



**OFWAT FORWARD PROGRAMME**

**2001-02**

**AND STRATEGIC ISSUES 2002-05**

## **OFWAT'S AIMS AND OBJECTIVES**

### **Our Vision**

A water industry that delivers a world-class service, representing best value to customers now and in the future.

### **Our Mission**

To regulate in a way that provides incentives and encourages the companies to achieve world-class services in terms of quality and value for customers in England and Wales.

### **How we do it?**

By:

- setting price limits at levels which enable companies to finance their functions and to share the benefits of efficiency between customers and investors;
- ensuring that we are aware of stakeholders' views and priorities by consulting with customers' groups, the industry and others and undertaking customers' surveys;
- facilitating the development of competition to promote further efficiency gains and, where practicable, further choice for customers;
- working with the quality regulators to ensure that the quality of drinking water and waste water is improved at an affordable rate to the benefit of customers and the wider environment and that the abstraction and use of water takes account of the need for sustainable development;
- ensuring that companies' tariffs are fair and do not unduly discriminate or show preference to any class of customer;
- handling disputes and complaints involving the companies economically, effectively and fairly;
- monitoring the companies' performance and taking action, where necessary, to protect the interests of customers and other stakeholders;
- being open and transparent and publishing information, which allows customers and other stakeholders to have their say in regulatory decisions; and
- making sure that Ofwat delivers best value in its regulatory role, and by valuing and encouraging the development of all its staff.



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## **FOREWORD**

A draft of this Forward Programme for 2001/02 was published for consultation on 9 November 2000. I am grateful for the comments we received. In particular, I welcomed the opportunity to discuss the proposals at our workshop with stakeholders in January. We have reflected on the contributions and comments we received (see Appendix 2) in setting out this, our programme for the coming year.

One of the recurring comments made was that our Forward Programme should look more than one year ahead. We accept this view. In setting out our plans next year for 2002/03 and beyond, we shall look forward at least to the next Periodic Review of price limits to take effect in the year 2005/06.

In practice, this plan already looks beyond the year ahead. We have reviewed Ofwat's overall purpose and our aims and objectives are set out in this plan. We received general endorsement of these aims in our consultation. We expect them to last with little, if any change for several years.

At the same time, Ofwat's crystal ball is no better than any one else's. Whilst we plan and prepare for the future we expect, we must also be flexible in responding to events. Some of the key areas of interest are set out below.

### **Draft Water Bill**

Ofwat has responded to the Government proposals published so far. Whatever the outcome we look for integrated proposals that will achieve an appropriate balance between environmental, social and economic goals in water regulation. We shall be ready to implement changes at the appropriate time.

### **Structure of the industry**

The equity model of company ownership has served the water industry and its customers well. Changes will need clear justification in terms of general benefits, for example in improved efficiency, for customers and shareholders alike. Since the publication of the draft programme, I have announced that I will not block the proposed acquisition of Welsh Water/Dŵr Cymru by Glas Cymru, a company limited by guarantee that would be wholly debt financed. This is subject to conditions and to licence modifications, which are currently being consulted on. I do not see the Glas model as readily capable of replication for other English and Welsh companies. Other companies are known to be considering restructuring options and we shall review each proposal put to us. We shall act to protect the long-term interests of customers, in particular, that the safety of drinking water, the environment and the security of water supply are not put at risk.

## **Competition**

The Competition Act 1998 (CA98) will have been in effect for two years by the end of 2001-02. Ofwat already has the function of facilitating competition in water services. We shall continue to do so. We shall rigorously investigate complaints into allegations of anti-competitive action, looking into possible abuses of the market, and providing advice and guidance on the continuing developments in competition, such as common carriage, inset appointments, and cross border supplies.

We also stand ready to respond to new Government initiatives on the promotion of competition in water services. In some cases, restructuring of companies may provide opportunities for competition by outsourcing operational business.

## **Company performance and the next Periodic Review**

New price limits took effect from April 2000. The annual return on the first year of performance following the 1999 Periodic Review will be received from companies in June 2001. This information will be in a standard form and be subject to scrutiny by the independent Reporters used by Ofwat. The quality regulators, the Environment Agency (EA), and the Drinking Water Inspectorate (DWI), will provide us with their assessment of each company's performance. We shall review all the information to assess whether each company has met regulatory expectations. This may lead to further regulatory action, such as more frequent reporting against an agreed action plan, or an interim determination of price limits.

Our work on monitoring each company's compliance with regulatory requirements and relative performance will be summarised and published in our annual series of five comparative reports.

We shall look at ways in which we can strengthen our capability to advise on environmental economic issues during 2001-02. This will reinforce our contribution to the debate on the appropriate balance to be struck in this area. We shall support the Department of Environment, Transport and the Regions (DETR) and the EA in any initiatives.

During the year, we shall act on the learning points from our evaluation of the 1999 Periodic Review. This will take account of the outcome of the two Competition Commission determinations, published in September 2000. These raised a number of issues requiring further work, much of which has already begun, for example, on the complexity of modelling issues and the treatment of capital maintenance. We shall consult on our proposals on how these issues will be developed and dealt with at the next Periodic Review in 2004.

## **Customers**

Over a quarter of Ofwat's income is allocated to customers' representation, including the Customer Service Committees (CSCs), their administrative support, and the Ofwat National Customer Council (ONCC). For 2001-02 they are being offered the opportunity to strengthen their independence as the voice of the customer. This will be achieved through a joint Memorandum of Understanding between Ofwat and ONCC which will set the framework for a more arm's length relationship based on the mutual aim of protecting customers.

Ofwat and ONCC/CSCs have each prepared their own Forward Programme 2001-02 in close co-ordination with each other.

### **Supply of clean water**

The industry supplies a vital service to the population and business infrastructure of England and Wales. Our aim is to ensure that now and over the long-term the industry can maintain its current supplies of clean water, taking account of forecasts of supply, demand and possible climate change.

### **A transparent approach to regulation**

We are committed to consultation and transparent decision-taking. We aim to work closely with stakeholders. This year we shall survey customers' concerns and the effectiveness of our main publications in supplying regulatory information to our stakeholders in a way that is appropriate to the audience.

We shall seek to enjoy continued good working relationships with the companies, quality regulators and other stakeholders. These relationships have contributed to the success of economic regulation of the water industry in England and Wales.

A handwritten signature in black ink, reading "Philip Fletcher". The signature is written in a cursive style with a large initial 'P' and 'F'.

**Philip Fletcher**  
**Director General of Water Services**

# 1 INTRODUCTION

## 1.1 The year ahead for Ofwat

This Forward Programme sets out the objectives and outputs to be delivered by Ofwat in 2001-02. Chapter 4 summarises the resources required by Ofwat and CSCs during 2001-02.

The Ofwat Annual Report, published in May 2001 (quarter 1) will report back on the Forward Programme for 2000-01.

The table below summarises our main outputs, and guides you to the related paragraph in this Forward Programme. We shall continue to carry out our routine regulatory functions and respond as required to new events, such as mergers, EU directives and incidents requiring investigation.

<b>OFWAT MAIN OUTPUTS 2001-02</b>			
		<b>Paragraph</b>	<b>Quarter</b>
<b>Annual Monitoring and Regulatory Action</b>			
<i>Regular published reports</i>			
	Annual Report	1.1	Q1
	Report on tariff structure and charges	2.1.3	Q1
	Report on levels of service	2.1.3	Q2
	Report on financial performance and expenditure	2.1.3	Q2
	Report on leakage and the efficient use of water	2.1.3	Q2
	Report on water and sewerage unit costs and relative efficiency	2.1.3	Q3
	Publication of June Return on CD-ROM	2.1.3	Q3
<i>Other annual outputs</i>			
	Consultation on tariff policy	2.1.4	Q1
	Leakage targets agreed	2.1.2	Q2
	Launch of Ofwat award for water efficiency	2.1.2	Q3
	Analysis and conclusions on June Return	2.1.3	Q3
	Approval of charges schemes	2.1.4	Q4
<i>Other regulatory outputs</i>			
	Seminar on long run marginal costs (LRMC)	2.1.2	Q1
	Position paper on LRMC published	2.1.4	Q1
	Seminar on bad debt	2.1.4	Q1
	Memorandum of Understanding with ONCC	2.1.5	Q1
	Review of Reporters appointment process	2.1.2	Q2
	Consultation on publication of regulatory capital value (RCV)	2.1.2	Q2
	EA, DETR, Ofwat report on leakage	2.1.2	Q2
	Contribute to review of social tariffs by DETR	2.1.4	Q2
	Report on customers' survey	2.1.4	Q2
	Study into making the public domain July Return 2002 available on the Ofwat website	2.1.3	Q3
	Report on prevention of sewer flooding	2.1.4	Q4

