



Water UK response to Ofwat's consultation: 'Setting price limits for 2010-15' – framework and approach'

Thank you for the invitation to respond to Ofwat's consultation 'Setting price limits for 2010-15' – framework and approach'. This is the response of Water UK, the organisation representing the water industry in the UK. Our member companies are all responding individually to the consultation and will demonstrate a diversity of views on many of the more specific aspects of your approach. Our response highlights points of principle regarding Ofwat's approach where the companies in England and Wales are in broad agreement. The response has been agreed following extensive industry discussions.

The industry faces significant challenges as set out in the companies' recently published Strategic Direction Statements (SDS). The Statements show a collective determination to meet consumers' priorities – a reliable supply of clean, safe water; failsafe wastewater collection and treatment – in a context characterised by uncertainty affecting water availability, network resilience, climate change, and environmental quality.

The diversity amongst companies' approaches reflects underlying differences in the environmental and socio-economic circumstances in which companies operate, the challenges they face, the preferences of consumers, and the business models adopted. It multiplies opportunities for innovative responses. Indeed, the nature of the challenges themselves demands new ways of thinking, if today's and tomorrow's consumers are to be well served. This may mean high-tech answers; but could also mean low-tech solutions, innovation in delivery mechanisms, cross-sectoral ways of working, and institutional development. The need for innovation has been highlighted by the recent CEMEP and Sainsbury reviews.

These twin challenges, diversity and innovation, demand a new flexibility in regulatory thinking. As much as companies may produce business plans aimed at meeting future challenges, regulators play a fundamental role in determining the risks and rewards - the incentive framework - within which companies produce those plans and operate. Regulation should foster diversity and innovation – a one-size-fits-all approach will not deliver this.

We agree that this means evolution not revolution – as we set out in our Future Regulation consultation in 2005¹. In concluding our report, we envisaged a ‘simpler, smarter, better’ way of regulating the industry² and our recommendations were strikingly similar to those of the Ofwat’s independent Baker review of PR04.³

In the consultation you describe your approach to PR09 as “evolution”. Several of the changes you propose are positively in line with the recommendations in the above mentioned reports; for instance, your support for long-term planning with the introduction of 25-year strategic direction statements; for companies to ‘own’ their plans; and for the use of social cost benefit analysis to underpin plans.

The industry recognises Ofwat’s intention to move forward in the desired direction. But companies have a number of significant concerns.

- Overall, the industry perceives an approach that appears to add up to a regime of targets, penalties, detailed scrutiny, data intensity, constrained opportunities for out-performance and few positive incentives for companies to develop sustainable solutions.
- The industry notes that financial markets are notoriously volatile, as current and continuing turbulence demonstrates. With over a year and half to go until final determinations for PR09, it is too early to know what the appropriate level for key financial parameters for PR09. The industry is therefore concerned that Ofwat’s consultation and recent statements around financial issues may have the appearance of prejudgement.
- At the same time, the momentum towards ‘better regulation’ seems to have slowed, leading to less transparency and inadequate detail on proposed changes.

The industry questions whether this approach will provide the incentive framework and balance of risk and rewards that will drive a culture of innovation and meet the challenges of sustainability.

In the consultation you say you are keen to sustain the ‘low risk’ nature of the business and claim in several places that your approach reduces risk. We question whether on balance this is so (see below), and what evidence supports this view. We also wonder how such an approach promotes

¹ Future Regulation for the water industry: A consultation, Water UK, July 2005

² Simpler, Smarter, Better, Water UK, March 2006

³ Report into the Conduct of the 2004 Ofwat Periodic Review, A report commissioned by Ofwat from the Independent Steering Group, August 2005

innovation or squares with your parallel desire to promote a regulatory environment that mimics competitive markets (which are clearly riskier).

We wonder if the approach has been too much driven by Ofwat's concern to ensure more 'robust' regulation on the one hand and more rapid development of competition⁴ on the other. Whilst these are undoubtedly important issues (and, as Ofwat is aware, we have sponsored an independent study by the Regulatory Policy Institute to assess the scope for competition) we urge you to reflect on your priorities in determining the approach to PR09. It is this price review that will drive customer bills, the crucial early phases of the industry's response to climate change, and the investment decisions that must be taken over the next 5 to 10 years and will have an impact well beyond.

