
REPORTER'S COMMENTARY ON THE BOARD OVERVIEW

Reporter's Scrutiny

In Accordance with its Instrument of Appointment, Dwr Cymru-Welsh Water (WSH) has appointed Halcrow Management Sciences Limited (HMS) a ring fenced member of the Halcrow Group, to provide reporting services to Ofwat.

The Reporter for WSH, Jeremy Hawkins of HMS, supported by a team of technical and operational specialists from Halcrow, has examined, tested and provided opinion to Ofwat on the information reported by the Company in its June Return 2006.

Ofwat regulates the appointment and work of Reporters by a Protocol which formally sets out the mechanism for appointment and the tasks the Director requires. These tasks include:

- Assessing the Company's compliance with Ofwat's June Return Reporting Requirements and guidelines,
- Ensuring that the Company's material assumptions have been disclosed and explained, and
- Preparing a written report to the Director General of Water Services together with a professional opinion on the Company process for developing its submission and on the accuracy and reliability of the information.

In accordance with our appointment we have carried out sample checks on the Company's processes and examined the reported data in the light of our knowledge of WSH and the prevailing conditions in the regulated water sector. We have examined and provided opinion to Ofwat on the Company's data tables, commentaries and other information forming its June Return 2006 and Board Overview. We have consulted with the Company's Auditors PriceWaterhouseCoopers where required on those financial measures for which we depend on each other's scrutiny.

The Company has co-operated with the Reporter and his team and has facilitated full and timely access to information and systems to enable the Reporter to properly discharge his functions.

The Reporter was present at the WSH Board's endorsement of the Return and Overview on 2 June 2006 and at the subsequent review of the Return by WSH's directors and senior managers on 13 June 2006.

Reporter's Opinion and Observations on the Board Overview

Having examined, scrutinised and challenged WSH's submission as appropriate, I consider that:

- The information reported in the June Return 2006 and accompanying Board Overview is consistent with the Reporting Requirements,
- The Company has implemented an effective and reliable process for the timely compilation of the June Return 2006
- The Return and the Board Overview fairly represent the Company's activities and performance in the Report Year.

As required by Ofwat, I have reviewed Chapters 1, 2 (costs), 3, 4 and 5 of the Board's Overview.

I have found that the Overview is consistent with the numerical data and commentaries in the June Return 2006 and the relevant reports to the Quality Regulators. I confirmed that the statements and numerical information reported in the Board Overview are consistent with the accompanying June Return.

Since 2001/02 the Company has implemented the majority of its capital investment and all its operations through a series of incentive-based partnership contracts with experienced service providers. The first set of these contracts covered the AMP3 period. The competitive tendering process (following EU procurement rules) for successor contracts was completed during 2004/05 and new strategic partners appointed from 1 April 2005. The AMP4 contracts are of longer duration than AMP3 and there is integration of capital and operational activities into an 'Asset Management Alliance'.

WSH retained its statutory obligations for the delivery of water and sewerage service under its Operations Licence during 2005/06 and fulfilled these by implementing effective contract

management processes utilising third party assistance in the areas of cost monitoring and control and in the audit of process and regulatory compliance.

The incentivisation contained in the AMP4 contracts is designed to benefit customers as well as other stakeholders. The service providers were contractually obliged to achieve key outputs, levels of service and expenditure targets, all of which are set with reference to the Company's 2004 Final Determination and AMP4 Monitoring Plan.

I confirmed that the Company was kept informed of the level and quality of the service being provided to its customers and had the contractual rights to step in and manage the delivery if necessary. The service providers are obliged under their contracts to report service performance information to WSH on a monthly basis. There is a comprehensive suite of associated KPIs which include the quality of the reported performance information. Additionally the information is subject to audit by WSH. Many of the contractual KPIs were aligned with the performance measures reported in the June Return.

The June Return 2006 was compiled by a small team of Company employees, the majority of whom are also responsible for the management of the outsourced contracts and the monitoring of performance during the year. The majority of the team were also responsible for compiling the various submissions for the 2004 Price Review.

In response to MD209, WSH increased the level of internal quality assurance applied to the June Return data collection process. Our audits of previous June Returns had confirmed that the Company's reporting processes were fundamentally sound but this year we observed increased ownership and more formalised sign off by data providers coupled with greater management review and challenge of data and commentaries and of compliance with Ofwat's reporting requirements. The WSH Board has satisfied itself of the quality assurance processes adopted.