<b>Industry Structure</b>			
	Respond in a timely and effective manner, including a process of consultation, to any proposals by companies involving mergers or restructuring.	2.2	As required
<b>Competition</b>			
	Guidance on best and reasonable practice for common carriage	2.3.1	Q1
	Seminar on best and reasonable practice for common carriage	2.3.1	Q1
	Consultation on companies' policy and practice on connecting mains and sewers	2.3.5	Q1
	Set out strategy for extending comparative competition	2.1.2	Q2
	Report on companies' policy and practice on connecting mains and sewers	2.3.5	Q2
	Publish work on extending comparative competition	2.1.2	Q3
	Report on the operation of the CA98	2.3.3	Q4
<b>Price setting</b>			
	Report on incentives for improving levels of service	2.4.2	Q1
	Consultation on water quality serviceability measures	2.4.2	Q1
	Publication of the review of levels of service index and weightings	2.4.2	Q1
	Review of licence modifications	2.4.2	Q1
	Consultation on licence modifications	2.4.2	Q2
	Consultation on upgraded financial model	2.4.2	Q3
	Consult on timetable and process for Periodic Review 2002	2.4.2	Q3
	Consultation on guidance for economic appraisal of long term capital maintenance needs	2.4.2	Q3
	Consultation on environmental quality serviceability indicators	2.4.2	Q3
	Draft and final determinations of interim applications for price limit adjustments	2.4.3	Q3
	Consultation on Ofwat publications	4.5	Q3
	Technical workshop on supply demand issues	2.4.2	Q4

## **1.2 Outline of this document**

Chapter Two sets out in more detail Ofwat's priorities for the coming financial year from April 2001 to March 2002. This includes key areas of work and objectives.

Chapter Three sets out Ofwat's strategic issues 2002-25.

Chapter Four contains details of financial and other resource implications for the coming year.

Appendix 1 explains the structure and organisation at Ofwat, including senior management and key team members.

Appendix 2 provides the results of the consultation process.

Appendix 3 provides a list of consultees.

Appendix 4 provides lists of organisations and individuals who responded in writing to the consultation and those who attended the workshop.

## **1.3 Your views were invited**

We issued the draft Forward Programme for consultation on 9 November 2000, asking for written comments by 18 January 2001. We received 40 responses to the consultation. We also held a stakeholder workshop on 16 January 2001 at Warwick University. This workshop was well attended by representatives from all stakeholder groups and beneficial to both Ofwat and attendees. A list of organisations who sent written responses and those who attended the workshop is attached at Appendix 4.

Support has been expressed for the Forward Programme. Similar comments were expressed at the workshop and in the written responses. We found all of the comments useful in determining the views of stakeholders of our draft Forward Programme. The comments highlighted weaknesses and areas for improvement. There were also areas where we could improve the presentation of forthcoming work to provide better clarity. A summary of the results of the consultation process is provided at Appendix 2.

## **2 OFWAT PLANS AND PRIORITIES FOR 2001-2002**

### **2.1 ANNUAL MONITORING AND REGULATORY ACTION**

#### **2.1.1 Regulatory action**

As part of the annual cycle of collecting detailed information, subsequent analysis and publication of results, Ofwat will consider taking action if one or more of the companies have failed to meet the agreed outputs. In the past this has included issues such as leakage targets, levels of service and supply of services. In the forthcoming year, we shall be particularly interested in looking at failures in levels of service, water efficiency and leakage targets.

#### **2.1.2 Annual monitoring of outputs and analysis**

##### Quality outputs

The companies are required to improve their assets to meet new environmental standards and compliance with new drinking water regulations. Ofwat is working closely with the EA and the DWI to ensure that the companies deliver these improvements. The quality regulators will report each year to Ofwat on the companies' progress. The Ofwat annual report on *Financial performance and expenditure*, published in July includes a summary of these reports.

The reports may identify shortfalls, or the risk of potential shortfalls in delivering the expected outputs. Ofwat and the quality regulators will want to understand the reasons for each shortfall and the measures being taken by the company to put things right. In some cases we may formally investigate the situation and publish our findings. We may require the company to submit a legally binding undertaking to ensure prompt delivery of the required improvement.

We shall take into account all shortfalls in the delivery of the quality improvement programmes at the next price setting, whether an interim determination or the next Periodic Review (see Chapter 2.4.3).

Ofwat will use the protocol set down in Appendix E of *Future Water and Sewerage Charges 2000-05* to deal with changes in the quality improvement programmes required by Ministers.

Every year (in the period 2000-05), each company will report on its performance on a package of specified service measures and its Reporter will audit the outcome. We shall assess the trends in serviceability to customers. If we have any concerns about whether a particular company is maintaining serviceability we may investigate and if necessary require the company to carry out the necessary remedial work. Any new indicators arising from the joint study with the quality regulators detailed in Chapter 2.4.2 will be incorporated into this annual monitoring cycle.

##### Monitoring Levels of Service

Ofwat will review companies' annual returns on the levels of service to customers and take regulatory action where standards of service are not acceptable.

Company performance is reported in Ofwat's annual report on levels of service published in July each year.

### Leakage

Ofwat monitors how companies perform against leakage targets, reporting performance in a press notice in June each year, explaining the action to be taken against companies that failed to meet the targets.

We work to ensure that companies have leakage targets that will bring them to the medium term economic level of leakage in 2002-03. Details of targets agreed with companies are published in the Ofwat *Report on leakage and the efficient use of water*, published in September each year.

In August 2000 Ofwat commissioned a joint study with the DETR and the EA on the future development of leakage policy. The study will recommend improvements to leakage target setting and review possible adjustments that could be made to take account of best practice in leakage management techniques. It will also seek to establish a set of key principles to be followed by the companies when they calculate their economic level of leakage. The study will recommend where the quality of data used in the analysis of economic leakage levels may be improved and augmented. The study will be completed in quarter 2 of 2001. It is our aim to publish the conclusions and to make them freely available for the companies to consider when updating their leakage appraisals and refining future leakage targets.

### Water efficiency 2001-02

Ofwat will review companies' annual returns on their activities in promoting the efficient use of water and take regulatory action where we are not satisfied that companies are fulfilling their statutory duty. We shall work with the companies, the Government and others to monitor the research being carried out to highlight useful studies and identify potential gaps or duplication.

In particular Ofwat will be involved in United Kingdom Water Industry Research Ltd (UKWIR) research on best practice for assessing water efficiency activity. The results of this work will be reported during the year by UKWIR. We shall encourage companies to share information on best practice and cost-effectiveness. This will improve the robustness of data on which decisions on the appropriate level of water efficiency activity are based.

Ofwat will sponsor an award for the company contributing most to the improved understanding of the economics of water efficiency. Our aim is to make the first award in quarter 3 of 2001-02.

### Long Run Marginal Costs (LRMC)

LRMC is an important tool for Ofwat and the companies in making decisions on a number of issues including, pricing policy; leakage control; bulk supplies; competition and the overall approach to supply/demand balance. Information is set out in our letter to the companies *MD159: Long run marginal costs and the regulatory framework*, February 2000. We shall continue to discuss with the companies how to improve the quality, consistency and comparability of LRMC estimates. We shall seek to build consensus about the most appropriate method for estimating LRMC. We shall publish feedback and hold a workshop in quarter 1 of 2001-02.

### Finance and Regulatory Accounts

Ofwat will monitor and analyse company results and regulatory accounts this year. The *Financial Performance and Expenditure Report* published each July will contain a summary. During quarter 4 Ofwat will implement changes in the Regulatory Accounting Guidelines (RAGs) for 2001-02 following its consultation with companies and other stakeholders which will take place in quarter 2. This review of the RAGs aims to ensure that best practice is followed.

This review will not change the fundamental principles of regulatory accounting; for example current cost accounting will be retained. It will take account of any recommendations from the Joint Regulators' Working Group on regulatory accounting.

During quarter 2 of 2001-02 we shall also consult the companies on whether to publish RCV details. This consultation will cover the options on the level of detail to be published and the process and timetable for publication.

### Transfer pricing and multi-utility regulation

Ofwat will continue to monitor and investigate transactions between companies and associates. We shall ensure compliance with licence requirements for ring-fencing and arm's length trading. This is to ensure that customers of the company are not disadvantaged by cross-subsidies to associated companies. The outcome of the monitoring will be published in the *Financial Performance and Expenditure Report* in July.