It would be helpful if, in concluding the consultation, you could explain the direction of travel - or Ofwat's 'vision' - for regulation (complementing possible developments in competition) and how you see the PR09 approach taking us towards this. It would be helpful if you were to outline how the approach allows you to meet statutory duties and the expectations of Ministerial guidance. Finally, the industry will be interested to understand whether and how the companies' SDS have led to any changes in approach.

Below we set out our comments on the proposals. We remain supportive of evolutionary change in regulation in the interests of sustainable development and offer suggestions as to how Ofwat's proposed approach might be adapted better to meet the challenges of the future.

Sustainability

Ofwat's consultation focuses almost exclusively on climate change under this topic of sustainability. However, whilst important, climate change is not the only facet of sustainability. It is a much broader agenda, encompassing social and financial as well as environmental sustainability – and a concept that should pervade the entire Ofwat approach, as indeed was recognised in Ofwat's earlier consultation on its duty towards sustainable development.

Above, we noted that the challenges of sustainability will require regulatory flexibility – and appropriate incentives - to galvanise into action the long term plans supported by social CBA that Ofwat expects

⁴ Competition is discussed further in the annex to this response.

from companies. An overly restrictive or rigid regulatory approach is unlikely to promote the collaborative and innovative approaches needed. We think Ofwat can go further than it is proposing in its present consultation to present a framework that clearly encourages sustainability.

The Ministers' Statement of Obligations, published in December 2007, clearly expects Ofwat to play its part in encouraging companies to make an appropriate response to climate change, expecting 'plans to be in place that will allow them to deal with climate change over the next decades' and 'energy consumption to be considered alongside any other aspect of sustainable development in delivering outcomes.' The Social and Environmental Guidance expected from Ministers this spring 'will set out at high level some specific actions the Government expects Ofwat to encourage companies to undertake'.

We accept that companies have a responsibility to present robust business plans for Ofwat's consideration. We have also welcomed recent dialogue with the industry on Ofwat's proposed approach to carbon, and Ofwat's work with the industry to agree appropriate guidance for carbon accounting in the June Return. However to be more convinced of Ofwat's commitment to sustainability we would suggest the following.

- **Catchment-based solutions and the interpretation of the PPP:** of particular relevance with regard to the delivery of Water Framework Directive, where collaborative efforts with the farming community may offer more sustainable and cheaper longer term solutions. However, Ofwat's consultation currently suggests a very restrictive set of circumstances in which these might be approved – we should like Ofwat to reconsider its stance, for instance, its suggestion that these schemes will not be allowed on land not owned by a water company.
- **Opex based solutions:** 'softer' more sustainable solutions may often be opex rather than capex based, yet companies currently may be disincentived from such approaches because these would render companies less efficient according to Ofwat's traditional means of measuring efficiency – we should like Ofwat to indicate how it will address these barriers.
- **Incentives for innovation** – we should like Ofwat to consider how it could better promote innovation within the sector: Ofwat's approach appears to be limited to expecting innovation to be planned into CBA plans, and to the basic incentives in the price cap to reduce costs. At the very least this would require Ofwat giving

more clarity as to its approach in approving finance for projects with more uncertain outcomes. Even so, we would like Ofwat to explore options for targeted incentives offering the appropriate risk-reward balance that R and D and innovation specifically demand. We note that other industries have adopted R and D incentives (for example, Ofgem).

