

Response to Ofwat's consultation:

Setting price limits for 2010-15: Framework and approach

United Utilities Water

January 2008

1. Overall

1.1. Summary

Overall, we believe that Ofwat's price review methodology should incentivise and deliver a long term sustainable water industry. It should do so in a way that appropriately allocates risk to those best placed to manage it, and provide sufficient incentives for companies to outperform and hence create future benefit for water customers. Finally, it should do this in an efficient manner by focussing the regulatory burden on those areas that are most material to the setting of prices for water companies.

We have some concerns that the proposals for PR09 constitute a significant shift in methodology compared with previous reviews, with Ofwat proposing some of the most radical changes to regulation of the water industry in England and Wales since privatisation.

Whilst we believe some of these changes represent favourable developments for stakeholders that increase the transparency of the regulatory process (e.g. long term planning via the strategic direction statement) there are others which appear to signal a shift away from incentive based price cap regulation, towards a more rate of return style of regulation (e.g. revenue adjusted price cap; indexation of the cost of debt).

We believe incentive based regulation (i.e. where good performance is rewarded and poor performance is penalised) has served stakeholders well since 1990, and that symmetric, transparent and well designed risk/reward mechanisms that allocate risk to the stakeholder best placed to manage it are the best way of encouraging innovation and improving performance and accountability.

We are concerned that Ofwat appears to be diluting the incentive base, whilst at the same time promoting competition as the source of the next step change in improved performance. We are also concerned that the majority of Ofwat's "incentives" only act to penalise companies as a results of poor performance.

We are also concerned that there appear to be a number of prejudged outcomes in the consultation, despite the fact that we have not yet even submitted our draft business plan, and before Ofwat have published the results of their research on these matters. For example:

- Ofwat have stated that the cost of capital for PR09 will be lower than that assumed for AMP4. Recent events results following problems in the sub-prime market have led to widening credit spreads and significant difficulties in the market for index linked debt. The monoline insurers are facing increasing risk of being downgraded from their AAA status, with Ambac (one of the biggest monolines) being downgraded recently two notches by Fitch.
- The consultation document states that the water industry will continue to improve its efficiency at a faster rate than the economy as a whole for the foreseeable future, and further that price limits **will** reflect this. This is despite the fact that (i) other regulators

such as CAA have already accepted the notion that “frontier shift” is no longer appropriate and (ii) Ofwat has not yet commissioned their cost trend and productivity studies for PR09

- It is presumed that all five of the current notified items be discontinued. A number of them have not yet crystallised into actual costs (and are clearly still uncertain), and that on bad debts is a water industry special case. The future uncertainty regarding the impact of the ban on disconnection lies less with the action of the water companies, and more with the state of the economy, and hence the number of householders falling into debt, and subsequently being advised to satisfy their other creditors in priority to their water company.

We further urge caution against Ofwat placing too much weight on recent history. In particular regarding the RCV premia being paid for regulated utilities, which has been driven by excess demand for index linked income streams. The impact of acquisitions by infrastructure funds should be treated with caution. It is not reasonable to assume that the observed RCV premia imply something about the “real” cost of capital. The recent excess of demand over supply has contributed to driving the price upwards of many classes of infrastructure asset.

In relation to the specific objectives (discussed in turn below) described in the consultation, we are concerned that Ofwat chose objectives other than the regulator’s duties. Ofwat are required to ensure that efficient companies are able to finance their functions, despite the fact that it is not a stated objective for the price review.

1.1.1. Provide a structure that places responsibility on all stakeholders to contribute to minimising the impact on bills to customers

We believe it is essential that the regulatory framework allocates risk to those best placed to manage it. Whilst the changes proposed for assessing capital expenditure seem to have made improvements in this area, there are a few instances where we believe that this is not the case:

- Indexation of the cost of debt. We believe that companies are best placed to manage interest rate risk. Companies have, in general, successfully managed their debt portfolios in raising new debt to fund capital improvements, and to refinance old debt. Seeking to shift this risk to customers would provide an incentive for companies to be more risk averse, and would result in an increase to the observed cost of debt, which is not in the interests of customers or other stakeholders.
- Revenue adjusted price cap. We believe that Ofwat should be incentivising companies to provide good customer service, to bill customers in an accurate and timely manner, and to seek out customers not currently being billed where it is profitable to do so. Ofwat’s proposals contain a number of unintended adverse consequences that seek to work against these principles. For example, under Ofwat’s proposals, it will no longer be cost beneficial to ensure the existing customer base is billed correctly, and there will be insufficient incentive to seek and bill properties that

were not previously being billed. There are alternative methods for dealing with Ofwat's concerns over income forecasts, whilst avoiding these potentially adverse consequences.

In both of these cases, we recommend that Ofwat's withdraw their proposal, and in the latter case we have proposed our own alternative which appears to better meet Ofwat's objectives.

1.1.2. Develop incentives for companies to deliver efficiency and give consumers value for money

UW is fully committed to an incentive based regulatory regime. Subject to Ofwat addressing the points set out in sections 3.1 (CBA) and 4.1 (menu regulation) of this response, we believe that the menu regulation approach and the use of cost benefit analysis will help deliver against this objective. However, there is still significant scope to enhance incentives for companies to improve delivery against customer priorities. Ofwat have historically been reluctant to provide revenue incentives for companies to deliver enhanced outputs, even though these have been successfully applied in the energy sector. There are two areas, in particular, where this could be used successfully:

- Water efficiency
- Greenhouse gas (GHG) emissions. Our customer research indicated that willingness to pay was an order of magnitude higher than the shadow price of carbon

Both of these are widely considered to be priority areas for the water industry to tackle. In the absence of specific revenue incentives, Ofwat's proposed methodology will incentivise companies in two ways, (i) by league table, and (ii) by using CBA to justify (as part of the price review process) additional capital investment.

