

What of Ofwat?



Philip Fletcher
16 October 2003

- A sustainable future
- A new Water Act
- Periodic review 2004

Sustainable Future

- Long term goals
- Long term industry

Sustainable Development

Sustainable development encompasses environmental, social and economic objectives. The Government's objectives are:

- social progress which recognises the needs of everyone;
- effective protection of the environment
- prudent use of natural resources; and
- maintenance of high and stable levels of economic growth.

Water Bill

- A new Ofwat.
(constitution and duties)
- A new WaterVoice.
(national and independent)

Competition

The Bill provides:

- a specific framework for common carriage and retail competition; and
- a formal framework for self-lay competition.

Competition

- The Water Bill entitles competitors to common carriage and buy water 'wholesale'.
- The new water supply licensing regime will commence in autumn 2005, with potential licensees being able to apply for licences from summer 2005.

Self-lay

- The Water Bill formalises arrangements for organisations other than water companies to lay water mains and sewers.
- Ofwat will have powers to determine disputes about the terms and financial conditions.
- The self-lay regime will be commenced 5 months after Royal Assent.

PR04

Where are we?

- Methodology - March 2003.
- Companies' draft business plans - August 2003.
- Ofwat's initial reactions - today in:
'Setting water and sewerage price limits for 2005-10: Overview of companies' draft business plans'.

Draft business plans

The draft business plan sets out:

- the company's preferred business strategy; and
- reference plans based on common assumptions provided by Ofwat, and packages of quality and environmental improvements agreed with the quality regulators.

Ofwat's initial reactions

The preparation of the draft business plans has been worthwhile, it has:

- helped each company to clarify its proposed strategies for 2005-10; and
- helped Ofwat to understand and identify issues where the companies' thinking needs to be tested for consistency and justification.

The plans will serve as a basis for advice to Ministers.

The Overview

Aims

- To set out the key issues arising from our initial scrutiny of the draft plans.
- To show how we are going to use these draft plans to prepare for the later stages of the review.
- To highlight the areas where companies will need to improve their justifications.