Ofwat will monitor procurement processes undertaken as a result of any increased outsourcing due to industry restructuring. We shall continue to regulate companies on a fair and equal basis whatever their structure.

Ofwat will continue to work closely with the other economic regulators on multi-utilities.

### Verification by independent Reporters

Ofwat will continue to use independent Reporters to verify regulatory information submitted by companies. The aim is to receive comparable regulatory information from the companies. We shall also use Reporters to assist in special investigations, for example into companies' performance in reducing levels of leakage.

We shall work with the companies to complete the programme of new Reporter appointments, which began in September 2000. The appointment process will be reviewed during quarter 2 of 2001-02 and options for improvement identified with companies and other stakeholders. Any changes to the appointment process will be made from quarter 3.

Ofwat will work with the new Reporters to achieve an effective and efficient transition into their companies, and ensure that they focus their efforts on the areas that have the most impact on regulatory decision making.

We shall continue to provide additional company specific guidance to each Reporter to assist them in their audit work on company information submissions. We shall continue to use briefings, meetings and workshops to help the Reporters focus their work, to understand our internal review processes and to give feedback on performance.

Ofwat will consult on possible changes in the roles of the Financial Auditors and Reporters in the audit of regulatory accounting information. This will form part of the planned review of the RAGs. Our decisions on these matters will be included in the revised RAGs (see page 13).

#### International Comparators

Ofwat will continue to compare the performance of companies with water enterprises operating elsewhere in the world. We aim to put the England and Wales companies' performance into an international context and to find best in class performance benchmarks that stimulate further improvements in service and/or efficiency.

We shall set out our strategy for extending the boundaries of comparative competition in quarter 2 of 2001-02. The results of this work will be published in quarter 3.

### **2.1.3 The five annual reports on company performance**

Ofwat collects a range of detailed information from companies throughout the year to enable a comparison to be made on performance and to set challenging but fair goals. The main submission received from companies is the June Return. The results of this work are published in five annual reports. They provide information for customers and other stakeholders on the comparative performance of companies. The reports comprise:

#### Report on tariff structure and charges (May 2001)

Sets out Ofwat policy on tariffs and details comparative information on the level of charges made by companies. This report also now includes companies' estimates of LRMC.

#### Report on the financial performance and expenditure of the water companies in England and Wales (July 2001)

Reports on the financial performance, investment and expenditure (both operating and capital) of the companies. It indicates financial trends and makes comparisons of actual performance compared with the financial projections underlying price limits.

#### Report on levels of service for the water industry (July 2001)

Informs customers and others of the levels of service achieved by companies across a range of indicators and any action taken by Ofwat to address poor service; it gives companies an incentive to compete to provide continuing high service levels.

#### Report on leakage and the efficient use of water (September 2001)

Reports on companies' activities to promote the efficient use of water and Ofwat's views on whether they are fulfilling their statutory duty. The aim is to ensure that companies are carrying out leakage and water efficiency work at a level which is economically appropriate in balancing supply and demand for water, to promote good practice across the industry and to contribute to the national debate.

#### Report on water and sewerage service unit costs and relative efficiency (December 2001)

Sets out the unit costs and relative efficiency of the water and sewerage businesses in 2000-01. The aim is to inform comparative competition of companies' performance and maintain the incentives on companies to improve their efficiency year on year.

Ofwat also produces a CD-ROM in December each year providing public access to the June Returns of all companies. We shall examine the feasibility of making the public domain versions of the June Returns 2002 available on our website in quarter 3.

#### **2.1.4 Protecting customers**

##### Review of Vulnerable Groups Regulations

DETR plan a review of the Vulnerable Groups Regulations during quarter 2. Ofwat will play an active role in the review, which will cover any other social tariffs already introduced by companies. The timetable for the review will be determined by DETR.

##### Sewer flooding

During the year we shall continue the study to gain a better understanding of the extent of the problem of sewer flooding and the cost effectiveness of alternative solutions. We shall examine companies' systems for prioritising work and dealing with flooding incidents. The conclusions will involve close working with the companies and CSCs. We shall publish the conclusions in quarter 4 of the year. We shall invite views on the way forward.

Ofwat will also contribute to work by the DETR on lessons to be learned from the autumn 2000 floods.

##### Tariff policy

Consultation and discussions with companies and customers' groups on a number of tariff policy issues during 2000 showed that further work is required on the following:

- interruptive and diurnal tariffs;
- methodology for allocation of costs between the component elements of trade effluent tariffs;
- the justification for lower tariffs for medium-use customers (i.e. below 50megalitres/annum);
- the introduction of an optional tariff for low users; and
- reduced charges for customers with private sewers.

Ofwat will work with the companies, DETR, and others, on the implications of this study, taking into account the Secretary of State for the Environment, Transport and the Regions' guidance on social tariffs. The conclusions will be the subject of consultation in quarter 1, to inform companies' charges schemes for 2002-03.

##### Approval of Companies' Charges Schemes for 2002-03

Companies need Ofwat's approval for their charges schemes. In line with the procedure adopted for 2001-02, companies will be asked to submit draft charges schemes (together with draft principal statements) in early October 2001 (quarter 3), to allow consultation with CSCs. We shall approve the schemes no later than early February 2002 (quarter 4).

Ofwat will consider new tariff proposals and monitor the compliance of increases in tariffs with price limits, through the checking of Principal Statements. We shall publish the outcome in our report *Tariff structures & charges* in May 2002.

### Customers in debt

Ofwat guidance on debt is well established and has provided the basis for Ofwat and CSC assessment of company policies and practices. The ban on disconnection of household customers, introduced in July 1999, has led to some changes in company policies. Ofwat and the ONCC will review the effects of these changes at a seminar on 1 May 2001 (quarter 1) for companies, CSCs and other relevant organisations. We shall revise the guidelines if necessary and amend Licence Condition G: Codes of Practice for customers and relations with the Customer Service Committees.

### Customers Survey

Ofwat will commission a customer survey on a range of customers' service issues to inform future regulatory policy and decisions. The ONCC and companies will be consulted on the content, but areas that might be covered include:

- customers' service priorities. These inform the weightings given to Ofwat's index of overall company service quality;
- reasons for customers' dissatisfaction;
- the development of e-commerce services;
- customers' information needs;
- customers' awareness of services and tariff options;
- service standards; and
- customers' views on the balance between speed and quality of response to enquiries.

The survey is planned for quarter 1, with a published report in quarter 2.

### **2.1.5 Ofwat and the CSCs**

Ofwat will continue to work closely with the CSCs in achieving benefits for customers. We shall consult with the ONCC and the CSCs on policy.

Over the year, Ofwat intends to achieve a relationship that is more 'at arm's length' enabling the ONCC and the CSCs to speak more clearly as an independent voice. This will improve the value of the service provided to customers. The relationship will be formalised in a Memorandum of Understanding between Ofwat and the ONCC, which will cover information sharing, consultation and external relations.

Ofwat will continue to support the work of ONCC and the CSCs by providing resources, accommodation and central services such as legal advice, IT and financial services.

The ONCC and CSCs will publish their own Forward Plan for 2001-02. Ofwat welcomes their intention to cover the following issues:

### Competition

- to represent customers' views on competition issues and to forward to Ofwat complaints that may represent an infringement of the CA98;

### Standards of service

- to report on the quality of service provided to customers based on sample audits of individual cases and other assessments of company practice.

These reports are to be provided in a form that enables comparisons to be made between companies. The service areas to be covered include:

- complaint handling;
  - customers in debt; and
  - service for customers with special needs;
- to advise on incorporating measures of quality to complement existing quantitative measures;
  - to advise on the content and implementation of companies' water efficiency plans;
  - to advise on how companies handle domestic customers in debt now that they are prevented from disconnecting them for non-payment of charges;
  - to bring to Ofwat's attention issues of customers' service which may require the exercise of its powers or which raise broader policy issues. On issues concerning multi-utilities, we expect the CSCs to liaise closely with the relevant customers' representative bodies for the other utilities;
  - to advise on companies' codes of practice before we approve them; and
  - to advise on best company practice in customers' service;

#### Tariffs

- to advise on tariff rebalancing and the development of companies' charging policies;
- to advise on any issues raised by statutory guidance from the Secretary of State for the Environment, Transport and the Regions and National Assembly for Wales;
- to monitor implementation of Vulnerable Groups Regulations and to participate in the DETR review of these Regulations; and
- to provide advice or information on issues which may arise during 2001-02.