Whilst league tables provide some active incentive, use of CBA will not enable companies to react to changes in the market (particularly changes resulting from the energy white paper in the case of GHG emissions), and will also provide companies with less incentive to consider opex solutions. Furthermore, there are no proposals in the consultation for companies to be incentivised to reduce any GHG other than carbon

Providing specific revenue incentives would enable companies to make a real choice between various capital and revenue options in order to deliver improved performance in these areas.

1.1.3. Implement a framework that will deliver long-term planning that balances local and global priorities

UW welcome the move to a more long term approach to planning and look forward to a PR09 outcome that enables us to provide a platform for the longer term priorities set out in our strategic direction statement (SDS).

1.1.4. Promote the development of a competitive market.

Ofwat expect that competition will drive and deliver incentives for innovation, and hence the next step change in performance and efficiency. We believe that there is much more that could be done to provide incentives for customer service for household customers, without waiting for competition. Whilst UW supports developments in this area, it is not realistic to presume that competition will be advanced enough to deliver such benefits in AMP5.

Ofwat also need to accept that competition will only provide incentives in contestable areas, and will not provide additional incentives for the areas of natural monopoly such as network performance. Given that some of the most high profile service issues (leakage, security of supply, sewer flooding, and flood alleviation) relate to these monopoly areas, it also cannot be presumed that competition alone will deliver desirable improvements in service performance.

There is much evidence (not least from the energy sector) that the introduction of competition can result in significant start up costs, and as such the water industry would need a properly codified competition notified item, to ensure that these costs are recovered. Considering the extent of these costs in the energy sector, we believe it is appropriate (and consistent with Ofwat’s approach to justifying investment) that the costs and benefits of competition should be subject to a rigorous CBA test.

2. Framework

We support the general price review framework and timetable, which largely mirrors that from PR04, and support the requirement to set out company business plans in the context of a longer term view.

2.1. Reducing the regulatory burden

There have long been calls to reduce the regulatory burden placed on companies, not least the Baker review which recommended "that Ofwat undertake investigative work to see whether similar price limits would have been produced in 2004 with reduced data requirements". UW consider that regulation should place an appropriate and proportionate burden on water companies. We do not agree with reducing information requirements as an objective in itself, as it must first be determined whether the existing requirements are excessive, reasonable, or possibly inadequate. We will as such be considering this in our response to the information requirements consultation in early February.

Information should support the key areas that enable Ofwat to deliver the price review in line with their duties, and should seek to reduce information requirements in areas that do not contribute to that. This assessment should also focus on areas of materiality, with less focus given to areas that (i) have no significant price impact and (ii) are value neutral in the long term (e.g. depreciation where any decrease imposed is offset by an increase in the RCV and hence an increase to prices in the longer term).

2.2. Presentation of bill impacts

Although we agree with your approach to presenting bill impacts set out in table 1 of your consultation, the detailed method for calculating these impacts in PR04 was fundamentally flawed, and needs to be rectified for PR09. In each of the assessments of the bill impact associated with "improvements in service", companies were required to only assess the impact on prices associated with increases in opex, return on capital, and depreciation. This approach excluded the impact on taxation (generally reducing tax, as the capital spend resulted in higher capital allowances), thus resulting in an overestimation of the bill impacts of service improvements, and a corresponding underestimation of the bill impacts resulting from changes in the taxation regime. It is essential that the bill impacts of the capital programme are correctly represented in this table, to ensure that stakeholders are properly informed.

2.3. Uncertainties

2.3.1. Notified Items

Ofwat propose that all of the current AMP4 notified items are removed as they are no longer necessary. We do not agree that this is the case for certain of them:

- Bad debts: The notified item for bad debts should not be removed as it is almost certain that the disconnection ban would become a major issue in the event of an economic downturn, with more households facing financial distress, and it is unreasonable for shareholders to be expected to bear the enhanced risk placed on water companies by the industry specific ban on disconnection.
- Meter optants: With the revenue adjusted price cap, we agree that this notified item would no longer be necessary. However, as set out in our comments in section 5, we oppose the revenue adjusted price cap. Therefore we consider that this notified item should remain. Further, we assume that any potential requirement to accelerate towards compulsory metering would be covered by RCC(1).
- EA charges: The full impact of this additional cost is unlikely to be reflected in the base year 2008/9. Therefore, increases to base costs will need to be taken into account in the price review if this notified item is to be removed
- Tax bulletin 53: We agree that this is no longer necessary
- Lane rentals: The full operating cost associated with lane rentals is unlikely to be reflected in the base year 2008/9, as many local authorities will not be applying these charges from 1 April 2008. Therefore, increases to base costs will need to be taken into account in the price review if this notified item is to be removed.

We will be providing more detailed proposals for notified items as part of our business plans, but in addition to the above, it is clear that some provision needs to be made for two significant AMP5 uncertainties

- Competition: The start up cost of any system changes that will be required to facilitate competition.
- Private sewers: Given the size of the potential costs that companies face as a result of adopting private sewers, it seems clear that Ofwat would need to include a best central estimate when assessing price limits. However, given the uncertainty surrounding the scale of this issue, a symmetric notified item will also be needed.

2.3.2. Logging up and down and shortfalling

Whilst the shortfalling rules are continuing to apply, it appears that Ofwat are considering abandoning logging up and down in the event of adopting menu regulation. Whilst we

understand the suggested reason for this (that the abolition of the RCV cap under menu regulation partially compensates companies for expenditure over and above regulatory assumptions) we still consider that logging up and down is necessary to differentiate between efficiency and material changes in circumstances.