Our audits have shown that the quality of the information reported in the June Return 2006 has been maintained at the generally high standard set in previous Returns. There were some improvements in data quality including water efficiency supporting data, the sewage flooding risk registers and sewerage explanatory factor financial and non-financial information. The Company also responded positively to feedback from Ofwat for improvements in the quality of some of the June Return narratives, particularly in relation to debt management, current cost depreciation and its policy on its Infrastructure Renewals Charge.

In addition to this overall view, I have the following comments on selected key information reported in the Board Overview.

Levels of Service

Improvements in DG2 and DG3 performance from the previous year were achieved resulting in out-performance against the DG2 and DG3 Monitoring Plan targets for 2005/06. Our field audits confirmed the reported performance and the quality of information provided by UUOS, WSH's water operations partner.

As in the previous 14 years, there were no DG4 water use restrictions in 2005/06.

We confirmed that the Company out-performed the aggregate 1 in 10 and 2 in 10 DG5 internal flooding 'at risk' targets for 2005/06. The 1 in 10 component of the Monitoring Plan target was achieved, but performance against the 2 in 10 component fell short. Recent changes to the reporting methodology adopted by the Company following consultation with Ofwat has led to the re-basing of the at risk register. This is not a deterioration in performance, the at risk register now encompasses the historic register as well as properties experiencing flooding from more severe weather. Changes to the reporting methodology have also led to more properties being added to the 1 in 20 risk register. The Company Monitoring Plan targets were extrapolated from figures based on the old methodology and would therefore underestimate the total number of 1 in 20 properties under the new reporting methodology. I consider that this accounts for the apparent underperformance against the 1 in 20 target.

The number of properties flooded internally due to overloaded sewers was lower than the Monitoring Plan target but the number of properties flooded internally due to other causes was more than target. At the end of 2005/06 472 properties are reported at risk of 1 in 20 flooding compared with the Monitoring Plan target of 213. This mixed performance was also evident in relation to external flooding incidents. 602 areas were flooded externally due to overloaded sewers against a Monitoring Plan target of 317 but only 749 areas were flooded externally due to other causes against a target of 900.

Our sample audits confirmed that the Company is correctly and consistently interpreting the Ofwat reporting requirements for sewer flooding incidents and that both its sewerage operational service partners (UUOS and Kelda Water Services) have fully implemented WSH's

reporting methodology. Knowledge of sewer flooding targets performance is held by the key stakeholders in the Company's Asset Management Alliance and we have seen evidence of effective communication and cooperation. WSH and its operational partners are focused on the regulatory sewer flooding targets for AMP4.

The Company has a challenging DG5 improvement programme in AMP4. I visited one scheme during 2005/06 whose scope included DG5 alleviation and confirmed the customer benefits arising from it. I have seen that many sewer flooding outputs are linked to catchment-scale quality schemes that were proposed for inclusion in the Early Start Programme. The extent of this programme was much reduced for various reasons and as a consequence the number of sewer flooding outputs achieved in the first year of AMP4 has suffered. A programme for delivery of DG5 outputs has been agreed with the Company's alliance partners whose performance is measured against the sewer flooding outputs achieved and performance against the AMP4 Monitoring Plan targets. Good progress will be needed in the coming year if the AMP4 outputs are to be met.

Although still well inside Ofwat's 'acceptable' banding, the Company's performance on customer service slipped from 2004/05 and fell marginally short of the Monitoring Plan targets for DG6, 7 and 9. The target for DG8 was exceeded, however.

An IT server problem in July 2005 caused delays in the handling of emails which adversely affected both DG6 and DG7 performance. We confirmed that the Company investigated the problem thoroughly and there has been no repeat. The system is now checked daily to enable any future problems to be spotted promptly. The number of written complaints increased by nearly 20% in the year due to the extension of the Company's debt management system to measured as well as unmeasured customers, the price rise in the first year of AMP4 and the cryptosporidium incident in north Wales.

There was an 11% increase in the number of customer meters this year and we saw evidence of new flexible working arrangements introduced during 2005/06 to tackle the problems of reading internally-sited meters. WSH is targeting improvements in DG8 performance in the coming year.

DG9 performance slipped slightly from the previous year continuing the gradual downward trend starting in 2002/03. Around 6% more calls were received than in 2004/05. We confirmed that the increase in calls abandoned and the incidences of all lines busy were caused primarily by

one major burst main incident in Cardiff in July 2005. We note the Company's score of 4.59 for the call handling satisfaction measure and we confirmed that the information provided to the market researcher for this purpose was robust.