- **CBA** - We strongly support the value of CBA as an important tool in decision making, but it is a tool, not an end itself. There is a need for pragmatism and proportionality, so as not to stifle innovation, or lose sight of the ultimate objective of more clearly sustainable outcomes, driven by stakeholder and consumer preferences.
- **Social cost of carbon** – we would like Ofwat clearly to confirm that it will expect carbon impacts to be factored into decisions about capital maintenance, to ensure that operationally companies' efforts to reduce their carbon footprint have regulatory support.
- **Incentives for carbon** – as Government guidance becomes clearer (from the forthcoming Ministers' Strategy for Water and Social and Environmental Guidance), we should like to see Ofwat responding positively to developing an appropriate incentive framework around carbon, perhaps as part of Ofwat's promised review of the OPA. Again, Ofgem has taken action to introduce such initiatives.
- **Renewable energy**: We also welcome Ofwat's apparent willingness to consider the case for financing greater investment in renewable energy. Here the industry has already made a significant contribution and could yet be an important contributor to further strides in this area nationally. Ofwat's promised review of its approach to classifying renewables (whether as part of the appointed business or otherwise) is important and the industry looks forward to being consulted in this process.
- **Incentives for water efficiency** – the revenue cap proposed by Ofwat may remove a perceived disincentive to promote water efficiency but we are not convinced that this would in itself provide a positive incentive in those water scarce areas where it would make most economic sense. We should like Ofwat to consider what measures it could introduce that would provide such incentives. The industry was disappointed that Ofwat's initial approach to this issue was to suggest voluntary - and uneconomic - targets for water efficiency. We look forward to the present review by Ofwat (with some companies) of the approach to targets, leading to a framework in line with the economic principles of the Water Resource plans and backed up by appropriate incentives.

- **Flooding** – Ofwat should take account of forthcoming recommendations from current reviews into flooding, and ensure that its approach allows for appropriate development of sustainable solutions.
- **Affordability** – a social aspect of sustainability, the industry believes that this is primarily a matter for Government rather than Ofwat. However, Ofwat will need to take note of any guidance from Ministers in this area, and the expectations of consumers, which may vary by region and demographics.
- **Joined up regulation**: the broad sweep of sustainability means that joined up regulation becomes particularly important. This was highlighted in the Baker Review. Yet Ofwat’s consultation refers in only a limited way to other regulators. In concluding on the methodology it will be important to clarify how Ofwat and other regulators are and will work constructively together and with the industry to ensure a sustainable approach at PR09.

Further comments on incentives and on joined up regulation are made in the sections below on incentives and on PR09 process.

Finance

As at previous price reviews, the industry will continue to require significant finance for investment at PR09 to meet the challenges of climate change, population growth, water resource scarcity and flooding and to deliver sustained high quality service to customers.

Whilst the drivers will vary from region to region, financing investment will remain a key issue for the price review. The scale of investment remains at a level where the industry will still remain cash negative, i.e. relying on investors to fund the difference between what companies collect in bills from customers and the capital expenditure they have to make.

It is crucial that the price review

- continues to provide sufficient returns to maintain the flow of funds from the city
- ensures that companies retain access to a diverse range of capital providers in a wide range of economic circumstances
- ensures this investment can be forthcoming at a reasonable cost,
- ensures that financing risks are appropriately allocated to those best able to manage them

- does not seek to determine companies' capital structures, as this may restrict companies' incentives to seek the optimal balance of different sources of finance.

We note that the Competition Commission in its airport inquiry report endorsed the principle that it is more costly to customers for a regulator to err too low when setting returns than to allow a rate of return slightly above the cost of capital. We would expect Ofwat to follow the Commission's lead of choosing point estimates which lie towards the top end of any estimated ranges.

Water UK has previously responded to Ofwat's earlier consultations on Financing Investment. We have also copied Ofwat our submission to the recent Competition Commission inquiry into airports regulation, enclosing a report on the indexation of debt. Building on those documents, we emphasise the following points for the PR09 approach.

Current versus longer term market data

In arriving at an appropriate cost of capital, whilst clearly needing to take account of recent capital market movements, Ofwat needs to be careful in determining the degree of weight to be given to short term evidence. The Competition Commission in its recent review of airports confirmed the principle that estimates of parameters such as the risk free rate and the cost of debt should be forward looking, based on the evidence that is available to a regulator at the time of its decision. Discussions to date with investors as part of our current Investor survey⁵ also indicate that investors favour a medium term approach to the WACC.

Financial markets are notoriously volatile, as recent developments triggered by the 'sub-prime' crisis have roundly illustrated. An upshot of these recent events is indeed that the types of deals that water companies were able to extract so successfully, and unexpectedly, following PR04 are now it would seem largely off the table. There is considerable uncertainty around the extent to which there remains access to the index linked debt market. Current difficulties faced by monolines has, we understand, effectively ruled out further use of wrapped debt structures such as Artesian for the time being.