In order for company performance to be properly recognised, it is important that when company actual spend is compared with the baseline and the company's menu choice for capex, that the baseline is comparable with the actual spend incurred. However, accepting that the loss of the RCV cap desensitises this issue, we would be willing to consider an increase in the triviality threshold which would achieve the objecting of reducing the information burden.

We are disappointed that Ofwat has not consulted on the material changes it is introducing to serviceability shortfalling part way through the 2005 to 2010 period. Introduction of such retrospective regulatory methodologies is not consistent with the principles of better regulation.

Serviceability Outputs

UW agrees in principle that there is a need for a mechanism to address the delivery of serviceability outputs. However, it needs to be agreed and applied ahead of a price review period to allow companies' to manage their programmes within known constraints.

We consider there are three key points:

- Ofwat's PR09/06 letter sets out a methodology of how adjustments will be applied part way through a price control period. Therefore companies were expected to make judgements about accepting price determinations in 2004 without full knowledge of the penalty mechanism that would apply in this area
- There needs to be a more detailed and fundamental review of the approach to assessing maintenance allowances for the sewerage service before implementing the approach set out in PR09/06. Despite action plans and company efforts to improve serviceability the trends across the industry in sewerage service have not shown a material upturn in serviceability assessments since the 2004 Final Determinations, as shown in the chart below.

Ofwat Final WaSC Serviceability Assessment				
Company	2004/05		2006/07	
	Sewerage Infrastructure	Sewerage Non-Infrastructure	Sewerage Infrastructure	Sewerage Non-Infrastructure
Anglian	Deteriorating	Marginal	Marginal	Deteriorating
Dwr Cymru	Stable	Stable	Marginal	Stable
Northumbrian	Marginal	Deteriorating	Stable	Marginal
Severn Trent	Stable	Stable	Marginal	Stable
South West	Marginal	Stable	Stable	Stable
Southern	Stable	Deteriorating	Marginal	Deteriorating
Thames	Deteriorating	Deteriorating	Marginal	Deteriorating
United Utilities	Stable	Stable	Stable	Stable
Wessex	Stable	Stable	Marginal	Stable
Yorkshire	Stable	Deteriorating	Stable	Deteriorating

It may have been tenable to argue that investment assumptions were sufficient at PR04 had there been an overall improving trend. However, as can be seen above, the most optimistic analysis shows only five improvements, which are offset by an equal number of declining trends, and three assessments remain in the deteriorating assessment category.

With the exception of UW, Northumbrian and South West Water the other company's efforts are not bearing fruit in terms of any improvement in their assessments. It appears implausible that the efforts of management in all these companies should not be achieving stable serviceability and therefore we conclude that there is something fundamentally wrong with the current approach.

- PR09/06 also contains a lack of clarity of how the methodology will be applied in practice. It would appear that there is some form of sliding scale adjustment that could be applied using judgement exercised by Ofwat. However, there is no detail set out in the letter for companies to make a reasoned assessment of the quantum of an adjustment in circumstances where one could be applied. This impacts a company's ability to prepare its business plans with any degree of consistency.

The industry has already expressed considerable concerns about the subjective nature of serviceability assessments during the AMP4 period, and this only exacerbates this situation.

We conclude therefore that there is a need for further consultation on the application of serviceability adjustments.

3. Justifying investment programmes

3.1. Customer preferences and cost benefit analysis

In order to assess customer willingness to pay for changes in service levels in the UW region, we have performed an extensive stated preference survey, the results of which informed our SDS as per Ofwat's expectation of stage 1 as set out in the consultation. However, there is no mention of the company's own research in stage 2 – CCWater deliberative research to inform company business plans, and stage 3 – Ofwat willingness to pay research to inform the determinations.

As such this leaves unclear the status of the company's own research, which provides specific information regarding the consumers in the company's own area. We fully intend to utilise our willingness to pay results in our draft and final business plans, and we expect that Ofwat will take them into account when setting the company's specific investment requirements in the determination, alongside their own research.

Ofwat are expecting companies to have a CBA methodology that they will follow. However, we also need Ofwat to be clear and consistent in their description of how each company's CBA will be assessed, while not being too prescriptive regarding how CBA is carried out. When developing the case for our investment plans, it is essential that we understand the way that case will be assessed.

Furthermore, there have been confusing messages about what CBA should and should not be applied to. Our understanding is that:

- Maintenance – companies should use CBA only where there is a proposed change in service level
- Statutory Quality – companies should present the costs and benefits, but it is not a requirement that all schemes are fully CBA justified

We expect the final methodology paper to be clearer in this issue.

Regarding benefit valuation on quality schemes, we are reliant on quality regulators providing this information, which has proved difficult in the absence of a "Memorandum of Understanding" between the industry, Ofwat and the quality regulators over what information is required and when.

We are also concerned about Ofwat's apparent rigidity regarding the application of CBA. We would not want to see willingness to pay used alone as "proof" against the need (for example) to resolve sewer flooding issues faced by our customers.

3.2. Sustainability

We are fully supportive of Ofwat's sustainability duty, and have made specific and challenging commitments to significantly reduce our carbon footprint as part of our SDS. However, we would like to see the company's impact on the atmospheric environment being given equal weighting with its impact on the aquatic environment. This needs to be addressed as soon as possible, as we will be burdened with the carbon impact of further tightening of quality standards for decades to come.

The consultation states that we are to use the new UKCIP scenarios. However, we do not think that we will be able to consider these as they may come out as late as early 2009. We propose that we will seek to anticipate them, and state our assumptions relative to 2002 UKCIP scenarios. If there is sufficient clarity in time for us to assess the impact of them following the Final Business Plan, we will present these as part of the company's response to the draft determinations, and thus make our final menu choice relative to any variation in the baseline cost caused by the new scenarios.

