

Financial performance and expenditure of the water companies in England and Wales 2007-08

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About this report

This report examines the operating profits, cash flows and balance sheets of the regulated water and sewerage companies and water only companies in England and Wales for the financial year 2007-08. This is the third year of the period 2005-10 for which we set price limits in 2004. It also provides information about each company's day-to-day running costs (operating expenditure) and the investment it undertakes to maintain and upgrade the pipes, sewers and treatment works (capital investment).

Most of the regulated companies are part of larger groups. Each company has a statutory duty to trade at arm's length with associate companies and with its parent company, so this report considers only the regulated businesses. However, we have included an analysis of the trade that each company carried out with its associate companies in 2007-08.

The information in this report is drawn from the June returns and regulatory accounts that each company submits to us. Copies of the regulatory accounts are available from our library or from individual company websites. The regulatory accounts include an independent accountant's report, which explains the responsibilities of the independent accountant.

Information in this report is provided on a current cost basis. Historic information has been inflated to 2007-08 prices using the Retail Price Index (RPI).

We have not included the performance of exceptionally small companies, such as Cholderton and Albion, in this report. This has no material impact on the information in the report.

Supporting information, including details of each company's financial performance, is available on our website at www.ofwat.gov.uk.

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Headline issues

Financial performance

The companies' pre-tax profits decreased by 12% to £2.2 billion in 2007-08. This is despite a 5% increase in operating profits, which has been more than offset by increased interest costs.

Operating profits were higher than in 2006-07 because higher revenues and a reduction in operating expenditure were only partly matched by increased costs for capital maintenance.

The companies' overall return on capital for 2007-08 was slightly higher (6.5%) than in 2006-07 (6.4%) and also lower than our expectation of 7.1% assumed in price limits.

However, corporation tax charges increased by 32% to £503 million.

Total interest costs are higher because of an increased level of debt. However, the water and sewerage sectors in England and Wales are able to access debt at rates lower than we assumed when we set price limits in 2004. We will review our assumptions about the interest rates the companies are likely to face when we next set price limits in 2009.

Operating expenditure

Total operating expenditure for the water and sewerage sectors in 2007-08 was £3.4 billion (excluding exceptional items). This was £125 million lower than in 2006-07 and represents a 4% decrease in real terms. It is £67 million (2%) less than we assumed in price limits for 2007-08 and £319 million (9%) less than the companies set out in their 2004 business plans. Total operating expenditure in 2007-08 was £113 million lower than in 2003-04 (3% in real terms).

Almost all areas of operating expenditure across the water and sewerage sectors are lower than reported last year. The most significant reduction compared with 2006-07 is for energy costs, which are 9% lower. There was a fall in energy costs in 2007-08 compared to 2006-07. Although there is a significant year-on-year reduction in power costs, they are 6% above what we assumed in our final determinations. The remaining reductions are distributed across the other areas of expenditure.

Investment

At the last price review in 2004, the water and sewerage sectors were expected to deliver a large programme of capital investment between 2005 and 2010 to improve and maintain assets. We are in the middle of the current price limit period.

Overall investment increased by 8.1% to £4.9 billion in 2007-08. Of this, the amount spent on maintaining the network alone was steady at about £2.5 billion.

The businesses have spent 9% less overall than we expected over the first three years of the current price limit period. Of this, companies report that 4% was the result of efficiencies, which we welcome. Planning issues contribute to some of the delays in delivering some schemes. We will continue to monitor each company, and where a company fails to deliver schemes, we will take this into account when we next set price limits so that its customers do not pay for improvements that have not been delivered.

Over the same period, quality enhancement expenditure is 28% lower than we expected. Companies have made only minor progress in catching up with delays from the first two years. Some of the delay is due to companies needing time to find optimal solutions. Despite these delays, companies report that they are on target to meet their statutory obligations.

1. Financial performance

The way we regulate the water and sewerage sectors in England and Wales – through limits on prices charged to consumers rather than by limits on profits or rates of return – provides the sectors with incentives to finance their functions as efficiently as possible. Companies need to make a return, so that they can finance their functions and attract additional investment.

When we set price limits in 2004 we expected that companies' revenue in 2007-08 would need to increase by inflation plus an average of 3.2%, compared with the previous year. In 2007-08, revenue growth was 2.2% higher, in real terms, than in 2006-07.

Companies' current cost operating profits were 5% higher when compared with 2006-07. They increased by £149 million to £2.9 billion. This reflects increased turnover and lower operating costs.