## **2.2 INDUSTRY STRUCTURE**

Since the 1999 Periodic Review a number of companies have been considering the options for restructuring their Appointed Business. Ofwat has responded to two proposals, from Kelda and Glas Cymru. Kelda decided to withdraw its proposal in July 2000, but Glas Cymru was recently allowed to proceed subject to six conditions, to test whether it could secure the financing required. We shall continue to respond to further proposals as they arise. In doing so our work will centre on the following tests:

- have the benefits to customers been clearly established and do these benefits outweigh any additional risks or uncertainty;

- how well are the incentives to efficiency maintained compared to the current equity-financed model;
- can the EA and DWI regulate the new structure;
- have the practical concerns associated with any separation of asset ownership from operations and the introduction of a competitive procurement strategy been addressed properly;
- have customers been properly consulted; and
- where the restructuring involves a change of ownership of the regulated business, are the buyer and seller independent.

The medium term regulatory framework including RPI-X policy and comparative competition would remain in force for any new structure.

### **2.2.1 Mergers**

Over the years, there has been much discussion of the efficiencies that might be achieved through mergers. Since privatisation, the number of companies in England and Wales has been reduced from 39 to 23, although there are still ten water and sewerage companies. Ofwat has ensured that, with this reduction in the number of companies, benefits have been secured for customers from the promised efficiencies. These benefits have to be considered alongside any possible harm from the loss of comparators to the effectiveness of comparative competition; something that has taken on increasing importance as the number of companies has fallen.

The Water Industry Act 1999 requirements on merger referrals were designed to protect customers by preventing erosion of comparators to preserve the benefits of comparative competition so far as a natural monopoly persists.

The companies have made substantial efficiency gains to the benefit of customers and shareholders. We believe that this is, in part at least, due to the successful use of comparative competition. It is important then, to retain sufficient comparators for these purposes, at least until price competition is more fully established.

### **2.2.2 Company licences**

The licences under which the companies were appointed, can be terminated on ten years notice, expiring not earlier than 31 August 2014. The Secretary of State for the Environment, Transport and the Regions is responsible for this function. Ofwat will respond to proposals as necessary in England and liaise with the National Assembly for Wales in relation to Welsh companies.

## **2.3 COMPETITION**

In November 2000, following its consultation on competition in the water industry, the Government announced in November 2000 that further work on options for extending competition would be undertaken.

It added that this work would involve Ofwat and include investigation of both licensing new entrants for common carriage, and separate licensing of different elements in the industry. Ofwat is working with the Government to examine options for developing the legislative framework in which competition can be extended. The Government will announce its conclusions, which may require primary legislation.

In the meantime we shall look to facilitate competition within the framework of its existing powers. This will be focussed on developing common carriage; securing competition in the provision of new mains by self-lay; and examining the scope for reforming the abstraction licence regime to further facilitate competition. The work on these and other issues is detailed below.

### **2.3.1 Common carriage**

Companies have prepared codes setting out how they intend to address requests for access to the network. Several have begun negotiations with customers and potential competitors. We shall continue to facilitate the development of common carriage, maintaining an open and stable market within the legal framework set by the Government.

Ofwat has reviewed the access codes and the options for taking common carriage forward, and will issue guidance on best and reasonable practice in quarter 1. This guidance will initially be issued in draft form and would be open to consultation. We expect to hold a seminar for stakeholders as part of the consultation process in quarter 1.

### **2.3.2 Abstraction licensing**

The Government has proposed draft legislation to implement changes to the abstraction-licensing regime and to ensure protection of water quality as competition develops. Ofwat has said that this package should be reviewed to ensure compatibility with competition proposals when they are published. We shall take part in any review.

### **2.3.3 Investigation of complaints under CA98**

Ofwat established an efficient process dealing with anti-competitive behaviour and for abuses of a dominant market position under CA98. We shall continue to ensure that complaints are thoroughly investigated and that there is proper consideration of issues arising and new precedents. Ofwat will investigate wherever it has reasonable grounds for suspecting an infringement of CA98. We shall report on progress in quarter 4.

### **2.3.4 Inset appointments**

Ofwat will ensure that completed applications are dealt with as soon as possible, and within four months for green-field sites and within seven months where a bulk supply or sewerage connection agreement is required. We shall continue to look for improvements in the application process, particularly whether the inset timetable can be shortened, and consider how the inset appointment mechanism might extend competition.

### **2.3.5 Connecting mains and sewers**

Ofwat is considering the scope for developers and other parties, as well as companies, to lay mains for new developments. Some companies already connect mains laid by developers subject to supervision and agreed standards being met but others are reluctant to do so. We shall examine companies' policy and practice in this area and consult on our findings in quarter 1.

## **2.4 PRICE SETTING**

### **2.4.1 Learning from the Periodic Review 1999**

The 1999 Periodic Review of company price limits for the years 2000-01 to 2004-05 finally drew to its end with the publication of the Competition Commission determinations for the two water only companies (Sutton & East Surrey Water and Mid Kent Water) in August 2000. Then in November 2000 the House of Commons Environment Audit Commission published its findings of its review of the Ofwat price setting - *Water Prices and the Environment*.

The Competition Commission broadly accepted Ofwat's approach to price setting but concluded that prices for customers of these two companies should be higher than we had determined. Many factors contributed to the increase in price limits, in particular assumptions of:

- a number of company specific factors;
- a faster rate of optional metering up-take;
- higher levels of capital maintenance to maintain serviceability ;
- higher levels of current cost depreciation based on accounting rules rather than broad equivalence between accounting charges and capital maintenance expenditure; and
- the desirability of allowing companies to recover through price limits their costs and fees arising from references to the Competition Commission.

Ofwat is considering the issues raised by the Competition Commission's conclusions and a number of specific areas of work are outlined throughout the Forward Programme.

The Environmental Audit Committee concluded that the Periodic Review process did provide a fair and open system for determining price limits and thus provided valuable incentives for companies to reduce costs and be innovative. The Committee made a number of recommendations as to how the process and methods used should be developed for the next major review of prices in 2004. They saw the need for substantive work in the following areas:

- setting the exercise in a longer term strategic framework that reflects Government policies and priorities as well as all the statutory and regulatory requirements;
- improvements in the methods of determining the appropriate levels of capital maintenance for the long term viability of company asset systems;
- improved co-ordination of customer surveys; and
- improved abilities to demonstrate the benefits and scrutinise the likely costs of environmental schemes.

Ofwat is considering the recommendations made by the Environment Audit Committee and a number of specific areas of work are outlined throughout the Forward Programme.

#### **2.4.2 Preparation for the Periodic Review 2004**

Ofwat will consult stakeholders during quarter 3 of 2001-02 on the timetable and process for the next Periodic Review. We will then publish a consultation paper in 2002-03 with specific proposals for the timetable.

Ofwat notes the wish for water companies to have early clarification of its price setting methods, particularly those where no change is likely at the next Periodic Review. Accordingly, we will inform water companies of any early decisions on methods when these are made.

A number of more specific areas of work will be developed during 2001-02, which will guide Ofwat's decisions at the next Periodic Review. These are as follows:

##### Efficiency

Setting challenging efficiency targets for the companies and putting in place incentives for them to out-perform has contributed to much lower bills for customers at the same time as which levels of service are improving. In its review of the price limits for two of the smaller companies the Competition Commission endorsed Ofwat's use of econometric modelling to assess relative efficiency and its rigorous approach to the analysis. The Competition Commission also made some helpful comments, which will be taken into account as Ofwat considers how to improve its methodology. This process will include discussions with other regulators, taking expert advice from professionals and academics, and listening to the views of the industry.

##### Formulation of quality enhancements for future price setting

In the last ten years, companies have carried out work to comply with exacting new quality standards. This will continue with a £7.4billion programme (May 1999 prices) to deliver enhanced drinking water and environment standards in the five years to April 2005. This programme was finalised after identification and thorough appraisal of new legal obligations and guidance from Ministers. Ofwat will assist the DETR and quality regulators in the initial assessments of the potential components of future quality and environmental improvement programmes. This includes the identification of work required to meet the new lead parameter for drinking water, progress with meeting river quality objectives and the procedure for implementing the Water Resource Framework Directive. This assessment will aim to ensure that any new improvements offer value for money for the environment and customers. We shall continue to give incentives to companies to implement cost effective solutions. Progress will be reported in the Forward Programme for 2002-03.