We fully support using the shadow price of carbon in CBA to support investment plans. However, it is likely that simply adding the shadow price of carbon into CBA is not enough, as (particularly in relation to quality investment) there is frequently little choice over the process solution that is required, as this is often driven by the required quality standard, i.e. in many cases, there may not be an alternative sustainable process. As part of our willingness to pay survey, our customers placed a value on carbon reduction that was significantly greater than the shadow price of carbon. We suggest that in addition to allowance within CBA, companies are also expected to deliver specific "sustainable" outputs, as supported by customer preference, as well as delivering "standard" outputs more sustainably.

In relation to investment in renewable energy generation, we understand that Ofwat would (subject to CBA) support investment in combined heat and power (CHP) and hydro-electric power generation, where such assets would be intrinsically linked to the company's other operational assets. Further, Ofwat would expect external market mechanisms to fund non regulated investment in separate power generation assets (e.g. wind turbines) that are used for external energy export. However, we seek clarification on whether Ofwat would be minded to support, as part of the appointed business, investment in an asset such as a wind turbine whose sole use was to help power a regulated asset such as a treatment works.

It is further stated in the consultation that innovation in renewables is non-regulated. However, we would consider that innovation to improve existing regulated technologies (such as improved CHP, or more energy efficient assets etc.) should be treated as an appointed business activity and included in the Final Determination assumptions.

It is not clear how we should account for schemes that are justified on a carbon beneficial basis. For example, if it was justified using CBA including the shadow price of carbon to replace early an existing, carbon inefficient (but otherwise functional) facility with a more carbon efficient one, should all of this cost be treated as maintenance, or should some of it

be treated as enhanced service? We seek clarification on whether Ofwat view carbon mitigation as a maintenance activity, or as a service level that can be enhanced.

3.3. Maintenance

We believe that there is a risk that Ofwat's approach to capital maintenance may understate required expenditure to maintain stable serviceability in AMP5. The serviceability benefit from enhancement expenditure is not fully represented by the standard allocation of enhancement expenditure. This can be observed by rising expenditure in infra and non-infra maintenance over AMP3 and AMP4 in order to maintain serviceability. Therefore taking a historic average as the start point will lead to an under-assessment in base level of maintenance need, even before assessing the impact of why the future is different.

UUW took a leading role in the development of both the Common Framework and the Asset Management Planning Assessment Process (AMPAP). As a result, we have actively incorporated the underlying methodologies in our approach to asset management planning across the business. The AMPAP process is already being used in our business improvement programme and in the development of tools, systems and processes.

We endorse the use of key parts of the AMPAP assessment to support the Price Review, rather than the development of alternative tests and approaches. In particular, we support the application of AMPAP as a self assessment which the Reporter would review and audit. We believe this approach is simple and reduces the burden on Ofwat / Reporter. It also provides transparency and comparability across the industry.

We support the use of five high level areas to review as proposed in the Ofwat Company Guidance information requirements for Chapter B3. These are: Management, Processes, Systems, Data and Analysis. We believe the AMPAP component level 'test' descriptions (developed by UKWIR) would be suitable for each of the five areas, without any further modification.

In this context we believe a heavier weighting should be applied to the 'Analysis' components (equally across all 10 components), as this is central to Common Framework and provides the most transparent assessment as to whether asset management planning has been carried out in a robust and satisfactory manner. We recommend that this area is given double the weighting relative to the other areas.

United Utilities further believes that the assessment should be broadened beyond these five high level areas, with two additional components being included in the overall assessment process:

- Policy component: We believe AMPAP component 2.2 should be included in the assessment ("Company policy for asset management planning reflects company objectives and stakeholder requirements and is clear, unambiguous, accessible and

dynamic"). United Utilities views the setting of top level business policies which are then 'optimised' or compared against each other in terms of a number of criteria as critical to setting the direction for the planned capital maintenance and the overall capital expenditure programmes.

- Stakeholder Engagement: We believe AMPAP component 1.1 should be included in the assessment ("Stakeholders views have been actively sought and taken into account in the planning process"). United Utilities strongly supports the emphasis Ofwat place on ensuring that the views of customers and other stakeholders are incorporated into the business plans submitted.

3.4. Security of supply

The consultation outlines the need for cost benefit assessment in this area. This ought to refer to the specific detailed cost benefit assessment methods developed for water supply demand, in particular UKWIR's national best practice report "Economics of Balancing Supply and Demand" (2002) which is supported by the EA's Water Resources Planning Guideline (2007).

Although this part of the investment programme is to be CBA justified, we are concerned that many parts of it may be driven more by policy and not economics (e.g. water efficiency targets, lower leakage based on frontier performance, free meter optants). In particular, we expect to propose an enhanced water efficiency programme that may not economically justified in its entirety in order to meet EA/DEFRA/Ofwat expectations. However, in accordance with Ofwat's acceptance that companies should not use CBA to challenge statutory requirements, we will of course seek to ensure that costs are minimised and benefits maximised subject to the constraints that may be placed on us in this area.

Section 3.6.5 of the consultation requires water companies to comply with Ofwat's good practice register for promoting water efficiency within existing operating expenditure. It goes on to refer to Ofwat's water efficiency output targets. The document does not recognise that the level of activity required to achieve these targets is likely to be far in excess of the current good practice register, and further that such activity is unlikely to be cost effective. Water companies are therefore almost certain to incur increased costs which we would expect to be considered as part of the price review.

3.5. Resilience and flood risk

We welcome Ofwat's recognition of the importance to customers of both the direct risk of flooding and the indirect impact of loss of service which can arise through a civil emergency (such as flooding) or a security event. The recent Interim Pitt Report highlighted the serious concerns of many of the people affected by the summer floods in 2007 regarding the reduced availability of drinking water and/or the potential risks to health of contaminated water.

