

Part I. Final determinations – summary

1. Our proposed price limits

This report summarises the outcome of our review of price limits for the 23 water companies in England and Wales for the period April 2005 to March 2010. It explains how we have arrived at our conclusions.

In October 2002, we published our timetable for this review and consulted on our approach. Following this consultation, we published our methodology paper, 'Setting water and sewerage price limits for 2005-10: Framework and approach', in March 2003.

To set price limits we need to understand the costs each company will incur to run its business and the revenues it will need to collect to finance it. The companies submitted their draft business plans in August 2003 and we published 'Setting water and sewerage price limits for 2005-10: Overview of companies' draft business plans' in October 2003. We worked with the companies, the quality regulators and the Government to determine what the companies will be required to deliver in the period 2005-10. In March 2004 the Secretary of State for Environment, Food and Rural Affairs and the Welsh Assembly Government published their principal guidance setting out the drinking water quality and environmental improvements they wished the companies to make.

The companies submitted their final business plans to us in April this year, setting out the price limits they consider they need. We scrutinised each company's proposals thoroughly and published our draft determination of price limits in 'Future water and sewerage charges 2005-10: Draft determinations' in August 2004 for consultation. This set out our initial views on the price limits the companies need for the period 2005-10.

Ministers provided their final guidance in October 2004. This clarified the environmental and drinking water quality outputs the companies are expected to deliver in 2005-10. In our draft determinations, we excluded a number of projects where we considered that further work needed to be undertaken to specify the requirements and costs. The Environment Agency, English Nature and the Drinking Water Inspectorate (DWI) have worked closely with the companies and us to do this and consequently our final determinations include more of these schemes.

In this monopoly industry we rely heavily on comparative competition. We assess how fast the industry can improve its performance within the economy at large. We compare each company's relative performance with that of other companies in the industry and make judgements about the speed and extent to which it can catch up with the performance of the best. This allows us to assess what each company can deliver over the period and within what price limits. We have taken a fair and consistent approach to each company's business plan, based on our published methodology and each company's individual circumstances.

Our final determination of price limits reflects a number of changes as a result of new information that has become available and some refinements to our approach in response to the representations.

1.1 Price limits

Our determinations of price limits for the period 2005-10 would mean an annual average price limit of 4.2% before inflation. The price limits for each company are set out in table 1. These price limits should enable companies to deliver their outputs, but are no higher than they need to be in the interests of customers.

Table 1 Price limits for 2005-06 to 2009-10

	Annual price limits					
Company	2005-06	2006-07	2007-08	2008-09	2009-10	Average ¹
Water and sewerage companies (WaSC)						
Anglian	3.8	0.0	2.8	2.7	2.7	2.4
Dŵr Cymru	14.2	3.6	4.1	3.3	2.2	5.4
Northumbrian	6.5	3.7	3.2	1.0	0.6	3.0
Severn Trent	11.8	4.8	2.0	1.7	2.3	4.5
South West	12.5	9.8	9.8	1.7	1.4	6.9
Southern	12.6	3.9	3.5	5.8	2.6	5.6
Thames	14.9	2.1	1.2	1.3	1.5	4.1
United Utilities	5.0	6.4	4.4	3.5	3.0	4.5
Wessex	8.9	4.9	5.6	4.0	2.9	5.2
Yorkshire	5.5	4.9	3.6	3.6	2.1	3.9
WaSC average (weighted)	9.4	4.0	3.4	2.7	2.2	4.3
Water only companies (WoC)						
Bournemouth & W Hampshire	15.9	2.2	1.6	-0.6	-2.4	3.1
Bristol	13.8	2.8	1.5	0.7	-2.3	3.2
Cambridge	11.8	1.6	0.3	-0.8	-0.3	2.4
Cholderton ²	7.0	7.0	5.6	0.0	0.1	3.9
Dee Valley	5.7	-1.4	0.2	0.6	-0.7	0.8
Folkestone & Dover	8.3	7.3	4.0	1.9	2.6	4.8
Mid Kent	9.0	0.5	1.9	2.6	2.7	3.3
Portsmouth	-0.7	-0.6	1.5	2.5	1.0	0.7
South East	15.8	2.3	2.2	0.5	-1.6	3.7
South Staffordshire	9.9	2.5	1.7	1.0	1.3	3.2
Sutton & East Surrey	12.9	2.0	1.1	-1.0	-1.1	2.7
Tendring Hundred	-1.8	-0.7	0.6	-0.3	-0.5	-0.5
Three Valleys	15.3	1.8	1.2	-0.2	0.1	3.5
WoC average (weighted)	12.4	1.9	1.5	0.4	-0.3	3.1
Industry average (weighted)	9.6	3.9	3.2	2.5	2.0	4.2

