider range of perspectives, ideas and opinions

- greater public participation and confidence in the policy process

- wider ownership of policy decisions and strategic priorities.

2.27 What we have in mind is an independent stakeholder group outside the Department which is able to take a strategic overview of NIW's activities, their economic, social and environmental implications and performance for consumers, and to advise the Minister accordingly.

2.28 *We recommend that an advisory body, which we have provisionally called the Water Advisory Panel, should be established here along the lines of the Scottish Executive's Quality and Standards Board.* It would report publicly to the Minister for Regional Development with advice on NIW's strategic objectives and priorities. Its membership would comprise nominees from the business and voluntary sectors, the regulators, consumer representatives, and independent experts. Its working practices would be open, transparent and inclusive. The papers which it produced would be publicly available through its website. It would be disbanded as soon as it had submitted its report.

Roles and Responsibilities

2.29 Many of those who submitted evidence to us emphasised the importance of clarifying the roles and responsibilities of the various agencies in the governance system.

<u>Department</u>

2.30 Several witnesses identified potential tensions amongst the Department's multiple roles in policymaking, performance monitoring and shareholding. As Accounting Officer, the Permanent Secretary is ultimately responsible for the proper use of public money across the services; he and his officials are responsible for the development and implementation of water policy and legislation; and they have important powers of enforcement and regulation. There was a particular concern that it might prove difficult for DRD to maintain the appropriate distance from NIW given that:

- the Shareholder Unit is an integral part of DRD
- the Director of the Unit is line-managed by and reports to the same Deputy Secretary as the Director of Water Policy Unit.

2.31 We believe that these concerns can be resolved through the leadership role of the Minister and through his accountability to the Assembly. As stated above, the Department operates under the direction and control of the Minister. As long as NIW remains in the public sector it will require a sponsoring Department and a senior civil servant to take on the role of Accounting Officer, alongside the Chief Executive as Accounting Officer in NIW. Where there is tension – for example between social and environmental priorities - it is the Minister's responsibility to reconcile them, in consultation as appropriate with his Executive colleagues. The function of the Department is to advise and support him.

2.32 We did consider whether we should recommend transferring the Shareholder Unit to another Department such as OFMDFM or DFP. We concluded that this would create greater fragmentation in an already complex system, and that it would not be cost-effective. It would be artificial and would leave the Unit isolated in an alien organisational environment.

2.33 We also looked at the possibility of scrapping the Unit altogether and distributing its powers and responsibilities to other elements in the system, including Water Policy Division. We concluded that for as long as NIW remains as a government owned company, the balance of the argument favours the retention of a distinctive Shareholder Unit which will focus sharply on NIW's financial performance. We would expect it to bring to bear a level of financial scrutiny and discipline which will be more stringent than the Civil Services' traditional approach to the performance management of NDPBs.

Utility Regulator

2.34 The 2006 Order gives the Department more powers in relation to the control of the regulatory system than is the case with other utilities. It was put to us that:

- the Authority should not be constrained in discharging key regulatory functions by the need to obtain Departmental consents

- there is no justification for the role of regulatory "enforcement authority" to be discharged by both the Authority and the Department, and the boundaries of the two bodies' enforcement roles are unclear

- there is no obvious rationale for greater Departmental involvement in the regulatory function in the 2006 Order than in the Energy (Northern Ireland) Order 2003

2.35 It is clearly essential that the Utility Regulator should ultimately be accountable to the political oversight of the Executive and Assembly, and we take the view that in the case of water and sewerage services this oversight should be exercised on their behalf primarily by the Minister for Regional Development. As far as the day to day exercise of his statutory functions is concerned, the Regulator must be free to conduct his affairs outside the shadow of possible interference from the Department. The operational independence of the Regulator is a crucial element in the system which must be guaranteed and protected.

2.36 *We recommend that the 2006 Order should be amended to clarify the Regulator's powers and responsibilities by bringing them into line with those that apply to electricity and gas.* In particular, the Regulator should have a general power to regulate without the need for specific authorisations (which potentially can be withdrawn individually) to be delegated from the Department. His powers and responsibilities should be clearly distinguished from those of the Department and the Consumer Council, and there should be no duplication between the powers and responsibilities of these three bodies.

2.37 It was also put to us that the Utility Regulator should not require the authorisation of the Department before making regulations setting guaranteed service standards, as required by the 2006 Order. These regulations give consumers enforceable rights to a defined standard of service. We agree.

2.38 *We recommend that Articles 69 and 152 of the 2006 Order be amended to enable the Utility Regulator and the Consumer Council jointly to make regulations setting Guaranteed Service Standards for water and sewerage, without first applying to the Department*.

2.39 Finally, it was argued in evidence to us that given the political decision to rule out privatisation it is was inappropriate for the Utility Regulator to have a statutory obligation to ensure that NIW is able to secure reasonable returns on capital. We agree.

2.40 *We recommend that Article 6 of the 2006 Order be amended to remove the Utility Regulator's obligation to ensure that NIW is able to secure reasonable returns on capital*.

Specialised Expertise

2.41 It was put to us by several witnesses that the Department was handicapped in the discharge of its shareholding function by a lack of specialised expertise. This is no reflection on the individuals concerned. In the Civil Service it is normal for officials to move through different postings after a few years, which can hamper the development of in-depth specialised expertise in a particular business area.

2.42 To tackle this difficulty the Department has already arranged access to the expertise available from the UK Shareholder Executive, and this should continue. But it is not enough. What is lacking is a close understanding of the local business context.

2.43 *We accordingly recommend that a small Business Advisory Panel should be set up which would bring an independent financial and commercial perspective to the Shareholder Unit's oversight and review of NIW's performance.* The Panel would meet no more than four times a year and would report to the Minister once a year on the Unit's performance. This would help compensate for the limitations created by the fact that (a) there is only one shareholder in the company, and (b) that shareholder is not an expert in financial and commercial affairs. It would also improve openness and inclusion, and promote public confidence.

Conclusion

2.44 We have made a number of recommendations intended both to improve the present governance arrangements and to restore public confidence in them:

- the appointment of an independent Water Advisory Panel to advise the Minister on economic, social, environmental and consumer priorities
- the appointment of a Business Advisory Panel to support the Minister in his role as majority shareholder
- stronger powers and duties for the Consumer Council
- clarification of the powers and responsibilities of the Department and the Utility Regulator

2.45 Some of our recommendations can be implemented immediately by administrative means. Others will require amendments to the 2006 Order and to NIW's operating licence. We are satisfied that the provisions in the Order for licence modifications are sound, and we consider that any amendments to the licence to provide consistency with our recommendations should be made by the Regulator in accordance with them.

2.46 In the next two chapters we will consider the larger question of whether the business model for which the 2006 Order provides is the best available for Northern Ireland beyond 2013.

3. FUTURE BUSINESS MODELS

3.1 We were asked to consider whether the Go-Co is the best and most appropriate business model in the new political context created by the restoration of the Assembly; and whether any other options might be better, such as those in Scotland and Wales.

3.2 In light of the Executive's decision to reject private control of water and sewerage services, we offer no assessment of the English private sector equity model. In assessing whether any other model is or is not within the public sector, we have noted the DFP guidance which states that: "…a body will be in the public sector if government exercises control over its general corporate policy". The guidance goes on to explain that government control may be evidenced by such things as:

- the power to appoint directors
- the provision of funding for specific purposes
- ownership of a majority of the shares
- the right to demand certain information, determine policies or decide how profits are used
- a general right to control day-to-day operations

3.3 As we explained in our Strand One report, the financial control regime applied to trading agencies in the public sector under Treasury guidance varies according to their legal status. Thus different options have different implications both for user payments and for public expenditure.

3.4 We are determined to minimise costs both to service users and to other areas of public expenditure. We recognised the value in restructuring the Water Service in April 2007 primarily because the continuing application of the Treasury's conventional agency control regime would have reduced the sum available for other areas of public expenditure here by over £90m annually. We will consider this dimension in greater detail in Chapter 4.

3.5 In examining the alternatives to the existing business model, we did not restrict ourselves to the Scottish and Welsh alternatives. We also considered the potential for such options as community-owned and cooperative bodies and trusts, and we looked at other examples from Europe and further afield. We did not have the time to analyse and compare these models in depth, but we were able to conclude that many of them would be problematic because of the substantial differences in their legal, political and cultural contexts.

3.6 As far as the UK alternatives are concerned, we recognise the value of learning from experience in Scotland and Wales. So we have focussed on the three different models already operating in Northern Ireland, in Wales and in Scotland, which are examples respectively of the Government Owned Company (Northern Ireland); the public interest Company Limited by Guarantee (Wales), which we have called "the Customers' Company"; and the Statutory Corporation (Scotland).

3.7 We also considered the case for reversing the reform process and reabsorbing NIW into the Civil Service. However with the loss of over £90m annually to public expenditure, the former arrangements failed to satisfy our criterion of cost-effectiveness: they would also be inconsistent with our earlier recommendation that the services should as far as possible be self-financing.

Government Owned Company (GoCo)

3.8 The present constitution of NIW is summarised in Appendix 5. It captures the essential features of the GoCo model. In general terms, a GoCo has the following attributes:

- constitution set out in Memorandum and Articles of Association
- unambiguously under public sector control
- established under and must conform with companies legislation
- over 50% of ordinary share capital owned by government
- shareholders may receive regular dividend payments
- accountability relationship with sponsoring Department
- permitted to recover costs and build up reserves through trading operations

Customers' Company

3.9 What we have in mind here is a sub-type of the Company Limited by Guarantee (CLG). The critical difference from a normal private sector CLG is that the Customers' Company would be owned by its members – representing customers' interests - and would have a duty either to plough back any surplus to its customers in the form of reduced bills or to invest it in service improvements. It would have the advantage that technically, under Treasury rules, it would be considered a private company. Consequently, it could potentially achieve a significantly lower cost of capital than would be possible within the constraints imposed by the Treasury on the state sector.

3.10 Unlike the GoCo, the CLG would have no shareholders but would be owned by its members: it would not pay dividends. The members' legal liability would be limited to their guarantee, usually £1, in the event of insolvency. They and the directors would be appointed independently of government.

3.11 The Customers' Company model is distinct from the concept of the mutual, which is often used to describe organisations whose members and customers are the same: certain building societies are the best known examples in the UK. In England in 2000 there was an attempt to convert the Kelda Group, owners of Yorkshire Water, into a mutual: but the economic regulator blocked this on the ground that there was no evidence of benefits for customers.

3.12 The best known example of a public interest CLG in the utility sector is Glas Cymru, which provides water and sewerage services to over three million people in Wales and adjoining areas. Originally a private company with share capital, Welsh Water (Dwr Cymru) was bought by a specially created public interest CLG, Glas Cymru, in 2001. Instead of paying dividends to shareholders, it redistributes its surpluses to its customers in the form of price discounts and service improvements.

3.13 In formal terms, Glas Cymru is a CLG and as such is owned and controlled by its members. These are around 50 individuals selected from various backgrounds across Wales. They are not intended to represent any interests other than those of the general public and service users. They are nominated by an independent panel following an open selection process which is based on best practice in public appointments. The panel has an obligation "…to ensure that Welsh Water maintains a balanced and diverse membership which is, as far as possible, broadly reflective of the range of customer and other stakeholder interests served by Welsh Water."

3.14 The members of Glas Cymru do not receive dividends and have no financial stake in the company. They have a duty to support its primary object of providing high quality water and wastewater services at least cost to the community. They play an active role in overseeing the Board's performance: they have the power to remove directors in the event of significant under-performance and to elect replacements.

3.15 The essential attributes of the Customers' Company as we have defined it may be summarised as follows:

- constitution set out in Memorandum and Articles of Association
- established under and must conform with companies legislation
- owned and controlled by customers' representatives
- subject to government regulations and statutory guidance, including guidance on drinking water and environmental quality programmes and social priorities
- dividends returned to customers as discounts or invested in service improvements
- under the right conditions may be able to access cheaper finance as described in Chapter 4
- while this would in reality be a company owned by the public it would enjoy the advantages of a private company under Treasury rules

3.16 Glas Cymru also exemplifies the thin equity approach to financing which we will consider in greater detail in Chapter 4. Its assets and capital investments are financed by bonds and retained financial surpluses. As a result, Glas Cymru told us in evidence that it has achieved the following improvements for its customers since 2001:

- lower water bills

- surpluses returned to customers, not distributed to shareholders

- improved drinking water quality, environmental compliance and customer service

- long term financial stability

- strong financial reserves to protect customers against future price shocks and improve the company's credit rating.

State Company Limited by Guarantee

3.17 A CLG may also take the form of a state owned CLG. Formally this is similar to the model described in the previous section. The main differences are that:

- the members would be appointed by the Minister or in accordance with terms and conditions set by him

- it could be established more quickly, without the need for extensive legislative changes

- it would be a public sector body and hence subject to the Treasury's financial control regime.

Some people might find this model more appealing than the Customers' Company since its members would be appointed by Ministers and it would be directly accountable to the Assembly, despite its potentially negative implications for public expenditure. This model would not necessarily achieve the same financial benefits for customers as the Customers' Company: whether it did would depend on the outcome of discussions with Treasury.

Statutory Corporation

3.18 Statutory corporations can be divided into those in which the government has a controlling interest (like the NI Housing Executive and Scottish Water) and those in which it does not (like the National Trust). The essential attributes of a statutory corporation are:

- created by statute
- constitution set out in legislation
- must act within the scope of its statutory functions and powers, which can be extended or varied only through further legislation
- accountable to sponsoring Department for proper use of public finance
- operating costs normally recovered by means of charges
- separate legal entity from its members
- where the government has a controlling interest, the members are generally the directors
- restricted ability to borrow for capital investments

- subsidies or capital grants score against sponsoring Department’s budget.

3.19 The Water Industry (Scotland) Act 2002 provided for the establishment of a statutory corporation, Scottish Water, as the successor to Scotland’s three water and sewerage authorities. The Act sets out Scottish Water’s corporate governance arrangements and gives it greater powers and commercial freedoms – notably in relation to borrowing - than its predecessors had enjoyed. Scottish Water is the only provider of water and sewerage services to domestic customers in Scotland, and is the fourth largest water company in the UK.

