

08 February 2008

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Your Ref

Our Ref

Dear Audrey

## **Draft Business Plan Information Requirements**

I am writing in response to the consultation on information requirements for the Draft Business Plan.

The key points of our response are set out in this letter. More detail is given in two appendices:

- Appendix 1 – Significant issues arising from the draft information requirements.
- Appendix 2 – detailed issues requiring clarification.

The key issues which we wish to raise are:

1. The extent of information required.
2. Areas where new approaches are being developed and full application will require further work after PR09.
3. Issues which will need further work for the Final Business Plan, including areas where specific requirements will not be known in time for the Draft Business Plan.

### **1. Extent of information requirements**

There is much in the information requirements which we support. In particular, in relation to new requirements, we welcome the addition of information on cost-benefit analysis and on carbon accounting. Overall, however, the extent of information requirements has increased rather than diminished, and we do not feel that this is the right direction for the regulatory framework. For both companies and Ofwat, the increased work in preparation and analysis:

- Adds to costs.
- Is likely to detract from focus on the key issues.

A member of the Severn Trent Group

- Is not designed to lead to the right outcomes for stakeholders.
- Goes against the direction Ofwat and companies are seeking through innovations such as menu regulation.

The need to minimise regulatory requirements is widely recognised. The Review of PR04 commissioned by Ofwat recommended that “Ofwat undertake investigative work to see whether similar price limits would have been produced in 2004 with reduced data requirements”. Defra, in the consultation on draft social and environmental guidance to Ofwat published this month, has stated that: “Ofwat should build on progress to date by developing a simplification plan in order to continue to consider ways in which to reduce or streamline the information requirements placed on companies. The Government expects Ofwat to justify any new burdens on compelling cost-benefit grounds”.

As noted above, we recognise that some additional information is necessary, but we believe that the Better Regulation Task Force principle of “one in, one out” should be applied. Their 2005 report stated that: “‘One in, One out’ is an easily understood description of the way we want people who are involved in putting administrative burdens on others to think and to behave. It is about prioritising, about putting the more important things ahead of the less important and accepting that, if we try to do everything, we know that either we ourselves or those around us will not be able to cope”.

Areas where we feel that information requirements should be reduced include:

- **Scorecard for capital cost estimation:** The Capital Estimating Scorecard (CES) is a highly prescriptive, very detailed approach to project management. The adoption of this approach could have the effect of forcing companies to adopt the technique to manage their investment programme. Otherwise, companies will be liable to have low scores on the scorecard, and have adjustments made to their capital expenditure estimates, regardless of how efficiently they are able to deliver their capital programme.

It is not appropriate for a regulator to be determining the appropriate approach to capital procurement, particularly when there are more contemporary and better approaches. We believe that companies should be free to innovate and carry out investment management as efficiently as they can. If the CES is to be applied, Ofwat needs to work with companies to ensure that it is applied in such a way that it does not require a specific approach to programme management.

- **Serviceability indicators:** regulatory requirements should focus on delivery of service to customers and the environment. These indicators do not, in general, accurately reflect whether the operational capability of assets has been maintained. For example:
  - Water non-infrastructure indicators relate to infrequent failures which are subject to random fluctuations from year to year, without there having been any variation in the state of assets or in company operations.

- Mains bursts detected vary with the level of leakage control activity.
- Reported sewer collapses vary with the amount of CCTV work undertaken.

We believe that it is inappropriate to set these as Determination outputs, and that doing so could lead to unnecessary expenditure being incurred, which will ultimately result in higher bills for customers.

- **Check on the level of depreciation:** The comparison of current cost depreciation with maintenance expenditure over the period to 2024-25 is a complex and time-consuming calculation which does not produce meaningful results. We suggest that this calculation, incorporated in Tables B7.10 and B7.11, should be abandoned.
- **PR09 projects database:** We can understand the need for information on individual enhancement projects but can see no benefit from the inclusion of individual capital maintenance projects in this database, unless they relate directly to outputs which will be specifically identified in the Determination.
- **Capital Maintenance Econometric Return:** We do not consider that it was necessary to require this information to be submitted before a decision has been made on whether menu regulation is going to be adopted, and therefore whether the Return is going to be used.