Initial reactions

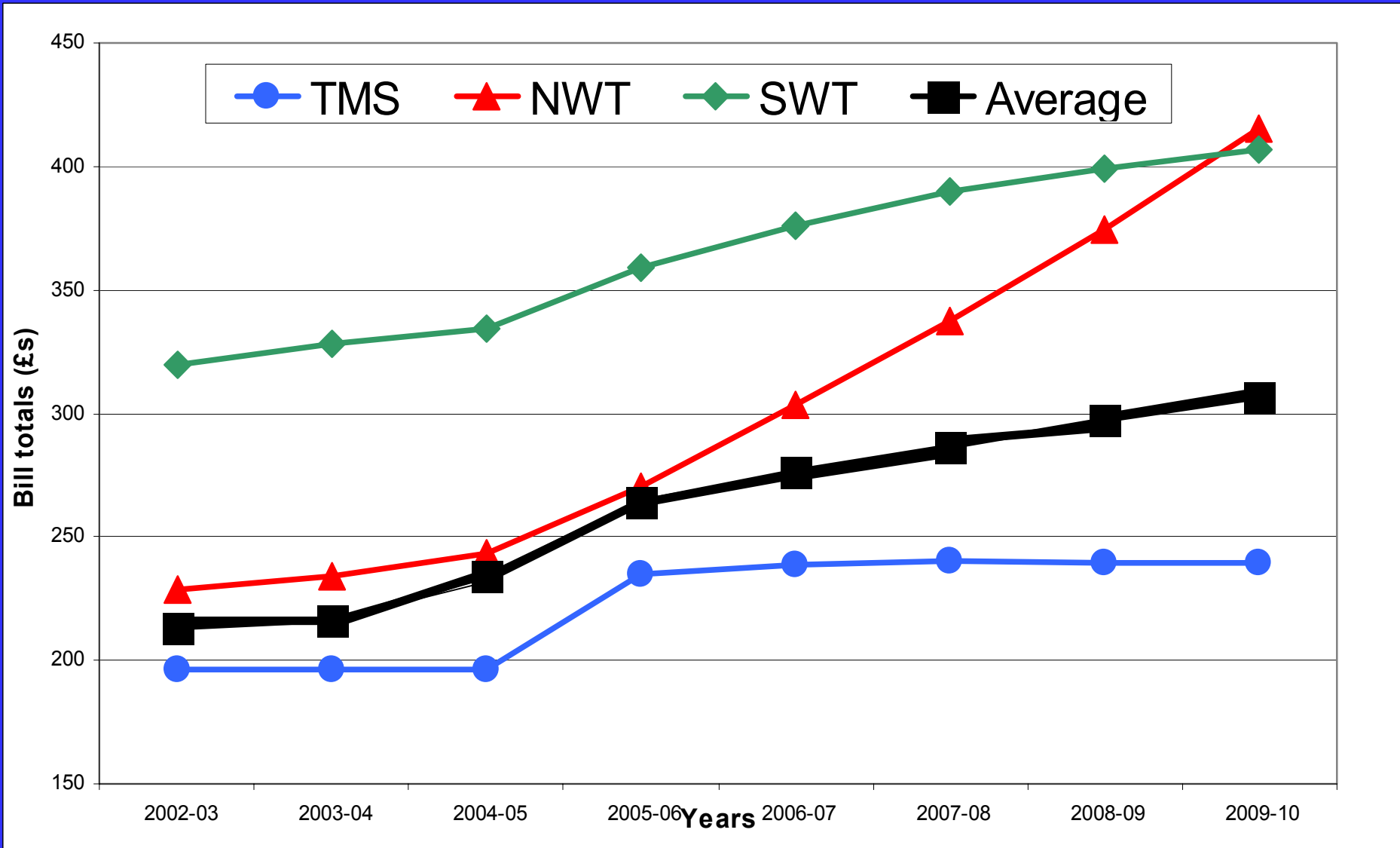
Big programme



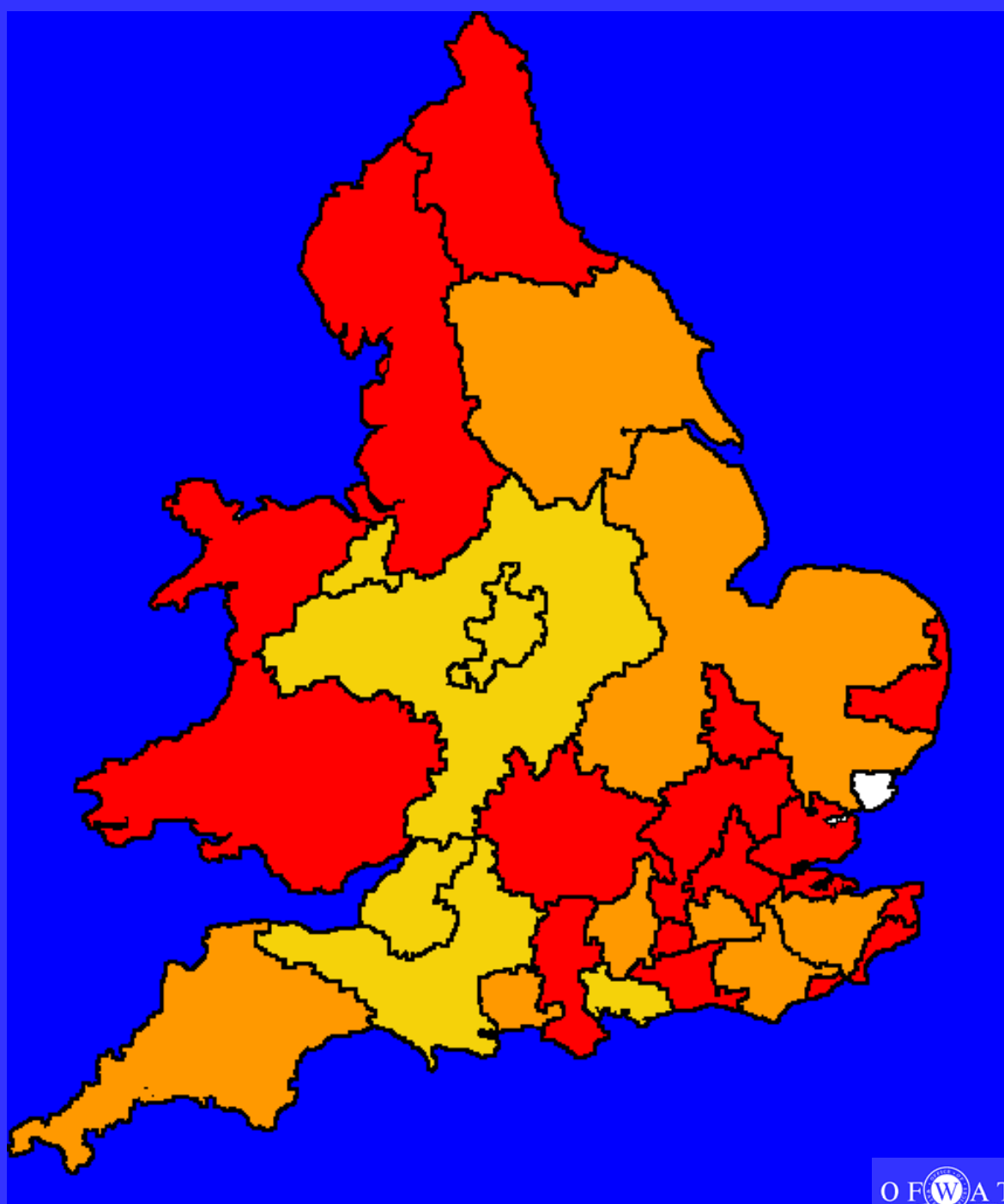