3.20 The 2002 Act gives Scottish Ministers a large degree of control over Scottish Water, and indeed they are required to direct the company as to how its affairs are to be managed and conducted. The Act provides for between 5 and 8 non-executive members and from 3 to 5 executive members: there must be at least 2 more non-executives than executives. The non-executives are appointed by Ministers.

3.21 The Statutory Corporation model can have advantages in terms of political control and clarity of objectives, in that its management, governance and delivery arrangements can be set out in statute. A possible downside is that any changes in these arrangements can be made only through further legislation: but the authority to make such changes can be delegated to Ministers by means of appropriate enabling provisions in the establishing legislation.

3.22 The degree of autonomy that is allowed to the directors of a statutory corporation depends on the terms of the establishing legislation. It may determine their duties and levels of remuneration or provide for these to be specified by another party such as the Regulator. The procedures for appointing and removing directors may be similar to those which presently apply to NIW, or the legislation may give appointment rights to parties other than the sponsoring Minister and Department.

3.23 The members of a government controlled statutory corporation may comprise its senior management (as with Scottish Water), or provision may be made for a wider membership. Where the government does not have a controlling interest, the procedures for appointing and removing members could be similar to those for a CLG. The establishing legislation could also require, permit or restrict the distribution of surpluses. It could also in theory give the corporation the power to borrow from the private sector: but we understand that this would not be permitted under current Treasury rules.

Assessment

3.24 We have identified four broad options for the future structure of our water and sewerage services under public or community control: the Government Owned Company, Customers' Company, State CLG and Statutory Corporation. If agreement could be reached with the Treasury so that the State CLG would enjoy a suitably low cost of capital, then we would favour this option. However, if that does not prove possible, the Customers'

Company might well be both more cost-effective and more popular in that it could offer a lower cost option over the long term. We will consider the cost of capital issue and its interaction with the governance model in the next Chapter.

3.25 In comparing the four options what matters is not so much which legal form is adopted as the content that is put in place in practice. Each model has the potential in principle to meet all of our objectives as identified at paragraph 1.11, depending on the manner and context of its application.

3.26 On the basis of the evidence we have received and the other information available to us we have concluded that the significant differences between the four options lie in the three areas of public confidence; potential cost-effectiveness; and access to cheaper finance.

Public Confidence

3.27 As indicated in Chapter 2, one of the most striking misconceptions that we have encountered in the course of our work has been the perception that Northern Ireland Water no longer belongs to the people of Northern Ireland.

3.28 In addition to the recommendations in Chapter 2, we have concluded that there could be a substantial improvement in public confidence and the creation of a real sense of community ownership if the Department transferred its shareholding in NIW to a Customers' Company established specifically for this purpose. The timing for any such change would need to be carefully planned as we will explain in the next chapter.

Potential Cost-Effectiveness

3.29 One of the drivers behind the reform process has been the quest for efficiency, and in our Strand One report we recommended enhanced efficiency targets for NIW. Under any of the four models, the question arises of how best to motivate the people who work in the services to deliver excellent results for their customers as cost-effectively as possible. We would not expect this to be determined by the choice of model: what matters is that the shareholders/members who own and control the company have the flexibility to decide on the details of the company's business policies in light of the company's primary purposes and industry norms, within broad strategic guidelines set by the Minister.

3.30 *We have concluded that the GoCo model potentially offers a greater degree of commercial freedom and operational independence – and hence efficiency - than the Statutory Corporation.* Since we are not persuaded that the Statutory Corporation offers any offsetting advantages, we have concluded that this option should be ruled out.

Access to Finance

3.31 We come now to the important dimension of financial efficiency. This is a complex area, which requires a detailed exposition. In Table 1 we compare the four business models which are the subject of this Chapter. Having ruled out the statutory corporation, we will look in detail at the potential implications for financial efficiency of the remaining three models in Chapter 4.

Table 1: Comparison of Business Model options

Model	Public Confidence	Efficiency	Access to Finance
GoCo	Required to pay dividend to Shareholder. Tainted by history of reform process, but main objection was to eventual privatisation. Our recommendations should improve confidence.	Has potential to achieve substantial efficiency gains if given operational autonomy and permitted to prioritise business objectives. Low transition costs and little disruption.	Not permitted to borrow from financial markets. Cost of capital set at a higher rate than is warranted.
Customers' Company	Owned by members on behalf of community. Obligation to re-invest surpluses in price reductions and/or service improvements. Credibility and independence of members vital. Potentially the best option.	Has potential to achieve substantial efficiency gains over time, building on achievements of GoCo. Transition costs will be covered by savings on borrowing in the long run.	Once good credit rating is established, should be able to borrow money for infrastructure development at best possible rates. But HMT may impose charges against loss of equity.
State CLG	Owned by Government, but not required to pay dividend.	Lower transition costs but less likely to achieve the same potential efficiency gains in the long run than a Customers' Company.	Can raise money more cheaply than a GoCo to the extent that debt is cheaper than equity. Finance will be provided by government.
Statutory Corporation	Owned by Government. Vulnerable to politically motivated criticisms.	Less flexible than a GoCo and least likely to achieve substantial efficiency gains.	Finance will be provided by government.

3.32 *We have concluded that the Go-Co is the best and most appropriate model to deliver quality services efficiently for the people of Northern Ireland at least for the next five years.*

3.33 For the longer term – say beyond 2013 - we have identified potentially substantial advantages in moving towards the Customers' Company model or State CLG once the right conditions are in place such that this transformation would result in a sustained reduction in NIW's costs of capital and hence also in user charges. *We recommend that the Minister should keep this possibility continuously under review in consultation with all key stakeholders.*

Transfer Issues

3.34 In relation to the possible transfer to a Customers' Company at some future date, the issue arises of whether DRD should simply hand NIW over to it without charge or sell it. If the former, there would be a very substantial cost to public expenditure. If the latter, it might be objected that Northern Ireland's ratepayers and taxpayers were being required to pay again for assets which can reasonably be seen as the product of a substantial financial investment made by them down the years. However because of the very substantial cost to public expenditure we feel there is no option but to recommend the sale. W*e recommend that if it is decided to move to the Customers' Company model, the Department's equity should be bought by rather than given to the Customers' Company. In setting the price for the transfer, however, the Department should bear in mind the importance of retaining public confidence.*

4. TOWARDS CHEAPER FINANCE

Introduction

4.1 We were asked to examine the financial model for the future of Northern Ireland’s water service, and in particular policies on the cost of capital and dividend. Within each of the possible business models which we assessed in the previous chapter there is scope for the application of a wide range of policies on borrowing and returns to shareholders. For example, we referred to Welsh Water’s thin equity approach: this could in principle equally well be applied by a GoCo, if the financial control regime in place permitted it.

4.2 NIW is a capital intensive business. Well over half of its spending is on infrastructure investments. We have accordingly addressed two main questions in depth:

- How can NIW’s financing costs be minimised?
- Would a different company structure help to minimise them?

4.3 In so doing we have tried to take into account the wider implications for public expenditure in Northern Ireland. Because NIW is under public control, its financing arrangements must comply with Treasury rules. These can vary according to the structure of the company and how it is classified by the Treasury for this purpose. Thus the choice of business model can in practice have substantial implications not only for customers’ bills but also for its sponsoring Department’s budget.

4.4 In formulating our recommendations we have had to accept the fact that options which could substantially reduce capital costs and hence customers' bills might also have a negative impact on broader public expenditure. It has not been possible for us to predict with confidence what the outcome might be of the negotiations with Treasury which would be needed to establish with certainty what the full financial implications would be of a process of transformation to a different business model. Consequently we cannot offer definitive recommendations on which business model would most benefit customers and the public purse financially.

4.5 Within that constraint, this chapter:

- assesses the risks facing the water business in Northern Ireland and who should carry them
- considers how different company structures would affect the pricing of this risk as expressed in the cost of capital
- examines the probable implications of Treasury policies and rules
- sets out our recommendations and a possible process of transformation from GoCo to Customers' Company

Risk Ownership

4.6 NIW is currently in the middle of a large investment programme which is planned to continue at least until 2014. To undertake such a programme efficiently it is essential that those who can best control the risks should own them: those who will have to pay for mistakes have the best incentive to reduce them. Risk ownership has implications both for how investments are funded and for the appropriate cost of funding.

4.7 Ultimately the customers and ratepayers of Northern Ireland will pay for their water and sewerage services: they carry all the risks of poor performance. If costs are higher than they need be, the people will pay either directly or through cuts in other public services. If NIW is run efficiently, the people will gain as costs are reduced. So there is a strong incentive for customers to ensure that NIW is efficiently run. The regulatory regime reflects this: costs are passed on to customers as there are no private shareholders to share the risks.

4.8 The business of NIW is the provision of clean water and the disposal of sewerage. Both these activities involve the development and maintenance of major infrastructural networks. In this regard the business has similarities to electricity and gas transmission. All these networks share a number of characteristics:

- they have a long life in engineering terms
- technical change is unlikely to make them obsolete
- they are unlikely ever to face competition
- they are highly capital intensive.

4.9 Unless there are major changes in the distribution of Northern Ireland's population, the water and sewerage pipes which are being laid today will continue to be used for decades. There is no alternative on the horizon. Today's infrastructure investments will benefit both current and future generations. This suggests that the rate of depreciation which is used in the calculation of customers' payments should be low, and this rate of depreciation should be reflected in NIW's financing policies.

4.10 Given that the infrastructure is a highly capital-intensive natural monopoly, there is little likelihood of competing networks developing to serve domestic users. Consequently the owners of the infrastructure can plan to finance new investment assets over their expected lifetime without any risk of competition reducing their future rates of return.

4.11 The low risk nature of network assets such as NIW's has been reflected in the financial markets in recent years in a number of ways. Even in the private sector, businesses that have substantial network assets have seen their valuation increase substantially, reflecting the secure nature of the return they can offer. In Britain, many such businesses have been taken over. Generally the new owners have been able to increase the gearing of the business (that is, the proportion of the capital funded through borrowing). This has been possible because the financial markets have responded to the low risk. With a constant profit for a reduced investment, the rate of return rises. This has contributed to the increase in the share prices of utility companies over recent years.

4.12 In Northern Ireland this trend has been very clear. Phoenix Natural Gas has been the subject of two takeovers, most recently by Terra Firma in 2005. Northern Ireland Electricity was taken over in 2006. These are just two examples in a wave of takeovers associated with two linked factors. Firstly, until recently the rate of interest on long-term low risk debt (especially government debt) had been low by historic standards. Network assets were seen to have a similarly low risk but higher rates of return. They were therefore a good substitute for low yield government debt. Secondly, the regulatory authorities have assumed unchanging shares for equity and debt in the financing of these assets, resulting in a constant relatively high rate of return. The overestimation by regulators of the risks inherent in network assets has offered the opportunity for investors to take advantage of attractive rates of return.

4.13 In this respect it is worth noting the Competition Commission's recent finding in relation to British Airports Authority which appears to signal a reduction in the allowed cost of capital for utilities. In a recent paper, "Regulation and the Cost of Capital", Jenkinson argues persuasively that Ofwat has set the cost of capital charge too high in setting prices for water companies in England and Wales. These findings could well be reflected in Ofwat's next price review, which is due to come into effect in April 2010.

4.14 In Northern Ireland the Utility Regulator has adopted a similar strategy to his counterparts in Britain in allowing returns to investors in electricity and gas assets on the assumption of an unchanging debt to equity ratio. However he has also adopted supplementary policies enabling customers here to share in the rewards that flow from reducing the costs of capital. In particular, the Regulator has overseen changes in the ownership and governance of the gas and electricity interconnectors between Northern Ireland and Scotland: both have been bought by the not for profit company Northern Ireland Energy Holdings. The Regulator has also recently announced his intention to permit the transfer of Phoenix Natural Gas's transmission assets to NIEH. In each of these cases, the change in ownership has dramatically reduced the cost of capital, leading to substantial price cuts for consumers.

4.15 An important implication of this is that the cost of financing for NIW, however constituted, should be low relative to most private companies operating in other sectors. Its assets are essential and they will have a long life. Its customers and ratepayers ultimately carry all the risks of unforeseen problems. Providers of finance, in particular debt finance, can be confident that the regulatory regime will ensure that all costs, including the costs of capital, are passed to consumers. The returns on their investment should reflect the fact that they incur only low risks.

Dividend

4.16 While DRD holds an equity stake in NIW on behalf of the taxpayer, the public expenditure regime ensures that the risks remain within Northern Ireland: there is no scope for subsidisation from Britain. The present arrangements require a rate of return on the Department's equity investment which would be appropriate to the risks of a standard equity investment but on a stake which is protected from those risks.

4.17 We have accordingly concluded that the cost of capital to NIW has been set too high. In principle the ownership of risk by the people of Northern Ireland should be reflected in a reduction in the dividend payable to the Department. Alternatively, the risk should be formally transferred to NIW's customers through the establishment of a debt based financial model whose returns would properly recognise where the risks lie. The rest of this chapter should be read in this context.

4.18 *We confirm the recommendation in our Strand One report that as the level of risk under the current ownership structure is the same for debt as for equity, the dividend extracted from NIW by DRD should be no higher than what customers would pay under a debt-financed model. This should continue to be the practice for as long as DRD retains an equity stake in NIW. The amounts received by DRD should be returned to NIW to prepare the company for a possible change in status at a later date.*

Timescale

4.19 The timescale over which consumers pay for an infrastructure investment project should depend on the nature of that investment. The surge in investment which is currently under way reflects the need to bring our services into compliance with international environmental standards. Subject to any increases in environmental and drinking water quality standards which may be imposed by the institutions of the European Union, it is likely that there will be scope for reducing the level of capital investment expenditure significantly from its current high levels after 2014.

4.20 The long life of water and sewerage infrastructure assets means that it is appropriate to spread the cost of funding them over a correspondingly long period. Full payment out of current revenue would be unfair since most of the burden would be carried by the current generation of customers, while the benefits would accrue to future generations at no cost to themselves. In principle, to the extent that there are intergenerational benefits, the investment programme should be financed through borrowing. This suggests (a) that the NIW investment programme should be funded predominantly through borrowing and (b) that the sums borrowed should be repaid over a period which corresponds with the lifetime of the assets which they cover, which will be well after the present investment surge has ended.