1 The average for the price limits is the geometric average of the annual price limits.

2 Cholderton is an exceptionally small company. Price limits have been set, but other than in this table, table 4 and its company-specific table in chapter 7, Cholderton is not included in tables in the remainder of this document. It does not have a material effect on the industry averages.

The increases customers will face vary from company to company. The price limits range from 2.4% a year, on average, for Anglian, to 6.9% for South West among the water and sewerage companies. For the water only companies the range is from an average reduction of 0.5% a year for Tendring Hundred to an increase of 4.8% a year for Folkestone & Dover.

The increases in the price limits are greatest in the first year, 2005-06. This reflects the costs faced by the companies. For the industry as a whole price limits will rise by 9.6% in that year. The size of the increase then reduces year-by-year for the remaining four years. Five water and sewerage companies and six water only companies will have price limit increases of more than 10% before inflation in the first year.

The price limits we have set are lower than those proposed by companies in their business plans. On average, they sought annual price limits of 6.2% before inflation, 2% more than the limits of 4.2% included in our final determinations.

Our price limits reflect the costs the companies face. The main influences are:

- increased running costs arising from changes to taxation, pension and energy costs and legislative changes;
- increased activity necessary to maintain the asset network and improve security of supply to ensure no deterioration in services;
- further improvements to drinking water quality and the environment required by Ministers; and
- significant reductions in sewer flooding.

Table 2 compares our final determinations at an industry level with the average price limits included in the companies' business plans. In chapter 4 we set out for each company how its business plan compares with our final determinations.

Table 2 Comparison of industry average price limits with companies' business plans for 2005-10

Price limits	2005-06	2006-07	2007-08	2008-09	2009-10	Average
Water and sewerage companies (weighted average)						
Business plans	13.1	7.1	4.7	3.6	3.1	6.3
Final determinations	9.4	4.0	3.4	2.7	2.2	4.3
Water only companies (weighted average)						
Business plans	16.7	6.8	2.7	1.2	0.9	5.5
Final determinations	12.4	1.9	1.5	0.4	-0.3	3.1
Industry (weighted average)						
Business plans	13.4	7.1	4.6	3.4	2.9	6.2
Final determinations	9.6	3.9	3.2	2.5	2.0	4.2

1.2 Changes from the draft price limits

In August 2004 we published our draft determinations of price limits. Table 3 compares our final determinations to our draft determinations. At the industry level, our final determinations are 1% higher per year on average than the draft ones.

Table 3 Final determinations compared to draft determinations

Average annual price limits 2005-06 to 2009-10 (%)			
Company	Draft determination	Final determination	Difference
Water and sewerage companies			
Anglian	1.5	2.4	0.9
Dŵr Cymru	4.5	5.4	0.9
Northumbrian	1.5	3.0	1.5
Severn Trent	3.5	4.5	1.0
South West	5.6	6.9	1.3
Southern	4.0	5.6	1.6
Thames	3.0	4.1	1.1
United Utilities	3.5	4.5	1.0
Wessex	4.2	5.2	1.0
Yorkshire	3.3	3.9	0.6
WaSC average (weighted)	3.3	4.3	1.0
Water only companies			
Bournemouth & W Hampshire	2.6	3.1	0.5
Bristol	2.6	3.2	0.6
Cambridge	1.8	2.4	0.6
Dee Valley	0.5	0.8	0.3
Folkestone & Dover	3.3	4.8	1.5
Mid Kent	0.7	3.3	2.6
Portsmouth	-0.5	0.7	1.2
South East	2.9	3.7	0.8
South Staffordshire	2.5	3.2	0.7
Sutton & East Surrey	1.6	2.7	1.1
Tendring Hundred	-1.4	-0.5	0.9
Three Valleys	2.8	3.5	0.7
WoC average (weighted)	2.2	3.1	0.9
Industry average (weighted)	3.2	4.2	1.0

We received more than 500 representations on our draft determinations (appendix 1 provides information on the types and numbers of respondents). We also met each company and the WaterVoice Committees to hear their views on our draft decisions. The representations are summarised in chapter 5 and will be published in full (other than, by exception, where the author required confidentiality) on our website (www.ofwat.gov.uk). Our website will also include a table summarising the responses, who made them and how we have responded to the points raised.