##### Water quality serviceability indicators

A joint DWI/Ofwat study is in progress to develop an improved package of water quality indicators that reflect more closely the serviceability of water treatment systems. Following completion of initial feasibility studies by DWI and Ofwat in 2000, we shall consult on the options and recommendations in quarter 1. Any new indicators arising from this initiative will be incorporated into the annual monitoring cycle as soon as possible, preferably for reporting in the June Return 2002 onwards.

### Environmental quality serviceability indicators

We will undertake a joint EA/Ofwat study to develop an improved package of environmental quality indicators to reflect more closely the serviceability status of sewage treatment and sewerage systems. Following completion of initial feasibility studies by EA and Ofwat early in 2001-02, the options and recommendations will be subject to consultation in quarter 3. Any new indicators arising from this initiative will be incorporated into the annual monitoring cycle as soon as possible, preferably for reporting in the June Return 2002 onwards.

Work undertaken on both packages of indicators will address the Competition Commission's call for a more collaborative approach to developing a method for assessing serviceability to customers.

### Economic appraisal of long term capital maintenance needs

In a letter to the companies *MD161 Maintaining Serviceability to Customers* April 2000, Ofwat summarised its concerns about the lack of robust economic appraisals of long-term capital maintenance needs and suggested criteria that should be included in any future company submissions. During 2000 Ofwat discussed with a number of companies how to address this gap. These discussions will continue in 2001-02 leading to the development of further Ofwat guidance and information requirements for an initial capital maintenance return for the 2004 Periodic Review. We shall consult on this guidance in quarter 3 and may hold a technical workshop before the end of the year.

### Supply demand balance

Ofwat will review price setting methodologies on supply/demand balance issues. We shall reconsider the basis for allowing extra expenditures to meet growth in demand and new development. Ofwat will take account of wider developments including long-term water resource planning, climate change and reform of the abstraction-licensing regime. We shall hold a technical workshop on supply/demand issues early in quarter 4.

### Incentives for maintaining and improving levels of service

At the 1999 Periodic Review, companies' price limits reflected past performances in delivering services to customers. This was based on an index measuring companies' overall performance. Ofwat plans to review both the index itself and the future mechanisms for linking future price limits and levels of service delivered to customers. We will work closely with the Office of Gas and Electricity Markets (Ofgem) who are currently working on a similar project. Conclusions on the review of the index, which will cover individual elements and their relative weighting, will be published in quarter 1. Views will be invited. Results of this work will be included in the planning for the next Periodic Review.

### Capital and operating expenditure incentive mechanisms

Ofwat will also carry out a review of the capex and opex incentive mechanisms prior to finalisation of the programme for the 2004 Periodic Review. Work will start on these issues during 2001-02, with a view to more detailed coverage in the next forward programme.

### Broad Equivalence

The Competition Commission has recommended a further study on the issue of whether there should be broad equivalence between depreciation and capital maintenance.

Ofwat will undertake a review to address the concerns of the Competition Commission. We shall refine the present approach as appropriate in conjunction with the developing policy on the economic appraisal of long-term capital maintenance needs.

### Financial Model

The financial model is one of many tools used by Ofwat when setting price limits. After the 1999 Periodic Review there was an internal review of the functionality and analytical capabilities of the financial model. This identified a number of improvements that would make using the model easier and the data-processing, required to calculate the inputs to the financial model, more efficient. Upgrading the model, incorporating the identified improvements while retaining the price setting arithmetic used in the last Periodic Review, will take place during 2001-02. This should address some of the Competition Commission concerns about the modelling process.

The upgraded financial model will be fully audited by independent consultants and documented in a Rule Book before replacing the current modelling system. In response to criticism of the transparency of the Periodic Review 1999 process, Ofwat will make the financial model software available to water companies and on request, to other interested parties. Ofwat will consult the water companies, during quarter 3, on the technical issues, process, timing and associated costs for making the financial model available.

### Review of Licence Modifications

In *MD167: Modification of Conditions of Appointment: Proposal about Condition B, Part IV and other possibilities 31 January 2001*, Ofwat said that we would be reviewing the companies' Conditions of Appointment. This is to see whether any further rationalisation of their existing terms might provide a clearer starting point for all companies at the next Periodic Review. This review will begin during quarter 1 and Ofwat will consult on any proposals during quarter 2.

### **2.4.3 Interim determinations**

Between five yearly Periodic Reviews a company, or Ofwat, can, in certain circumstances, require an interim determination of price limits where there are significant changes in costs or revenues. In the 1999 Periodic Review we identified three specific areas where there was a risk that cost pressures would arise but were not taken into account in price setting. If changes in these areas are material, prices can be reset. These areas are:

- a faster than expected take-up of optional household metering;
- increased levels of bad debt arising from the loss of the power to disconnect household customers; and
- the administrative costs of protecting vulnerable groups, as required by Regulations made under the Water Industry Act 1999.

In 2000-01 three companies sought interim determinations. In preparation for any interim determinations in 2001-02 Ofwat will issue a MD letter in May 2001 consulting on and setting out the process. We shall consider how best to codify and explain our current approach to interim determination claims and provide a summary of the issues arising from the applications and determinations made in 2000.

To revise price limits for 2002-03 Ofwat must receive any interim determination notices from a company by 1 October 2001. However, it would be helpful to both parties if companies considering requesting an interim determination were to discuss this both with Ofwat and their Reporter in advance. The interim determination must be issued no later than three months from the receipt of the formal notice from the company.

Ofwat can also issue a counter notice to a company seeking an interim determination where legal obligations have been reduced, allowing customers to be reimbursed.

## **2.5 NEW LEGISLATION**

### **2.5.1 Draft Water Bill**

In November 2000 the Government published a paper *Water Bill – Consultation on draft legislation*, following the decision to exclude clauses relating to the regulation of the water industry from the Utilities Act 2000.

Ofwat's response to the draft Water Bill is published on our website ([www.ofwat.gov.uk](http://www.ofwat.gov.uk)). Ofwat welcomes the aims of the proposals included in the draft Water Bill. In particular we welcome the objective of placing customers at the heart of regulation. We are moving in the direction proposed by the draft Water Bill and working to ensure the customers' representatives (ONCC and the CSCs) are recognised as speaking in the customers' interest independently of Ofwat. The Memorandum of Understanding setting out the working relationship between ONCC and Ofwat will be published later in 2001. We already meet the requirements of the draft Water Bill in respect of our Forward Plan, Annual Report and in giving reasons for our decisions.

Ofwat is contributing to the DETR work on developing the draft Water Bill. This work includes developing proposals for competition.

Meanwhile, we shall work with the DETR and ONCC to enhance clarity and accountability within the current statutory framework and to consider the implications of proposed changes.

For example, we have indicated our readiness to see a duty on sustainable development included in Ofwat's functions following a recommendation by the Environmental Audit Committee. We shall need to consider with DETR how such a duty could best be integrated with Ofwat's other functions.

### **3 STRATEGIC ISSUES 2002-05**

#### **3.1 INTRODUCTION**

The Forward Programme provides details on our aims and objectives for the 12 months to 31 March 2002. Much of this work will be further developed over the next three to five years. This chapter provides a commentary on issues over the medium term.

#### **3.2 UNCERTAINTY**

It is important to stress that in delivering our objectives over the medium term we face a number of uncertainties in, for example:

- Government policy and legislation;
- EU Directives;
- company restructuring;
- UK economic forecasts;
- climate and environmental change; and
- water quality and public health issues.

Our aim is to ensure stability by maintaining close links with all the key stakeholders with the objective of minimising uncertainty and risk to companies and customers.

#### **3.3 DRAFT WATER BILL**

Ofwat will respond to future Government proposals as necessary.

#### **3.4 PRICE LIMITS AND PERIODIC REVIEW 2004**

This Forward Programme details the preliminary work we shall carry out in preparation for Periodic Review 2004. In the second half of 2002 it is expected we shall issue the timetable, key stages and an outline of information requirements for Periodic Review 2004. At this stage it is envisaged the main work of the review will take place between spring 2003 and the end of 2004. However, this will be confirmed by December 2002.

#### **3.5 COMPETITION**

The development of competition across the industry has so far largely been confined to a few areas e.g. inset appointments and mains laying. There has not been the same progress as in the gas and electricity market. It remains for the industry to develop competition and choice for customers based on common carriage and other means. The draft Water Bill, should it proceed through Parliament, is expected to give the office greater powers to promote competition.

### **3.6 WATER QUALITY AND THE ENVIRONMENT**

The long-term programme of improving water quality and reducing pollution is the main component of the industry's capital expenditure. During 2002 and 2003 it is important that the scope of future quality requirements is accurately compiled. This will ensure they can be taken account of at the next Periodic Review. This work will depend on setting a timetable and a mechanism for information exchange between DETR, EA, DWI and ourselves during 2002.