## 2. Development of new approaches

There are a number of areas where new approaches to data and analysis are being adopted for PR09. While we support some of these initiatives, they require additional modelling and data which will need further development after PR09. This includes the following aspects of the price review:

- **Least-cost planning for sewerage supply-demand:** we support the development of this approach and are seeking to improve our analysis in this area, addressing potential flooding and pollution problems before they happen. However, limitations of data (e.g. on location and timing of new development) and of current modelling techniques mean that we will only be able to partially apply the approach for PR09.
- **Carbon accounting:** there will need to be further work after PR09 on quantifying carbon impacts, particularly for embedded carbon and supply chain carbon.
- **Cost-benefit analysis:** we are well placed to apply cost-benefit analysis (CBA) to much of our programme, through the work we have carried out on customer willingness to pay and other initiatives. However, there are some aspects of service where CBA is difficult to apply. We are particularly concerned about the approach for projects which provide increased resilience for failure, e.g. due to flooding. Where the probability of failure is low, and the cost of failure is very high, and both are hard to measure, CBA results need very careful interpretation.

We support the initial conclusions from the Pitt Review “Learning lessons from the 2007 floods” that Defra should work with Ofwat and the water industry to explore how appropriate risk-based standards can be achieved.

### **3. Issues which will need further work for the Final Business Plan**

Ofwat states that “Each company should produce a Draft Business Plan which:

- is consistent with its strategic direction statement and its draft water resources plan;
- is owned by the company;
- puts in place a package of outputs which will deliver statutory outcomes;
- is in line with consumer priorities for service levels and bills;
- optimises and exposes the costs and benefits of the plan at the overall and component level; and
- is underpinned by a sustainable financing plan.”

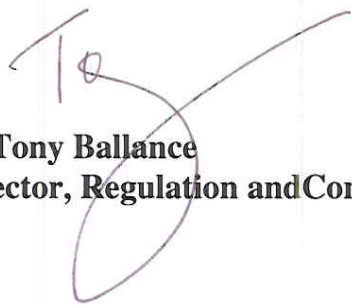
We agree with these principles and in order to fully comply we have put together a detailed timetable to deliver the Draft Business Plan including all appropriate governance and quality checks. This timetable has been shared with both Ofwat and the Reporter. A key principle underlying the timetable is that the project level information to be used in the investment optimisation process is finalised at the end of March 2008. Therefore, we propose a pragmatic approach be taken to information released after this date. We will make reasonable endeavours to include the impact within the Business Plan. If this cannot be done, we will include it in the list of planned improvements between Draft and Final.

It may be necessary to include initial assessments of impacts in the text of the plan, while not modifying the tables for late changes. These would be assessed in detail for the Final Business Plan. Discussions on the environmental improvement programme with the Environment Agency will be continuing, on the Water Framework Directive programme and on specific requirements such as resolving Unsatisfactory Intermittent Discharges.

Further details on areas where we need to carry out further work for the Final Business Plan are set out in Appendix 1. Two significant areas are cost-benefit analysis and carbon accounting. While we will have completed our work for cost-benefit analysis at an overall programme level, it is likely that there will be further work to do on individual projects for the Final Business Plan, particularly in relation to the environmental programme. In addition, we are carrying out work on assessing embedded carbon but the extent to which we will be able to include this in the Draft Business Plan is not yet certain.

I am copying this letter to Keith Mason as our Ofwat Board-level contact.

Yours sincerely

A handwritten signature in purple ink, appearing to be 'T. Ballance', with a large, sweeping flourish that loops around the text below.

**Dr Tony Ballance**  
**Director, Regulation and Competition**