4.21 *We have concluded that NIW's current investment programme should be regarded as exceptional and that as such it should be largely funded through borrowing. The loans should be repaid over a period which corresponds with the lifetime of the assets which they cover. Similarly, depreciation charges should be related to the assets' real life expectancy.*

Preferred Funding Model

4.22 In this chapter we consider and assess two basic scenarios for the capitalisation of Northern Ireland Water. The first would involve NIW continuing to operate in its current form, with the improvements in governance which we recommended in Chapter 2. The second would entail shifting to the Welsh approach which we have described as thin equity. In the first case there would continue to be a substantial government equity stake in NIW: in the second, most of the equity would be replaced by debt. Either approach could in law be applied under any of the business models assessed in the previous chapter: but the constraints and limitations imposed by the Treasury might differ.

4.23 Let us now consider the implications of each of these two scenarios for the cost of capital and hence for consumers' bills.

<u>GoCo with Continuing Equity</u>

4.24 In April 2007 NIW started life as a GoCo. DRD owned all of the £650m share capital in the business. Its remaining capital of £150m was debt which was ultimately sourced from the Treasury. Thus the opening gearing ratio (the proportion of the company's capital provided by borrowing) was less than 19%. The price control regime allows NIW to recover from its customers sufficient revenue to meet the costs of an efficient business, including an allowed rate of return on its investment.

4.25 NIW's Strategic Business Plan assumes a rate of return of around 6.8% in real terms before tax. The Plan does not propose extracting the full allowed return from the business: it provides for extracting the full return on debt (i.e. interest) and only a partial return on equity (i.e. dividend). At around 5.1% the dividend payable to DRD is less than the full return on equity. What this means is that the Department has agreed to reinvest part of its equity return back into the business and to the company's financing part of its capital programme from internal resources (as opposed to incurring further debt). Compared to borrowing, currently at 5.25%, the current level of dividend combined with its lagged payment could offer a small cash-flow advantage to the company. According to the SBP the rate of dividend payable will increase significantly over the next few years.

4.26 NIW started life with little debt and significant capacity to absorb more. In a relatively short period of time NIW is forecast to take on a substantial increase in debt to fund its capital investment programme: after 5 years its gearing is projected to jump from 19% to over 53%.

Customers' Company

4.27 A thin equity company is one whose capital is predominantly funded by debt, although some limited shareholder equity remains, usually in the form of customer reserves. What we have in mind is a gearing of around 80% (i.e. 80% debt, 20% equity). In the wider economy thin equity companies are often seen as offering higher risks and correspondingly higher returns for shareholders.

4.28 NIW in its existing form as a GoCo could move to a thin equity structure relatively easily: DRD could simply exchange a portion of its equity capital for a corresponding increase in debt capital. It is possible that the Regulator in his first price control will assume a gearing closer to this than the present level.

4.29 However, the advantages of the thin equity approach could also be achieved by creating a Customers' Company to take ownership of the GoCo. The overall risks inherent in a thin equity version of NIW ought to be the same as in an equity dominated GoCo. If it were a company in private hands the effect of the change in capital structure would be to concentrate risk in the hands of the much smaller stock of equity. However, in the case of NIW, the regulatory regime means that the long-term risks are carried by consumers, with the result that there would be little change in the company's long-term risk profile.

4.30 As indicated above, NIW's Strategic Business Plan assumes returns of around 6.8% in real terms before tax. Assuming that current levels of equity returns and debt costs are maintained, and that the capital structure is transformed to the thin equity approach, the new cost of capital could be in the region of 4.7%, a reduction of over 2 percentage points. Savings over the longer term could be in the region of 6% to 10% of allowed revenue, resulting in the potential for a corresponding reduction in customers' bills. (This estimate is in line with the 8.5% savings calculated by Stones in his 2001 paper "Changes in the Pipeline? Economic and Public Policy Implications of Water Industry Restructuring").

4.31 While there could be significant long-term benefits for consumers from such a change, an early move to a thin equity CLG could cause significant financial strain for NIW. In line with our criterion of financial stability, we consider that it be prudent to delay any such transformation until NIW has built up its internal reserves and achieved the potential for a solid credit rating.

4.32 We would favour leaving the current company structure largely unchanged if it could enjoy the same financial advantages as it would have after the transformation to a Customers' Company without any loss to wider public expenditure. This will depend on the Treasury's attitude.

4.33 *We accordingly recommend that the Minister should keep under review the potential for moving towards the thin equity approach in the light of the evolving business context as NIW matures.*

Implications for Public Expenditure

4.34 As a GoCo, Northern Ireland Water is treated by the Treasury as an asset of the Northern Ireland Government. It is assumed to be able to pay a dividend to DRD. This dividend is then treated as part of Northern Ireland's public expenditure budget. Thus if the dividend is reduced Northern Ireland will suffer a corresponding reduction in the funds available for public expenditure.

4.35 In addition, if the rate of dividend were permanently reduced there is the possibility that under the prevailing public accounting procedures the value of NIW would be written down (an impairment charge) with a further loss to the public expenditure budget. However, we have learned that there is an agreement between the Treasury and DFP whereby if the Regulator decides to cut the cost of capital at the first price control the Treasury would reflect this new rate in the charges applied to the DRD budget. At the very least these possible differences in treatment make it difficult for us to predict the likely outcome.

4.36 Probably the ideal solution would be for NIW to move to a thin equity approach, reducing its cost of capital (and dividends), combined with an agreement by Treasury to make good any consequential loss to Northern Ireland public expenditure. The prospects of achieving such an agreement would need to be assessed.

4.37 If no such agreement can be reached, the alternative would be to move NIW to a thin equity approach under the ownership of a Customers' Company. In accordance with the Treasury's criteria – as summarised at the start of Chapter 3 – such a company would technically be classified as outside the government's control. In the long term this could have three advantages:

- If payment were required, the Customers' Company would borrow the money to buy NIW on the financial markets. This sum would then be available to be shared between public expenditure here and the Treasury.

- Because DRD no longer owned NIW there would no longer be an asset on its balance sheet requiring a return to be earned in the form of a dividend.

- The Customers’ Company would move to the thin equity approach, reducing its cost of capital and helping to keep customers’ bills down.

4.38 In summary, the move to a Customers’ Company would ideally allow bills to be reduced while retaining community ownership. This reduction could be achieved at no cost to wider public expenditure. The sale of NIW would raise a capital sum which would potentially benefit both Northern Ireland and the Treasury. By reducing Northern Ireland’s cost base the change would benefit the overall economy, and this in turn would produce additional tax revenue for the Treasury.

The Transition

4.39 The transition from a GoCo to a thin equity Customers’ Company could not be achieved overnight. Too early a move would risk severe financial strain on NIW as its planned investment programme drives up borrowing. As we have argued above, it would be prudent to delay any transition until the company has established itself on a more favourable financial footing. We would expect this to take at least 5 years.

4.40 While a Customers’ Company which was largely debt funded would not involve any shareholder interest it would require some capital which would fulfil some of the functions of equity. For example, Welsh Water does not distribute all the savings which it has made on its financing costs, but retains some of them as “customer equity”. It uses this:

- to hold down gearing
- to retain sufficient liquidity, primarily through the ability to access debt
- as a financial buffer against cost shocks
- to help finance large capital investment programmes.

4.41 This customer equity would have to be built up over a number of years. In the case of NIW this could done by reinvesting the dividends payable to DRD in the company for the next few years. This would mean that the benefits would not at first go to consumers, and there would be a cost to the public expenditure budget. However, these costs would be offset by the long term benefits of a sustained reduction in the cost of capital.

Conclusions

4.42 We have considered the financial implications of two possible scenarios for the organisation and financing of our water and sewerage services beyond 2013. The first would mean maintaining NIW as a government owned company with the improvements in the governance system which we recommended in Chapter 2. The second would mean creating a Customers' Company which would be controlled not by the state but directly by representatives of the community selected for this specific purpose. *We recommend that the first should continue to apply for at least the next five years, but that the Minister should review the potential for moving to the second in the light of the evolving business context as NIW matures.*

4.43 In our discussions with Treasury officials, we were given to understand that they would not obstruct any changes in the structure of NIW, provided that any consequential costs were borne by the Northern Ireland public expenditure budget.

5. INVESTMENT PLANNING

5.1 We were asked to review the scale, structure and phasing of NIW's planned investments and to assess whether the current investment planning arrangements are sufficient for identifying the appropriate level of funding needed over the next 20 years to meet our requirements and those of EU legislation.

5.2 We addressed the issue of underinvestment in our Strand One report. In Strand Two we focussed on the process through which strategic priorities are set for NIW's capital investment programme. In the first part of this chapter, we will assess the current Strategic Business Plan and the process through which it was produced. Looking ahead, we will consider how the process might be made more open and responsive for the next planning round.

Strategic Business Plan (SBP)

5.3 NIW's investment programme as set out in the SBP amounts to £1.6bn over the 7 year period to March 2014. Most of this is for capital works, although there is also provision for equipment, new technology and metering. We understand that the priorities for the programme were set by DRD in consultation with the Water Service and the DOE environmental regulators.

5.4 At various stages in its development the capital programme was reviewed by Halcrow, an independent firm of engineering consultants, who were asked to assess its accuracy, necessity and appropriateness. The programme was revised to take account of issues raised by this review process. The outcome was presented as the minimum acceptable to the environmental regulators.

5.5 The capital programme is funded through a combination of debt finance and internally generated income. While progressively more will be funded from internally generated income over time, the prime source of finance will be debt, which will account for some 70% of the capital programme in the period to 2010.

5.6 It is useful to consider the capital programme in two parts: the 3 year period to 2010 and the remaining 4 year period to 2014. The period to 2010 was the basis for the initial DRD price control, while the period from 2010 to 2014 was to be covered by the Utility Regulator's price control regime.

5.7 The second period is more uncertain for a number of reasons:

- priorities will be informed by Ministerial guidance on social and environmental matters
- there may be stricter European environmental standards emerging from the Water Framework Directive
- the Regulator will reset the target level for capital efficiencies.

5.8 During the earlier period, NIW plans to invest £667m, which will be concentrated on Wastewater Treatment Works (WWTW). As a result, the number of people served by compliant works will increase from 77% in 2006 to 94% by 2009. We will by then be fully compliant with the European Urban Wastewater Treatment Directive. In terms of drinking water quality, much of the required investment in water treatment works has either already been completed or will be completed shortly.

Assessment

5.9 Within the time and resources available to us we have not been able to validate the NIW investment programme or its constituent elements in detail, and we would have gone beyond our remit if we had attempted to do so. However, we have been able to conclude with a reasonable degree of confidence that:

- by 2002 a large scale capital investment programme was needed in order to meet national and international quality standards
- the investment programme in the SBP has been presented to us as the minimum acceptable to the environmental regulators
- more expensive options were rejected for a number of reasons, including affordability
- the Utility Regulator has a responsibility for monitoring NIW's investment performance and ensuring that the current capital works programme delivers the promised outputs
- NIW's investment priorities after 2010 will be reviewed in the light of forthcoming Ministerial guidance.

5.10 We have found no reason to doubt that the consultant engineers discharged their remit to a satisfactory professional standard, and that the current investment programme is valid to the extent that it is consistent with their recommendations and findings. We are concerned however that:

- Halcrow did not have full access to all the information they needed to offer a comprehensive and accurate assessment
- they did not cover the costs of major PPP schemes
- their recommendations were not fully implemented
- the programme was subsequently adjusted in ways which did not conform to their recommendations
- the process of finalising the investment programme was apparently rushed in order to meet the target date of April 2007
- the process of finalising the programme was not as open, inclusive and transparent as it should have been.

5.11 We are not convinced that the full implications for financing and service delivery of the adjustments which were made in the finalisation of the programme were clearly identified and properly taken into account.

5.12 We are particularly concerned at a number of apparent weaknesses in the process of producing NIW's transformation programme:

- that it was not properly integrated into the overall SBP planning process
- that a number of elements were introduced without a clear rationale to justify them
- that the expected benefits were never properly identified
- that substantial sums were earmarked for areas to be subcontracted without clear evidence that this was the most cost-effective option.

Unfortunately the Panel is unable to publish detailed evidence to support these conclusions as it was given to us on the basis of commercial confidentiality.

Ministerial Guidance

5.13 Looking ahead, there is no time to lose: the process of preparing for the first price review has already begun. Both the Regulator and NIW need clear directions from the Minister and Department on the objectives and priorities which NIW will be required to pursue in and beyond 2010.

5.14 Article 7 of the 2006 Order sets out a procedure for the Department to provide guidance on social and environmental matters. The guidance is subject to consultation as the Department considers it appropriate, and to negative resolution in the Assembly.

5.15 In England at an early stage in the price review process, the Secretary of State produces initial guidance for Ofwat. This informs the water companies' draft business plans. Ofwat analyses the plans, including their potential implications for bills, and advises Ministers accordingly. The environmental regulators separately provide advice to Ministers on the environmental costs and benefits of the companies' draft investment plans. After considering the regulators' advice, the Minister issues "Principal Guidance" which covers the schemes that should be included in the final business plans. Following publication of the draft determination by Ofwat, the Minister issues his Final Guidance.

5.16 In Scotland the process begins with the establishment of the Quality and Standards Board. The Board sets up a series of working groups to examine discrete areas for investment. They are asked to establish the costs and feasibility of a range of scenarios ranging from the minimum necessary to what would be necessary to meet the standards already achieved in England and Wales. Each group then produces a series of options which are submitted to Ministers for consideration alongside the regulator's advice on the deliverability of the proposed investment programme. Since Scottish Water is government controlled, Ministers then have to consider the proposals in the context of the limited availability of finance for capital investments across all public spending areas. After a period of public consultation, the Executive reports to the Scottish Parliament setting out in detail its objectives for the upcoming investment period. The Executive's statement is subsequently given legal force by the making of a direction. The direction places a requirement on Scottish Water to prepare a business plan showing how it would achieve the Executive's objectives, and to obtain approval from the regulators that the plan satisfies those objectives.

5.17 Following the completion of the economic regulator's price review, Scottish Water is required to publish a delivery plan which again must be approved by the environmental and water quality regulators. This plan is then used to monitor progress in the implementation of the investment programme.

5.18 In Northern Ireland, the first Ministerial guidance is scheduled to inform NIW's investment programme after 2010. Such guidance is not only fundamental to the investment planning and price review processes, but also provides a clear opportunity for the Minister to set the strategic direction for the development of the services. While it is never going to be easy to reach a universal consensus on the balance between economic, social and environmental objectives, the guidance is an opportunity to promote sustainability in an area of activity which touches on many important social, health and environmental issues. We will return to these issues in Chapter 6.