### **3.7 CUSTOMER REPRESENTATION**

Over the next two to three years the new independent Consumer Council for Water may be set up. We look forward to building a strong constructive relationship with the new Council and its regional committees. In the interim we shall seek to strengthen the independent voice of the consumer. We shall encourage the CSCs and ONCC to raise their profile at both a regional and national level.

### **3.8 CLIMATE CHANGE**

Current Government pronouncements indicate that climate change is increasingly likely to cause extremes of weather from drought to floods. Over the medium term we shall work with the DETR and EA to gain a better understanding of the possible economic impact to the industry.

### **3.9 COST OF CAPITAL**

Recent forecasts on the UK economy indicates over the medium term, a period of low inflation, low interest rates and moderate growth. This stability presents a positive outlook for industry in financing its functions. We shall continue to keep regular contact with the City and monitor closely the cost of capital. The information gained will contribute to determining cost of capital projections for Periodic Review 2004.

### **3.10 RESTRUCTURING**

Since Periodic Review 1999 some companies have considered various models of restructuring, primarily to reduce the cost of capital and also to reduce operating costs by outsourcing. We shall continue to encourage any initiative that reduces costs and prices without increasing risks to customers or reducing levels of service.

### **3.11 OFWAT'S RESOURCES**

H M Treasury's *External review of efficiency in the regulators* (February 2001), notes that Ofwat had effectively controlled its costs over the past few years. We shall continue to constrain costs within the ceiling set in companies' licences, Condition N: Fees.

In the next Forward Programme 2002-03 we shall publish for the first time our three-year expenditure forecasts. This will set out our resource estimates as notified to H M Treasury.

### **3.12 COMPARATIVE COMPETITION**

Over the medium term the keystone of incentive-based regulation will be comparative measures of performance in costs, outputs and levels of service. We shall continue to restrict our information requirements and take further action to ensure our approach and decisions are clearly articulated and justified. Any merger proposals will be tested to ensure the benefits of comparative competition to customers are not devalued more than needs be. Efficiency gains are needed to provide some compensation for the loss of a comparator.

## **4 RESOURCES**

### **4.1 INCOME AND EXPENDITURE**

Fees charged under Condition N of the companies' licence fund Ofwat and the CSCs. In 2000 Ofwat returned £450,000 of savings to companies by reducing their fees. We shall continue to keep a tight rein on expenditure, keeping well within the ceiling allowed by Licence Condition N.

The estimated income to be recovered from companies to fund Ofwat for 2001-02 is £11.9 million. This is the same amount charged in 1999-2000. It represents 0.18% of companies' turnover or 52 pence per connected household per year in England and Wales.

In the year ahead, resources will be allocated on the following proportions:

	%
Customers' Representation	25
Economic Regulation	75

The proportion of total resources allocated to economic regulation will be split:

	%
Competition and Mergers	20
Price Setting	30
Annual Monitoring	50

Should new demands and priorities emerge, we shall ensure that a quick reaction is made to changing resource allocation.

### **4.2 SERVICE DELIVERY AGREEMENT**

The Ofwat Service Delivery Agreement sets out the main objectives relating to the Modernising Government initiative. This is available on the Ofwat website, details of the Modernising Government initiative are available on the Cabinet Office website ([www.cabinet-office.gov.uk](http://www.cabinet-office.gov.uk)).

### **4.3 HM TREASURY EXTERNAL REVIEW OF EFFICIENCY**

H M Treasury published the review in February 2001. The report carried out by W S Atkins provides 19 recommendations. Some of these are considered priorities and others are for consideration by the regulators. Ofwat will examine each recommendation carefully and working with other regulators and HM Treasury, will put in place an action plan for 2001-02.

### **4.4 WEBSITE AND THE INTERNET**

The Ofwat website is acknowledged to provide a comprehensive source of information. However it lacks a search engine and other features of current website development. By the end of quarter 3 we shall have in place a redesigned website. This will include pages dedicated to the ONCC, the CSCs and customer representation.

All CSC offices will have Internet access by the end of quarter 1.

#### **4.5 TRANSPARENCY AND INFORMING STAKEHOLDERS**

Openness and transparency in decision making underpins Ofwat's approach to regulation. We work hard to improve our transparency and keep stakeholders informed about our work and our performance.

We review our procedures to ensure that we communicate regulatory information about our own work and about the performance of the companies in a cost effective and efficient way. This is to help others to make an informed contribution to our decision making and reasoned judgements about company performance.

Ofwat will consult stakeholders during quarter 3 of 2001 to ensure that the information that they receive from us in reports, leaflets and other publications is delivered effectively and that its presentation is appropriate to their needs.

Quality review procedures will be further developed to ensure:

- published documents are in plain English; and
- we shall continue to improve internal quality assurance processes to ensure our published decisions and methodologies are clearly articulated and understandable.

#### **4.6 SECURITY**

The office has invested heavily in the past two years to ensure its computer systems are secure as possible. During the year we shall develop the use of encryption software to permit the routine transmission of confidential information to companies and others. This work will include consultation on the approach, with completion by the year end.

#### **4.7 STAFF**

During the year the senior management team will make further progress on the Modernising Government and Civil Service Reform initiative. This will include:

- a review of our current pay system;
- review flexible working and home/life balance;
- maintenance of our Investors in People objectives; and
- performance management.

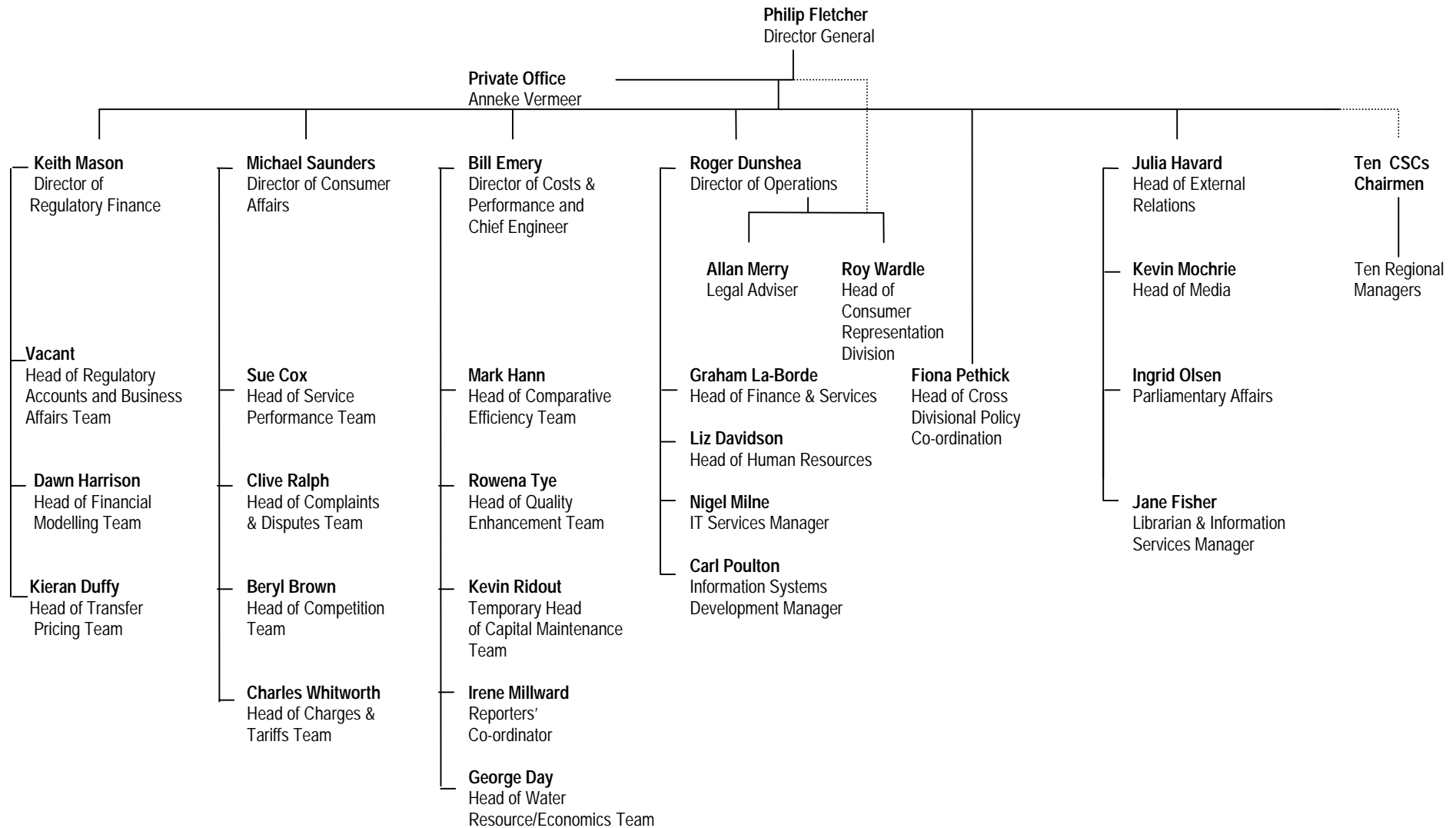
#### **4.8 RISK MANAGEMENT**

During 2001-02 we shall be implementing the required procedures of risk management in line with the Government's requirements for internal control. This process will formulate how Ofwat assesses and mitigates the risk associated with the work of the head office and ten regional CSCs.