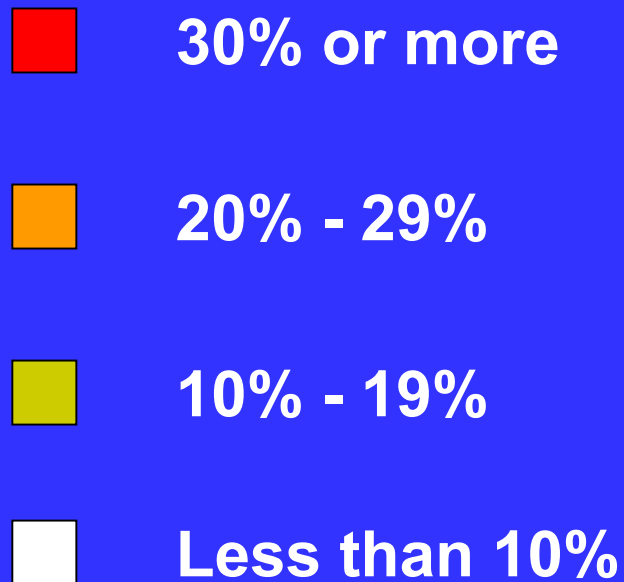
Big cost

(On average proposals = +30% real terms increase over 5 years ranging from (for WaSCs) 70% to 12%)