⁵ The Investor Survey will be reported at Water UK's forthcoming City Conference on February 28th 2008

In setting price limits for PR09 Ofwat should adhere to its previously established principles of being guided by longer term finance costs in order to ensure long term financial stability.

Recent transactions and market to asset ratios

In considering the relevance of recent evidence on acquisition prices and market to asset ratios to consideration of the appropriate level for the cost of capital in the water sector, Ofwat must take account of the other factors that also impact on the market prices in the sector. These include investors' expectations of:

- outperformance on opex, capex and other regulatory expenditure and income assumption;
- the value of non-regulated businesses;
- synergies in costs at the holding company level;
- the possible presence of an infrastructure “bubble” where some element of premia may reflect short term inflated demand from particular types of investors for infrastructure assets.

All of the above may have significant effects on value that need to be taken into account in examining the implications of recent market prices in the sector for the regulatory cost of capital.

We also note that the recent Competition Commission recently decided that the bid price for BAA does not provide reliable evidence on the cost of capital for BAA because there are so many uncertainties in the bid assumptions that affect the market price.

Gearing

Water UK recognises the difficulty that Ofwat faces in determining an appropriate assumption for gearing in setting an industry wide cost of capital at PR09 – one that tries not to ‘force’ a regulatory view of what is an appropriate capital structure (sustaining the view that this is for companies to decide), whilst also not delivering the possibility for some companies to arbitrage the resulting compromise gearing assumption. However, on balance we believe that the crucial criterion is to continue to ensure that companies have access to a wide range of finance, and that a range of business and financial models can co-exist.

It is also important that Ofwat ensures that its approach to the cost of capital and taxation are consistent. The consultation document indicates that Ofwat will extend its policy of setting tax allowances on a company-

specific basis to provide for claw-back of tax benefits that emerge from refinancing exercises. This is not immediately compatible with the Competition Commission's view that the tax savings associated with an increase in gearing are partly offset by an increase in the vanilla WACC.

Financeability

We note Ofwat's proposed approach for dealing with the issue of financeability at PR09 – in particular Ofwat's view that revenue uplifts are to be avoided, that companies should produce business plans that do not require them, and that if required, they should be NPV neutral. We reiterate that it remains crucial for financeability to be tested at PR09, and do not believe that it is necessarily feasible to rule out uplifts. We note the possibility under menu regulation for companies to propose large capex programmes – yet it is not yet clear whether Ofwat have thought through the financeability implications.

Ofwat needs to avoid prejudging the extent to which it will be possible for companies efficiently to address financeability through the mechanisms preferred by Ofwat ie new equity issuance, NPV neutral adjustments and access to index linked debt markets (which we have discussed above). Details such as allowing for the costs of issuing new equity (as has been accepted by other regulators eg Ofgem) and how any NPV neutral adjustments would be will be important for Ofwat to clarify for companies and investors / credit ratings agencies.

Ofwat has referred to taking a 'flexible' approach to financial ratios in determining financeability issues. It is important that Ofwat spells out what it means: ratios used must be consistent with those that are regularly used by credit ratings agencies to set ratings, which determine companies' ability to raise finance in the real world. Ofwat must also ensure that its ratio assumptions are consistent with the credit rating underlying its cost of debt assumptions.

Ongoing projects

Independent consultants are currently working for Water UK on two projects that will provide useful evidence and information for Ofwat and for companies' business plans in the finance area. The first is our Investor Survey (being undertaken by Indepen, and on the steering group of which Ofwat sits) which will provide direct evidence of the views of investors on the sector, as at previous price reviews. The second is a project on the cost of capital and financeability (being undertaken by NERA).