Current cost profits before tax actually fell by 12%. They totalled £2.2 billion in 2007-08, down by £306 million compared with 2006-07. This was because of higher interest costs and a smaller financing adjustment, which is determined by RPI. Although companies' profits are at the highest levels for the last five years, they are still 16% lower than the peak level seen in 1999-2000 (after adjusting for inflation).

Table 1 shows the industry aggregate current cost profit and loss account for 2007-08 and the previous four years.

Table 2 shows some of the key financial indicators for the sectors as a whole, for each year over the five years between 2003 and 2008, including those that we considered as part of our 2004 price review. These indicators provide a snapshot of the companies' financial health. Two ratios in particular (cash flow:capital expenditure and retained cash flow:debt) have recovered following a dip in 2006-07. One reason for this is that there were no special dividends paid in the year, compared with almost £2 billion in 2006-07.

Table 1 Current cost profit and loss account

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2006-07 to 2007-08 change £m
Turnover	7,923	8,123	8,888	9,039	9,239	200
Operating expenditure	(3,282)	(3,301)	(3,453)	(3,600)	(3,521)	79
Capital maintenance charges:						
– Current cost depreciation	(1,920)	(1,986)	(1,977)	(2,024)	(2,062)	(38)
– Infrastructure renewals charge	(509)	(505)	(695)	(725)	(806)	(81)
Working capital adjustment ¹	7	6	(3)	40	21	(19)
Other operating income	61	35	24	66	74	8
Current cost operating profit	2,280	2,371	2,784	2,796	2,945	149
Other income	20	14	12	10	9	(1)
Net interest	(1,206)	(1,252)	(1,393)	(1,215)	(1,414)	(199)
Financing adjustment ¹	577	739	598	924	670	(254)
Current cost profit before tax	1,671	1,872	2,001	2,515	2,209	(306)
Current taxation	(72)	(69)	(321)	(383)	(504)	(121)
Deferred taxation	(73)	(209)	(273)	(0)	219	219
Dividends reported	(1,390)	(1,358)	(1,774)	(3,264)	(1,467)	1,797
Current cost profit retained	136	236	(368)	(1,132)	457	1,589

Note:

1. The working capital adjustment accounts for the impact of general inflation on the real value of working capital to the business. The financing adjustment accounts for the impact of general inflation on the real value of net finance for the business.

Table 2 Financial indicators

	2003-04	2004-05	2005-06	2006-07	2007-08
Cash-based indicators					
Cash interest cover (net) ¹	3.8	3.5	3.6	4.5	3.8
Cash interest cover (gross) ²	3.5	3.2	3.2	3.7	3.3
Adjusted cash interest cover I ³	1.7	1.5	1.5	1.7	1.6
Adjusted cash interest cover II ⁴	2.1	2.1	2.0	1.9	1.8
Debt payback period (years)	5.1	5.2	4.9	5.3	5.5
Cash flow:capital expenditure	50.4%	60.8%	67.0%	28.7%	67.2%
Funds from operations:debt	14.0%	13.4%	14.3%	13.2%	12.5%
Retained cash flow:debt ⁵	8.1%	8.7%	8.0%	2.6%	8.2%
Accounting-based indicators					
Historic cost dividend cover ⁶	1.1	1.1	1.0	1.5	1.3
Current cost dividend cover ⁶	1.1	1.2	1.0	1.7	1.3
Interest cover	2.0	1.9	2.5	2.3	2.1
Gearing⁷					
Gearing – net debt/RCV	59.3%	61.2%	58.5%	62.2%	66.0%

Notes:

For 2005-06 onwards, we have adjusted the indicators to exclude the effect of arrangements where inter-company payments of dividends are made effectively in lieu of interest.

1. Cash interest cover (net) is calculated as: net cash flow from operating activities/net interest.
2. Cash interest cover (gross) is calculated as: funds from operations/gross interest.
3. Adjusted cash interest cover I is calculated as: (funds from operations less capital maintenance charges)/gross interest.
4. Adjusted cash interest cover II is calculated as: (funds from operations less capital maintenance expenditure)/gross interest.
5. Retained cash flow:debt is calculated as: (funds from operations less dividends paid)/net debt.
6. Dividend covers exclude capital restructuring dividends. Dividend covers will not reconcile to those reported in table 12. Dividend covers in the table above additionally exclude all special dividends, thereby eliminating distortions to the industry trends.
7. Net debt and gearing excludes loans to group companies for the purposes of capital restructuring.