Delivering the Quality Compliance Programmes

Water Service

Some progress was made on the water service Early Start Programme including completion of the Strata Florida quality scheme and design work commenced on the pesticide removal facilities at both Bolton Hill and Felindre WTWs. However the front-end loading of the MNI programme caused resourcing and planning difficulties and the work was not progressed as originally envisaged. WSH has been in communication with Ofwat on this issue.

The S19 water mains programme proved challenging for WSH in 2005/06 and outputs fell short of target. Despite extensive forward planning, particular difficulties were encountered in achieving output rates in urban areas (the AMP4 programme of work is more urbanised than in AMP3). Additionally more trunk mains work has been required than originally planned and only 120km of mains were cleaned in relation to the Monitoring Plan target of 337km. Despite these problems we have seen in the field that the Company is actively managing the programme with its Alliance Partners but will be unable to confirm its revised output profile until the results of further water quality sampling is known later in the year. WSH has been keeping DWI informed of progress.

Strata Florida WTW was the only AMP4 Year 1 water treatment improvement output. Our sample scheme audits included this works and were able to confirm the completed work and the new facility was operating satisfactorily.

Sewerage Service

The Company was unable to deliver all the required outputs on the sewerage Early Start Programme. Good progress was made on the non-infrastructure maintenance element of the programme. The Company's catchment approach to sewerage investment, first used in AMP3 and now extended into AMP4, has achieved good value, more than if a piecemeal approach had been adopted. However the absence of approval for large elements of the quality early start programme hampered the up-front planning associated with this approach and has meant that

many of the Early Start outputs for 2005/06 (and some sewer rehabilitation work) have been re-profiled to be delivered later in AMP4. Projects have been brought forward to compensate for early start projects that could not be delivered. This is evident in the flooding programme where a total of 174 problems have been tackled of which only 47 were in the early start target of 106 problems. Of the eight Quality schemes in the sewerage Early Start Programme, two were completed, five are in progress and one is awaiting commencement.

Good progress was achieved on both the AMP4 Year 1 intermittent and continuous programmes. Some AMP4 outputs from later in the period were also completed. Most delayed AMP3 schemes were delivered, including the major sewerage and sewage treatment works at Holyhead.

Early in 2005/06 the Company undertook a fundamental review of its AMP4 First Time Sewerage (S101a) programme to confirm that benefits would be achieved in all cases. Of the 23 outputs originally included the Final Determination, 13 have been suspended due to poor cost/benefit and four are deemed to be no longer required. The remaining six schemes are underway, five of them to fulfil statutory obligations and one where a clear cost/benefit exists. WSH told us that Ofwat, WAG and the EA had been consulted over the outcomes from this review.

Maintaining Serviceability to Customers

Water quality mean zonal compliance fell slightly from the 2004/05 level. Iron compliance 'at the tap' increased from the previous year and outperformed the Monitoring Plan target.

Bacteriological compliance 'at the tap' increased from the level reported in 2004 and compliance was broadly maintained at WTWs and improved at service reservoirs. Iron, turbidity and THM performance was either maintained or increased but manganese and aluminium compliance fell slightly from the levels achieved in 2004.

Our audits confirmed that the reported level of burst mains fell slightly in 2005/06 to its lowest level in recent years.

In light of the reported performance, we consider the Company's assessments of stable serviceability on both the water infrastructure and non-infrastructure to be appropriate although we note its concern over the longer term serviceability of its plastic and asbestos cement water

mains.

Sewage treatment works compliance against numeric consents has been reported as 96.49%. This cannot be directly compared to last years figure or to the monitoring plan due to changes in the OFWAT definitions. The denominator this year being number of treatment works with WRA consents whereas last year the denominator was total number of treatment works. The equivalent figure to compare with last year would be 97.35%. This is down slightly from the previous year and slightly short of the 97.70% target in the Monitoring Plan. The measure is very sensitive to a small number of problems. There were only an additional 2 small works failures compared to last year. I do not believe this reduced performance indicates a drop in the serviceability of the Company's non-infrastructure sewerage asset base. Next year's performance may clarify this. WSH's operational partners are incentivised to maximise compliance at these works.

Bathing water compliance was maintained at 100% against mandatory standards and increased to 91% (up from 86%) against guideline standards.

We confirmed that the number of Category 1 and 2 pollution incidents from CSOs and foul sewers increased to 11 from six over the previous year. This performance is just within the Monitoring Plan range for AMP4. However the total number of pollution incidents in Categories 1 to 3 from these sources fell from last year. Whilst the Company recognises that it has to closely monitor and manage these incidents, I do not believe there is evidence of deteriorating serviceability at this point in time.