#### **4.9 FORWARD PROGRAMME 2002-03 AND STRATEGIC ISSUES 2003-06**

A full consultation will take place between November 2001 and January 2002. We shall hold a stakeholder workshop early in December 2001.

## APPENDIX 1 - OFWAT STRUCTURE



## APPENDIX 2

### RESULTS OF CONSULTATION

The following paragraphs summarise the main elements and how these have been taken into account in finalising the Forward Programme.

#### 1 Consultation

Ofwat's policy of consulting stakeholders on issues was welcomed. Some were concerned that the result of a consultation exercise was not always evident in the final output. We shall seek to improve its explanation.

Companies and other stakeholders asked to be included in reviews of policy areas detailed in the draft Forward Programme, as well as larger projects such as the Periodic Review 2004 and Licence renewal. We agree and have made amendments to a number of our work programmes, including those for the next Periodic Review and annual monitoring.

#### 2 Competition Commission

There were requests for Ofwat to identify individually those issues that the Competition Commission recommended for further consideration. This has been done.

#### 3 Resources

The table provided on resources was welcomed, although many people thought that more use could be made of the information if it could be tracked over a number of years. Some asked that Ofwat should set itself specific efficiency targets. These issues are addressed in Chapter 4.3 on the HM Treasury report on efficiency.

The presentation of figures was criticised. Chapter 4 of the Forward Programme now uses an alternative formulation.

#### 4 Transparency and process

Not all stakeholders were persuaded that Ofwat is as transparent as it claims. They asked for more explanations and involvement.

We agree that stakeholders should be included in the planning of any process and given explanations. As part of our Code of Practice on consultation, we are committed to explaining to stakeholders how their responses have been taken into account in our decision making. Recent examples include:

- sharing with the companies the details of how their overall performance scores were built up;
- publishing the special factors taken into account when assessing operating cost efficiencies in the *Report on water and sewerage service unit cost and relative efficiency*;
- exposing more details about the tariff proposals following discussions with business customers;
- greater openness with companies over the interim determination process; and

- the inclusion of primary purpose categories in the June Return.

Additional steps proposed for the future include:

- identifying in the Tariffs report company proposals that have not been agreed;
- the upgraded financial model software will be released in preparation for the next Periodic Review;
- consider publishing information on the RCV; and
- seminar to look at debt recovery procedures and debt guidelines on 1 May.

## **5 Overall Performance Assessment**

Stakeholders welcomed the review of the assessment and were keen that it should include a look at the individual indicators and also the weightings. Quality as well as quantity of response to complaints and billing queries etc should be considered. We agree with these points.

Some argued that there should be no retrospective application of any revised service level indicators. This comment is consistent with one made by the Competition Commission.

## **6 Quality**

The companies urged Ofwat, DETR, EA and DWI to work closely in determining future quality outputs.

## **7 Leakage**

Consultation was suggested as a way forward by means of an effective joint working between Ofwat, DETR, EA and DWI. Economic levels of leakage are supported, with the proviso that it is not an exact science and a range would be more suitable than a specific target. We have included a study on best practice in our work programme for next year.

## **8 Water efficiency**

The proposed study was welcomed, as was Ofwat's role in researching best practice. The importance of assessing cost effectiveness of water efficiency activity was highlighted.

## **9 LRMC**

It was felt that the timetable for this work was ambitious. There was a need for a workshop to be held by Ofwat to discuss the applicability of LRMC as well as its methodology. We agree with this comment and have included in our work programme a seminar on LRMC.

## **10 Financial accounts**

The consultation was welcomed. We have included in the Forward Programme details of who will be involved in this consultation and what it will involve.

## **11 Transfer pricing**

The importance of transfer pricing and 'at arms-length trading' was confirmed, especially in light of possible new structures in the industry.

## **12 Reporters**

Both the role and the appointment of Reporters were mentioned. It is hoped that this would result in a more efficient service being possible. We have included in our Forward Programme a review of the Reporter appointment process and the Reporters and Financial Auditors roles. This will include consultation with stakeholders.

## **13 International comparators**

The value of this work was recognised, although it was suggested that focussing on Europe would be more beneficial. Ofwat appreciates this comment but believes that wider comparison is beneficial in examining the water industry in England and Wales in an international context.

## **14 The five annual reports on company performance**

A review of these reports would be useful, as they had now been produced in a similar way for a number of years. There was a suggestion that the *Report on water and sewerage costs and relative efficiency* could be brought forward. We have already stated that we shall consult on these. The Efficiency report cannot be brought forward due to the nature of the work involved and the importance of establishing robust data.

## **15 Market research**

There was general support for Ofwat undertaking customer surveys, and agreement to the areas proposed for inclusion. Again there was a wish for all relevant stakeholders to be involved as well as note taken of previous research produced. We have now included consultation with companies in this work and enlarged the list of matters that might be included.

## **16 Tariffs**

There was general agreement with the work proposed. Business customers were anxious that Ofwat should review its policy on a number of tariff issues and these have now been included in the Forward Programme.

## **17 Sewer flooding**

There was general agreement that this is a priority area of work for Ofwat and needs further consideration by all parties involved.

## **18 Ofwat and the CSCs**

Support was expressed for the more 'at arms length' relationship proposed in the Forward Programme.

Responses agreed that this should not result in any extra burden on the companies and that Ofwat should consult on the Memorandum of Understanding. Consultation will take place between Ofwat and ONCC.

## **19 Restructuring**

It was thought that Ofwat could be more proactive in this area. Consultation was seen as the right way forward, with Ofwat leading the way. Lessons could be taken from experience in other industries. Areas suggested for initial work by Ofwat included, separation of function and strengthening of Ofwat's test criteria e.g. cost of capital. The belief expressed was that each case should be treated on its own merits. We have listened to these comments and the Forward Programme clarifies how work will be carried forward. However, it is not Ofwat's role to establish model structures for the industry.

## **20 2014 licence renewal**

DETR are responsible for the issue of licences renewal. We shall seek discussion with DETR on this matter.

## **21 Competition**

The main concern was that Ofwat was not doing enough to encourage what was possible in competition already and was not devoting enough of its resources to this area. Specific questions were also asked, e.g. on the study of access codes, separation of function, effluent charges, abstract licences, inset appointments and new connections. It was stressed that there should be safeguards for customers and the environment. The results of the operation of CA98 were welcomed. These comments have been taken into account in revising the Forward Programme.

## **22 Price setting**

The review of past experience and look forward to Periodic Review 2004 was welcomed. There were repeated requests for ongoing consultation on methodology and agreement on future policy. The importance of issues highlighted by both the Competition Committee and the Environmental Audit Committee were stressed. The list of issues identified by the draft Forward Programme was agreed and comments were provided on how policy could be progressed in each area. Specific mention was made of making the financial model available, as well as broad equivalence, serviceability, future quality obligations, climate change, reuse of water, meter take up, growth and service performance.

Ofwat has considered all of these comments and concludes that the amended Forward Programme covers the issues resulting from the Competition Commission reports. Further, consultation will take place on issues as detailed specifically in the text.

## **23 Interim Determinations of Price Limits between Periodic Reviews (IDOKs)**

A request was made for Ofwat to publish the lessons learned to date, possibly in a MD letter and subsequently the process for future applications. The importance of early dialogue was stressed. We now intend to issue a MD letter, which will include all of the issues raised in the consultation exercise.

## **24 Draft Water Bill**

The importance of this proposed legislation was acknowledged. A request was made for Ofwat to consult on its proposals and publish its response to the draft Water Bill consultation. We have amended the Forward Programme to clarify involvement in the development of the draft Water Bill. Our response is on the Ofwat website.

