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Sent: 30 January 2008 12:10

To: Audrey Mason

Cc: Irene Millward; Bateman, Jon; Pinard, Paul; Clark, Robin; Hawken, Glen; Wilde, Jon

Subject: Information Requirements for PR09 - Consultation Response

Dear Audrey,

Please find below a number of preliminary, general comments on aspects of the PR09 information requirements which have arisen either from the Consultation document or from recent technical workshops which tend to cover a greater level of detail.

Alternative Plan

What criteria or level of materiality should trigger an Alternative Plan and can the documentation and supporting detail be limited to the issues affected so long as cost and customer impact are clearly set out?

Sewer Flooding

The Consultation document advises that the 2/10 and 1/10 Registers of properties at risk of sewer flooding will be assumed to be mature and stable. We are aware that much work is still to do at some companies to achieve the position expected at 2009/10 and these expectations may not be realised. Whilst we support the concept that maintaining the sewer flooding registers at a stable level should subsequently be funded through base service (supported by investment from supply/demand where growth would otherwise be a contributory factor in reducing the levels of service), it would seem that the properties which will be remaining on the Registers will generally be the more complex and/or more expensive to resolve. New arisals will be a mixture of lower and higher cost, so it is worth identifying at this stage in order to maintain the 2009/10 LoS, a greater average funding per property would seem to be required than has been allowed in the past.

Planned Overlap

Whilst the approach appears to allow for company proposals for major projects/initiatives which require investment over a period which is not coincident with an AMP period as well as allowing companies to smooth expenditure across AMP periods, we consider greater clarity is needed on how overlaps between AMP4 and AMP5 could be accommodated.

Asset Inventory

'The company is required to carry out a full re-survey of its entire asset base as set out in RD 12/07...'. In practical terms we suggest that an adequately supported and justified statistical sample of assets across all categories would suffice as otherwise this could be extremely onerous and unnecessarily costly.

Sewerage Supply Demand Balance

We consider there may be merit in each catchment being considered and reported upon individually.

Reliance on recent research

We have some concerns that the guidance for key elements of the Draft Business Plan places reliance on very recent research work carried out by UKWIR and other research houses. Much of this research is 'hot off the press', under restricted access and has not been widely circulated, debated or subject to public scrutiny or robust practical application.

Whilst much of this research offers a welcome advancement in the knowledge base and may form a robust platform for consideration and consolidation into good and more efficient operational practice during AMP5, its use at PR09 (given the absence of experience in practice across the industry) may in some circumstances raise concerns over the extent and consistency of application in PR submissions. For instance future capital schemes are to be tested by cost benefit analysis using guidance given in a recent UKWIR report (07/RG/07/10) "The Role and Application of Cost Benefit Analysis: Sewer Flooding Guidance". This is not publicly available and the generic guidance (Volume I - 07/RG/07/9) is not yet published.

As experienced Reporters, we anticipate that the untested nature of such principles may militate against consistency across the industry, allowing scope for regional variations in decision criteria on individual schemes. We have similar concerns over the recent UKWIR 'Carbon Accounting Methodology' and the 'Condition Grading of Water Infrastructure Assets' for which an UKWIR report is expected to be published in early 2008.

Menu Regulation - Preferred approach for capital expenditure

In the light of substantial outperformance in previous price control periods, we welcome the fresh approach to incentives, encouraging accuracy in forecasting and for distributing outperformance between company and customer which Menu Regulation appears to offer. Whilst Menu Regulation is reported to be in use by Ofgem in the energy sector, it is totally new to the water industry and companies, regulator and reporters are relatively inexperienced in its application and the change in the embedded risks/benefits of this approach. There will inevitably be analysis & modelling by companies to finesse their outturn position which cannot realistically be matched by the individual reporters (who have no exposure or familiarity with any potential 'ruses'). To achieve adequacy of audit in this area, we suggest it would be advantageous if Ofwat were to identify forward risk factors to customers and to reinforce both Ofwat's and Reporter's teams with appropriate expertise and/or to otherwise help equip the Reporter's teams with sufficient skills and knowledge on this issue. Similarly we suggest that regulators and reporters should properly resource and have ample time for proper diligence in this area.

You say that Menu Regulation is Ofwat's preferred approach for three stated reasons. That being so, we are aware that industry commentators are questioning the need for the very comprehensive cost base exercise currently under way. As Reporters we feel that, although there may be some scope to simplify the cost base and resulting benchmarking processes, this proven approach to setting capital efficiency targets should be retained to provide a means of calibrating the efficacy of the menu regulation incentives or, *in extremis*, a clawback in the event that menu regulation exposes customers to unacceptable risk/cost.

On more specific issues:

Estimating Scorecard

As mentioned at a recent Workshop, we have noted the thresholds applied for identifying the projects which should be used to complete the estimating scorecard.

At 1% of annual service turnover, the numbers of projects 'scorecarded' will be far greater than the 20 or so that Ofwat envisage, and applying that threshold to a company's on which I report, using AMP4 as a test, there are indeed around 100 projects which would qualify. This is likely to be similar for all companies. We suggest that the threshold of 2% should apply (this being the same as the threshold for identifying which projects require project milestone information), supplementing the number if there are insufficient in number or where there is significant expenditure in a category without any relevant projects otherwise 'scorecarded'. This should still achieve your expectations expressed at the Workshop.

Scheme Cost Estimates - Reporter Role

The role of the Reporter appears to include an expectation that *'every project that a company proposes must have identified costs which the Reporter must challenge and validate'*. For most companies, particularly the larger water and sewerage companies, there will be hundreds, perhaps thousands of schemes. We consider it is not feasible in terms of time or resource, nor indeed cost effectiveness to undertake this quantity of work. Our experience suggests that the Reporting Requirements actually require Reporters to undertake sufficient work across the full spectrum of scheme types, sizes and purposes, by scrutinising and challenging the derivation of the costs, to satisfactorily conclude and demonstrate that the costs are reasonable central estimates and conform to the stated confidence grades and that the solutions proposed are appropriate and are expected to efficiently deliver the stated objectives. This will be further supported by the work on a representative sample of schemes where the estimating scorecard will be completed. We seek confirmation of, or clarification on, this issue.

As our engagement in the process increases over the coming months, any further comments or concerns will be communicated as they arise. We look forward to our involvement in the Periodic Review and continuation of the working relationships with Ofwat and water companies.

Kind regards

Reporters and teams

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