

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 2005.

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 2005 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.

As this Return marks the end of the AMP3 period, we also checked the factual accuracy of the Company's statements on its performance against the AMP3 Monitoring Plan and reviewed where possible the Company's efficiency achievements and other factors against the 1999 Final Determination and IDOK assumptions. The Return also marks the beginning of the AMP4 period so the information was checked against the 2004 Final Determination where appropriate.

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 3 June 2005.

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 2005 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 2005
- 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 2005 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. These contracts were competitively let in 2001 (following EU Procurement Rules) and expired at the end of the AMP3 period. The tendering process 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 2004/05 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 compliance.

The incentivisation contained in the AMP3 contracts was 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 1999 Final Determination and AMP3 Monitoring Plan. Similar performance target setting is being implemented for AMP4.

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 were 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. A similar performance measurement regime has been implemented for AMP4.

The June Return 2005 was compiled by a small team of Company employees all 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.

Our audits have shown that the quality of the information reported in the June Return 2005 has been maintained at the generally high standard set in previous Returns. There were some improvements in data quality namely for some sewerage explanatory factors, property classifications and for non-resident population estimates.

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

Levels of Service

With the exception of DG9, where there was a slight shortfall, the Company met or out-performed its Monitoring Plan Levels of Service targets for 2004/05.

There was improvement in DG2 performance over the previous year resulting in a significant out-performance against the DG2 Monitoring Plan targets for 2004/05. Our field audits confirmed the reported performance.

Although there were significantly more properties affected by unplanned DG3 interruptions to supply than in 2003/04, the percentage of properties affected remains relatively low compared with the industry average. Our audits confirmed that there were five events which contributed substantially to the problem, each of which proved operationally difficult to overcome within the target six hours. However, the Company significantly out-performed the DG3 Monitoring Plan targets for 2004/05, despite the deterioration in performance from the previous year.

As in the previous 13 years, there were no DG4 water use restrictions in 2004/05.

We confirmed that there was a slight reduction in performance over the previous year in the number of properties flooded due to hydraulic overload, however the majority of the incidents occurred in two severe weather events in August and October. Despite this, the Company has outperformed all its DG5 Monitoring Plan targets for 2004/05. We confirmed the Company is geared up to deliver the agreed DG5 outputs for Year 1 of AMP4. We noted the Company is awaiting clarification and guidance from Ofwat on interpretation of the guidance relating to the addition of previously unreported properties on to the 1 in 20 risk register. Discussions between WSH and Ofwat are planned for the near future. The outcome of these discussions could be significant if the Company is required to amend the historic DG5 Register. This could affect the Company's ability to meet the targets in the AMP4 Monitoring Plan. As many as 300 properties currently classified as 1 in 20 based on storm return periods may have to be transferred to the 2 in 10 risk category based on actual incidents.

My audit team visited one scheme during 2004/05 whose scope included DG5 alleviation and confirmed the customer benefits arising from it. WSH recognises the challenge it faces in AMP4 regarding the detection and alleviation of DG5 flooding problems. I have seen that it is preparing with its service providers to deliver the improvement targets it has been set.

Our audits confirmed that the Company's overall customer service performance as reported through the DG6, DG7 and DG8 indicators was either maintained or improved over 2003/04, continuing the trend recorded the 2002/03. There were generally fewer contacts with customers than in 2003/04. Our field audits confirmed the effectiveness of new customer-focussed initiatives during the year such as the accreditation to ISO 9000 for quality management systems for the services provided to WSH by Thames Water and accreditation to ISO 18001 for occupational health and safety systems. Additionally two Welsh language phone advisors were successfully accredited under the National Vocational Qualification scheme.

Particularly notable were the improved response times for DG7 and the best ever performance on DG8. The Monitoring Plan targets for 2004/05 for DG6, DG7 and DG8 were exceeded.

DG9 performance slipped slightly from the previous year continuing the gradual downward trend starting in 2002/03. The DG9 Monitoring Plan target for 2004/05 was missed by 0.4%, however the Company's performance still remains in the Ofwat 'acceptable' category. The Company plans to replace its ageing customer service mainframe computer and associated systems during AMP4 in association with its customer service provider Thames Water.