In early October we received the final ministerial guidance on the expected quality improvements.

Our final determinations will lead to an annual average price limit of 4.2% compared with an annual average price limit of 3.2% included in our draft determinations. The first year price limit in 2005-06 will be 9.6%, an increase of 1.8% compared with our draft determination of 7.8%.

The changes between our draft and final determinations are particularly marked for Northumbrian, Southern, Folkestone & Dover and Mid Kent, where the average final price limits over the five-year period have risen by 1.5% or more compared with the draft price limits.

A number of items are contributing to the changes between our draft and final determinations. We have made a great many detailed changes which affect individual companies. Most of these have a very small effect on price limits. The issues which have a more significant overall general effect are:

- an increase in the capital programme of £1.1 billion to reflect additional quality improvement schemes, maintenance and greater investment to reduce the risk of sewer flooding;
- a reassessment of the efficiency assumptions for operating costs in the sewerage service;
- new information on current trends in energy and pension costs;
- clarification and new information from each company on issues specific to them; and
- recognition as notified items of potential risks from changes to water companies' taxation and charges in respect of abstractions and discharges from the Environment Agency and others.

In response to demands from customers and companies, we have increased the investment allowed in price limits to deal with properties at risk of sewer flooding. This was a high priority for all of the WaterVoice Committees and each of the sewerage companies. As a result, our price limits allow for measures to reduce the risk or impact of sewer flooding for each existing high risk problem where overloaded sewers cause flooding which companies proposed to resolve, including capital solutions for the vast majority of cases.

In our draft determinations, we excluded a number of environmental and drinking water improvement schemes that we considered were insufficiently clear and where further work was required to determine the costs of these schemes. As a result of further work by the Environment Agency, English Nature, the DWI and the companies on specifying the outputs and costs, we have included more of these schemes in our final price limits, as well as the majority of those schemes on which particular emphasis was laid in the final guidance from Ministers.

We have not changed our views on the cost of capital for the industry compared with the draft determination. However, the larger capital programme in our final determinations has exacerbated the financial constraints companies face if they are to maintain an adequate financial position in the last three years of the period. For this reason, price limits are higher than they would otherwise have been in order to maintain financeability in those years.

We have maintained the principles and approach underlying our assumptions on the future efficiency gains achievable by the companies over the period. This is explained in more detail in chapters 5 and 10. Our efficiency assumptions for the period 2005-10 continue to be demanding. However, we have revised our assessments in the light of the latest information in companies' annual returns. We also accepted representations from the sewerage companies that it is inappropriate to use Thames as a benchmark company for sewerage efficiency. This is because of the special factors in its operating environment that advantage that company in disposing of wastewater from London. The new benchmark will mean slightly less demanding assumptions in the sewerage service on the catch-up necessary by the less well performing companies.

We have allowed a higher level of operating costs than we did in our draft determinations. This is in response to concerns about the upward pressures on operating costs resulting from increased pension contributions, energy prices and property rates, together with other new information not available in companies' final business plans.

1.3 Increases in customers' bills

The price limits control average bills. Overall, companies proposed an increase of 29% in average household bills by 2009-10, which would have required an increase of £72 in real terms (ie before adjusting for general inflation) on the average bill in 2004-05. The price limits now set will mean that the average household customer will pay around £46 more in real terms by 2009-10 than in 2004-05, an increase of around 18%. This is less than two-thirds of the increase in bills sought by the companies.

Average household bills will rise by 8.5% in the first year 2005-06 for the industry as a whole – around half of the total five-year increase. Companies wanted an increase of 12% on average. The profile of bills is discussed further in section 1.4.