Indexation of the cost of debt

Finally, we note Ofwat's apparent interest in the proposal for indexing the cost of debt. The industry rejects this proposal. Similar views are also strongly emerging from the initial phase of our Investor Survey. As set out in the First Economics paper noted above, we believe that indexation would result in the inappropriate shifting of financing risk from companies to customers, who are far less able than the companies, with their Treasury management expertise, to manage these risks. Although the CEPA report contends that this is not a key issue, this was not the view of the Competition Commission in considering the issue in the context of the airports inquiry. We reject the CEPA view and attach a critique of the CEPA arguments by First Economics. As noted in the FE conclusions

'The principle that risk should be allocated to the party best able to manage it..... should lead to customers paying lower prices than under any alternative regulatory rule'.

CEPA's predilection for indexation furthermore appears founded on a flawed assessment of the 'insurance premium' that the CC's recent cost of debt determination implied. Once these flaws are acknowledged, the supposed insurance premium identified by CEPA is seen to be illusory. The FE paper also remarks that the problems which beset the CEPA analysis – deriving from the need to define an appropriate and non-controversial benchmark cost of debt - present precisely the same trap for Ofwat if it were to attempt indexation.

Uncertainty and risk–

Ofwat's approach to uncertainty and risk needs further careful thought. Ofwat appears to wish to reduce risk in line with what it perceives as a lower cost of capital at PR09. Conceptually, this has some merit. However, there are a number of issues which need to be considered.

- Notified Items provide an important mechanism for dealing with significant uncertainties outside of management control. Ofwat is proposing to remove all present notified items. Whilst we agree that it is important to review the range of items that should be "Notified", we do not agree with Ofwat's assertion that the current items are now in all cases risks that can be best managed by companies – and Ofwat also needs to remain open to consideration of new Notified Items (see annex).
- At the same time, Ofwat is proposing to tighten the approach to base costs and continues to assert that leading companies ought to be

capable of reducing costs in real terms. This stands in contrast to the line that the CAA and CC have taken in the airport price control review, and contradicts Ofgem's assessment in the gas distribution price control review that the underlying rate of productivity growth affecting network industries is broadly cancelled out by rising input price inflation (implying a zero rate of frontier shift).

- In recent years, companies have also been able to balance unexpectedly high energy cost increases against other areas of potential outperformance eg on revenue (though this has not been possible for all companies), on tax and capital structure, and on the cost of debt – yet here Ofwat is suggesting indexation (and in the case of the cost of debt, we do not think this represents an appropriate transfer of risk to customers anyway, as discussed above). Ofwat's proposed claw back of the tax benefits of capital restructuring also removes the incentive to optimise financing - one of the upsides in the current regime. This might be to the detriment of consumers in the long run.
- In addition, whilst the proposal for menu regulation reduces the risk of overspending on capex, as presently structured it also reduces the potential rewards for capex efficiency.
- There is also an increasing recourse in practice to financial penalties –and Ofwat's letter PR09/06 adds significantly to the potential downside risks on serviceability failures.
- Ofwat is as yet offering limited potential for new sources of revenue or outperformance from new incentive mechanisms – as discussed below and in the section above on sustainability.

Clearly, a full assessment of the balance of risk and reward within Ofwat's proposed framework cannot be made except by individual companies on receiving their Final Determinations. However, a better view of where this may be heading would be assisted in March by some attempt by Ofwat to flesh out its methodologies and by a more rigorous assessment by Ofwat of what it sees as the impact of its regulatory changes on the risk/return balance, and on the cost of capital.

We do not agree with Ofwat's assertion that asymmetric risk is not a relevant consideration for Ofwat. Asymmetric risks affect the cost of capital of companies in a number of different sectors. It is not possible to conclude at present that it will not affect the cost of capital of water companies until the price methodology package, capital expenditure assessments and risk/incentive framework are determined.

By comparison to other regulated network companies it appears as though water companies are more likely to be exposed to general unexpected costs risks as a result of the wide range of activities that they undertake from abstraction to metering. Contractor price inflation is one area in which companies will face particular uncertainty when preparing AMP5 business plans. Major swings in the demands on contractors from infrastructure projects in other sectors of the economy, together with an increasingly uncertain macroeconomic outlook, make it extremely difficult to determine how quickly tender prices will increase during the course of the next 5-10 years.

Formal modelling of the price setting methodology and the revenues and costs of companies is needed before Ofwat can conclude that companies are not exposed to risks that will affect the distribution of returns in an asymmetric manner and affect the cost of capital required by investors.