Delivering the Quality Compliance Programmes

I note that compliance with water quality regulations 'at the tap' was maintained at the 2003/04 level but fell slightly short of the Monitoring Plan target for 2004/05. Iron compliance 'at the tap' fell slightly from the previous year but outperformed the Monitoring Plan target for 2004/05. WSH attributes this to the change in the sampling regime as a result of the change in maximum size of water supply zones in line with the Water Supply (Water Quality) Regulations 2001, rather than operational or asset serviceability problems.

The Company successfully completed its planned AMP3 investment in water quality enhancements in the distribution system and at treatment works and all the Monitoring Plan targets for 2004/05 were met. Our sample audits included three water mains refurbishment schemes and we confirmed the links between these and the quality improvements reported in the Return.

In broad terms the Company met its Monitoring Plan Combined Sewer Overflow (CSO) improvement output target for 2005 although the scope of the AMP3 programme altered as a result of better information and ongoing liaison with EA Wales. 714 CSO outputs were delivered in AMP3 resulting in 86% of CSOs being satisfactory at the end of the period. The Monitoring

Plan target was 81%. We reviewed four CSO schemes during the year and confirmed progress and links to the quality programme.

The Company describes in its Overview the reprogramming of its AMP3 wastewater treatment schemes in response to planning delays. Some schemes programmed for the later years of AMP3 and the first year of AMP4 have been accelerated to mitigate slippage on earlier projects. As for 2003/04 this has meant that the associated outputs for the year are different than anticipated in the Monitoring Plan. We audited three wastewater treatment improvement schemes and confirmed the links with the reported quality outputs for the year. I also made a further visit to the Holyhead scheme during the year and confirmed that the work was progressing well and that the UWWTD outputs required by the end of 2005 should be met barring significant unforeseen events.

Maintaining Serviceability to Customers

Bacteriological compliance 'at the tap' fell from the level reported in 2003 but compliance at WTWs was maintained. Manganese, aluminium and turbidity performance increased but iron and THM compliance fell slightly to from the levels achieved in 2003. The Company attributes the fall partly to a change in the sampling regime.

Our audits confirmed that the reported level of burst mains fell in 2004/05 to its lowest level in recent years. This most probably resulted from the favourable weather conditions in 2004/05 and the ongoing investment in mains replacement and refurbishment and the continued pressure management programme. The improvement in bursts means that the Company achieved its Monitoring Plan target for 2004/05.

Overall sewage treatment works compliance was 97.8%, up slightly from the previous year but short of the 100% target in the Monitoring Plan. However, the increase in compliance reverses the downward trend which first started in 2001/02. The measure is very sensitive to a small number of problems. We have seen that the Company continues to increase its knowledge of the risk and consequence of failure of its asset stock. Its analyses of intervention options and their effects on serviceability resulted in Ofwat's support for an increase in capital maintenance expenditure on sewage non-infrastructure in AMP4.

Bathing water compliance increased to 100% against mandatory standards and to 86% against guideline standards.

We confirmed that the number of Category 1 and 2 pollution incidents on the sewerage network increased by one (from five) over the previous year. Despite this the Company achieved its Monitoring Plan target for 2004/05.

The number of sewer collapses increased slightly from the previous year but remains lower than the peak achieved in 2001/02. As in previous years the vast majority of collapses occurred on non-critical sewers. I note however that the number of collapses which had a direct impact on customers, ie those that caused sewage flooding, fell from the previous year. The latest sewer collapse position is worse than the 2005 Monitoring Plan target (which is the same as the starting position for AMP4) and provides an added challenge to the Company in meeting its objective of maintaining stable serviceability on the sewerage network during AMP4. I have seen evidence of the AMP4 initiatives designed to improve knowledge of the sewerage asset base and its performance and to develop and implement more effective predictive tools to increase the effectiveness of investment and operation of the network. The Company's partners involved in the maintenance, improvement and operation of the sewerage systems in AMP4 are aware of the performance targets and I am assured they will be appropriately incentivised to achieve them.