Table 4 sets out the average expected household bills for individual companies. Although price limits have been prepared on a consistent basis for all companies, the level of increase will vary according to the circumstances of each company and the outputs it is required to undertake over the next five years.

At the last review of prices in 1999, we were able to reduce customers' bills on average, mainly by taking account of the large efficiency improvements which the companies achieved in the late 1990s. These have not been repeated over the last five years. But this means, taking account of this reduction, average household bills will have increased by only around £20 or 7% (in real terms) over the decade from 1999-2000 to 2009-10. Taking an even longer perspective, over the 20 years since privatisation in 1989, bills will have increased by 42% before inflation, in real terms around 1.8% a year.

All customer groups are predicted to spend more as a proportion of their income on water and sewerage bills in 2009-10 than in 2004-05. However, this will still be less than the proportion of disposable income spent on water and sewerage charges before 1999-2000.

The increase in average household bills is less than that suggested by the price limits for 2005-10. Average household bills will rise by 18% but the cumulative price limit increase is 23%. This is because during the period some customers will switch from an unmeasured to a measured supply to save money. Price limits need to be higher than the rise in average household bills to allow for the loss of revenue that companies experience because of this switching.

The average household bill is, by definition, an average across all customers. Individual customers' bills may rise by more or less than the average because of their particular characteristics, for example whether they have a measured or unmeasured supply. We have set out later in this report, changes in 'typical bills' for customers with typical characteristics, particularly distinguishing measured and unmeasured charges. In appendix 2 we also set out a number of illustrative examples of bill changes for customers with differing consumption levels or rateable values.

Regional effects

Changes to customers' bills will vary according to which company supplies them. Customers of South West, Southern and Wessex would see the largest percentage increase in their bills, 25% on average over the five-year period.

Customers of Anglian would see more modest changes in their bills over the period, with increases of only 7%, and those of Northumbrian around 12%. Customers of Northumbrian have, however, faced higher bills in 2004-05 than set in 1999. The company sought an uplift in its price limits for that year to meet the additional costs it faced. The price limit for 2004-05 was increased from nil to 10%. United Utilities also sought an uplift to its price limits for 2004-05, the price limit we set was 8.9%.

For the water only companies, customers' bills for Folkestone & Dover would rise by 23%, but those for Tendring Hundred and Dee Valley would fall by 2% and 1% respectively.

The combined bill for South West is expected to be £444 by 2009-10. This is significantly higher than the next highest of £352 for Dŵr Cymru.

Table 4 Average expected household bills¹

Company	Average annual household bills (£) ²							% change
	2004-05		2009-10		Change		Total	
	Water	Sewerage	Water	Sewerage	Water	Sewerage		
Water and sewerage companies								
Anglian	122	172	140	173	18	1	20	7
Hartlepool	94	–	108	–	14	–	14	15
Dŵr Cymru	123	163	153	199	30	36	65	23
Northumbrian	100	132	114	146	14	14	28	12
Essex & Suffolk	132	–	153	–	21	–	21	16
Severn Trent	116	105	133	132	16	27	43	20
South West	126	231	179	265	53	34	87	25
Southern	91	168	110	214	19	46	65	25
Thames	113	98	156	104	44	7	50	24
United Utilities	133	136	147	175	14	39	53	20
Wessex	126	151	170	177	44	26	70	25
Yorkshire	117	126	133	155	17	28	45	18
WaSC average (weighted)	118	132	142	155	24	23	47	19
Water only companies								
Bournemouth & W Hampshire	107		122		15		15	14
Bristol	108		122		14		14	13
Cambridge	91		101		10		10	11
Cholderton	136		166		30		30	22
Dee Valley	107		106		-1		-1	-1
Folkestone & Dover	143		176		33		33	23
Mid Kent	131		151		19		19	15
Portsmouth	77		80		4		4	5
South East	129		151		21		21	16
South Staffordshire	91		106		15		15	17
Sutton & East Surrey	127		143		16		16	13
Tendring Hundred	162		158		-4		-4	-2
Three Valleys	118		138		20		20	17
WoC average (weighted)	113		129		16		16	14
Industry average (weighted)	117	132	140	155	23	23	46	18

1 This table is quoted in 2004-05 basket year prices. All other figures quoted in this document are in 2002-03 financial year average prices unless otherwise stated.