## **25 Ofwat environmental role**

Responses included the proposal that Ofwat should also have some role for the environment. Sustainability and environmental economics are now included in the Forward Programme.

## **26 Logging up**

A number of respondents suggested that Ofwat should take account of expenditure and financing costs incurred between reviews on additional new obligations on a cumulative basis. The suggestion was to achieve this by converting the Periodic Review logging up process into a rolling annual process. We doubt the benefit of this suggestion. Of course individual companies can use the logging-up proformas to keep Ofwat informed of the likely impact of new obligations identified by them as additional to those funded in price limits.

## **27 Capex and opex incentive mechanism**

A recommendation was made that Ofwat include a review of the capex and opex incentive mechanisms prior to finalisation of the programme for the 2004 Periodic Review. Ofwat will review the operation of the incentive mechanism in time for the 2004 Periodic Review.

## **APPENDIX 3**

### **LIST OF CONSULTEES**

#### **Other government bodies**

Department of the Environment, Transport and the Regions  
Wales Office  
National Assembly for Wales  
Water Industry Commissioner for Scotland

#### **Water companies**

Water and sewerage companies  
Water companies  
Water UK

#### **Quality regulators/environmentalists**

Council for the Protection of Rural England  
Council for the Protection of Rural Wales  
Countryside Agency  
Countryside Council for Wales  
Country Landowners' Association  
Drinking Water Inspectorate  
English Nature  
Environment Agency  
Friends of the Earth  
Institute of Hydrology  
National Farmers' Union  
Royal Horticultural Society  
Royal Society for the Protection of Birds  
Surfers Against Sewage  
UK Round Table on Sustainable Development

#### **Other regulators**

Office of Gas and Electricity Markets  
Office of the Rail Regulator  
Office of Telecommunications  
Civil Aviation Authority  
Office for the Regulation of Electricity and Gas (Northern Ireland)

#### **Reporters and Auditors**

Water companies' Auditors and Reporters

#### **Organisations representing customers' interests**

Age Concern England  
Association of British Chambers of Commerce  
Chartered Institute of Purchasing and Supply  
Chemical Industries Association Ltd  
Child Poverty Action Group  
Confederation of British Industry  
Confederation of British Industry, Wales

Consumers' Association  
Food and Drink Federation  
Help the Aged  
Institute of Directors  
Major Energy Users Council  
Money Advice Association  
National Association of Citizens Advice Bureaux  
National Campaign for Water Justice  
National Consumer Council  
National Council for One Parent Families  
National Federation of Consumer Groups  
National Federation of Small Businesses  
National Federation of Women's Institutes  
Ofwat Customer Service Committees  
Public Utilities Access Forum  
Save the Children Fund  
Utility Buyers Forum  
Waterwatch  
Welsh Consumer Council

**Trade bodies, suppliers and contractors**

British Plastics Federation  
British Water  
Chartered Institute of Water and Environmental Management  
Clay Pipe Development Association  
Federation of Master Builders  
House Builders Federation  
Institute of Plumbing  
Sewer Renovation Federation  
Society of British Water Industries

**Trade unions**

TUC  
UNISON

**Members of Parliament**

Associate Parliamentary Water Group  
Liberal Democrat Spokesman on the Environment  
Shadow Secretary Environment, Transport and the Regions

**Local government organisations**

Local Government Association  
National Association of Local Councils  
Welsh Local Government Association

## **APPENDIX 4**

### **LIST OF ORGANISATIONS AND INDIVIDUALS WHO SENT A WRITTEN RESPONSE**

#### **Other government bodies**

National Assembly for Wales

#### **Water companies**

South Staffordshire Water

Bristol Water

Portsmouth Water

South West Water

Southern Water

Severn Trent Water

Thames Water

Yorkshire Water

Anglian Water

Bournemouth Water

Wessex Water

Three Valleys Water

South East Water

United Utilities

#### **Quality regulators/environmentalists**

DWI

Centre for Ecology & Hydrology

English Nature

The Environment Council

Marine Conservation Society

#### **Reporters and Auditors**

Strategic Management Consultants

#### **Organisations representing customers' interest**

Central CSC member

North West CSC

South West CSC

Wessex CSC

Mencap

Consumers Association

National Union of Residents' Association

Surfers Against Sewage

#### **Trade bodies, suppliers and contractors**

CIWEM

Federation of small businesses

Utilities Buyers Forum

IOD

Water UK

**Members of Parliament/Political Parties**

UK Independence Party

**Local government organisations**

Bournemouth County Council

**Other regulated companies**

Centrica

**Academics/Advisors**

Chris Baines

Ralph Turvey

Peter Lehmann

## APPENDIX 4

### LIST OF ORGANISATIONS AND INDIVIDUALS WHO ATTENDED THE STAKEHOLDER WORKSHOP

	NAME	ORGANISATION
1.	Ian Acford	Society of British Water Industries
2.	Melinda Acutt	Yorkshire Water Services Ltd
3.	David Arnell	Binnie Black and Veatch
4.	Professor J C Baines	Academics/Advisor
5.	Malcolm Barley	Mid Kent Water Plc
6.	Jonathon Bateman	Halcrow Management Sciences
7.	Professor C J A Binnie	Chartered Institute of Water and Environmental Management
8.	J Bowhay	Kellogg/Food and Drink Federation
9.	Peter Bowler	Waterwatch
10.	Phil Burston	Royal Society for the Protection of Birds
11.	Paul Butler	Mid Kent Water Plc
12.	Stephen Cripps	Yorkshire Water Services Ltd
13.	Jon Darwent	WRc Plc
14.	R Dowers	Welsh Water (Dwr Cymru Cyfyngedig)
15.	Tony Evans	Welsh Water (Dwr Cymru Cyfyngedig)
16.	Les Fair	RKL Arup
17.	Leon Fields	Oxera
18.	Brian Flynn	Institute of Civil Engineers
19.	Rob Francis	Frontier Economics
20.	John Fraser	Environmental Agency
21.	Alison Giacomelli	English nature
22.	Gerald Godby	Federation of Small Businesses
23.	Stuart Godfrey	British Plastics Association
24.	Julia Gorman	Mid Kent Water Plc
25.	Duncan Green	Pick Everard
26.	Eleanor Greer	Water Industry Commissioner for Scotland
27.	Sue Garvan	Thames Water Utilities Ltd
28.	Martin Hall	Three Valleys Water Plc
29.	Colin Harley	Southern Water Services
30.	R Harrington	Bournemouth & West Hampshire Water Plc
31.	K Harris	Welsh Water (Dwr Cymru Cyfyngedig)
32.	Ben Haywood Smith	Strategic Management Consultants
33.	David Holt	Bristol Water Plc
34.	Peter Hraftelj	Welsh Water (Dwr Cymru Cyfyngedig)
35.	Peter Hooker	Major Energy Users Council
36.	Mark Jaegar	Environment Council
37.	C Jones	Northumbrian Water Ltd
38.	Tony Kenworthy	Society of British Water Industries
39.	Dr P J Lehman	Academics/Advisors
40.	Chris Lewis	Utilities Buyers Forum

41.	David Mannering	Anglian Water Services Ltd
42.	Ian McAth	Folkestone and Dover Water Services Ltd
43.	Tom Morris	A H Marks & Co
44.	Robin Mortimer	Department of the Environment, Transport and the Regions
45.	Ken Newman	Sutton and East Surrey Water Ltd
46.	John Owen	Severn Trent Water Ltd
47.	Colin Page	Montgomery Watson
48.	Milo Purcell	Drinking Water Inspectorate
49.	Keith Richards	South West Water Ltd
50.	N J Roadnight	Portsmouth Water Plc
51.	R Sainsbury	Academic/Advisor
52.	Roger Sawdon	W S Atkins
53.	Adam Scorer	Consumers Association
54.	Graham Setterfield	Water UK
55.	Jason Shingleton	Polypipe Civils
56.	Robert Siddall	Chemical Industries Association
57.	Graeme Sims	North West Water Ltd
58.	L C Sondon	Sutton and East Surrey Water Ltd
59.	Adam Tennant	South East Water Plc
60.	Peter Vass	Centre for the study of Regulated Industry
61.	Glen Watts	Environment Agency
62.	Robert Weedon	Water UK
63.	Keith Wey	Chemical Industries Association
64.	Brian Williams	National Economic Research Associates
65.	Mark Wilson	Severn Trent Water Ltd