Table 3 shows current cost turnover and operating profit by service for each year over the period 2003-08. The proportion of revenue collected from metered consumers (including large users) rose from about 39% in 2003-04 to 45% in 2007-08. This reflects the increase in the number of households with meters.

Current cost operating profits were higher for the sewerage service than for water, with profit margins of 34% and 29% respectively. The profit margins reflect the relative size of the asset base for each service.

Table 3 Current cost turnover and operating profit by service

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2006-07 to 2007-08 change £m
Water service						
Turnover:						
– Metered water revenue	1,377	1,432	1,621	1,728	1,833	105
– Unmetered water revenue	2,173	2,202	2,392	2,359	2,366	7
– Large users	193	199	301	250	248	(2)
– Other	149	150	110	148	146	(2)
Total turnover – water	3,892	3,983	4,425	4,486	4,594	108
Operating expenditure	(1,819)	(1,791)	(1,903)	(1,988)	(1,928)	60
Capital maintenance charges:						
– Current cost depreciation	(840)	(838)	(837)	(846)	(867)	(21)
– Infrastructure renewals charge	(399)	(377)	(456)	(457)	(505)	(48)
Working capital adjustment	2	2	(2)	20	12	(8)
Other operating income	23	22	19	24	43	19
Current cost operating profit	859	1,000	1,246	1,238	1,349	111
Sewerage service						
Turnover:						
– Metered sewerage revenue	1,344	1,447	1,621	1,736	1,850	114
– Unmetered sewerage revenue	2,362	2,366	2,468	2,458	2,459	1
– Large users	149	155	230	222	213	(9)
– Trade effluent revenue	98	98	89	88	88	(1)
– Other	79	76	55	49	36	(13)
Total turnover – sewerage	4,031	4,141	4,463	4,553	4,645	92
Operating expenditure	(1,462)	(1,511)	(1,550)	(1,612)	(1,593)	19
Capital maintenance charges:						
– Current cost depreciation	(1,081)	(1,148)	(1,140)	(1,178)	(1,195)	(17)
– Infrastructure renewals charge	(109)	(128)	(239)	(268)	(301)	(33)
Working capital adjustment	5	3	(1)	20	9	(11)
Other operating income	38	13	5	42	31	(11)
Current cost operating profit	1,421	1,370	1,538	1,558	1,596	39

Tables 4a and 4b show the turnover and current cost operating profit for each company for each year over the period 2003-08.

Table 4a Turnover by company

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m
Water and sewerage companies					
Anglian	867.0	875.1	925.5	947.1	956.9
Dŵr Cymru	529.3	539.1	588.5	592.8	614.2
Northumbrian	498.1	540.6	574.7	583.9	595.3
Severn Trent	1,080.3	1,098.3	1,218.0	1,245.2	1,256.8
South West	322.3	330.5	367.3	389.4	413.2
Southern	512.5	518.3	576.8	590.2	609.9
Thames	1,263.3	1,266.0	1,459.8	1,443.2	1,454.4
United Utilities	1,168.0	1,248.3	1,317.6	1,364.3	1,418.2
Wessex	320.6	332.6	364.5	376.4	390.7
Yorkshire	691.8	709.5	749.6	771.6	785.0
Total WaSCs	7,253.2	7,458.3	8,142.2	8,304.2	8,494.6
Water only companies					
Bournemouth & W Hampshire	32.5	33.2	37.3	36.3	36.9
Bristol	78.6	75.6	86.1	87.1	87.8
Cambridge	17.0	16.9	18.9	19.4	20.7
Dee Valley	19.0	18.6	19.8	19.2	18.9
Folkestone & Dover	15.7	15.7	16.7	17.0	17.6
Mid Kent	44.5	43.4	48.0	45.8	46.0
Portsmouth	35.1	34.7	34.6	34.1	33.9
South East	106.0	105.2	121.6	114.0	118.0
South Staffordshire	69.1	68.5	75.1	75.8	76.5
Sutton & East Surrey	45.3	44.4	49.6	49.5	49.8
Tendring Hundred	14.9	15.0	15.4	14.9	14.0
Three Valleys	191.8	193.4	223.0	221.6	224.3
Total WoCs	669.5	664.8	746.1	734.7	744.3

