

3. The longer term context – beyond 2010

When implemented, the Water Act 2003 will oblige the new Water Services Regulation Authority (WSRA) to carry out its duties in the manner which it considers is best calculated, amongst other things, to contribute to the achievement of sustainable development. (The WSRA will replace the role of the Director General of Water Services.) This obligation is not yet in force. However, we believe that the concepts underlying sustainable development are consistent with our current statutory duties, and that the price limits will contribute in a balanced way to achieving the following four objectives: social progress; effective environment protection; prudent use of natural resources; and maintenance of high and stable levels of economic growth.

The long term

Our starting point is that achieving sustainable development requires a long-term perspective: meeting the needs of the present without compromising the ability of future generations to meet their own needs. We set out in 1992, before our first price review, “the objective of ensuring the effective, and financially viable, long-term provision of appropriate quality services to customers and the community” (Ofwat’s strategic business plan manual). This remains so. Although at a price review we inevitably concentrate on the next five years we set this within an evolving longer term perspective. We asked companies to set out proposals that extend to 2014-15, with longer term projections for asset maintenance requirements, and water resource plans that cover a 25-year period.

Climate change

The water industry and its regulators need to take account of the many uncertainties when looking to the long term. A major issue is the rate of climate change and its likely impact on all aspects of the provision of water and sewerage services and the environment. It is neither possible nor sensible to set out detailed requirements to cater for these eventualities now. But the coherent framework of regulatory and asset planning systems can identify, and allow the companies to address the impact of, climate change as it becomes evident. In general, companies’ plans did not seek significant precautionary investment, but confirmed climate change as a growing future issue and gave some indications of possible implications for both the water supply and the sewerage networks. Gaining greater certainty in these areas is a priority for the next few years so that appropriate integrated strategies can be incorporated into future price reviews. We believe that the action proposed for the period 2005-10 will prepare the industry to deal with changes within the range of possibilities forecast without undertaking inappropriate and unnecessary investment. We will take account of the latest and best evidence as it develops.

The remainder of this section links the objectives of sustainable development to the outcomes described in this report.

Social progress

Since privatisation, customers have benefited from major improvements in the quality and continuity of supply of drinking water, as well as higher levels of customer service. Price increases are never welcome. But for most customers the average increase in water bills, of around 7% in real terms over the decade from 1999 to 2009, is less than the likely growth in household incomes. For those customers on low, fixed incomes served by companies with current or prospective high bills, the increase may be difficult to afford. It is not open to us or the companies to extend cross-subsidies between better off and less well-off customers within a company’s area. We therefore welcome the Government’s review of affordability

issues and we have taken a full part in its deliberations. We took an active part in the seminar held with all stakeholders to expose the main issues. We consider that measures such as potential changes to tax and benefits, expansion of the direct payments scheme, and developments to the vulnerable group tariff could all help to mitigate the problems of affordability that could arise from these price limits.

Effective environmental protection

During the course of the review we have raised questions about value for money issues where projects put forward by companies and/or the quality regulators appeared not to meet our long established criteria. These criteria include: a soundly-based needs assessment, clear outputs, wide options appraisals and robust costs and benefits assessments. In the vast majority of cases our challenges have been addressed through changes to the proposals, deletion of the projects or additional information such that we have been able to include well over 95% of the proposals set out in ministerial guidance. However, there remain a small number of proposals where we have had to make some difficult decisions or, where we are able to, we have allowed in price limits for further investigatory work.

We see the open challenge process as a crucial strength of the regulatory regime. Difficult decisions will always be required but these should follow a constructive and well-informed debate between the relevant parties. We see no reason to expect future periodic reviews not to involve similar challenge, informed debate and difficult decisions.

Overall, the improvement programmes included in price limits will enable water companies to make a further substantial contribution towards delivering national and international environmental obligations, many under European Directives. The 2005-10 programmes build on the huge improvements, so far mostly due to water and sewerage companies' activity, in river and coastal water quality over the last fifteen years. The full benefits of the current programmes will not be evidenced for a number of years.