2 The actual impact on customers' household bills will also be governed by companies' approved charges schemes.

1.4 The profile of bills

The customer research we undertook with others indicated that most customers would prefer that, where possible, increases in bills are brought in gradually to allow customers to adjust their budgets accordingly. Several WaterVoice Committees made this point in their representations. Companies, on the other hand, have indicated a strong preference for observing the principle that their income should in general match expected costs in a given year. We have considered these preferences fully. Overall, we have concluded that we should maintain the general principle that the revenues that companies can raise reflects their expected costs in a given year for the final determinations. This means that it is essential in most cases to allow a significant part of the increase, nearly half of the five-year total on average, to take effect in April 2005.

Price limits are in general so much higher in the first year because this is the first opportunity to adjust price limits for the costs which companies have incurred over the last five years. These include factors such as the climate change levy and National Insurance contributions. In addition, several important changes which affect price limits come into effect from April 2005. These include a more onerous corporation tax regime, and the impact of the revaluation of the rating system. The increased cost of companies' pension schemes and the impact of rapid increases in wholesale energy costs have also been taken into account. Part II of this report provides more information about each of these and other factors. The extent to which companies have outperformed our assumptions at past reviews and improved their efficiency has helped to mitigate the impact of these increases in costs, but has not offset them fully. Chapter 2 provides more detail on each of the factors influencing the future level of bills.

We have considered whether costs and outputs could be phased to later in the five-year period to mitigate the impact of rising bills in 2005, without jeopardising the level of service that companies provide. This has only been possible to a limited extent. For example, we have concluded that it would not be appropriate to assume that changes could be made to the implementation dates of schemes set up under statutory agreements between the water companies and the DWI for essential improvements.

Smoothing price limits without deferring costs means bills are higher at the end of the five-year period because less revenue is collected in the early years and more is required in the later years. In addition, where a company's costs in a year exceed revenues, this would tend, in most circumstances, to increase the perceived risk for that company of failing to fulfil its financial obligations. Lenders and investors would assess the risk accordingly and require an appropriate premium to compensate for it, adding still further to customers' bills. For example, if the increase implied by final price limits were smoothed evenly over the five years, we estimate that the overall increase required by 2009-10 would be around 25% rather than 18% – an increase of 7% due to smoothing alone. This is without assuming any additional revenue to compensate for risk – the increase would be even higher if this were included. This point was not made clear to customers in the market research.

South West, Bournemouth & West Hampshire, Cholderton and Folkestone & Dover have asked us to undertake a limited smoothing of their final price limits. This is to moderate the effect of the very sharp increase that would otherwise be due in April 2005 and allow their customers to adjust to the new levels of bills. We accepted that some smoothing is appropriate for these companies as they are prepared to manage any additional risk to which they may be exposed.

1.5 What will companies achieve for the price limits we have set?

We have reviewed each company's strategy with a focus on what it proposed to deliver over the 2005-10 period. For the most part we have been able to endorse the strategies and associated outputs. Delivery of these strategies does require a further substantial investment programme.

Our price limits assume increased levels of investment by nearly all companies to maintain their assets. They also include significant further investment on improving drinking water quality and the environment to address the final guidance from Ministers.

Our determinations also assume that companies will reduce the numbers of properties at risk of flooding from sewers and improve water pressure, taste, odour and hardness of drinking water for some affected customers. Companies will also be able to undertake more activity to maintain the balance between supply and demand so that new and existing customers' demand for water and sewerage services continues to be met adequately.

We assess each company against the delivery of the output requirements, not on how much money it spends. If a company outperforms our cost assumptions but delivers the required outputs then it will benefit; conversely if it underperforms then it will have to carry the extra costs.

To allow the companies to maintain current services and meet new obligations we have assumed in our price limits a capital investment programme of almost £17 billion over the five years. This is shown in table 5. This compares with the £21 billion (net of capital contributions) sought in the companies' business plans.

The main differences relate to the exclusion of quality and service improvement schemes that require further consideration (£0.5 billion), a higher level of efficiency savings than assumed by the companies (£1.0 billion) and a reduction in the required outputs (£2.4 billion) – including a slower rate of increase in capital maintenance expenditure.