The Defra Statement of Obligations has helped to clarify the responsibilities of water and sewerage undertakers in this area. However, we are concerned that the absence of common planning standards and approaches may lead to wide variations in the standards proposed and lack of coherence across various bodies. Furthermore, the data upon which to base robust risk assessments (and CBA) are limited, especially when considering fluvial flooding and the potential impacts of climate change.

3.6. Quality

Ofwat claim to be “providing a structure that places responsibility on all stakeholders to contribute to minimising the impact on bills to customers”. Whilst we might agree that this is a worthwhile aim, Ofwat must accept that they cannot require this of the industry’s quality regulators. It would perhaps be more achievable to provide a structure that more clearly exposes the benefits associated with the investment programme, and places responsibility on companies to ensure that it is delivered in a way that minimises the impact on bills to customers.

Ofwat also state that companies should submit plans that contain CBA justified statutory schemes that are low carbon. Our interpretation of what is required is that, in justifying our quality programmes, we are to ensure that they are as cost beneficial as possible, where the shadow price of carbon is to be used in the analysis of costs. It must be accepted that there may be instances where quality schemes will not be cost beneficial, and will result in increased energy consumption, if this is the only way to meet the required statutory quality output.

3.6.1. Water quality

We support the recognition of raw water deterioration and the Water Framework Directive (WFD) as key quality drivers for the water service. However, we are concerned that Ofwat have not also recognised turbidity and taste & odour as key drivers for AMP5.

Furthermore, section 3.8.3 of the consultation appears to imply that our Large Diameter Trunk Main cleaning programme would be classified as maintenance, not quality. This would constitute a serious change, and be inconsistent with the treatment in AMP4.

We welcome recognition by Ofwat of catchment management solutions to water quality issues (as exemplified by our SCAMP programme). However, Ofwat expect that:

- the company owns the land;
- the land contributes to the achievement of the aims of the regulated business;
- the investment relates to changes in land management practice to meet a defined legal requirement;
- the proposal is both cost effective compared with other options and is cost beneficial.

We consider that the first and third of these are too restrictive, as we should be carrying out programmes which are cost beneficial regardless of these points. Ofwat also appear concerned about water customers paying a cross subsidy to address third party pollution issues. However, if such pollution issues are already being dealt with at the water treatment works, customers will already be paying.

Ofwat should make it clear that, in accordance with the instruction from Defra, water companies are required to exclude WFD impacts on water abstraction (e.g. changes required to abstraction licences or assets), except where changes are required to comply with the EU Habitats Directive.

In relation to SEMD, water companies will need very clear guidance from the government security adviser to ensure we are able to produce robust CBA for such schemes, particularly given the high consequence/low risk nature of the benefits being provided.

3.6.2. Wastewater quality

Regarding odour, the consultation is limited to odour from treatment processes. However, we urge Ofwat to also consider odour from sludge processes and pumping stations

On WFD, Ofwat state that companies should "identify a realistic timetable to achieve WFD objectives over three river basin plan periods to 2027 at the overall least cost". These words seem to imply that companies can defer WFD outputs past 2015, which is at present not the case.

3.7. Service enhancements

We agree with Ofwat's approach to service enhancements, but must reiterate the point that company's own willingness to pay survey results should be used to influence the required service enhancements in the company's region.

4. Approach to assessing costs

4.1. Menu regulation

We provided a comprehensive response to Ofwat's proposals in our initial views on menu regulation in November 2007. Rather than repeating that at length we would summarise our views on this as follows:

- We are supportive of this approach, in particular the abolition of the RCV cap, and we agree that it places appropriate incentives on companies when producing their business plans.
- We do not believe that menu regulation will result in a short term reduction to the WACC
- We need more clarification regarding the assessment of the baseline
- We believe that the base level of incentive for accurate business planning should be greater than zero (e.g. 2.5% as Ofgem applied for Gas distribution).
- We are concerned that if the baseline was assessed as a result of a series of regulatory adjustments arising from company business plans, then it would be virtually impossible for a company to make a menu choice significantly below the baseline
- We suggested an alternative presentation of the incentive formula that makes the scheme far more transparent.
- We believe that logging up and down should be retained and used as an adjustment to the baseline.

Following on from this, and from the very useful workshop that was held by Ofwat on 5 December, our views have developed in a few areas.

- Our main concern is whether or not companies would have a real choice other than the baseline if:
 - A choice above the baseline resulted in returns below the cost of capital, which would be unacceptable to company owners, regardless of the likely reduction in operational risk
 - A choice below the baseline would be unlikely if the baseline was set following a series of cuts from company business plans.
- The solution to this appears to be twofold
 - Assessing cost base challenge adjustments based on the "average" cost base rather than the frontier, would result (other things remaining equal) in the baseline allowance for a cost base frontier company being higher than that in its business plan, thus enabling companies to make a menu choice below the baseline.
 - Adding in a reward for accurate business planning (as per Ofgem's 2.5% for Gas distribution). This effectively enables a company to make a menu choice higher than the baseline and still earn the cost of capital on its investment.
- Ofwat need to be cautious of the cashflow and financeability implications of a high menu choice, e.g. a company choosing 130% of the baseline will only receive 107.5%

up front in prices, leaving the remaining 22.5% effectively inadequately financed in prices in the period (albeit that it would be added to the RCV etc. at the next periodic review). This scale of overspend within period is such that it would be sufficient to trigger a substantial effects IDoK (although it would presumably not be eligible).