5.19 Now that the Panel has completed its work, *we recommend that the Department should give high priority to commencing the process of preparing Ministerial guidance on social and environmental matters; and that this guidance should define clearly the expected outputs of NIW's investment programme over at least the next five years*.

5.20 We would draw attention to our recommendation in Chapter 2 for the appointment of a Water Advisory Panel which will bring together the company, its regulators, the Consumer Council, relevant voices from the business and voluntary sectors, and independent experts. The Panel's primary function will be to advise the Minister on the substance of this guidance.

5.21 *To this we would add that once the investment programme for the next five years or more has been determined, an Output Monitoring Group should be established, similar in role and membership to that in Scotland, which will report to the Minister on progress towards meeting the planned outputs in the programme. This body will be able to ensure that the programme is on track and to provide an early warning system should any problems emerge.*

6. SUSTAINABILITY

"The past 20 years have seen a growing realization that the current model of development is unsustainable. In other words we are living beyond our means. From the loss of biodiversity with the felling of rainforests or over fishing, to the negative effect our consumption patterns are having on the environment and the climate. Our way of life is placing an increasing burden on the planet - this cannot be sustained. The increasing stress we put on resources and environmental systems such as water, land and air cannot go on for ever." Extract from the UK government's Sustainable Development website: www.sustainable-development.gov.uk

Sustainable Development

6.1 Many countries throughout the world are now committed to sustainable development, which is broadly defined as "Development which meets the needs of the present without compromising the ability of future generations to meet their own needs". The European Union published its Sustainable Development Strategy in 2001. Key objectives include tackling climate change and the protection of natural resources.

6.2 The United Kingdom published its first sustainable development strategy in 1999 but following devolution in Scotland and Northern Ireland the strategy was revised to provide a framework for a consistent approach across the United Kingdom. In 2006 the then Secretary of State launched Northern Ireland's first Sustainable Development Strategy. It recognised that climate change, finite resources of fossil fuels and water posed serious challenges to the way we live. "Our lifestyle threatens the very planet that supports us". It concluded that if we are to embrace sustainable development we must assess the environmental, economic and social impacts (both direct and indirect) of what we are doing.

6.3 The strategy is based on six guiding principles:

- Living Within Environmental Limits
- Ensuring a Strong, Healthy and Just Society
- Achieving a Sustainable Economy
- Promoting Good Governance
- Using Sound Science Responsibly
- Promoting Opportunity & Innovation.

6.4 All future policy should consider all six principles and assess their importance. Often the different principles will conflict, but the aim should be to deliver the greatest economic, social and environmental benefits, and where one principle is considered more important than another, this should be made transparent.

6.5 In 2007, the Executive produced its draft Investment Strategy, "Building a Better Future". It contains three cross-cutting objectives:

"(a) economic – investment in infrastructure to accelerate economic growth and improve competitiveness of business;

(b) societal – investment in infrastructure to promote equality of opportunity and the desirability of good relations, promote regional balance in future development, and tackle areas of social disadvantage;

(c) environmental – investment in infrastructure to protect and enhance our environment, particularly addressing areas affected by EU directives."

6.6 The Executive goes on to say:

"These objectives can be mutually reinforcing, helping to ensure that development is sustainable. The objectives influence both programme selection, and delivery to maximise returns. We will seek opportunities to promote social inclusion and equality of opportunity in the procurement of infrastructure programmes. This will impact through employment plans, by building opportunities for local apprenticeships into major delivery contracts, and through a tendering process that prioritises the most economically advantageous option in this context."

We fully endorse and support this approach and recommend that it be applied to the future development and implementation of NIW's investment programme.

6.7 Turning to the environmental dimension, a central element of the Sustainable Development Strategy for Northern Ireland is the protection and enhancement of the freshwater and marine environment. Most of the strategy is being driven from the EU through the environmental objectives in the Water Framework Directive (WFD). NIW is the principal environmental contractor for this work. The WFD creates a new framework for an integrated approach to the protection, improvement and sustainable use of rivers, lakes, estuaries, coastal waters and groundwater. The objectives must be met by 2015.

6.8 Under the WFD each EU Member State must designate administrative areas, known as River Basin Districts, to serve as a unit for management. River Basin Management plans must be developed by 2009 and fully implemented by 2012.
Northern Ireland must also develop a policy and legislative framework for protecting the marine environment by 2008. Flood Risk Management Plans will also be required in accordance with the EU Flood Directive, which has still to be adopted. These will have to be integrated into the River Basin Management Plans.

6.9 Northern Ireland must also meet the requirements of the Nitrates Directive and the Urban Waste Water Directive. Both have implications for how we manage water. The Nitrate Directive will reduce the nitrate and phosphate inputs to waterways – the suspected cause of high levels of eutrophication - and the Urban Waste Water Directive will reduce the quantity of untreated effluent being discharged into our rivers and lakes.

6.10 The Northern Ireland Sustainable Development Strategy notes our commitment to tackling the problem of surface water in its Sustainable Urban Drainage Systems (SUDS) programme. The aim is to change from a system which moves surface water from one point to another as quickly as possible to one in which the water is slowed down by attempting to reproduce predevelopment patterns of discharge. This should reduce the risk of flooding and improve water quality. A SUDS cross Departmental working group has been established to consider the policy and legislative implications.

6.11 The SUDS programme will consider how the amount of impermeable surfaces, particularly in urban areas, can best be reduced. The concreting over of gardens should be discouraged. *We recommend that the SUDS working group should consider the potential for offering rates reductions to provide an incentive for ratepayers to conserve or restore permeable surfaces.*

6.12 There is a commonly held view in Northern Ireland that as we have so much rain there is no necessity to conserve water. This ignores the fact that it takes a lot of electricity and chemicals to produce high quality drinking water, a large quantity of which we flush down the toilet. If we reduce the amount of water we consume, our carbon footprint from the use of electricity will be smaller and we will cause less damage through the use of chemicals.

6.13 In our Strand One Report we rejected metering for the foreseeable future on the grounds that there are more cost-effective ways of promoting water conservation. We suggested a number of actions:

- Replacement of old single flush toilets with dual flush toilets
- Replacement of high-flow with low-flow showerheads
- Use of water efficient white goods

- Flushing toilets with storm water instead of drinking water

- Reducing leakage from NIW's supply pipes.

6.14 Friends of the Earth in their evidence to us suggested that significant cuts could be made in the way water is used through the reuse of grey water or the harvesting of rainwater. Grey water reuse involves the collection of used water from showers, baths, wash-hand basins and washing machines. It can be as simple as redirecting the water into a butt or involve more elaborate plumbing. Grey water can then be used for washing cars and watering the garden. Rainwater harvesting has the potential to save up to 50% of household water consumption. Again, it can involve a water butt or a more complex system of pumps, which can treat water to a potable standard. As they point out, the most cost effective method for conserving water is through small scale technical measures and changes in lifestyle. They propose that a water rebate be applied to households which install efficiency measures.

6.15 *We recommend that Building Regulations should be changed to encourage water conservation measures in new buildings. We also recommend that a reduction in water charges should be used to provide incentives for implementing water efficiency measures in existing dwellings*.

6.16 Millions of sanitary waste items are flushed down Northern Ireland's toilets every year. These include condoms, sanitary towels, tampons and panty liners, incontinence pads, used bandages, disposable nappies, liners and baby wipes.

They cause blockages in the sewer system and damage screens designed to filter out different waste. During heavy rain when it is sometimes necessary to relieve the pressure on combined sewers to prevent homes from flooding, these items have to be released into the rivers and sea.

6.17 *We recommend that there is a comprehensive education programme to encourage more responsible behaviour in the disposal of sanitary waste.*

6.18 We consider that these recommendations will have the support of a wide section of the population as there is an increasing concern in Northern Ireland about the environment. The latest Continuous Household Survey showed that in 2006-2007 four out of five households were very "concerned" or "fairly concerned" about the environment. Climate change was the most commonly cited concern (34% of households) and this proportion had increased significantly each year since 2003-2004.

Environmental Governance

6.19 All these developments in the protection and enhancement of water and the prevention of flooding have far reaching implications for environmental governance in Northern Ireland. Professor Sharon Turner has provided a detailed analysis of the topic in the Journal of Environmental Law (2006).

6.20 The current statutory responsibilities are divided among a number of different organisations answerable to different government Departments as can be seen in Figure 1 in

Appendix 5. As well as the main agencies responsible for the provision and regulation of water and sewerage services as outlined in the Appendix, three other agencies have important roles in the protection of water and avoidance of flooding.

6.21 The Rivers Agency, which is part of DARD, is responsible for reducing the risk of life and damage to property from flooding from rivers and seas and for preserving the productive potential of agricultural land. It has around 450 staff. It recently commissioned an independent review of its flood management policy, which concluded that the delivery of the River Agency's objectives would be best achieved through the establishment of a new Environmental Protection Agency for Northern Ireland.

6.22 The Drainage Council is an independent advisory body appointed to oversee the programme of public funded drainage and flood defences in Northern Ireland. It too is sponsored by DARD.

6.23 The Fisheries Conservancy Board is a non Departmental Public Body which is sponsored by DCAL. It is responsible for the conservation and protection of most of the salmon and inland fisheries of Northern Ireland. It undertakes agency work for DOE in relation to river monitoring and pollution and a bailiffing service for DCAL.

6.24 Over the past 25 years a number of reports have reviewed the state of environmental governance in Northern Ireland. In 1989, the DOE commissioned an efficiency study of what was then its Environmental Protection Division. It was carried out by Halcrow, who concluded that water quality management issues were dispersed in “penny packets” and that the structure was inherently inefficient. In 1996 the Environment and Heritage Service (EHS) was established as a Next Steps Agency of the Department, but public criticisms persisted.

6.25 In November 2001 the Comptroller and Auditor General published a report on the control of river pollution in Northern Ireland. This was subsequently considered by the Public Accounts Committee, which published another critical report on the failures of the EHS. It concluded: “Despite all the promises of progress, we remain deeply concerned about a situation where NI is the only part of the British Isles without an environmental protection body. The totally unsatisfactory nature of the watchdog role within government up until now strongly suggests that real independence is essential for building up long-term public confidence that our environment is being properly safeguarded”.

6.26 In 2002 the case for an independent environmental regulator to strengthen sustainable development was evidenced in relation to sewerage ‘hotspots’ – areas which did not meet EU minimum sewerage treatment standards. Following concerns expressed by the EHS, the Minister for the Environment imposed a moratorium on all planning applications in 56 sewerage hotspots. Following a review, he announced a ‘pragmatic approach’ according to which the EHS would no longer object to developments in these locations, and a considerable volume of development went ahead. In the event social and economic concerns took priority over environmental sustainability.

6.27 In 2004 Professor Richard Macrory was commissioned by a coalition of non-governmental organisations to produce proposals for strengthening our environmental governance system. His report addressed three core themes: delivery arrangements, accountability mechanisms and the provision of policy advice.

6.28 Macrory noted that the EHS was the only environmental regulator in the United Kingdom which was structured as an executive agency rather than a Non-Departmental Public Body (NDPB). As a result, he argued, it lacked formal independence from the Department of the Environment and had not been able to develop ‘a distinctive, authoritative and more independent voice in policy debate in Northern Ireland’.

6.29 Against this background, Macrory considered a number of options: no change; full incorporation into DOE; transforming the EHS into an environmental protection authority with separate legal status as either an NDPB or non-Ministerial Department; and returning responsibility for major areas of environmental regulation to local government.

6.30 In February 2006 the then Minister for the Environment appointed a panel of experts to conduct a further independent review of environmental governance in Northern Ireland. It was chaired by Tom Burke, with Gordon Bell and Sharon Turner. Its main conclusion was that the assets of environmental governance here are fit neither to resolve the legacy of past environmental problems nor respond to emerging issues, particularly the mounting risks posed by climate change.

6.31 The Burke Report recommended that a new autonomous Environmental Protection Agency should be established and that the EHS's responsibilities for environmental regulation should be transferred to it. Burke argued that an independent agency would strengthen public confidence, transparency and accountability and enhance the sustainable management of water both as a resource and as an environmental medium.

6.32 *We strongly endorse the Burke Report's recommendation for an independent Environmental Protection Agency and recommend that it should be established as a non-Ministerial Department. We further recommend that the new agency should discharge the current roles of the EHS, the Rivers Agency, the Fisheries Conservancy Board, the Drainage Council and the Loughs Agency. It should also have a specific new responsibility to oversee the production of a Water Demand Management Strategy for Northern Ireland.*

Regulating for a Sustainable Water Sector

6.33 The establishment of an Environmental Protection Agency will go only some way to rebuilding public confidence and achieving a sustainable water sector. But as the Green Alliance has argued, more needs to be done to achieve a regulatory regime capable of meeting the standards set by the WFD. This must be carried out in the context of providing long-term value for customers and making a meaningful contribution to the government's sustainable development goals.

6.34 During the review some members of the Panel had the opportunity to visit the new Belfast sewer project and new waste water treatment works at Portrush. Although these projects were not a product of the current governance arrangements, they provide illustrative case studies of the sustainability issues that are increasingly likely to arise in the future.

6.35 Both projects will make a significant contribution to dealing with current problems. The new Belfast sewer, which will cost around £100 million, will have a major impact on the cleanliness of the river Lagan and prevent sewerage overflows in various parts of the city. The North Coast WWTW, which will cost £45 million, will provide modern wastewater treatment for 100,000 people in the area and will improve the quality of bathing waters around one of the North's premier tourist resorts. Both will help us meet our obligations under EU legislation.

6.36 However, both also raise a number of sustainability issues. First, they rely on end-of-pipe treatments to ensure water quality: neither was designed to tackle the problems at source. Second, both use state-of the art engineering solutions to meet the current environmental regulations. The environmental building costs are not known, but the carbon footprint would have been substantial, particularly in terms of cement production for the linings for the Belfast sewer. Third, both projects lock us into a particular technological solution which will be costly to alter for the next 30 or 50 years. The WWTW, for example, requires 6 lorries per week to carry sludge from Portrush to an incinerator in Belfast. Sludge from the outset was seen as waste rather than a fertile resource. Finally, both projects will require a considerable amount of energy to run.