Table 5 Capital investment assumptions 2005-10

	Final determinations		Total £ billion
	Water £ billion	Sewerage £ billion	
Capital expenditure¹ (five-year total)			
Capital maintenance	4.2	4.2	8.4
Supply/demand balance	1.7	0.6	2.3
Quality enhancements	2.1	3.4	5.5
Enhanced service levels	–	0.6	0.6
Total	8.0	8.8	16.8
£ per property	341	391	732

¹ Capital expenditure is net of capital contributions.

In our draft determinations we assumed total capital expenditure over the five-year period of £15.7 billion. The capital programme in our final determinations is £1.1 billion or 7% higher. Final price limits allow for further investment to relieve sewer flooding (an increase of

£0.3 billion) and further quality improvements (an increase of £0.4 billion), with smaller increases in capital maintenance and the supply/demand balance.

Maintaining services and the companies' assets

Companies must ensure that there is no deterioration in service to customers or in the level of compliance with their environmental consents and licences. Our price limits assume that the current levels of service to customers will, as a minimum, be maintained. This means compliance with drinking water quality regulations and the levels of service indicators and other measures that we use to assess each company's performance. Compliance with environmental consents and licences also covers abstraction from and discharges (continuous and intermittent) to the water environment.

Adequate maintenance of the asset system is essential to ensure continuing services to customers both now and into the future. Companies must sustain stable serviceability – fitness for purpose – throughout the period and beyond. Where the current position is not satisfactory we have assumed that the company will have achieved stable serviceability by the end of 2008-09 or earlier where specified. This includes maintenance of the sewerage systems to deal with newly emerging sewer flooding problems, as well as some schemes to reduce odour nuisance at sewage treatment works.

We have worked with the industry to develop an improved framework for assessing capital maintenance needs. We are pleased with the progress made by the companies. We have reviewed each company's plan to assess what it needs to maintain the serviceability of its assets.

Companies will have spent around £7.5 billion in 2000-05 (including an estimate for 2004-05) on maintaining their assets. The industry sought £9.4 billion for the 2005-10 period. We have assumed that companies will invest £8.4 billion on maintenance in the next period. This is a 22% increase over that assumed at the last review, and a 13% increase on estimated expenditure during the period 2000-05.

Maintaining the balance between supply and demand

Our price limits assume that companies can: meet all changes in demand for water both from new and existing customers; promote the efficient use of water by customers; install and operate optional meters; and ensure that leakage is kept at the economic level. Where the current security of supply position is not adequate we have assumed that the company will make the required improvements either by reducing leakage to the economic level, enhancing demand management, or commissioning new sources to the timetables set out in our determinations.

Our price limits assume that companies will need to invest £2.3 billion (or £3.1 billion gross of capital contributions) to ensure that the supply of water meets essential demands and that companies' sewerage systems can deal with the increased volume of sewage. This includes extending and upgrading the sewerage systems to deal with newly emerging problems of regular flooding from overloaded sewers in all but exceptional rainfall events. This is around a 60% increase compared with the last review. Companies included £3.3 billion (or £4.1 billion gross of capital contributions) to maintain the balance between supply and demand in their business plans.

Quality and environmental improvements

In total, companies will have invested nearly £25 billion from 1990 to 2005 on improving drinking water quality and the environment.

Our price limits assume that the industry will invest around £5.5 billion for new quality and environmental expenditure following our challenges to the companies' proposals of £6.9 billion. Our determinations include almost all of the projects included in companies' business plans to deliver the quality improvements supported by ministerial guidance. Not all of these are funded in full. When company proposals were not fully specified, or are dependent on the outcome of investigations, we have included in price limits the costs of investigation only. A few company proposals are very costly for the benefits to be delivered, and we have not at this stage included them. All of these schemes and the outcome of any investigations will be reappraised during 2005-10.

Enhanced service levels

We have included £0.6 billion for companies to improve some aspects of their service to customers. Most of this relates to sewer flooding. Further expenditure on sewer flooding is also included in the supply/demand balance and capital maintenance categories, so that in total we have assumed about £1.0 billion to address the problem of sewer flooding. This will enable companies to provide permanent solutions to the vast majority of current hydraulic problems they identified in their business plans and mitigation measures for the rest.