Incentives

There are significant concerns in the industry that Ofwat's incentive framework is becoming increasingly unbalanced towards penalties rather than rewards (sticks not carrots). For example, downside penalties could be greater than 10% of turnover per annum if leakage and serviceability targets are not met, but upside potential is extremely limited. It would be helpful to understand whether this is Ofwat's intention or perception, as it does not seem conducive to a climate of innovation or pushing the boundaries of efficiency or service improvement. Conversely, an excessive focus on penalties could lead to risk aversion and a reduction in innovation. We note that other regulators take a more 'last resort' approach to penalties, preferring instead to use positive incentives to encourage companies.

Our second comment is that Ofwat's incentives still continues to be focused on cost outperformance rather than on identifying and delivering improved outcomes. As noted in the section on sustainability, the industry considers (and companies have a number of individual proposals) that there is the potential to consider the development of new incentive mechanisms related to the delivery of specified customer service, carbon reduction, skills development or R and D. The work done by companies on customer WTP should provide a rich seam of data to consider in the context of developing incentives that are calibrated according to the value place on particular outcomes by customers. We would hope that Ofwat will consider this specifically or in the context of its review of OPA, or in its consideration of how any menu proposal is developed. Ofwat's weak

incentive framework is in contrast to the approach taken by other regulators, for instance Ofgem.

We encourage Ofwat to consider the judicious use of appropriately outcome-targeted incentives. In future these might replace upfront inclusion in price limits, or serve as a continuing incentive beyond the price review, allowing continuous search for improvement not tied to the 5 yearly cycle. At the same time, there needs to be a balance with providing an appropriate reward for good business plans in the first place.

Menu regulation – we have previously responded to Ofwat in detail on the proposals for menu regulation. To recap, companies will require considerably more understanding of the proposed mechanics of the mechanism before they will be able to say whether it is acceptable, even if they may agree with the high level principles. Thus, whilst the menu purports to offer choice to companies and to reward good business planning this is highly dependent on the specific structure of the menu.

We have currently engaged CEPA in a review of the menu proposals, with a view to assisting Ofwat in designing a workable option that does have the possibility to deliver on those high level principles. Water UK and CEPA are mindful that any menu proposals need to meet Ofwat's statutory duties and recognise the interests of all stakeholders, i.e. we will be aiming to develop proposals that are realistically implementable. We also note that a key remaining challenge will be to explain in simple terms to customers, to investors and to other stakeholders how the menu works.

We have welcomed Ofwat's interest in our project and would ask for your continued engagement in this constructive initiative. In reaching your conclusions on menu regulation, we should welcome your response to the eventual recommendations from the CEPA work.

CEPA's review is focusing on the following key issues below, that it will be important to resolve satisfactorily before companies will be able to consider accepting the menu proposal:

- How will the baseline be set? – CEPA's initial review suggests that greater clarity about the intended approach is required from Ofwat. One way to achieve this could be by adopting an approach similar to the current approach to setting determinations, although options for incremental improvements will be evaluated. Companies have expressed concerns with aspects of Ofwat's proposed changes to the

current approach that appear to take a more backward looking approach than has more recently been developed through the common framework.

- The breakeven point of the menu and comparisons with the Ofgem menu – CEPA's preliminary work indicates support for an Ofgem approach which enables companies to share in the benefits of introducing a menu regulation. CEPA is also looking at an approach that recognises that no forecast will be 100% accurate (the implied standard of Ofwat's current proposal).
- The incentives of the menu, in particular at the extremes, and for frontier companies – CEPA proposes to examine a number of options for the design of the incentive structure in order to increase the effective choice faced by companies and to sustain strong incentives for companies to push the frontier
- Financeability and the credibility of Ofwat's future commitments to the menu approach – the project is examining the design of the menu and how rewards and penalties feed into price limits, so as it should not lead to situations where a company's choice of menu option could be inconsistent with achieving financeability
- The regulation and monitoring of outputs under menu regulation – a key point is to ensure clarity about the outputs that are expected under menu regulation. The CEPA project is exploring companies' concerns that where output variations are beyond companies control these should still be subject to IDOKs and logging up – but also the possible scope for outputs to be specified at a higher level, enabling companies to have more flexibility in how they are delivered.
- The impact of menu regulation on simplification – this is potentially a useful benefit from menu regulation, and CEPA will be exploring the impacts of its proposed specifications on the regulatory burden.