Sustainability Duty

6.37 The Northern Ireland (Miscellaneous Provisions) Act 2006 imposes a statutory duty on public authorities to promote sustainable development in the exercise of their functions. This Act came into effect from 31 March 2007. Under the Act a public authority must act in the way it considers best calculated to contribute to the achievement of sustainable development in Northern Ireland, except to the extent that it considers that any such action is not reasonably practicable in all the circumstances of the case. Public authorities are defined as Northern Ireland Departments and District Councils and any other person designated by OFMDFM.

6.38 Northern Ireland Water, since it became a GoCo, is not subject to the requirements of the Act, although OFMDFM has the power to extend the list of public bodies. *We recommend that OFMDFM add Northern Ireland Water to the list of public bodies required to act to promote sustainable development.*

6.39 In contrast to NIW, the Utility Regulator is under a legal duty to carry out its functions ‘in the manner that it considers is best calculated to contribute to the achievement of sustainable development’. However, it remains unclear how this will be achieved in practice. In evidence to us the Regulator defined his role as: “Sets prices and quality standards. Enforces licence and many statutory obligations. Approves NIW’s investment plans. Final ‘appeal’ role in certain categories of customer complaint (e.g. trade effluent, connections)”. There was no mention of the duty to contribute to the achievement of sustainable development. However, in a case study of the price-setting and investment planning process, it was suggested that the consultation with stakeholders might cover sustainability and that consideration should be given as to how the cost of carbon should be factored into investment and demand management plans. We welcome this element in the investment planning process.

6.40 We remain concerned about the lack of development of a robust methodology to enhance sustainability and also the narrow period of the price review, which is likely to create an economic bias in favour of traditional engineering end-of-pipe solutions rather than sustainable solutions. These need to be compared over the length of the life of end-of-pipe assets. In addition, incentives in the pricing mechanisms need to be developed to encourage sustainable solutions.

6.41 *We recommend that more consideration is given to how conflicts over sustainability and efficiency savings are to be determined; that the current biases in favour of end-of-pipe engineering are eliminated; and that incentives are created through the price review process for NIW to invest in sustainable approaches.*

6.42 *We further recommend that all future investment is subject to a full cost-benefit analysis which takes account of environmental and resource costs. The development and application of full cost-benefit analysis should be undertaken jointly by the new EPA and the Utility Regulator and should be published for maximum transparency.*

6.43 NIW is one of the largest users of electricity in Northern Ireland. Its energy consumption will increase as new plants are developed. It uses some green energy and currently exceeds its target of sourcing 8% of green energy by 2008. *We recommend that NIW continues to act to improve its energy efficiency*.

6.44 The housing sector also has a vital role to play in sustainable water management. There is a need to ensure that water protection is at the centre of the planning process. Developments must not be allowed to proceed unless there are adequate supplies of water and good quality facilities for sewerage disposal. Dual quality water supply, water harvesting and on-site wastewater treatment should become the norm.

6.45 *We recommend that DOE produce, as a matter of urgency, a Planning Statement on Water Sustainability in spatial planning and building design. This should include proposals for the legal duties to be followed in making planning decisions*.

7. AFFORDABILITY

7.1 In making the recommendations in our Strand One report we were conscious of the need not to exacerbate poverty or widen social exclusion. We considered a number of different ways the water and sewerage services could be paid for and the issue of affordability was always at the forefront of our thinking. We quickly ruled out the option of keeping the Water Service as an agency funded from the rates because this would have cost public spending power of over £90m annually and increasing. This loss of spending power would have had a greater impact on the poor than on the better-off.

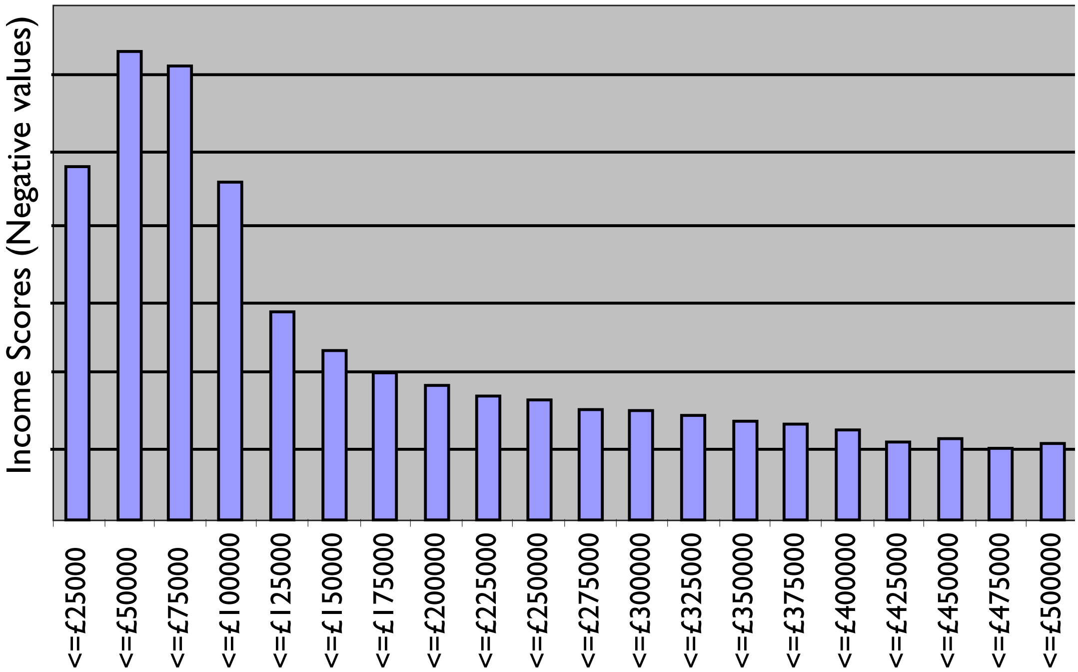
7.2 In our Strand One report we rejected metering for the foreseeable future for a number of reasons. It would be costly and would mean that every household would have to pay at least an extra £43 per year on their bill simply to install and run the metering system. Moreover unless it was made compulsory for everyone, metering would result in cross subsidies from the poor to the better off.

7.3 We therefore recommended that domestic users should be required to pay an amount based on the capital value of their property. An important practical advantage of this system is that it can easily be aligned with the rating system. Moreover, as demonstrated in the next section, the evidence indicates that the capital value calculation provides a reasonably fair reflection of households' ability to pay.

Capital Value and Affordability

7.4 The NI Statistics and Research Agency analysed capital values and income data from the Northern Ireland Multiple Deprivation Measure by geographical output areas. (These are areas with around 2,000 households and there are about 5,000 in Northern Ireland.) Income was expressed in negative terms in that the lower the income score, the lower the level of income deprivation. Capital values were collected into bands of £25,000 and an average output area income score was calculated for properties in each band. The results are shown in Figure 2.

Figure 2: Average income score by output areas and banded capital value



7.5 As can be seen there is a reasonably strong relationship between income score and capital value: the lower the capital value the lower the income. The band with the lowest capital values (<£25,000) goes against the pattern: this is explained by the fact that many of these properties are caravans or lock-up garages.

Affordability Tariff

7.6 As noted in our Strand One report, under NIO Ministers' proposals, there was to be an Affordability Tariff to help people on low incomes. The intention was that no low income household should have to spend more than 3% of its income on water and sewerage services. Any household in receipt of Income Support, Jobseeker's Allowance, Pension Credit or Housing Benefit was to be eligible. The tariff was to take the form of a three-tier flat rate charge. After the full phasing in of charges by 2010, the combined tariff for water and sewerage services was to be as follows:

- capital value up to and including £70,000 £88.96
- capital value from £70,000 to £100,000 £133.44
- capital value over £100,000 £177.92

7.7 For Strand One we carried out a number of analyses using these rates to estimate what levels of water poverty would be once our recommendations had been implemented. We used the same definition of water poverty as applying to any household which would have to spend more than 3% of its income on water and sewerage services.

7.8 From our first raw analysis we discovered that 10.5% of households would still be in water poverty. What struck us most about this analysis was that almost all of those who qualified for the tariff were lifted out of water poverty. The tariff apparently worked well for those already claiming one or more of the passport benefits. But there were many others in need of help who were ineligible because they were not already claiming a passport benefit. This applied in particular to pensioners and working families on low incomes.

7.9 We then carried out two further analyses with refinements to the original model. First, we included the receipt of working tax credit combined with child tax credit as a passport for low income working families with children: the results showed that this made no appreciable difference. Second, we included the receipt of attendance allowance as a benefit for pensioners which is free of the stigma of means testing: again, this made no real difference.

Zero Rated Affordability Tariff

7.10 The Northern Ireland Anti-Poverty Network welcomed many of our Strand One recommendations, but expressed concern about the continuing lack of protection for low income families. They argued that there is “nothing affordable about ‘affordability’ tariffs”. The basis of their argument is that the government has determined a minimum acceptable level of income, and that help should be provided to for anyone who falls below that level. To charge them for water, however little, would be wrong in principle and create hardship in practice.

7.11 Levels of benefits are determined for the UK as a whole. In setting benefit levels an amount is provided for water and sewerage services. Northern Ireland is the only devolved administration which in addition has introduced universal affordability arrangements. As we have seen, when people are passported onto the Affordability Tariff, it is successful in taking them out of water poverty.

7.12 The Consumer Council recently carried out a survey into Customers' views on charging for water. They discovered a majority view that it is fair and reasonable for everyone to pay something for water, and general agreement that those who can least afford to pay should pay less. On person expressed the view: *"…I don't think anyone would begrudge paying for water at a fair and reasonable rate".* Another said: *"…I wouldn't mind paying what I consider a fair charge for it".*

7.13 We recognise that there is an arbitrariness in setting the water poverty level at 3%. We explored this issue in our analysis: when the level is set at 2%, the percentage in water poverty does not alter significantly but at 1% it does. This suggests that 3% is as an appropriate cut-off point in practice.

7.14 We considered the effect that domestic water and sewerage service charges would have on people living on a level of income below which the government has decided no one should fall. We repeated our analysis on the assumption that those who qualified for the Affordability Tariff would pay nothing. This confirmed our original finding that the tariff at its current level would take these households out of water poverty: but we also discovered that it could cost an extra £23m to take fewer than 300 additional households out of water poverty. We do not believe that this would represent good value for money.

7.15 We also considered the option of providing a zero tariff for all pensioner households. There are an estimated 170,000 of them, and we calculated that it would cost around £54m to exempt them from water charges. According to our calculations, between £44m and £51m of this would go to people who would not need it: and as little as £3m to £10m would go towards those in need. In short, a policy of free water for all pensioners could not be justified.

7.16 *We have concluded that everyone should contribute towards our water and sewerage services. If every household pays, no matter how little, this reminds people of what an important asset water is and gives them a stake in the services' future.*

Acknowledgment of Past Payments

7.17 Our original Strand One analysis took no account of the fact that households had already been paying a contribution for water through their rates of on average £160 a year. We recommended that this fact should be clearly acknowledged in future bills. For Strand Two, we modelled the impact of this reduction on levels of water affordability. We faced a choice as to whether this contribution should be considered as a reduction in the overall bill or as an addition to household income.

7.18 When treated as additional household income, the analysis suggested that some 11% of households would experience water poverty. However, fewer than 1% of people receiving the Affordability Tariff then remained in water poverty. Of these some 29% were single female pensioners, 21% pensioner couples, 13% couples or single people with children and 13% single males without children.

7.19 When treated as a reduction in the household bill, coupled with the Affordability Tariff, the water poverty rate fell to 4%. Nearly a third of those experiencing water poverty were still single female pensioners and couples with children were 11%. Other groups badly affected were single men without children (16%) and couples without children (15%). Significantly, of those who were entitled to an Affordability Tariff, all were removed from water poverty. This further confirms that the Affordability Tariff is successful in removing households from water poverty provided that they are already in receipt of a passport benefit. The problem remains in the fact that many people do not take up to the benefits to which they are entitled.

Asset-rich and Income-poor

7.20 One important concern that has been raised with us is the position of those people who are asset-rich and income-poor: people with low incomes living in houses with high capital values. We were unable from the data available to determine the precise number of people or households in this category. However in a study of the relationship between income groups in Council Tax Bands in England and Wales, based on FRS data for 1998 to 2002, Orton concluded that asset-rich and income-poor households are a minority in the population, comprising just under 200,000 households in England and Wales.

7.21 One of our key principles is to prevent anyone from falling into water poverty.

7.22 *We accordingly recommend that all vulnerable households, including the asset rich, should be entitled to the Affordability Tariff. For those better off pensioners who are not eligible for the Affordability Tariff we recommend that a deferment scheme, similar to that proposed for rates payments, should be made available. This would allow them the choice of either paying the charges now or deferring them at a concessionary rate of interest until the sale of their house. The debt would be secured by creating a charge on their property*.

7.23 We consider that the issue of support to the asset rich and income poor should be subject to wider debate. The growth of owner occupation and recent rises in house prices have given a large section of owner occupiers a significant asset, which increases their access to credit, finances their old age and provides their children with inherited wealth. This has increased the number of people who are asset rich but have little income. These large capital gains from which older generations of home owners have benefited are balanced by large increases in the housing costs faced by younger households. Therefore any rate relief or water affordability allowance to the asset rich and income poor will further increase the divide between those with assets and those without and lead to an intergenerational transfer of resources.

Rate Relief Scheme

7.24 The low income Rate Relief Scheme was introduced in April 2007 to provide additional help for low income households who were receiving either no or only partial help with their rates through Housing Benefit. It is based on the Housing Benefit rate rebate scheme but is an extra layer which sits on top of Housing Benefit. Households complete a Housing Benefit form (the same application form is used for both schemes) and their income is then assessed. Eligibility for rate relief is based on an assessment of 'excess income'. This is the difference between the level of a household's income and the personal circumstances that apply to that household. A household with excess income below zero is entitled to full rate relief. Any income over and above zero reduces the relief to which the applicant is entitled.

7.25 The Rate Relief Scheme treats excess income more generously than Housing Benefit so even though a claim for Housing Benefit may have been unsuccessful in the past, the Scheme may provide help. If income is marginally over the threshold for Housing Benefit, the form is passed on to either the Housing Executive (in the case of tenants) or to the Rate Relief Team in the Rates Collection Agency (in the case of owner occupiers) for assessment.