4.2. Operating costs

The consultation indicates (largely) a continuation of the PR04 approach to setting operating costs, but with early signals (e.g. on pensions) that allowances for base cost increases will be minimal, and that ongoing outperformance relative to the economy is expected. We do not believe it is reasonable for Ofwat to ignore the potential for base cost increases, as they effectively result (when incurred) in a hidden efficiency that companies are expected to achieve in order to absorb the cost increases. Ofwat must also recognise that efficiency has an associated cost (capex and/or opex) and should be assumed in price limits to make clear the true efficiency expectation placed on companies.

On comparative efficiency, we fully support Ofwat's investigation into alternative efficiency modelling techniques (e.g. time series analysis as per the recent UKWIR project). Further, we hope that Ofwat will take more account of alternative efficiency models suggested by companies, particularly where they result in significant differences from Ofwat's own models.

We continue to support the use of special factors to adjust company costs prior to modelling. We understand that Ofwat are also considering a triviality threshold for special factors. We suggest that, for consistency, Ofwat should use a value equivalent to their normal triviality threshold (for IDoK), which is the NPV of 15 years of opex being greater than 1% of service turnover. This equates to circa 0.3% of service opex, or just over £500k for UUW.

4.2.1. Pensions

The consultation includes the following statement on pensions:

‘We intended our approach [in 2004], which dealt with pension fund deficits and future contributions, to remove the need for us to take pensions related action at future price reviews. We are satisfied that this remains the case.’

Our initial reading is that this implies a continuation of the methodology from 2004. However, this leads to a series of more detailed questions, such as:

- How will the 2004 methodology take account of the subsequent (and fundamental) change to the pension regulations governing the funding of pension schemes, namely the scheme specific funding regulations which are subject to Pensions Regulator oversight?
- How long a period will deficits be corrected over, for example the 2004 final determination assumed deficits would be corrected over 13 years, so does the

statement in the consultation paper mean that we have a further 8 years to go of deficit correction assumptions?

- What deficit position will be used, for example will the 2010-15 assumptions be based on 2004 deficit levels, or will they be updated, for example to take account of updated market conditions?
- How will the recovery of investment markets (which had a bearing on the deficit recovery assumptions in 2004) be factored in to 2010-15 assumptions?

In addition, we know that companies are looking at their pension risks in a very different way compared with 2004. Key drivers here are the changes to the pensions accounting regulations and changes to the “Debt on Employer” regulations. Specifically, companies are increasing their focus on the balance sheet risk posed by their pension schemes, and some have even gone as far as de-risking their schemes by investing lower risk assets (mainly bonds). We believe that Ofwat’s 2010-2015 price review methodology could have a major bearing as to whether companies in the Water sector will look at the pensions de-risking options, which (if implemented) could lead to higher headline pension costs.

Given all of the above, we recommend that there is a further discussion and debate on the 2010-15 Price Review methodology for pensions. We suggest this debate takes place directly with the Water Pensions Network affiliated to Water UK and we recommend that Ofwat takes expert pensions advice as part of this debate. We believe the target objective for the debate should be setting an overall framework for pension cost allowances which does not cut across company specific issues (e.g. a surplus/deficit issue which is specific to a single company) but is robust in the medium to long-term and sufficiently detailed to deal with the issues highlighted above. We recognise this is a difficult challenge but we are firmly of the view that now is the right time to have the debate.

4.3. Overlap programme

We support the concept of the overlap programme. However, there are two aspects of it which we are concerned about:

- It leaves a gap regarding “late finish” of AMP4 or “early start” of AMP5, which needs further consideration.
- The provision for only one additional year in the following period may be too prescriptive. It should be flexible, depending on the scale and timing of the identified projects, with the expectation that the majority would fall within the first year.

5. Financing

5.1. Capital charges

We believe that Ofwat should use company specific splits for investment by asset life, and also use of company specific asset lives. This will best represent the company’s specific mix of outputs and its choice of solution. If this is inefficient, that will be revealed by the cost base assessment and the opex efficiency analysis. Overwriting asset lives with industry generic assumptions potentially double counts these other efficiency tests.

For the “overall check on depreciation”, the consultation proposes to rebase the start of the broad equivalence assessment 5 years later than PR04 (starting at 1997/8). However, this still places too much emphasis on past investment and depreciation and not enough on whether the current and future level is justified. We firmly believe that the information required for this test is overly burdensome to provide (and even then likely to be relatively unreliable) and unnecessary given that a suitable alternative exists. The comparison of the depreciation charge with the company’s asset inventory is a far better (and simpler) indicator of this. Given that the depreciation allowance in the price setting process is value neutral economically (as there is an NPV neutral trade off between depreciation assumptions in price limits and the RCV), we believe it is an area where Ofwat can legitimately take a reasonable view of materiality and simplify the methodology to ease the regulatory burden on companies.

On the Infrastructure Renewals Charge (IRC), we fully support the move to allow a forward looking average when setting the IRC, as this is the basis we have been using in our regulatory accounts to assess our IRC for AMP4. It would appear that Menu regulation means that it will no longer be necessary to windout any historic infrastructure renewals accrual or prepayment in future periodic reviews.

5.2. Taxation

The consultation does not set out how tax forecasts will be calculated, however we must urge caution against the use of historic tax computation data that Ofwat have been collecting in recent June Returns. Some adjustments to the June Return figures would be absolutely necessary, e.g. stripping out group relief and related adjustments to tax pool values, to arrive at a company only basis. If the June return information is used without adjustment, allowances in prices for tax will be understated.

Ofwat state that Company specific gearing should only be used where this is above the gearing assumption contained in the cost of capital. This effectively amounts to a pronouncement by Ofwat that a company’s capital structure is financially inefficient, if geared below Ofwat’s assumption. Ofwat have stated previously that it is not within the remit of the regulator to dictate capital structure to company management, and have only ever intervened

to strengthen ring fencing provisions to ensure that the regulated business is adequately protected. For Ofwat to seek to determine a company’s capital structure is surely not appropriate. Furthermore, it runs contrary to encouraging equity and hence diversity of ownership in the sector.