This would resolve 9,210 or about 90% of the known and emerging high risk internal flooding problems which companies proposed to deal with and 6,030 or 80% of external ones. It would do so at around 75% of the cost proposed by the water companies.

To help customers where proposed capital schemes may not be cost beneficial we have assumed that companies will install measures to protect properties from the effects of flooding. Together with the mitigation already proposed by some companies this means that the effects of sewer flooding will be reduced for 4,660 properties. Price limits therefore now include either a capital scheme or measures to reduce the risk or impact of flooding for all those currently known high-risk problems which the companies proposed to tackle by 2010.

This is a significant change from our draft determinations and reflects the concerns expressed in representations. In their responses to our draft determinations, many companies, customer representatives and other stakeholders said that too little had been allowed for sewer flooding which is a key customer priority. Government and parliamentary committees also considered that early progress on sewer flooding should be made. In light of these views we have changed our approach to sewer flooding as explained below and in more detail in chapter 13.

In our draft determinations, we allowed for schemes which cost below £120,000 per problem solved and provided for further work which proved to be cost beneficial to be taken into account at future price reviews. In our final determinations we have assumed that all proposed expenditure on schemes costing below £120,000 per problem is likely to be cost beneficial. In addition, a proportion of expenditure on schemes costing more than £120,000 is likely to be justified on cost-benefit grounds, and has therefore been built into price limits. We judge that 70% of expenditure on schemes costing between £120,000 and £250,000 per problem and 40% of expenditure on schemes costing more than £250,000 is likely to be cost beneficial. It is for the companies to take decisions about the individual schemes to complete.

We have used these assumptions to decide how much customers should be asked to finance to address sewer flooding at this stage, and we have forecast the numbers of problems which could be resolved.

In addition, our price limits allow for measures to deal with 3,700 cases of flooding caused by repeated blockages.

We have also allowed for improvements to water pressure, taste and odour or hardness of drinking water by a number of companies.

1.6 Involving customers

We have taken account of customers' views in our decisions about future water and sewerage charges. We have taken a number of steps to ensure that we are aware of customers' views in the price setting process. We have received direct correspondence from customers and other interested parties, and we have considered water companies' evidence of customers' priorities submitted in their business plans. WaterVoice has sent us comments throughout the process on behalf of customers. Independent research was also jointly commissioned with other industry stakeholders, which has informed both our decisions and Ministers' guidance on what improvements are required for drinking water quality and the environment. We have looked to companies to reflect their customers' priorities in their business plans and have checked for customer support where improved service levels are proposed. In arriving at our final decisions, we have had regard to the views expressed by customers in their representations.

WaterVoice

Each of the WaterVoice Committees submitted reports to us setting out their views on the companies' business plans and whether these reflected the views and needs of local customers. WaterVoice Committees have built up an understanding of these issues through contact with customers and regular public meetings with water companies to discuss price review issues. These reports have been particularly useful in helping us to assess the value of the proposals put forward by the companies to improve service levels.

The WaterVoice Committees and customers themselves have expressed concern about the prospect of increases to customers' bills at this price review. The WaterVoice Council considered the price increases sought by companies in their business plans to be neither acceptable nor affordable, and feared that more customers could find themselves in debt. In its public letter of 3 June 2004, the WaterVoice Council called on Ofwat and the Government "to act as a matter of priority in the final stages of the price review, to enable increases in bills by the water companies to be cut by at least one third on average". Our final determinations of price limits meet our statutory duties and, in the event, are a third lower than the price limits in the companies' business plans.

Each WaterVoice Committee has held meetings with the water companies and with us in the period since we announced our draft determinations. The Committees have also submitted written representations to us setting out their views on our draft determinations. Further detail on their representations is included in chapter 5 and in the company-specific pages in chapter 7.

Business customers

Our regular meetings with business customers provide them with an opportunity to put forward their views on what we should be seeking to achieve when setting price limits. Like

household customers they want bill increases to be as low as possible. They are particularly concerned that, operating in competitive markets, they will be unable to pass on to their customers any increases in the costs of water and sewerage services. In some markets, including overseas markets, passing on such increases would make them uncompetitive. High rates of increase in any single year would also be a cause for concern.