7.26 During the recent Review of Domestic Rating in Northern Ireland, information from the Land and Property Service was examined to explore the relationship between the award of Rate Relief and levels of deprivation. This showed a positive correlation between deprivation and Housing Benefit receipt levels amongst owner occupiers. Further analysis was carried out using levels of Housing Benefit within all wards for all groups of ratepayer, which showed the same positive relationship. This indicated that 'providing enhanced relief through the main rate relief scheme would have positive socio economic effects'.

7.27 In our original analysis we used data from the Family Resources Survey 2005/6 to model different water charging scenarios based on those who qualified for the Affordability Tariff. That analysis did not include receipt of rate relief as the Scheme was introduced only in April 2007. We were therefore unable to ascertain how many households would be passported onto the Affordability Tariff because they were in receipt of rate relief.

7.28 The Panel considers that there are a number of advantages to the Affordability Tariff being linked to rate relief:

- assists take-up
- reduces administration costs
- increases consistency

- reduces information requirements

- maximises ease of explanation.

7.29 The Panel notes that under the current arrangements the Affordability Tariff could be terminated in 2010. *We recommend that the Affordability Tariff should continue after 2010; that it should continue to be funded out of general public expenditure; that it should be improved as necessary to compensate for any upward movements in prices; and that all those entitled to rate relief should continue to be entitled to the Affordability Tariff*.

Take-up

7.30 There appears to be a widespread belief among home owners that they are not entitled to Housing Benefit or a Rate Rebate and hence to Rate Relief. A recent Omnibus Survey asked: “Rate Relief and Rebates are available to some households. Would you consider applying for help?” Some 26% of respondents answered: “No, I don’t think I’m eligible because I own my house”.

7.31 The recent Review of Domestic Rating in Northern Ireland identified a considerable shortfall in take-up of the Rate Relief Scheme amongst owner occupiers. It was estimated that of those eligible only 42% took up the relief. It appears to be mainly pensioners who do not take up the relief. This is part of a broader problem in that many pensioners do not claim all the benefits to which they are entitled. We known, for example, that the average number of pensioners entitled to Pension Credit and not claiming is between 17,000 and 86,000. Total Pension Credit take-up in 2004-2006 was in the range 49% to 83% by caseload and 60% to 91% by expenditure.

7.32 To help overcome the lack of take-up, particularly among pensioners, the Review of Domestic Rating concluded that the savings limit for Rate Relief should be raised from £16,000 to £50,000. The new savings limit will apply to pensioners only. Other actions to improve take-up include:

- awareness-raising targeted at pensioners and owner occupiers
- simplifying the application process
- engaging community and voluntary sector partners
- improving data sharing to allow for more automatic awarding of reliefs.

7.33 The Panel fully endorses the recommendations in the recent Review of Domestic Rating for action to increase the take-up of rate relief, as they will increase the number of people eligible for the water Affordability Tariff. *We recommend that an effective and properly resourced campaign should begin urgently to ensure that all those who qualify for Rate Relief or other passport benefits get them.*

7.34 We believe that another reason for the poor take-up of the Rate Relief Scheme is its name. It suggests a throwback to the Poor Law and in our opinion is a major factor in deterring people from applying for it and hence not being passported onto the Affordability Tariff. *We recommend that the Rate Relief Scheme should be renamed the Rate Refund Scheme. This sounds relatively neutral and does not carry any pejorative overtones*.

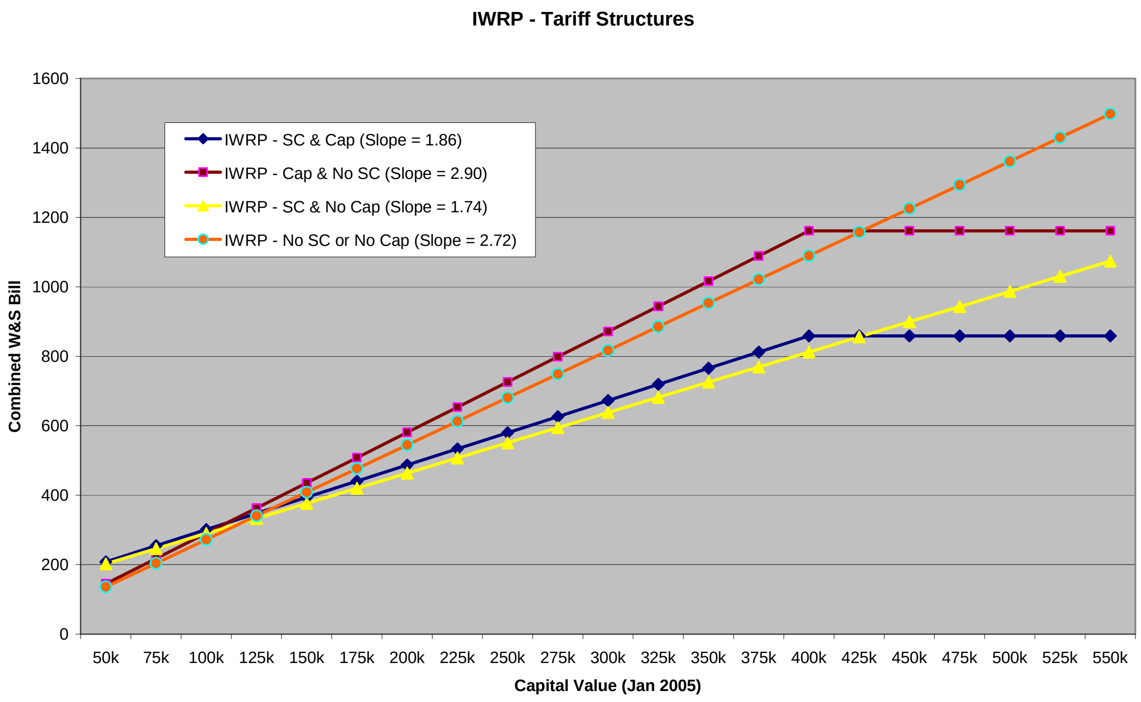
The Cost of the Affordability Allowance

7.35 We estimate that the Affordability Tariff is likely to require an annual subsidy to NIW of around £25m. If all households which are at risk of water poverty applied for the Affordability Tariff, we estimate that this would cost a further £10m. If the Executive introduced a zero tariff for all those on benefits, this would cost roughly £50m in total.

Tariffs and the Cap

7.36 We undertook some modelling of tariff structures based on capital values. Figure 3 illustrates the impact on properties with a capital values as set at January 2005 as part of the domestic revaluation.

Figure 3: Tariff Structures



7.37 Four tariff structures are illustrated:

- Standing Charge with Cap (blue line)
- No Standing Charge but with Cap (purple)
- Standing Charge with No Cap (yellow)
- No Standing Charge or Cap (orange)

7.38 The key messages are as follows:

- Abolishing the standing charge is much more important in making the charge less regressive compared to capital value: orange versus yellow

- Abolishing the cap makes only a minor impact: blue versus yellow. Retaining a cap makes the charging structure slightly less regressive up to the level of the cap.

- The abolition of the standing charge increases the spread of the charges with the break even point at around a capital value of £110k: households with a capital value of below £110k are better off without a standing charge, while those above £110k are worse off. Around 60% of households have a capital value of £110k or less.

- The existing plans involved a cap of £400k. Approximately 1 % of all households would benefit. A cap at this level limits the spread of bills without imposing excessive costs on those whose capital value is below the cap.

- No cap at all would expose some households to bills as high as £7,000 a year.

- Any cap will increase inequalities between the asset-owning and the non-asset owning classes.

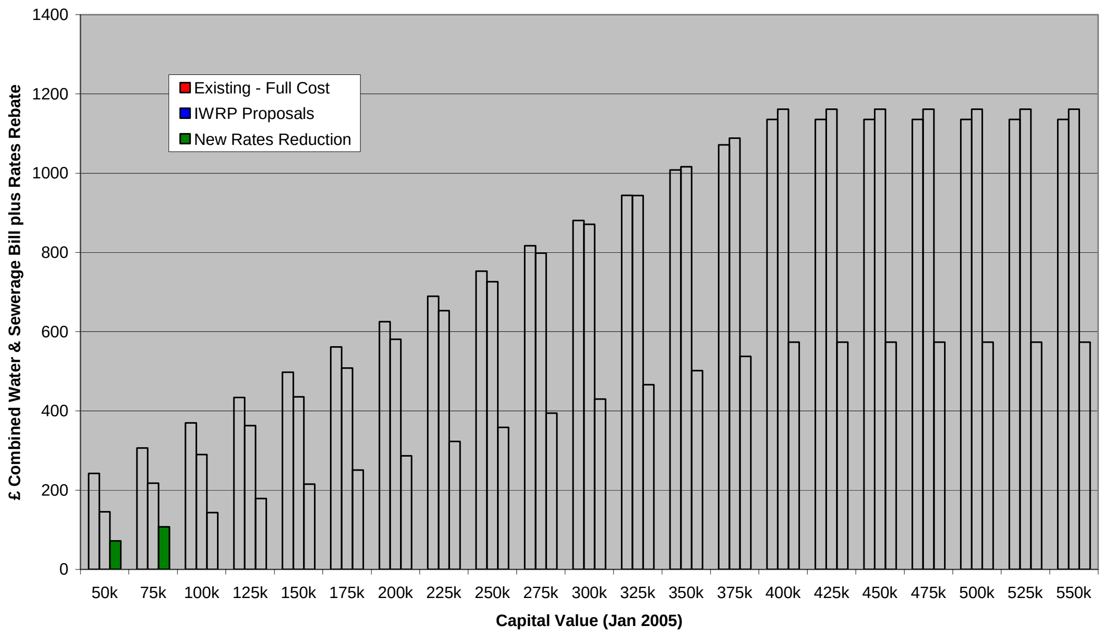
7.39 The above analysis excludes the benefit that households will receive due to the reduction in the domestic regional rate which the Executive has already announced. For an average household with a capital value of around £112k the rates reduction will be around £160 a year. There is a correlation between water bills and the reduction in rates in that although those with high capital values will have higher water bills they will also receive larger rates reductions. Indeed with the abolition of the standing charge there is a better match between the degree to which a household "loses" on the water bill and "wins" on the rates bill – i.e. the household rates rebate would be equivalent to something of the order of half of the revised water bill.

7.40 The Executive has recently accepted that the cap on rates should be lowered from £500,000 to £400,000. Figure 4 below compares the impacts for different value bands of our Strand One recommendations combined with a cap at £400,000. This shows that such a cap would strike a good balance between fairness for all and excessive bills for people with very high value houses. Moreover, this level of cap would align the water payment system with the rating system, which will increase administrative efficiency.

7.41 *We recommend that the £400,000 capital value cap as recently announced for domestic rates should also be applied in calculating water and sewerage bills*.

Figure 4

Illustrative Tariff Impact with £400K Rates Cap



Conclusions

7.42 *We recommend that*:

- *all vulnerable households, including the asset rich, should be entitled to the water Affordability Tariff*

- *for those better off pensioners who are not eligible for the Affordability Tariff a deferment scheme, similar to that proposed for rates payments, should be made available*

- *all those entitled to Rate Relief should continue to be entitled to the water Affordability Tariff*

- *the Affordability Tariff should continue after 2010; should continue to be funded out of general public expenditure;*

and should be improved as necessary to compensate for any upward movements in prices

- *the Rate Relief Scheme should be renamed the Rate Refund Scheme*
- *the £400,000 capital value cap as recently announced for domestic rates should also be applied in calculating domestic water and sewerage bills.*

APPENDIX 1: MEMBERSHIP IN TERMS OF REFERENCE

TERMS OF REFERENCE ON INDEPENDENT REVIEW OF WATER & SEWERAGE REFORM PROCESS

PURPOSE

To establish an independent and comprehensive review to advise the Minister for Regional Development on the level of funding needed as well as options to manage, govern and finance our water and sewerage services for all our citizens now and in the future.

In particular, to ensure the ongoing and continued investment in our water and sewerage infrastructure needed to deliver quality, value for money services at the lowest possible cost and the highest levels of efficiency possible within a publicly-owned organization which protects the public interest.

APPROACH

The Executive agreed to conduct a comprehensive review of the financing of water and sewerage services on 10 May 2007. In doing so, it agreed not to impose new water charges as had been planned in 2007/08. This decision will save the average household £100 in the year ahead. The Executive also established a sub-committee to agree the terms of reference of the review for its approval.

The review is to be taken forward in an open and transparent way on behalf of the citizens as the real shareholders in our water and sewerage services. The aim of this review is to make sure that there is public trust and confidence in the arrangements for financing and delivering water and sewerage services.

Privatisation of our water and sewerage services is not an option.

The Review will comprise two distinct strands:

1 Cost of water and Sewerage services and how these will be funded.
This strand will be undertaken by the Independent review panel and report to the Minister for Regional Development, Executive sub-committee and the Executive.

2 Management, Governance and delivery of high quality water and sewerage services within a public ownership model. This strand will also be undertaken by the independent review panel reporting to the Minister for Regional Development, Executive Sub-Committee and the Executive.

It has been agreed by the Executive that this review will be short and focused. The Minister for Regional Development will report back to the Executive as follows;

Strand 1: Final Report in Autumn 2007; and Strand 2: Final report in December 2007, (interim report in Autumn 2007).

It is recognized that the Minister and the review panels will have to conduct their work within a short turnaround time which includes the summer holiday period. All efforts will be made to mange this effectively. The Minister for Regional Development will give monthly updates on progress against time, objectives and delivery to the Executive sub-committee and (where the sub-committee agrees it is necessary) to the Executive. The Regional Development Committee is a key stakeholder in this process and will be consulted and updated as the review progresses by the Minister for Regional Development.

The review will be serviced by an independent secretariat.

The review panel will have full access to all relevant documentation in support of its work. It will also invite expertise, evidence and analysis from others as required including the statutory partners, namely the shareholder (DRD), the undertaker (NIW), the regulator (NIAUR) and the consumer representative body (CCNI), the Regional Development Committee, DFP, HMT, advisors, analysts and consultants involved to date, as well as other interested parties as identified by the review panel.

Implementation

The review panel will make any recommendations arising in Strand 1 of the review by the autumn. Any recommendations arising from Strand 2 of the review will be made within the context of a 2-3 year implementation period to allow for changes which would take longer to implement. The output from Strand 2 will be subject to a 12 week consultation period from January to March 2008.