5.3. Cost of capital

5.3.1. Cost of equity

We do not think that Ofwat should assume that beta is less than unity. Whilst observations on the CAPM components can be useful in building up the base of evidence, it was generally accepted at the recent cost of capital conference at Exeter University that market observations using CAPM tend to underestimate the cost of capital, and that regulators should use a form of “CAPM with caution”. We further note that we expect the “Asset Beta” of water companies to be lower than the FTSE in general, but that water company gearing is significantly higher than the FTSE average. Hence, the equity beta used in CAPM will not necessarily be lower than unity.

It is claimed in the consultation that asymmetric risk will not be explicitly allowed for, but will be mitigated by Ofwat’s other methodologies, and be taken into account implicitly in their overall judgement of the cost of capital. We believe that companies face significant asymmetric risks, not least the uncertainty caused by the quinquennial price review process, where political and regulatory decisions have a material impact on share prices in ways that are uncorrelated with the market. We therefore believe that evaluation and quantification of these should be a fundamental part of Ofwat’s impact assessment as set out in section 1.4 of the consultation.

We urge caution against Ofwat placing too much weight on recent history. In particular regarding the RCV premia being paid for regulated utilities, which has been driven by excess demand for index linked income streams. The impact of acquisitions by infrastructure funds should be treated with caution. It is not reasonable to assume that the observed RCV premia imply something about the “real” cost of capital. The recent excess of demand over supply has contributed to driving the price upwards of many classes of infrastructure asset

5.3.2. Cost of debt

It is imperative that the cost of debt is sufficient to allow companies to service their existing debt, to raise new debt to finance new investment and to refinance expired debt.

We do not think that Ofwat’s proposals regarding indexation of the cost of debt are appropriate or necessary. In order for this assessment to be meaningful, Ofwat would need to use a sufficiently long period average that properly reflects the long term nature of water

company investments. Ofwat have always taken account of historic evidence when setting the cost of debt at the price review.

It also seems clear to us that companies are best placed to manage interest rate risk. Companies have, in general, successfully managed their debt portfolios in raising new debt to fund capital improvements, and to refinance old debt. Seeking to shift this risk to customers would provide an incentive on companies to be more risk averse (as they would no longer be in full control of managing that risk), and hence result in an increase to the observed cost of debt, which does not appear to be in the interests of customers or other stakeholders. It would also create an additional regulatory burden.

5.3.3. Gearing

We continue to hold the view expressed in our response to the Financing Networks consultation that the only way to address Government concerns about high gearing is to positively incentivise conventional levels of gearing or (equivalently) to negatively incentivise high levels of gearing. This would require that the lower overall rates of return be provided to higher geared companies. This idea was first proposed in Colin Mayer’s 2004 paper “Commitment and Control in Regulation”.

It would be sensible to use an average of the actual level of gearing over (say) the previous five years, to avoid a perverse incentive for a company to temporarily reduce gearing.

5.4. Financeability

Whilst Ofwat have moved to temper expectations on the outcome of PR09 financeability tests relative to PR04, it is still the case that the final determinations need to ensure that companies can efficiently finance their functions, and therefore need a stable “A3” credit rating.

We are therefore concerned about what is meant by Ofwat seeking to adopt a “more flexible approach to financial ratios”. We agree that the PR04 ratios and thresholds should be reviewed and updated if necessary, but the PR04 framework was generally sound. We also note that Moody’s recommended ratios for A3 are comparable to Ofwat’s AMP4 financeability test. We are most concerned that “flexible” means “ignore”. Ofwat must accept that the market will not be flexible in this respect.

If Ofwat assume that a proportion of a company’s debt is index linked, this must not be done on a company specific or a “frontier” basis. At most (if any), the assumption should be based on the industry average level of index linked debt (ILD), together with the assumption that no more ILD will be issued. The existing ILD “market” is struggling with the Monolines in difficulty, Ambac (one of the biggest monolines) being downgraded recently two notches by

Fitch. It is unlikely that we will see much more new ILD being taken by utility companies as it is likely to be significantly more expensive.

It may be reasonable for Ofwat to comment that an equity injection is an option for a company. However, it would seem overly intrusive for them to assume this in a company's price determination. Whilst cost associated with equity issuance should be added to the costs recovered in prices, Ofwat cannot ignore the current trend towards gearing up in the industry. It should not be presumed that equity issuance is a plausible option for companies, as there may not be the demand in the market for it. It was suggested at Ofwat's methodology seminar that this could effectively be achieved by dividend reprofiling. If Ofwat assess that a company could not pay out the cost of equity and remain financeable, it implies strongly to us that the allowed cost of capital is wrong, not that companies should restrict their dividend payments. This may be a reasonable assumption to make for a growth stock (effectively to reinvest dividends in the business), however water companies are fundamentally income stocks, and as such dividend retention cannot be considered as a reasonable regulatory tool when setting prices.

Ofwat have given a clear signal that revenue uplifts for financeability reasons are unlikely for AMP5. We think that this has been dismissed too easily, particularly given the exit point for the period for many companies, with significant financeability adjustments in the final year of AMP4. This is likely to create price instability and undermine confidence that the regulator will behave consistently between reviews, thus increasing the perceived risk in the sector.

5.5. Notified index

Ofwat propose a change in the notified index (for capex inflation) from the Construction Output Prices Index (COPI) to one element of COPI, the "infrastructure index". This would not appear to be a necessary change, given the understanding of COPI within companies and their contractors. The infrastructure index has historically been more volatile than COPI and will create more uncertainty in contract costs (if used), or may discourage the use of it at all in the company's contracting arrangements.