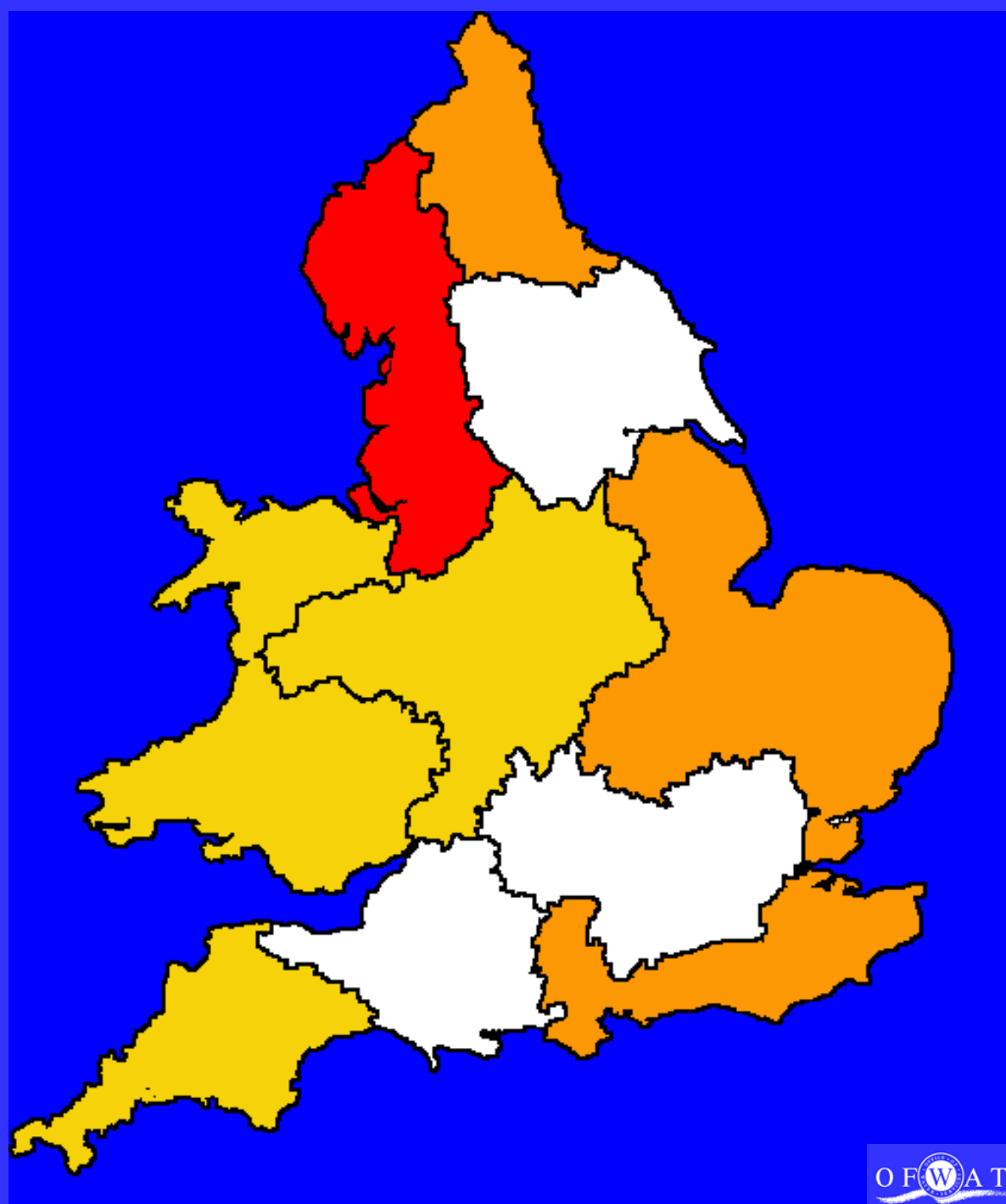
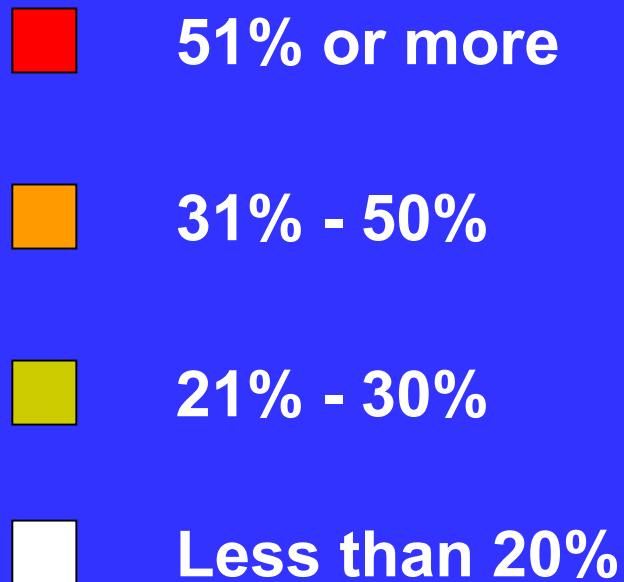
Trends in bills: Company preferred strategy



% Increases in water bills



% Increases in sewerage bills



What is driving the increase in bills?

Average household bill in 2004-05		£234
Less	(1) past efficiency and savings and outperformance	(8)
	(2) Scope for reduction through future efficiency improvements	(10)
Plus	(3) maintaining base services	37
	(4) maintaining security of supply to all customers	12
	(5) the impact of improvements in services	41
Average household bill in 2009-10		£306

What is driving the increase in bills?