Supply/Demand Balance

WSH has had extensive discussions with EA Wales during 2004/05 over the Company's methodologies and assumptions used in preparing the Water Resources Plan submitted in 2003. A number of further investigations have resulted from this dialogue and some background assumptions and data have changed. There have been revisions to the calculated resource position in a number of zones.

However the forecast resource calculations remain provisional as the Company is still awaiting the publication of projected local-level population figures from the 2001 census. These figures are expected to be available in July or August this year and, when incorporated into the forecasts, may well alter the landscape of the Water Resources Plan in that the zones currently shown to be in deficit may change. Whilst small in value compared to the overall AMP4 investment programme, the Company is understandably not progressing some of its planned supply/demand initiatives until the resource position is recalculated and agreed with EA Wales.

Operating Expenditure and Efficiencies

The Company's AMP3 operational partners were incentivised to deliver performance improvements over and above the Final Determination targets. The use of appropriate

mechanisms to monitor and drive performance continued.

WSH has reported a small increase (1%) in real terms in water operating expenditure over the previous year. Total base operating expenditure during AMP3 for the water service was £531 million (at 1999 prices), some £33 million higher than the £498 million allowed at the 1999 Final Determination.

There was a less than 1% real term decrease in sewerage operating expenditure over the previous year. Total base operating expenditure for the sewerage service during AMP3 was £428 million (at 1999 prices) , some £20 million higher than the £408 million allowed at the 1999 Final Determination.

Total AMP3 operating expenditure of £961 million (at 1999 prices) was £55 million more than the £906 million allowed at the 1999 Final Determination.

Operational costs in total reduced by 16% in real terms in AMP3. The Company's AMP3 operational contracts expired at the end of March 2005. A new set of much longer duration contracts organised along different functional and geographical lines was procured during 2004/05 and came into force in April 2005. Whilst many of AMP3 partners have been retained, the most significant development has been the consolidation of the former eight sewerage contracts into two. This, coupled with greater integration between operations and capital investment across both services, is designed to achieve further opex efficiencies in AMP4.

Capital Expenditure and Efficiencies

Capital expenditure in 2004/05 for both the water and sewerage services was around £44 million (17%) less than the Final Determination for the year (including IDOK and using Ofwat's November 1999 assumptions). The cumulative position for the AMP3 period was that expenditure is some £164 million (12%) below the Final Determination (as defined above and applying COPI indexation).

Delivery of the bulk of the Company's AMP3 investment programme lay with its Strategic Alliance partners consisting of contractors, designers and cost managers. The AMP3 quality investment programme outputs set at PR99 or revised with agreement with the quality regulators were met or exceeded in broad terms. There were some variations in capital maintenance outputs, the most significant of which was the lower than planned renewal or replacement of sewers as part of the CSO improvement programme.

WSH has declared capital efficiency savings over AMP3 of £5 million and £164 million for the water and sewage services respectively. These almost entirely reflect savings made in implementing the various quality programmes. I am aware that WSH's partnering approach has aided its expenditure efficiency. Because of its expenditure allocation methodology, it is difficult for WSH to desegregate the efficiency savings. Consequently the Company has not provided a description of the areas from which the savings have been made. I believe that the variations do not stem from large-scale changes in the Company's policies or strategies compared with the 1999 Final Determination.

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 the associated reports on the Management of Health & Safety and on Stress Management. 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 2004/05.

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.

At JR04 WSH 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 AMP3 outsourced service contracts. I confirmed this practice continued during 2004/05.

I looked at the procurement and supply chain assessments WSH made as part of the selection of its AMP4 alliance partners. I also reviewed the ongoing development of the remits for the Company's Supply Chain Business Support Team and Commercial Management group. In these areas it was clear to me that the Company's activities embody the principles contained in the British Water guide.

June Return 2005



J J Hawkins

Halcrow Management Sciences Limited

Reporter to Ofwat for Dwr Cymru Welsh Water

17 June 2005