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FROM THE CHIEF EXECUTIVE - CHRISTOPHER LOUGHLIN

Ms Regina Finn
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Chief Executive's Office	
Date Received 25 January 2008	
Action	SAM OKYERE - For short acknowledged me
Copies to	Regina Finn Fiona Pethick Andrew Dunn Mark Hann

24 January 2008

Dear Regina,

FRAMEWORK AND APPROACH TO PRICE SETTING

We have this week provided your PR09 Planning Team with a detailed response to the October 07 consultation paper on the framework and approach to price setting. The purpose of this letter is to bring to your attention those key aspects of the forthcoming review that we believe will be critical to its success.

South West Water is committed to developing a plan which balances the affordability issues faced by some of our customers with the need to maintain investor confidence to ensure that future investment can be efficiently financed.

Affordability

We want water bills to be as stable as possible from 2010, and will present a business plan that avoids the kind of saw-tooth profile that makes annual budgeting for low income customers more difficult. Indeed, some of our customer research indicates a clear dissatisfaction with price cuts followed by price increases. We would also ask for Ofwat recognition of programmes that target specific help for vulnerable customers; this may be through a nationally recognised WaterCare programme as recently trialled by SWW, wider access to vulnerable group tariffs, as well as the promotion of innovative tariffs.

Investor confidence

Debt and Equity investor confidence in the sector is at a high level, and reflects investor appreciation of an effective, transparent and stable regulatory regime. An overriding concern must be to maintain this so that new funding can be raised at competitive rates, to the benefit of customers' bills. The PR09 methodology should make the process for determining price limits as transparent, consistent and equitable as possible, thus minimising regulatory risk.



INVESTOR IN PEOPLE

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Revenue adjusted price cap

We support the long term protection provided to customers and investors alike from this new mechanism; however, the price setting process must adequately recognise the growing downside risk of year-on-year income volatility for companies such as ourselves with a predominantly metered customer base.

Menu regulation

We recognise the rationale for considering Menu Regulation as a possible development to the existing regulatory system. However, in our view the existing system for capital expenditure regulation has proved effective in providing appropriate challenges and incentives for investment optimisation and outperformance.

Much of the detail surrounding Menu Regulation has still to be worked through, and in our view could introduce a new set of 'gaming' incentives with potentially perverse outcomes. We do not believe there is sufficient time to refine this complex mechanism for the PR09 price review, particularly given the need for emergent investment drivers linked to climate change and asset robustness to be properly reflected in companies' specific and detailed capital investment plans. Premature introduction of a new key regulatory methodology could significantly increase sector risks and damage investor confidence.

Cost benefit analysis

We recognise the key role of cost benefit analysis in considering whether discretionary investments are in the best interest of our customers.

However, we are concerned about the practicality and resource implications of having to apply this process to every part of the capital plan, including schemes and work programmes driven by legislation, such as statutory and Defra required obligations, and believe extending cost benefit analysis to these areas would create additional and abortive workloads for both Ofwat and companies.

In the same manner, where climate change and carbon concerns are drivers, cost benefit analysis may risk marginalising necessary investment for the longer term. Application of cost benefit principles across our capital investment programme should be firmly grounded in and consistent within the key elements of the anticipated Defra Water Strategy.

Measurement of serviceability

In assessing future investment to meet serviceability measures, we shall be aligning our projections with the key performance measures that the Environment Agency and Drinking Water Inspectorate use to monitor the impact of asset performance on customers and the environment. We believe that the methodology document should address this matter as part of the overall approach to serviceability.

Efficient investment – recognition in Regulatory Capital Value

We want to work with farmers and landowners such as the National Trust, to promote and fund 'upstream' catchment management improvements, that would negate the need for expensive process solutions at our water treatment works and deliver multiple benefits in providing lowest-cost service delivery to our customers. We believe investment in this type of improvement should be recognised as a capital addition to Regulatory Capital Value, and that the methodology should be revised to allow for this.

We would also seek a similar approach to the promotion of pilot Integrated Urban Drainage Solutions, in key locations such as Torbay and Camborne (along the lines of the Endocrine Removal trials sanctioned in K4), involving multiple stakeholders currently engaged on the Defra pilot projects for example.

Financeable business plans

We recognise the onus that is placed on companies to present a financeable business plan, having regard to the financial ratios necessary for an investment grade credit rating. The draft methodology notes that assuming a proportion of index linked debt may assist this objective. We must draw to your attention that one of the two major credit rating agencies, Standard & Poors, does not recognise any interest cover ratio improvement arising from the use of index linked debt. Financeability will therefore need to be addressed through other means.

In the interests of brevity, I have focused on those aspects of the framework where we are seeking improvement or clarification. In much of the proposed approach to PR09, we remain supportive of the objectives and methodology, in particular the emphasis on customers and their priorities for the services we supply. I look forward to working with Ofwat and all of our stakeholders to achieve the very best outcome in 2009.

Yours sincerely



C Loughlin
Chief Executive