The impact of improvements in services	£41
Of which (a) drinking water quality	10
(b) environmental improvements	26
(c) service performance	5

Maintaining base services	£37
Of which (a) changes in revenue	3
(b) changes in operating costs	6
(c) changes in capital maintenance	19
(d) impact of taxation	9

Improvements in Service

- Drinking water quality
- Environmental improvements
- Service performance

Drinking water quality

- DWI has given preliminary technical support to companies' proposals for enhanced treatment.
- DWI believes other enhancements are desirable.
- Ministers will give guidance in January.

Adds £10 to bills

Environmental quality

- The Environment Agency, English Nature and the Countryside Council for Wales instructed companies on further improvements likely to be needed in 2005 -10.
- Companies have costed most of these in their proposals at £4.7 billion.
- Ministers will give guidance in January 2004.

Adds £26 to bills

Service performance

- Sewerage companies propose investing £1.6 billion to address the worst cases of sewer flooding.
- 9 out of 10 propose additional spending to deal with odour nuisance.
- Very few other enhancements due to perceived satisfaction.

Adds £5 to bills

Maintaining security of supply

- Companies suggest that net capital expenditure should more than double.
- Majority of increase (in water service) is due to Thames Water's plans for mains replacement and enhancements to resolve leakage and security of supply issues in London.

Adds £12 to bills

Capital maintenance

- Increase of £1.7 billion since 2000-05 (an increase of 23%).
- Companies state that substantial increases are needed to maintain:
 - the serviceability of their assets; and
 - sustain levels of service to their customers.

Adds £19 to bills

Operating costs

- Operating costs: increases in expenditure of 8%.
- Pension costs account for about a third of this.
- Other concerns include bad debt.

Adds £6 to bills

Taxation

The increase in the impact of tax is caused by:

- Inland Revenue changing the way it treats certain types of expenditure
- also possible further increases due to changes in accounting standards.

Adds £9 to bills

Past and future efficiency

- Many companies stated that future efficiency savings based on our initial research are not deliverable.
- We continue to update and refine our view on efficiency.
- Companies assume that past efficiency would reduce costs by 4%, more than we assumed in 1999.

Reduces bills by £18

Revenues

- Companies expect optional metering to reduce their revenue.
- Companies are forecasting continuing declines in the revenues they expect to recover from industrial customers who fall outside the 'tariff basket'.

Adds £3 to bills

Cost of Capital

- In their draft business plans the WaSCs' estimates for the WACC ranged from 5.2% to 5.8%.
- All companies argued that the weighted average cost of capital (WACC) used at the last review was too low at 5.0%.
- Too early to draw firm conclusions on the appropriate cost of capital.

Cost of Capital

- The current view is that it is unlikely to be lower than at the 1999 review.
- The case for some of the higher company estimates may be overstated.
- Believe scope to assume a slightly higher level of gearing (55% - 65%) than 1999 without forcing companies to adopt over risky structures

Financeability

- A company's cash flow, revenues and profits must allow it to raise finance on reasonable terms.
- For some companies a significant element of price limits is to achieve their view of an acceptable financial profile.
- Large capital programmes mean companies will not generate positive cash flows.

Financeability

- Too early at this stage to consider the exact levels of financial indicators.
- Continue to have dialogue with credit rating agencies and investors.
- To target credit ratings comfortably within investment grade category.

Further work

- Joint customer research.
- Guidance from Ministers.
- Further work on the potential efficiency gains.
- Clarity on the impact of forthcoming court cases on issues.
- Clarity on the implications of Government decisions eg traffic management.

Advice to Ministers

Based on:

- the draft business plan proposals;
- forthcoming discussions with each company; and
- forthcoming discussions with WaterVoice committees.

It is still too early to signal the likely outcome of the review.

‘Prices will be no higher than they need to be.’

Next Steps

- Our letter to Ministers (December 2003).
- Ministers' principal guidance (late January 2004).
- Final business plans (7 April 2004).
- Draft price determinations (28 July 2004).
- Final price determinations (25 November 2004).
- Bills from April 2005.