We also would encourage Ofwat to think about ways in which the idea of menu regulation and choice for companies has applications that go beyond decisions about capex. Having asked companies to place the interests of customers at the heart of their future strategies, it is important that Ofwat tailors its incentives to the specific challenges that companies have identified. It is unlikely that a one-size-fits-all regulatory regime will be as capable of accommodating the diverse needs of customers as a more bespoke approach to incentive design.

PR09 Process

The industry is disappointed in three main aspects of the PR09 process: the conduct of the review in terms of transparency and consultation; the continued complexity of regulation; and the lack of coordination between

the roles of Ofwat, Defra and other regulators (in spite of expectations after PR04 and the strong recommendations of the Baker review).

On the first point, the industry is concerned that some of the key proposals have insufficient detail to allow proper consideration by company boards. Furthermore, lack of detail (in how business plans will be assessed and outputs defined and monitored) risks undermining the ability of companies to “own” the development of their business plans and build investment cases on solid evidence.

Companies are concerned that in some areas there has been little consultation with the industry and even a sense of pre-judgement, for example in relation to the proposed withdrawal of the small company premium; that the consultation documents appeared piecemeal and lacking coherency; and there is a degree of retrospection (for example in the approach to logging down/shortfalling as set out in PR09/06).

Although Ofwat has made efforts to simplify in some areas, (for example the capital maintenance econometrics), in others proposed simplifications are if anything retrograde (for example the simplified scoresheet, to replace the more systematic approach of the common framework for capital maintenance, is likely to produce a less robust or forward-looking approach to setting the baseline under menu regulation); and the removal of notified items as discussed above would reallocate risk inappropriately. At the same time you are introducing greater complexity in the detail expected of companies' CBA, and in the menu approach. Furthermore, the introduction of a menu, the revenue cap and claw back of tax benefit and the indexation of cost of debt if adopted, and any adjustments for NPV neutrality would all require correction at future reviews. Apart from adding new layers to regulation, these proposals together add to the complexity for analysis in interpreting company results and increase the scope for unintended consequences.

The consequence for data requirements is that these are increasing, as our initial review of Ofwat's parallel consultation on the PR09 business plan information requirements suggests. (We will respond separately in more detail on that). We would remind Ofwat that the Baker review recommended that Ofwat ‘undertake some investigative work to see whether similar price limits for the periodic review 2004 would have been produced with reduced data requirements’, yet this important analysis appears not to have been explicitly done. We should like to suggest that Ofwat does not lose the opportunity with the consultation on its information requirements for PR09 to address transparently and

systematically the question: why do we need the various elements of data?

Finally, a focus of the Baker review was to address concerns regarding the clarity of roles and responsibilities of regulators and the process of reaching decisions on the environmental programme. Whilst Ofwat has convened a Regulators' Group to chorale discussions around PR09, it is by no means clear that greater regulatory coordination and consistency is being achieved at PR09. A statement from all regulators explaining how their approaches are aligned to delivering jointly their duties on sustainability could be helpful. We look forward in particular to greater clarity that all regulators are agreed on the approach to cost benefit analysis and the resulting outputs to be financed through the price review. On the WFD there remains a lack of clarity about whether and what regulators will agree on how measures that are not sufficiently clear for inclusion in PR09 are treated. Ofwat must be clear, and be agreed with Defra and the EA, whether the approach is to expect these to be allowed as Notified Items or to be deferred to PR14 or beyond. There needs to be a clear process for reaching decisions on these points, so that companies are not left with the risk of carrying unfunded obligations beyond their control.

