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DGW/dr - 01/003L\_08

23<sup>rd</sup> January 2008

Dear Rhiannon

**Setting Price Limits for 2010-15**  
**Framework and Approach - a consultation paper**

I am writing in response to your consultation paper issued in October 2007 concerning setting price limits for 2015-2015. You will receive industry representations on the broader industry wide issues, therefore this response has focussed on what I believe are the key issues for this Company.

**1. Notified Items**

**1.1 Debt**

Your proposal to remove the 5 notified items that are currently in place. However, we believe that the item for debt management should remain. Accordingly, where companies can demonstrate that their debt collections measures are 'best practice', as endorsed by the annual Consumer Council for Water debt audits, then increasing levels of bad debt should be funded at the appropriate time.

As the Company moves towards its proposed target of 100% metering by 2012 there is a risk that affordability issues may arise. This could increase the risk to our level of bad debt, potentially beyond that which we can reasonably forecast.

The recent publicity around sub-prime mortgages, and the anticipated credit crunch, illustrates the current volatility in the credit markets, which creates pressure in consumer spending. There is also increasing pressure on customers' disposable income due to significant rises in other bills, such as food and utilities, where we are currently seeing significant volatility leading to rises. This will increase customers focus and priorities and could have an impact on our ability to collect debts. Local socio-economic conditions should also be taken into account.

**1.2 Competition**

The consultation clearly states that competition will be promoted and that companies should factor this into their business plans. However this is an uncertain area for the industry and until we see how new entrants and customers react it will be difficult for us to build this into our Business Plans.

We assume that the revenue price cap mechanism will protect all parties from any volatility in income. However, companies could incur significant additional costs for activities which result from competition, such as suppliers of last resort. Accordingly, this should be included as a notified item.

We also have concerns about the level of uncertainty around competition and the impact this could have on the costs of capital – this is dealt with further on in this response.

## **2. Sustainability**

As we have stated in our Strategic Direction Statement the issue of sustainability is a key concern for us and we welcome the emphasis that OFWAT has placed on this area of the Business Plan. It is a subject that our customers are becoming more aware of and it is clear that they expect us to act in a timely and appropriate manner to deal with the challenges that this will present us with.

Clearly we are still working on our plans to adapt to, and to mitigate our impact on, climate change. OFWAT needs to acknowledge that there could be upward cost drivers on customer's bills but the tone of the consultation paper suggests that it may be difficult to get funding approved unless there is an immediate positive cost benefit analysis calculation available. In the case of innovative schemes this may not always be available.

A reliance on shareholders to fund 100% of any proposed innovative scheme could stifle innovation and restrict future new developments. This needs to be a partnership approach.

## **3. Cost Benefit Analysis**

In general we support this approach as it is clearly good business sense to run large capital investment proposals through a cost benefit model. However we are concerned that each individual company is being expected to develop its own CBA model that should be subject to technical/peer review. This appears to be an inefficient way of developing a model, with each company incurring significant cost. There is also a risk that we do not tick all the boxes on the OFWAT assessment criteria. We are concerned that OFWAT will rank the CBA models and this could have an impact on the allowance awarded to individual companies.

As mentioned above in (2) there may be innovative pilot schemes that initially may not be cost beneficial, but once fully developed and implemented they could lead to future cost effective investment. Therefore OFWAT needs to allow companies some flexibility in their use of CBA.

During attendance at some OFWAT workshops all parties discussed the possible need to submit additional Business Plans if some capital schemes were not cost beneficial. This is not mentioned in the Consultation paper and we need more clarity on the exact requirements – does this refer to the overall capital programme or individual schemes.

It would also be useful to have detailed guidance as to how this applies to all the capital investment envelopes, in particular MNI and IRE.

#### **4. Incentives**

Since privatisation the existing regulatory framework has achieved significant efficiencies across the water sector. However there will come a time when all water companies have approached their optimum operating efficiency, we believe this could be in the current AMP period and that the proposed 60% catch up may not be achievable.

The OFWAT focus is still on cost cutting and we believe it is time to move towards incentives that reward companies on delivering the specific levels of service that their customers indicate they want, and are willing to pay for.

The efficiency models include costs over which we have no direct control, and which often increase at rates above inflation. Such costs should be removed from your models; these include business rates, Environment Agency charges, electricity and insurance premiums.

While supportive in principal of the menu regulation proposals, and the proposed review of the Overall Performance Assessment mechanism, we would like greater visibility of the detail of OFWAT's proposals to enable a robust assessment to be undertaken prior to adoption. To be discussing these items so close to the preparation of the Draft Plans does cause us significant concern.

#### **5. Future Financing**

It is anticipated that we will need to maintain, or increase, levels of capital expenditure to meet all the challenges ahead. Failure to provide sufficient funding in AMP5 will mean that we are storing up problems, and increasing bills, for the AMP6 period.

As mentioned in the points above the actual regulatory process is changing, the overall economy is under pressure from the credit crunch and the exact impact of the competition initiatives are unknown. This generates a higher level of uncertainty and risk from that seen at the time of the AMP4 submission.

Therefore it is important that both the small company premium and the financeability tests remain in place and adjustments are made to price limits accordingly. OFWAT needs to be transparent regarding the ratios that it will use.

OFWAT must also pay close attention to the views of the financial markets and the credit agencies when setting the cost of capital and the need to retain the small company premium. There will be numerous studies produced to support the Business Plans, from all parties, and these must form the basis of the informed decision. The approach needs to be long term and needs to take into account movements in the cost of capital over the long term in order to reflect the long term investment nature of the sector.

In summary the key to ensuring the success of this periodic review is an open and transparent dialogue, with adequate attention being given to the items discussed above. We are pleased to have been given the opportunity to comment in some detail on your proposals and look forward to more lively debate over the next two years.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D Walton', with a stylized flourish at the end.

David Walton  
**MANAGING DIRECTOR**