

24 January 2008



Regina Finn
Chief Executive
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

1 Queen Anne's Gate
London SW1H 9BT
Telephone 020 7344 1844
Fax 020 7344 1866
e-mail contact@water.org.uk website
www.water.org.uk

Pamela Taylor
Chief Executive

Dear Regina

Water UK response to Ofwat's consultation on the PR09 approach and methodology

I have pleasure in enclosing Water UK's response to your consultation on Ofwat's proposed approach to the PR09 methodology. Given the long-term nature of the industry and the challenges it faces, decisions made at PR09 will be vital to ensuring the long-term sustainability of the industry, the services it delivers to customers and its impact on the environment.

We face an increasingly complex future, in which the challenge of climate change adds to the already significant uncertainties against which water companies must invest and deliver the number one priority of consumers: the delivery of clean, safe and reliable supplies of water.

As you know, to meet these challenges, Water UK shares Ofwat's commitment to evolutionary change in the regulatory framework for water. Like Ofwat we recognise the importance of regulatory stability for sustaining consumer and investor confidence. It is also clear that the need for stability highlights the importance of transparency and predictability in developing and introducing new proposals. But evolution must also be forward looking and fit for purpose.

We note that the regulatory system for water, intended to be incentive-based has over the years since privatisation developed into a highly detailed and complex approach, increasingly focused on detailed planning, intensive scrutiny of that detail, targets and penalties for failure.

In a more complex world, where we agree that innovation must be fostered and diversity recognised, we urge Ofwat to consider carefully whether the answer is greater complexity and regulatory 'intrusion' or indeed greater flexibility and a lighter touch - as for instance might be the expected trademark of a regulatory system attempting to mimic the forces of competition. It is also clear that in a more complex and diverse world there is no room

for one-size-fits-all regulation and reliance on comparative models becomes increasingly questionable.

We recognise Ofwat's readiness to embrace the sustainability agenda and to set price reviews in a longer term context and the steps you have taken in adapting the PR09 approach to this agenda (eg SDS and cost benefit analysis). Likewise, we believe that allowing companies true 'ownership' of their plans is a step towards embracing a more flexible and lighter touch approach.

However, Ofwat's proposed regulatory framework of incentives and approach to uncertainty and risk and to sustainability, does not, in our view, currently add up to a regime that is well-suited to meeting the demands of the future.

This may not be the intention - a lack of detail prevents a proper assessment, but also incidentally risks undermining improvements in transparency made during PR04 that were widely acclaimed by investors and consumers. From our members' perspective, we are particularly concerned that lack of detail about how business plans will be assessed and outputs defined and monitored, could effectively prevent companies from "owning" their business plans and developing well-evidenced investment cases.

In sum, we ask that Ofwat adapts its proposals to ensure the approach:

- establishes a clear and transparent approach to determining price limits;
- recognises the diversity of companies' circumstances and approaches
- sets a forward-looking and balanced incentive based framework with flexibility for companies to plan and innovate to deliver on consumer priorities;
- provides sufficient incentive and financing for companies to develop appropriate responses to the challenges of climate change, in line with Government policy expectations
- sets a rate of return consistent with long-term investor expectations and that sustains access to a wide range of financing under a range of economic circumstances so that the necessary scale of investment can be financed efficiently;
- demonstrates how it fits with Ofwat's duties, the Strategic Direction Statements of companies, Ministers' long term strategy and guidance for the sector and the EA's Sector Plan.

In setting out your conclusions it will be helpful to explain Ofwat's longer-term strategic direction for regulation of the sector and how the approach to PR09 represents a constructive step on that route, linking this to the development of your Forward Programme.

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The industry looks forward to working with Ofwat during the remaining stages of the price review, to ensure the sustainable outcomes that all our stakeholders seek.

Yours sincerely

A handwritten signature in black ink that reads "Pamela Taylor". The script is cursive and fluid, with the first letters of each word being capitalized and prominent.

Pamela Taylor
Chief Executive

Tel 020 7344 1800
Fax 020 7344 1853
E-mail ptaylor@water.org.uk
www.water.org.uk

Summary of Key Points

Sustainability

- Ofwat should adopt proportionate expectations and evaluation of cost benefit appraisals
- The social cost of carbon should be factored into CBA, including assessments of maintenance;
- Ofwat must clearly set out how its approach meets Government policy and guidance, for instance on climate change and the development of renewable energy; Ofwat should respond positively by developing an appropriate incentive framework around carbon, perhaps as part of Ofwat's promised review of the OPA.
- Ofwat should adopt a more flexible and pragmatic interpretation of the polluter pays principle that allows for the development of integrated catchment-based solutions including on land not owned by water companies
- Ofwat should consider how it can better incentivise opex-based solutions where these are cost-beneficial
- A clear process must be established for clarifying the outputs agreed by all regulators to be included in price limits, and where outputs are uncertain there must be clarity about their expected treatment at IDOK, logging up or deferment to PR14.
- Regulators must set out a statement to explain how their approaches to sustainability are aligned, at each key stage in the PR09 process.

Finance

- Ofwat should take account of a range of evidence in setting the cost of capital;
- Where a range of estimates is produced Ofwat should adhere to Competition Commission precedent and choose point estimates which lie towards the top end of any estimated ranges – the CC considers that it is more costly (for customers) to err too low in setting the cost of capital;
- Given the volatility of capital markets Ofwat must adhere to principles of setting key financial parameters such as the risk free rate and the cost of debt, on a medium-term basis, and in light of the best evidence available at the time – there should be no pre-judgement;
- Indexation of the cost of debt should not be introduced as it allocates financing risk inappropriately to customers, who are less able than companies to manage it;
- Ofwat's approach to taxation and cost of capital should be consistent.

Incentives

- The focus of incentives should move on from short term cost cutting to longer term innovation and delivering the outcomes consumers value.
- Incentives should be more balanced providing carrots as well as sticks and more clearly designed around the delivery of key outcomes, including increasingly important aspects such as, carbon reduction, renewable energy, water efficiency and innovation.
- Incentives should include an appropriate mix of incentives for good business planning and output based incentives related to customers' willingness to pay.
- The menu proposal should be explained clearly and in detail; baselines should be set on a forward looking basis and reflect central estimates; incentive rates should be designed to provide real choice; clarity around output definition must be provided – if not, it will not deliver the purported benefits to customers and companies will not support it.
- In considering the rate of frontier shift Ofwat should assess the expected rate of productivity improvement alongside real input price inflation, reflecting recent regulatory precedent (Ofgem, CAA).

Uncertainty and risk

- Notified items should be in place for significant uncontrollable risks, including: implementation of the traffic management act, increases in tax as a result of introduction of IFRS accounting standards, adoption of private sewers, costs of introducing competition; where notified items are not adopted, central estimates of costs must be adopted. Adoption of menu regulation does not alter this.
- The impact of changes in methodologies on risk and on the cost of capital should be assessed and clearly set out
- Asymmetric risk is relevant in a variety of circumstances and should be taken account of by Ofwat through modelling once the price review package is clear.