The companies' plans, as taken forward through these price limits, should also help ensure a coherent long-term approach to environmental protection. We are not in a position to assess how significant the programme of environmental improvements for water companies will be in the period beyond 2010. By 2010, one of the main statutory drivers for work on the water environment is likely to be the Water Framework Directive. Draft river basin management plans will be published in 2008 and a programme of measures in each river basin district to deliver the environmental objectives will be established in 2009. This should fit with the timetable for the next price review in 2009. However, the focus of the Water Framework Directive is on the overall environmental outcomes and is not specifically directed at the water companies. The expectation is that the polluter should pay. As a recent Government consultation paper 'Developing measures to promote catchment-sensitive farming' (June 2004) indicated, this particularly puts the focus on diffuse pollution. The significant investment on the control of point source pollution by the water and sewerage companies over the period 1990-2010 should mean that water customers are not expected to continue to fund new investment at the current rate beyond 2009. However, until the plans and programmes of measures are published, it is not possible to estimate the level of expenditure necessary by the first milestone of 2015, the date by which environmental objectives need to be met.

Prudent use of natural resources

In its report to Ministers, 'Maintaining water supply' (July 2004), the Environment Agency has advised that all companies will, if they follow their water resources and drought plans, be able to meet their customers' needs for water for the next five or more years without unnecessary restrictions or inappropriate drought permits and orders. Where justified,

resources have been included in our price limits for investigative and developmental work on long-term enhancements to supply, and on improving the security of supply. We have continued to encourage water companies to control leakage effectively, with companies expecting to reduce leakage by more than 8% between 2003 and 2010, and to carry out their duty of promoting the efficient use of water by customers. Long term, the most effective and efficient way of encouraging water conservation is to relate the price paid to the amount used. Significant progress in the installation of domestic meters will be made over the coming five years and one company, Folkestone & Dover, plans to apply for 'water scarce area status', which would give it greater freedom to install meters.

High and stable levels of economic growth

In relation to the water industry itself, we consider that these price limits provide a demanding but achievable and fair basis for encouraging the industry to further improve its efficiency. This will benefit shareholders as well as customers. In supporting the economy at large, it is essential that the industry should be able to maintain high-quality water and wastewater services. To do so, the complex asset networks developed over 150 years must remain fit for purpose. The development in the last four years of a coherent common framework for the risk-based assessment of long-term spending needs is a major step forward. Many companies have used the framework to good effect in their business plans. On the strength of their work, we have assumed significant increases in spending on maintenance, and noted evidence that asset maintenance may need to be further increased in the period 2010-15.

It is essential that the industry should be able to continue to finance its work. Companies' revenues are insufficient to pay directly for high levels of capital investment. They therefore need access to the financial markets to service increasing debt levels or to raise new equity. Providers of finance need to be confident that companies can make returns that adequately match the risks of investment. We have fully considered these issues at this review.

The size of the capital programme beyond 2010 is not defined but is likely to be substantial and there will be a need to maintain financeability in the longer term. The need for companies to maintain an adequate financial position so that they can continue to raise finance may mean that continuing large capital programmes may have a disproportionate effect on price limits. We have had to allow in the price limits for 2005-10 for higher than average industry returns at the end of the period than at the beginning, due to financing considerations. Such an approach may not be economically sustainable at reasonable cost if companies are required to sustain negative cash flow indefinitely. We shall consider these issues further in preparing for the next price review.

Competition in the water industry

As a result of the Water Act 2003, a new market competition regime for the largest business customers using 50 Ml a year of water or more is likely to come into force in 2005. This will not affect other business customers, at least until after a review due in 2008, or domestic customers. The Government wants to see how price competition evolves before considering extending it to smaller business customers. It is difficult to predict, but we expect price competition to be more of an issue at the price review in 2009.