The sewer collapse rate decreased slightly from the previous year but fell short of the Monitoring Plan target. We confirmed that the Company's interpretation of a collapse aligns with the WRC definition. Collapses on rising mains are included in the reported totals.

We consider the Company's assessments of stable serviceability on both its sewerage infrastructure and non-infrastructure assets to be appropriate in the light of the reported performance.

Supply/Demand Balance

WSH has had discussions with Ofwat during 2005/06 over the derivation of WAFU values (as

part of the SOSI calculation) and potential inconsistencies between values derived for Ofwat and EA. The problem has been acknowledged but this had led to some short term uncertainty in the reported forecast zonal balances. Additionally there continues to be a need to update some population forecasts at local zone level in the light of recent published growth rates having varied considerably across the region. Populations in some zones are markedly different from the earlier forecast estimates. The lack of definitive forecasts is in essence creating moving SOSI goalposts. Whilst small in value compared to the overall AMP4 programme, the Company is finding it difficult to target effectively investment to resolve supply and demand issues under such circumstances and the Company is delaying decisions on investment and water efficiency measures until the situation is resolved.

Operating Expenditure and Efficiencies

The Company is reporting real term decreases in both water and sewerage operating expenditure from the previous year despite significant increases in power costs. Power costs are forecast to increase again in real terms in 2006/07.

The Company's AMP4 operational partners are incentivised to deliver performance improvements over and above the Final Determination targets. Mechanisms to monitor and drive performance are in force. These are similar to those adopted in AMP3. Whilst many of AMP3 partners have been retained for AMP4, the most significant development has been the consolidation of the former eight sewerage contracts into two. The transition from the AMP3 to AMP4 operational arrangements was well planned and implemented. The consolidation of the sewerage contracts, coupled with greater integration between operations and capital investment across both services and process improvements within and between the partner organisations, appears to have created the opportunity for real operating efficiencies although the Company is prudently predicting that costs in the forthcoming year will be more aligned to those assumed in the Final Determination.

Capital Expenditure and Efficiencies

Capital expenditure in 2005/06 for both the water and sewerage services was around less than the Final Determination for the year (inflated to current prices using RPI).

We have confirmed the reasons given by the Company for the 'underspends' in both services.

The most significant changes in Year 1 outputs concern the water maintenance expenditure programme (MNI), planning delays relating to six UWWTD schemes, and the rephrasing of several intermittent discharge schemes within the AMP4 period. Whilst many of the AMP4 Year 1 output targets have been achieved in terms of numbers, the underlying message is that in several areas of the programme delays with specific projects has necessitated the delivery of a different set of outputs than was originally planned. Consequently the Company is understandably not reporting any capital efficiencies at this stage in AMP4. I have seen that the Company and its alliance partners are geared up to deliver the AMP4 outputs by 2010 although they have highlighted risks in delivering the full S19 mains renovation programme and the quality improvements at Court Farm WTW.

Upward construction cost pressures are becoming evident. WSH is still planning to deliver the AMP4 capital expenditure programme at or around the Final Determination allowance although its ambition is to achieve efficiencies by absorbing the difference between COPI and RPI inflation.

Health and Safety

I have reviewed the information on WSH's health and safety performance presented in Chapter 1 of the Board Overview. I have also reviewed and audited the health & safety information reported in Table 41 and confirmed the factual content of the associated reports on the Management of Health & Safety (including the Company's health & safety communications strategy) and on Workplace Driving. My detailed comments are given in my commentary to Table 41. As a result of my review, I consider that the data and statements made in the Overview illustrate the Company's approach to fulfilling its health and safety obligations under its outsourcing arrangements and present an accurate picture of the performance achieved in 2005/06.

Sustainable Procurement

I have reviewed the Company's statements on sustainable procurement made in Chapter 3 of the Board Overview and have discussed them with its Procurement Manager.

The Company has demonstrated to me how it met, and in some cases, exceeded the principles included in the British Water 'Guide to Sustainable Procurement' and the Construction Clients

‘Charter’ in its AMP4 outsourced service contracts.

I inspected the terms of reference and samples of the output from the Supply Chain Business Support Team. I also reviewed a sample of the common procurement procedures in use across the supply chain. I confirmed that monthly meetings were held between WSH and its main partners at which performance was reviewed and issues discussed. It was clear to me that through these activities the Company embodies the principles contained in the British Water guide.

J J Hawkins

Halcrow Management Sciences Limited

Reporter to Ofwat for Dwr Cymru Welsh Water

23 June 2006