Despite the fact that the infrastructure index is more water industry specific (with water industry costs having a higher weighting than for COPI), the remainder of the index is constituted by largely maintenance focussed sectors such as rail and energy, and will not reflect the significant (largely "new build" rather than replacement) enhancement investment made by the water sector, which may be better represented by COPI. It must be noted that one of the reasons for choosing COPI in the first place was that it was exogenous.

5.6. Revenue adjusted price cap

Ofwat propose that the difference between a company's actual revenues and the revenues assumed at the Final Determination be passed back to customers on an NPV neutral basis, with companies only receiving compensation for the average cost of billing additional customers.

It appears to us that this proposal is a reaction by Ofwat to some companies appearing to benefit from under-forecast revenues, and that the asserted impact on company incentives not to promote efficient water use is more of a secondary issue. As set out in 1.1.2, we believe that a "revenue incentive" would be a far more effective method for delivering improvements in water efficiency than the revenue adjusted price cap.

We are also concerned at the clear dilution this proposal causes to the incentive framework. We believe that companies should be incentivised to invest in active management of their customer base in order to ensure that all customers are billed, and that this is done accurately and on a timely basis.

The proposed adjustment for property numbers is far too simplistic and will be inadequate in value. In reality this will set a cap on how much companies should be willing to spend to find and bill additional properties, as all additional income will be passed to customers on an NPV neutral basis. Currently, companies are incentivised to find and bill companies where it is truly profitable to do so, as would be the case in a competitive market.

Furthermore, there would also be an explicit disincentive to spend any money on ensuring existing billed customers are billed appropriately, as all potential income gains would be clawed back (on an NPV neutral basis) with no additional allowance for the cost. This disincentive would also extend to meter replacement.

Overall, we strongly believe that this proposal runs counter to the interests of customers and that the adverse impact on incentives significantly outweighs any perceived benefit. Ofwat should reconsider their approach in this area. We agree that it is appropriate for Ofwat to seek to set a framework that reduces the risk of customers being disadvantaged, but it also needs to provide meaningful and valuable incentives on billing, customer service and water efficiency.

We cannot support the current proposal and suggest as an alternative that Ofwat consider using a form of their menu regulation approach in setting base income forecasts. We believe that this would be a far better method for incentivising accurate forecasts at the same time as retaining the incentives on companies to ensure that all customers (existing billed customers, and those not currently billed) are billed accurately and on a timely basis. We would be more than happy to discuss this proposal further with Ofwat to develop this as the best way forward.

6. Incentives

6.1. Overall Performance Assessment (OPA)

We understand that Ofwat are currently undergoing a review of the OPA that will be assessed over the AMP5 period. We believe that the OPA should contain the following features:

- The OPA needs to be “full” in terms of its coverage across service performance measures, otherwise it will not be “overall”. We are not concerned that the measures in the OPA may also be incentivised elsewhere.
- OPA weightings should depend on a combination of (i) importance to customers and (ii) opportunity to improve.
- We do not think it is valid to exclude measures from the OPA where there is historically similar performance across the industry, or seek to tighten the assessment range to “create” a measurable performance differential. We believe that if a service measure matters to customers, and the industry generally performs well on it, then this should not be used as a reason to exclude it from the OPA.
- Similarly, Ofwat should not make arbitrary changes to the range of K impacts for the OPA in order to create variations between companies where this may not be supported by differences in actual performance levels.
- New measures for consideration should include:
 - Billing accuracy
 - Repeated complaints
 - Customer perception (in addition to customer experience)
 - Sustainability (e.g. CRC performance, % methane converted to CHP)
 - Promotion of water efficiency
- Given the potential cost of compliance for any new measures introduced, all changes to the OPA need to pass through Ofwat’s impact assessment

We need clarity and certainty over the details of the OPA assessment for AMP5 and price impact at PR14. Further to this, we would not support any changes to the scale of the OPA rewards and penalties for AMP4 as this would be retrospective.

6.2. Rolling mechanisms

We support Ofwat’s suggestion that as a result of menu regulation, the capex roller should be discontinued after PR09.

We also support continuance of the opex rolling adjustment, but we are concerned that the determination cost assumptions are not comparable with the actual costs incurred by companies, thus diluting the value of the opex roller. At PR04, Ofwat assumed that part of the likely increase to energy costs would be recovered through higher RPI inflation. Whilst we agree that this was (in principle) likely to be true, this assumption places an inherent

disadvantage on companies when assessing their opex performance as part of the rolling opex adjustment, as such costs will be included in a company's actual opex, but not in the company's final determination opex assumption. The same is true for operating costs that are assumed to be captured by notified items and relevant changes in circumstance in the event of an interim determination.

We would like to see a commitment from Ofwat that any costs assumed to be reflected in higher RPI, or that formed part of a notified item, will be added to the determination opex at the following price review for the purpose of the rolling opex test, such that company outperformance is properly rewarded. Furthermore, we expect that the impact on RPI of higher energy costs in AMP will also added to AMP4 determination opex for the PR09 rolling opex assessment.

Regarding the “multipliers” applied to companies at or near the frontier, we are concerned that this places further undue reliance on the opex efficiency models. At best this may reward companies with beneficial circumstances, rather than rewarding true efficiency, and at worst, may actually only be available to those companies. Although we generally approve of increasing the value of incentives on companies, we do not believe that the incentive multipliers can be justified, and consider that it is sufficient benefit to the companies that perform best on the efficiency models that they receive the lowest efficiency targets.

6.3. Other “revenue” incentives

As discussed earlier in section 1.1.2 we believe that Ofwat could introduce simple revenue incentives for:

- Water efficiency
- Greenhouse gas (GHG) emissions

Providing specific revenue incentives would enable companies to make a real choice between various capital and revenue options in order to deliver improve performance in these areas.