Business customers also asked us to ensure that the price increases they face only reflect increases in costs that are attributable to them.

Joint stakeholder market research

In preparation for this review we worked with eight other stakeholders (Department for Environment, Food and Rural Affairs, Welsh Assembly Government, DWI, Environment Agency, Water UK, WaterVoice, Wildlife & Countryside Link and English Nature) to commission two market research studies into customers' views. We have used this research in arriving at our final determinations. Chapter 8 sets out in more detail what the research told us about customers' views and priorities.

1.7 Risk and uncertainty

Inevitably, whenever we set price limits and outputs at a price review there are uncertainties about the costs companies will incur in delivering the outputs and their precise nature. We also recognise that there may be subsequent changes in the requirements placed on a company.

Price limits and outputs are a package. This package will include some outputs that turn out to be more costly than assumed and others that are less so. Where a company can deliver for less than we assume in price limits then it gains from this outperformance.

Our price setting methodology gives companies incentives to perform efficiently, accepting that there may be both favourable and unfavourable changes between price reviews. Our methodology must also offer assurance that the impact on companies where circumstances or requirements change will not be so large as to outweigh the incentives to continue to improve efficiency. Equally we need to provide assurances to customers that price limits are no higher than they need to be to meet the outputs the company has to deliver.

For the majority of outputs we can make reasonably confident central estimates of costs and we aim to make the price limits we set sustainable over a five-year period. However, if there are significant changes to specified outputs or if very significant events occur that are outside the control of an efficient company we have mechanisms to allow for changes to price limits (up and down). These mechanisms are known as interim determinations and substantial effect determinations respectively (see chapter 16 for details).

These mechanisms have worked well over the past 15 years and we will continue to use them. The mechanisms include the use of our change protocol (a procedure for dealing with changes in outputs between price reviews) published in MD197 'AMP4 change protocol'. The change protocol sets out the principles and outline procedures for water companies and the quality regulators to obtain confirmation of any changes to the improvement programmes assumed in price limits for the period 2005-10.

The five-year price review process ensures that water companies do not carry risks for more than five years. The resulting relatively low level of risk inherent in the water industry is reflected in the cost of capital and we do not include any general allowance for unforeseen costs.

As set out in chapter 15, we have tested the final price limits for ‘financeability’ ie are the companies able to continue to raise the finance in the capital markets necessary to undertake their investment programmes? This enables the water sector as a whole to continue to achieve good credit quality. We have not, however, allowed any further ‘headroom’ in financial projections to absorb possible unanticipated cost shocks or risks of not achieving efficiency assumptions. To do so would even further insulate companies and would suggest a rather lower cost of capital than the one underpinning these price limits. As noted above, the price limits, outputs and protective mechanisms in the regulatory framework are an overall package.

A few issues are too uncertain to be included in our price limits. However, we are creating ‘notified items’ so that if the issues do arise and have a material impact on a company’s costs then they can be considered as a reason for resetting that company’s price limits between reviews. Companies put forward many potential items in their business plans and representations. After assessing the companies’ proposals we believe that notified items are needed for:

- a difference (up or down) in the expected uptake of optional meters;
- increased levels of bad debt or debt management costs arising from the companies’ disadvantaged position, including their inability to disconnect household customers for non-payment of bills;
- increases in charges for abstraction and discharges to controlled waters;
- increases in costs arising from lane rental or the Traffic Management Act; and
- the impact of International Financial Reporting Standards on the taxation of infrastructure expenditure.

The last three are new notified items for this review. We included notified items for meter optants and the level of bad debt and debt management costs at the last price review. These are set out in more detail in chapter 16.

1.8 Infrastructure charges

At price reviews we set infrastructure charges for connection of domestic properties to water or sewerage services for the first time. The infrastructure charge is a contribution towards the costs of developing local networks to serve these new customers. Companies can levy an infrastructure charge as well as the direct costs of making connections.

We are setting infrastructure charges at £239 (in 2002-03 prices) for both the water and the sewerage services in 2005-06. This is the same limit in real terms as set at the 1994 and 1999 price reviews but increased by inflation. Charges for future years will rise in line with inflation.