Cost

Resources must be identified to conduct this review as decided by the Executive on 10 May 2007 in order to deliver this review in the timescale outlined above.

Strand 1: Cost of Water and Sewerage Services and how these will be funded

Scope

There is a need to address the funding of water and sewerage services in the shorter term and therefore this strand of the review must report by Autumn 2007 to advise the funding decisions by the Assembly and the Executive.

1. what the real cost of providing water and sewerage services is; and

2. how these costs should be met.

In particular, two key aspects of public concern and interest must be considered;

Paying twice: - the review needs to ascertain how much people already contribute through the regional rate as a starting point as the public should not be expected to pay twice for this service.

Under-investment: - the review must establish the costs of rectifying the legacy of under investment that has occurred and to make the case for securing a contribution towards past underinvestment.

(The review will take into consideration the DFP Rating Review)

Strand 2: management, Governance and delivery of high quality water and sewerage services within a public-ownership model.

Scope

This review will be conducted by the fully independent review panel and serviced by an independent secretariat. The review panel will be tasked with identifying the level of funding needed and set out options to examine the most appropriate way of managing, governing and delivering our water and sewerage services within full public-ownership. It will make recommendations on the way forward.

This review will examine the following:
1. Legislation, license, articles of association and governance letter. Do these arrangements sufficiently support and meet the needs of a publicy-owned business model? What amendments or additions would

be recommended?

2. Governance

Are the governance arrangements suitable and appropriate? Do the arrangements sufficiently take account of and support the restoration of the new Assembly and the decision to keep in public ownership?

3. Investment Programme.

The Panel will review the scale, structure and phasing of investment planned to meet requirements. The Panel will also assess whether current arrangements are sufficient for identifying the appropriate level of funding needed over the next 20 years to meet our requirements and that of EU legislation. The Panel will also identify what element of funding need relates to legacy costs due to past underinvestment or maintenance needs, and what element are future development costs.

4. Business Model

Is the Go-Co, including arrangements with third parties, the best and most appropriate model to meet the purposes as defined above and within public ownership? What option or options would be best to consider and/or implement
e.g. Scottish and Welsh business models?

APPENDIX 2: STRAND ONE - SUMMARY OF MAIN FINDINGS AND RECOMMENDATIONS

- Direct rule Ministers' proposal for water charges should be abandoned, saving householders around £153m in 2009/10.
- NI would lose annual spending power of over £100m if the Water Service continued to be funded from the rates. Consequently it is in the public interest to introduce and clearly identify separate water and sewerage payments.
- In the interest of administrative efficiency, these should be collected through the same billing and collection system as the rates. There should be no separate bill for water and sewerage services. Householders' payments should be clearly and separately identified on their rates bill and earmarked for Northern Ireland Water.
- From 2009/10 these payments should be sufficient to ensure that the services are self-financing at the lowest possible cost to users.
- Plans for metering domestic customers should be discontinued. Future household payments should be based on property values and supported by an improved affordability scheme to prevent water poverty.
- Households should not have to pay for unfair costs such as roads drainage and the extra cost of the shareholder's dividend.
- Northern Ireland Water's savings target should be almost doubled.

- Despite the potential costs to the NI Block, there should be at least a partial waiver of the dividend extracted from NIW by DRD, such that customers will pay no more than they would under a debt financed model

- The Reasonable Cost Allowance Scheme for developers should be reviewed to ensure that it is cost reflective and is operated at no cost to other users

- The level of investment in our water and sewerage infrastructure has been less than in Britain.

- Payment arrangements for the non-domestic sector should proceed as planned, and should be reviewed by the Utility Regulator in due course to ensure that there is no cross-subsidy between the two sectors

- Given the high level of drinking water compliance already achieved and the substantial investment required to effect further marginal improvements, the Executive should consider as a decision properly to be taken at the political level the cost effectiveness of increasingly exacting drinking water compliance targets.

APPENDIX 3: MEETINGS AND CONTRIBUTIONS

A2B: access to benefits for older people

Advice NI

Consumer Council for Northern Ireland

Devenish Partnership Forum

DFP

DRD

Drinking Water Inspectorate

Environment and Heritage Service

Friends of the Earth

Help the Aged

NI Authority for Utility Regulation

NI Water

NIPSA

Northern Ireland Energy Holdings (NIEH)

Ronnie Spence (Permanent Secretary DRD 1999-2001)

Rothchilds Investment Bank

SDLP

Strategic Investment Board

The Shareholder Executive

Ulster Farmers Union

APPENDIX 4: MILESTONES IN THE REFORM PROCESS

1. The water reform process began in March 2003 with the publication of the consultation document: “The Reform of Water and Sewerage Services in Northern Ireland”. This outlined five broad possible models for the future legal framework of the service:

   - Privatisation
   - Public Private Partnership
   - Not for Dividend company (the Welsh model)
   - Statutory Corporation (the Scottish model)
   - Government Owned Company (the current Northern Irish model

2. A report on the responses was published in October 2003. This revealed that public ownership was the salient issue, rather than the form it should take: of the 784 responses only 126 commented on the business model options. The NIO Minister then ruled out Privatisation for the foreseeable future, giving the following reasons:

   - The absence of a secure and sustainable revenue stream
   - The poor condition of the water and sewerage infrastructure
   - The need to drive through a significant efficiency programme
   - Public and political opposition

3. In January 2004 the DRD Water Reform Unit produced an internal assessment of the GoCo and Statutory Corporation options. The following criteria were used in this assessment:

- Capable of efficient and innovative procurement
- Capable of efficient, effective and sustainable capital investment
- Able to deliver effective progress towards full compliance with EU standards
- Able to access finance at the best available interest rates
- Capable of efficient and effective service delivery
- Able to provide strong incentives for management to deliver lowest possible charges without compromising standards
- Able to retain and attract management and staff with knowledge and experience of the water industry, and of working within a commercial and regulated environment
- Sufficiently flexible to accommodate future evolution
- Provided with a clear and unambiguous remit for management, so that day to day decisions are independent of political influence
- Clearly accountable to customers and the public
- Subject to effective regulation to protect both the environment and the interests of consumers

- Aware of the need to promote equality of opportunity and good community relations

- Capable of gaining the confidence of the Executive, Assembly and public

- Capable of delivering a fully self-financing organisation by March 2010

4. On the basis of this assessment, the NIO Minister announced his decision in favour of the GoCo model. In November 2004, the Minister commissioned a strategic financial review ("the UBS review") to identify what capital and corporate structure might best ensure that the new GoCo would:

    - achieve self-financing status

    - deliver the lowest possible costs to customers without compromising standards of service

    - be able to access finance at competitive borrowing rates

    - be capable of efficient, effective and sustainable capital investment to meet national and international compliance targets.

5. The review team reported in May 2005. They concluded that the greatest efficiency improvements in the service, and thereby lower bills for customers, were likely to be realised through an element of private sector participation, but that this would not currently be practicable or politically acceptable. They also concluded that most of the desired criteria – apart from efficiency and political

acceptability – could be met under any of the structural models. Their recommendations also covered the regulatory framework, the company's internal management arrangements and capital structure. (The full report is available at www.waterreformni.gov.uk).

6. In response, the Minister confirmed the decision that the Water Service would be restructured as a GoCo. He also accepted the review team's recommendation that the regulatory framework should be based on that in England and Wales.

APPENDIX 5: THE PRESENT GOVERNANCE SYSTEM

Legislative framework

1. Northern Ireland Water Limited (NIW) is a company limited by shares, created under the Companies Order (Northern Ireland) 1986. All the shares are owned by the Department for Regional Development (DRD). The legal and corporate governance structure for the Go-Co was intended to:

   - maximise the likelihood of delivering efficiency gains
   - clarify relationships with government
   - reduce political and regulatory risk
   - ensure effective accountability both to environmental and water quality regulators and to customers
   - create a stable and sustainable capital structure based upon a conventional incentive framework of regulation.

2. Further to the process of policy development outlined in Appendix 4, the Water and Sewerage Services (Northern Ireland) Order 2006:

   - provided for the establishment of a GoCo – Northern Ireland Water - to deliver water and sewerage services in Northern Ireland
   - provided for DRD to transfer all its water and sewerage assets to the GoCo provided for DRD to issue a Licence which sets out the conditions under which the GoCo

operates established and defined the powers and responsibilities of the Utility Regulator, the Consumer Council, DRD and NIW.

3. We examined the 2006 Order in conjunction with:

- NIW's Memorandum and Articles of Association
- the Governance Letter issued by the NIO Minister then responsible on 20th March 2007
- NIW's Licence

4. The Order and these documents are accessible through the Panel's website, www.iwrp-ni.org.uk

5. We also took into account the fact that NIW must act in accordance with company law, in particular the Companies Order 1986; and that all the agencies concerned must act within the wider framework of relevant EU legislation. The principal EU directives driving expenditure on our water and sewerage infrastructure are the Water Framework Directive, the Urban Waste Water Treatment Directive and the Drinking Water Directive. These directives are translated into domestic law by regulations enacted by the Assembly.

Memorandum

6. The Memorandum formally establishes the company NI Water Limited. It declares 52 objects in all, the most important of which may be summarised as follows:

- To take over the assets and liabilities of the DRD Water Service

- To deliver water and sewerage services

- To provide the necessary physical infrastructure

- To further the conservation and enhancement of the natural environment

- To promote water conservation

- To preserve public access to places of natural beauty

- To carry on business as a commercial company

- To trade in water and sewerage products

- To trade in goods and services associated with the use of water and water conservation

Articles of Association

7. The Articles of Association cover such aspects as:

- the rights and powers of DRD over NIW

- the powers of NIW's Directors to borrow money

- Board membership, appointments and removals

- Directors' remuneration

- Dividends

8. Under the Articles of Association, NIW may not without the Department's approval:

- issue or vary the rights attaching to its shares
- appoint or remove any director
- amend its own Memorandum or Articles of Association
- acquire shares in any other company
- conduct any negotiations with any third party regarding any potential investment in the company
- adopt or amend its own Strategic Business Plan
- make any material change in the nature of its business
- sell or purchase any assets with a value in excess of £1 million
- approve or amend the remuneration granted to any director of the company or the terms and conditions of their employment
- change its name
- borrow money other than from the Department or in the ordinary course of business.

Governance Letter

9. The Governance Letter sets out the principles underpinning the relationship between NIW and DRD as its only Shareholder. In particular:

- the NIW Board is to “take due consideration of relevant communication from the Shareholder on shareholding matters, for example Government objectives, business strategy, performance reporting, Board remuneration and appointments”

- DRD is to manage separately its policy and shareholding interests (which it has done by creating a “Shareholder Unit” within the Department)

- the DRD Shareholder Unit is responsible for appointing the Chair and non Executive Board members and can veto the appointment of Executive Directors

- the Shareholder Unit sets the terms on which the Directors are appointed, including remuneration packages and incentive schemes

- the Shareholder Unit can veto NIW’s Strategic Business Plan (SBP) and annual budgets

- the NIW Board is accountable to the Shareholder Unit for delivering on the SBP and the efficiency improvements which it incorporates.

10. The Governance Letter also outlines:

- arrangements for NIW's borrowing from DRD
- arrangements for NIW's managing subsidies from DRD
- arrangements for NIW's financial control

Licence

11. The Licence is the formal instrument of appointment signed by a senior official of the Department (currently the Director of the Shareholder Unit) on 23 March 2007. It authorises NIW to provide water and sewerage services across Northern Ireland and sets out in considerable detail the conditions under which it is to do so. It covers such areas as:

- charging arrangements, schemes and limits
- accounting procedures
- procurement procedures
- codes of practice (e.g. in relation to customer relations)
- relations with the Utility Regulator and Consumer Council
- asset management and land disposals

Internal Governance

12. The NIW Board is responsible for setting the company's strategic direction; senior management appointments; financial probity; and oversight of operational performance. Under the Articles of Association, the Board is to comprise not fewer than 2 and not

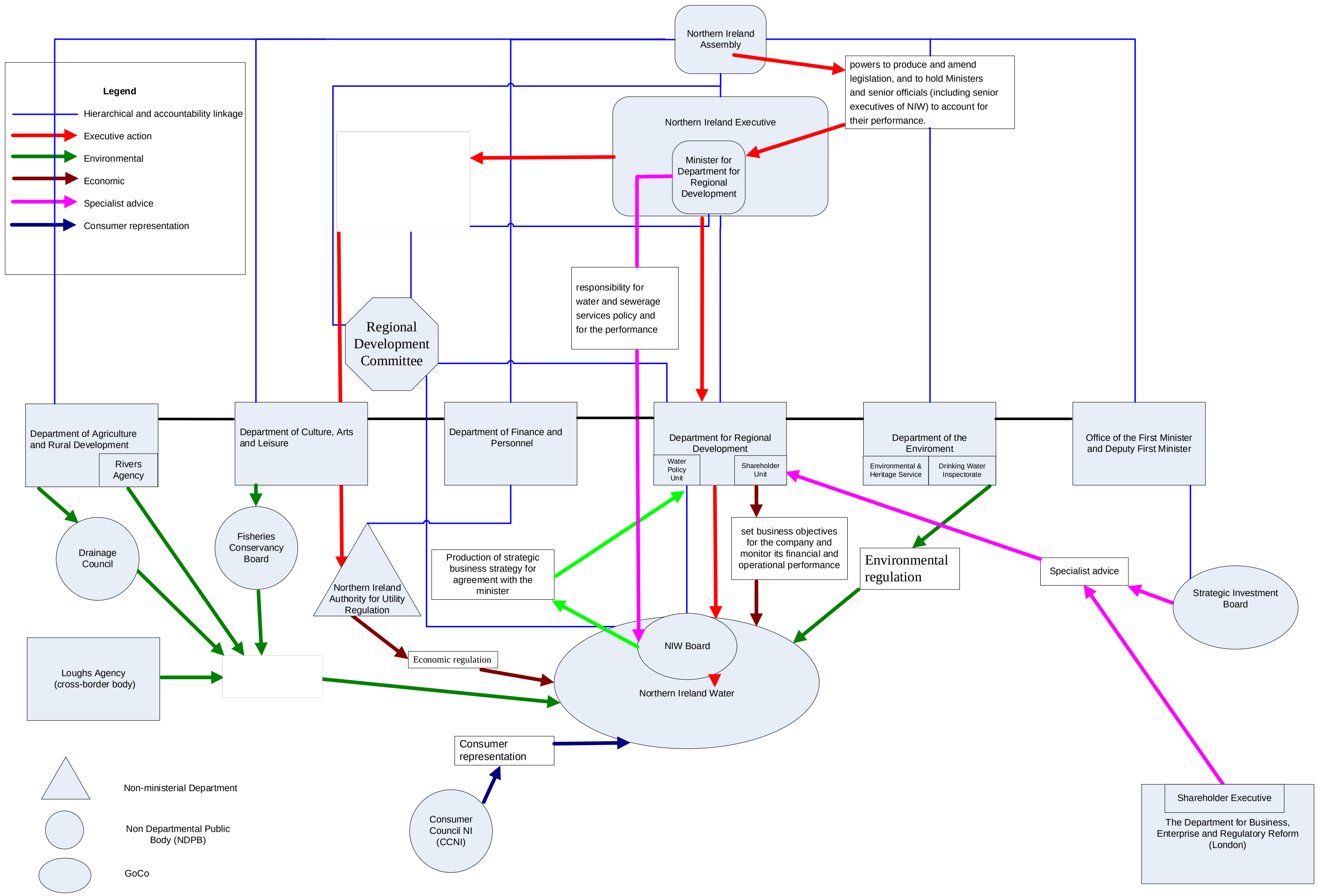
more than 10 members. It currently consists of 4 executive directors (Chief Executive, Director of Finance and Regulation, Director of Operations, and Director of Asset Management) and 3 non-executives, including the Chair. The Department told us that it intends the Board to have no fewer than 8 members, with 2 more non-executive members than executives. On this basis there are currently 3 non-executive vacancies. The Board is responsible for the appointment of executive directors, and the Department for non-executive directors. Both types of appointment require Ministerial approval.