ANNEX - NOTIFIED ITEMS

Allowing for cost pass-through of significant and uncontrollable cost and revenue risks has been an important factor in ensuring investor confidence, containing the cost of capital required by investors, and in the long-term ensuring customer bills are as low as possible. Clearly, risks may change over time and it is appropriate periodically to review candidates for notified items. Where notified items are not to be applied or dropped it is important that a central estimate is adopted to ensure that companies face symmetric upside and downside risks with regard to those items.

Ofwat's consultation suggests that none of the existing five notified items should be retained for PR09. We disagree, particularly with regard to the following.

- *Impact of the implementation of the Traffic Management Act (TMA).* The impact of this Act is still far from clear, but is potentially highly significant. (*Quote figures?*) We note that in their recent Final Determinations of the Gas Distribution Price Review, Ofgem treated the impact of the TMA as a "reopener", broadly equivalent to a notified item, as insufficient information was available at the time of the determination to include it in price limits.
- *Increases in the taxation of infrastructure expenditure arising from the introduction of International Financial Reporting Standards.* As many companies have not yet adopted IFRS, and the impact of being required to do so would be significant, the rationale for this notified item is unchanged.

For the other three current notified items (bad debt, meter optants and charges for abstraction and discharges), there may be a range of views in the industry. The current notified item on EA charges is subject to the outcome of the ongoing Environment Agency consultation on the level of these charges – if sufficient information is not available by the time of Final Determinations for a central estimate to be incorporated, then a notified item would still be necessary.

There are two specific new items where there is a potentially large impact and limited management control, where we propose Ofwat should adopt a notified item. It may also become clearer during coming months whether other items should be considered for Notified Item status.

- *Transfer of private drains and sewers.* The expected transfer of responsibility for private drains and sewers to companies is subject

to considerable uncertainty, both in terms of timing and in terms of financial impact. In our view, an appropriate way to manage this uncertainty, for the benefit of both customers and companies, would be for a reasonable central estimate of the costs of the transfer to be incorporated into price limits, with a symmetrical notified item for significant variations from this central estimate.

- *Initiatives to promote competition.* Ofwat proposes that companies should take account of initiatives to promote competition in their business plans. Clearly at this time there is considerable uncertainty as to the form of competition that may be pursued. The development of competition – including any preparatory work on accounting separation, and any initiatives to increase the size of the WSL market - is likely to involve significant start-up costs, as experience in other sectors has demonstrated. Unless there is sufficient clarity to incorporate these costs into Business Plans for PR09, then it would be appropriate to include them in the Final Determination as a notified item.

ANNEX - COMPETITION

We note the emphasis placed in the consultation document on competition as a future direction for the sector, and agree that it is important that the potential scope, benefits and costs of competition in water and wastewater services is considered carefully. The study of these issues by the Regulatory Policy Institute, led by Professor George Yarrow, will be an important contribution to this debate.

While it is important to bear in mind potential future directions for the sector, price cap regulation will be the dominant feature for PR09, rather than market competition – and given the natural monopoly nature of a significant proportion of the industry’s activities, economic regulation will still be important well beyond this.

In the PR09 consultation, Ofwat suggests that companies should take account of Ofwat’s initiatives to promote competition in their business plans. Where there is sufficient clarity on these initiatives, their timetable and impact for them to be incorporated into companies’ Draft Business Plans, companies will do so. However, we note that these initiatives are subject to ongoing consultation and several are dependent on new legislation – the prospects for which are unclear. We also note that measures which will be considered by companies as part of the Water Resource Management Plans, such as investigating the potential for increased cross-border supplies, could also have competition benefits.

Ofwat’s consultation indicates a preference to promote accounting separation. We welcome Ofwat’s workshop with the industry on 25 January 2008, and look forward to starting to work with Ofwat to ensure that any proposals are practical and proportionate.

Accounting separation has the potential to result in significant costs – as would other potential initiatives such as expanding the WSL market to cover all non-households. Expansion of the contestable market in this way would inevitably result in significant costs of developing and implementing new systems and processes, as is apparent from the experiences of the energy sector and the water competition regime in Scotland.

Recovery of “set-up” costs for competition initiatives such as these will remain a key concern for the industry, and we would welcome clarity

from Ofwat over how such costs should be included in companies Business Plans (or as a notified item, see above).

We will be responding separately to the WSL 10/07 consultation.