Accountability

13. Figure 1 summarises the main relationships of accountability and regulation in the governance framework.

Figure 1

Main elements of governance and their inter-relationships



14. The principal actors, their roles and responsibilities, may be summarised as follows.

Assembly

15. The Assembly and it Committees have substantial powers to make legislation, to scrutinise the performance of Departments and public sector agencies, and to hold Ministers, officials and senior executives of NIW to account for their performance. DRD and NIW are subject to the same general obligation as any other public bodies to account for themselves to the relevant policy committee (primarily the Regional Development Committee) and the Public Accounts Committee. Similarly, the Assembly has the power to review any public funding provided for NIW through the regular appropriations process. NIW's shareholding may not be transferred out of Departmental control without the Assembly’s approval.

Minister

16. The Minister for Regional Development is answerable to the Assembly and has overall political responsibility for policy on and the performance of the water and sewerage services and for their regulation. The legislation establishes the broad objectives which must be met, but allows him substantial flexibility in how best to meet them. He also has a specific power to give the Utility Regulator guidance about the attainment of any social or environmental policy objectives.

17. The Minister is responsible for the appointment of the Chair and non-executive members to the NIW Board. These appointments come within the remit of the Commissioner for Public Appointments. He also has power to veto the appointments of the Chief Executive and executive directors; Board members' terms of appointment and remuneration; and the company's Strategic Business Plans.

18. The Minister also has a regulatory role in relation to drinking water, which is exercised largely through the Drinking Water Inspectorate in the Department of the Environment (DOE).

19. Finally, he has a variety of other powers which include the approval of NIW's byelaws and any compulsory purchase orders.

Department of Regional Development

20. While it is possible for some purposes to distinguish the powers of the Minister from those of the Department, Article 4 of the Departments (NI) Order 1999 clearly establishes that "The functions of a Department shall at all times be exercised subject to the direction and control of the Minister"; and that any of the Department's functions may be exercised by the Minister. For most practical purposes the powers of the Department may equally well be viewed as powers of the Minister.

21. As a result of the political decision to keep the company in public ownership, the Department has retained substantial powers and multiple roles in relation to water and sewerage services. These include policy development, priority setting, strategic planning, performance management, oversight of the regulatory system,

issue of guidance to the Utility Regulator, and acting as sole shareholder. Subject to the approval of the Assembly, it also has the power to make subordinate legislation on such issues as water quality, standards of performance and charging arrangements.

22. The Permanent Secretary is personally answerable to the Assembly for the Department's use of public funds, including money allocated to NIW: he has designated the Chief Executive as the Accounting Officer for NIW, who is answerable for the use of public money within the company.

23. Reporting to the Permanent Secretary, DRD Water Policy Division has been responsible for the development and implementation of the water reform programme, including policy and legislation on governance, regulation and charging. Its continuing responsibilities will include supporting the Minister in his policy development role, for example in developing guidance on social and environmental matters. Any such guidance must be laid before the Assembly where it will be subject to negative resolution.

24. In accordance with the Governance Letter, the Department has established a separate Shareholder Unit. Its stated purpose is to set business objectives for the company and monitor its financial and operational performance. It does this through various means, including Quarterly Shareholder Meetings. It has an agreement with the Shareholder Executive in London, a specialized UK-wide agency which provides it with access to expert advice on business issues.

25. When NIW was established in April 2007, the Shareholder Unit set it a number of objectives:

- deliver substantially better services more efficiently and at lower cost
- manage the business within the agreed financial parameters
- achieve maximum affordable improvements in environmental compliance
- enhance shareholder value and provide returns that match or exceed the regulatory cost of capital
- strive to outperform the targets set in the Strategic Business Plan.

Regulation

26. The regulatory structure for water and sewerage services is set out in the 2006 Order, with environmental regulation on the wastewater side in the Water (NI) Order 1999. As with the water industry in Britain, NIW is regulated in relation to four dimensions: economic, consumer, environmental, and drinking water quality.

<u>Utility Regulator</u>

27. The 2006 Order provided for a new independent regulatory body to be called the Northern Ireland Authority for Utility Regulation (the Utility Regulator). This parallels Ofwat (the Office of Water Service), which regulates the private water and sewerage companies in England and Wales, and the Water Industry Commission for Scotland, which regulates the statutory

corporation Scottish Water and private non-domestic suppliers. Unlike its counterparts in Britain, NIAUR's remit also covers the electricity and gas industries.

28. NIAUR is technically a non-Ministerial Department, which means that it has more autonomy than an NDPB. Its chair and members are appointed by the Department of Finance and Personnel (DFP). It is required to deliver an annual report to the Assembly.

29. NIAUR is responsible for regulating NIW as the sole provider of water and sewerage services in Northern Ireland, and to do so within the framework laid down by the legislation. It is required to act independently of the company, government and other stakeholders. It has a duty to:

- protect consumer interests (where appropriate by facilitating competition)
- ensure that NIW carries out its functions properly throughout Northern Ireland
- ensure that NIW is able to finance its functions, in particular by securing reasonable returns on capital.

30. In discharging these primary obligations, NIAUR must take into account a number of secondary objectives, which include that of contributing to the achievement of sustainable development.

31. The 2006 Order provided for DRD to delegate its regulatory powers to the Authority. The powers which it has actually passed over include:

- powers for making further appointments of service providers (i.e. issuing further licences) and terminating or varying the area covered therein

- enforcement powers in respect of NIW's general duties to develop and maintain the water supply system, to provide, improve and extend the public sewer system, and to promote the efficient use of water by its customers

- powers to waive enforcement action in lieu of an undertaking by NIW

- powers in respect of apportioning NIW's costs amongst its various user groups

- powers to oversee and authorise NIW's surplus land disposals.

32. The Regulator may impose financial penalties for breaches of NIW's Licence conditions and other infractions.

Consumer Council

33. The Consumer Council was established in 1985 under the General Consumer Council (Northern Ireland) Order 1984. Its functions in relation to water and sewerage parallel those of the Consumer Council for Water in England and Wales and Waterwatch in Scotland.

34. The Consumer Council is funded by the Department of Enterprise, Trade and Investment (DETI). It describes its mission as "…to speak up for consumers and give them a voice." It helps

individual consumers with complaints about transport, electricity, gas and coal.

35. The 2006 Order gives it a further specific remit to promote and safeguard the interests of water and sewerage service users. Its functions include providing service users with advice and information; investigating their complaints; research, including surveys of consumers' views and concerns; and representation of consumers' collective interests.

36. The 2006 Order specifies that where the Consumer Council cannot resolve a customer issue with NIW, it can take the complaint to NIAUR for a final decision.

DoE Environment and Heritage Service

37. The Environment and Heritage Service (EHS) is an executive agency within the Department of the Environment (DoE). It employs around 700 staff. Its stated mission is "To protect, conserve and promote our natural environment and built heritage for the benefit of present and future generations." It works to control pollution and promote sustainable development. EHS takes the lead in advising Ministers on and implementing the Government's environmental strategy. It has specific regulatory powers and responsibilities in relation to environmental compliance by NIW, mainly through arrangements under the Water (NI) Order 1999.

38. The parallel agencies are the Environment Agency in England and Wales and the Scottish Environment Protection Agency. Both are

autonomous Departments which report directly to elected representatives.

Drinking Water Inspectorate

39. The Drinking Water Inspectorate (DWI) is an expert unit within EHS which is responsible for monitoring and regulating the quality of drinking water, which it does in consultation with health and environmental health authorities. It parallels the Drinking Water Inspectorate in England and Wales and the Drinking Water Quality Regulator in Scotland (DWQR). In Scotland the DWQR is independent of Ministers, whereas in England and Wales the DWI discharges its enforcement role on behalf of Ministers. The Northern Ireland Inspectorate:

- regulates drinking water quality in both public and private supplies
- assesses drinking water quality against international regulatory standards
- carries out detailed inspections of water sampling and analytical processes
- assesses water treatment and distribution policies and practices
- publishes an annual overview of drinking water quality in Northern Ireland
- develops policy on drinking water regulation issues with the other UK Drinking Water Regulators

- deals with complaints from consumers and incidents which could affect drinking water quality.

<u>Water Management Unit</u>

40. Water Management Unit (WMU), also within the DoE's Environment and Heritage Service, is responsible for the protection of water in the environment. Its activities include:

- monitoring the quality of water in the environment
- preparing water quality management plans
- controlling effluent discharges
- taking action to combat or minimise the effects of pollution
- supporting environmental research

41. As a result of the water reform programme, which removed Crown immunity from the Water Service, NIW has since April 2007 required specific consents under the Water (Northern Ireland) Order 1999 for discharges from its treatment works and sewerage systems. These take into account the requirements of European Directives such as the Urban Wastewater Treatment Directive.

42. WMU has issued consents for some 1100 waste water treatment works, 30 water treatment works and 300 sewer systems. Each contains conditions relating to the quality and quantity of the discharge. NIW is now subject to the same enforcement action as any private individual or company for non-compliance with consent conditions and pollution incidents caused by a failure to maintain and operate its infrastructure properly.

43. The Water Management Unit has established a Water Utility Regulation Group (WURG), whose primary function is to regulate discharges made by the water utility sector. Discharges may arise from:

- sewage treatment works
- combined sewer overflows (intermittent discharges from sewers which carry both foul sewage and rainfall)
- emergency overflows from sewage pumping stations
- water treatment works (waste waters may arise as by-products of drinking water purification processes).

<u>Regulatory Co-ordination Group</u>

44. The 2006 Order imposes duties of co-operation on the various agencies in the regulatory system. DRD has accordingly established a Regulatory Co-ordination Group which brings together the economic and environmental regulators. Its terms of reference are:

“1. To provide a forum for the consideration of environmental, drinking water and economic regulatory issues applying to the Northern Ireland Water industry.

2. To fulfil the duty placed upon regulators under Article 11 of the Water and Sewerage Services (NI) Order 2006 to promote co-operation and the exchange of information between them and to promote consistency of treatment of matters which affect them.

3. To foster the development of effective regulation of the NI water industry, in respect of both policy and practical working relationships, in a way that minimises duplication and administrative burdens on NIW.

4. To provide a forum for discussing policy input and presentational issues raised by water-related environmental issues with the aim of ensuring consistent advice on environmental, drinking water and economic regulatory matters to Ministers."

45. The Group's membership comprises representatives from DRD Water Policy Division, DOE Environment and Heritage Service, Drinking Water Inspectorate, Utility Regulator and NIW. The secretariat is provided by Water Policy Division. Memoranda of Understanding have been or are being produced between the members which are intended to enable each to discharge its responsibilities effectively without duplication of effort.

APPENDIX 6: GLOSSARY

Bonds	-	A bond or corporate bond is a form of loan through which a company can access debt finance
Capex	-	Capital expenditure
CCNI	-	Consumer Council for Northern Ireland
CLG	-	Company Limited by Guarantee
CLS	-	Company Limited by Shares
Cost of Capital	-	The combined cost of the return on debt (interest) and the return on equity (dividends and retained earnings)
Credit Rating	-	The credit worthiness of a company, or of a bond issued by a company, as assessed by a credit rating agency
DFP	-	Department of Finance and Personnel
Dividend	-	The distribution of (part of) a company's earnings to its shareholders
DOE	-	Department of the Environment
DRD	-	Department of Regional Development
DWI	-	Drinking Water Inspectorate
EHS	-	Environment & Heritage Service
Financial Reserves	-	Access to liquid financial funds built up through the retention and reinvestment of surpluses within the business.

Gearing	-	A measure of the level of debt in a business. It is usually defined as Debt / (Debt + Equity) although in this report it typically refers to Debt / RCV.
Go-Co	-	Government Owned Company
NIAUR	-	Northern Ireland Authority for Utility Regulation or “Utility Regulator”
NIO	-	Northern Ireland Office
NIW (or NIWL)	-	Northern Ireland Water
OFWAT`	-	The economic regulator for the water and sewerage industry in England & Wales
Opex	-	Operating expenditure
RCV (or Regulatory Capital Value)	-	The asset value of the business on which the regulated return is earned
SBP (or Strategic Business Plan)	-	NIW’s Strategic Business Pan of 3 May 2007
Shareholder Executive	-	The Shareholder Executive was established to improve the UK Government's performance as a shareholder in businesses
Shareholder Unit	-	A directorate within DRD that executes the Minister’s shareholder function
Thin Equity Model	-	A company which is predominately financed by debt and where only a small proportion of equity persists