Table 4b Current cost operating profit by company

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m
Water and sewerage companies					
Anglian	274.4	266.9	278.3	327.6	316.0
Dŵr Cymru	117.1	138.9	182.9	171.1	173.5
Northumbrian	113.8	157.0	185.3	182.0	179.8
Severn Trent	343.1	306.5	387.3	412.0	318.4
South West	123.4	98.8	105.5	135.4	148.7
Southern	135.3	142.0	176.0	198.9	175.3
Thames	330.7	332.7	417.1	338.7	459.9
United Utilities	351.1	402.1	445.2	476.6	525.0
Wessex	123.2	129.0	144.5	151.2	167.8
Yorkshire	210.6	239.1	252.9	223.8	298.9
Total WaSCs	2,122.8	2,213.0	2,574.9	2,617.3	2,763.5
Water only companies					
Bournemouth & W Hampshire	7.4	8.7	9.8	11.7	12.4
Bristol	17.0	12.4	19.3	16.8	16.9
Cambridge	11.9	5.1	4.2	4.7	4.5
Dee Valley	4.6	5.1	3.5	2.7	3.0
Folkestone & Dover	4.4	5.3	5.6	5.4	5.8
Mid Kent	15.4	13.3	14.7	14.1	14.3
Portsmouth	9.4	9.2	6.1	8.2	5.5
South East	28.4	18.6	46.0	32.0	34.1
South Staffordshire	13.0	14.5	17.8	16.8	17.0
Sutton & East Surrey	9.3	10.1	10.6	10.8	10.1
Tending Hundred	5.5	6.2	6.3	5.2	5.0
Three Valleys	30.6	49.1	65.2	49.9	52.9
Total WoCs	156.8	157.7	209.0	178.3	181.5

The cash flow statement in table 5 shows the industry aggregate cash position for 2007-08 and the previous four years, while table 6 shows the key cash flows by company.

Companies continued to increase their levels of capital investment; at almost £4.6 billion for 2007-08 it is higher than at any point in the past five years. Interest represents about 21% of net cash flow from operations, which reflects companies' continued large borrowing requirements to fund their capital programmes.

Table 5 Cash flow statement

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2006-07 to 2007-08 change £m
Net cash flow from operating activities¹	4,690	4,828	5,211	5,356	5,631	274
Returns on investment and servicing of finance:						
– Net interest	(984)	(1,105)	(1,163)	(918)	(1,197)	(279)
– Dividends paid on non-equity shares	(50)	(47)	(28)	(26)	(20)	6
	(1,034)	(1,152)	(1,191)	(944)	(1,218)	(274)
Taxation paid	(70)	(74)	(209)	(383)	(416)	(33)
Investing activities						
– Purchase of fixed assets ²	(3,392)	(3,142)	(2,755)	(3,289)	(3,739)	(450)
– Infrastructure renewals expenditure	(559)	(521)	(588)	(780)	(856)	(76)
– Disposal of fixed assets	84	51	60	102	183	81
– Movements on long-term loans to group companies	n/a	n/a	n/a	(32)	(1,148)	(1,116)
	(3,866)	(3,612)	(3,283)	(4,000)	(5,560)	(1,561)
Dividends paid on equity shares	(1,450)	(1,203)	(1,820)	(3,274)	(1,448)	1,825
Net cash flow before financing	(1,730)	(1,213)	(1,291)	(3,244)	(3,012)	232
Financing:						
– Net loans	1,522	1,485	439	4,578	2,895	(1,683)
– Finance lease capital payments ³	3	241	58	(148)	(9)	139
– Proceeds of share issues	411	12	405	(0)	5	5
	1,936	1,738	902	4,430	2,891	(1,539)
Management of liquid resources	(6)	(367)	97	(1,099)	436	1,535
Increase/(decrease) in cash and cash equivalents	201	157	(294)	87	316	228

Notes:

1. Net cash flow from operating activities is calculated by adjusting the current cost operating profit shown in table 1 for items which are not direct cash flows (that is, depreciation) and the change in the components of working capital which are mainly debtors and creditors. It is also adjusted for infrastructure renewals expenditure (IRE), which is shown as an investing activity.
2. The timing of cash payments means that the amounts shown in the cash flow statement for purchase of fixed assets cannot be directly reconciled to the gross capital expenditure amounts discussed later in this report. This line includes any purchases of subsidiaries.
3. This includes the draw down of finance lease facilities netted off finance lease repayments.

Table 6 Key cash flows by company

2007-08 prices	Net cash flow from operating activities					Net cash flow before financing					Net increase/(decrease) in cash				
	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m
Water and sewerage companies															
Anglian	522.8	591.9	567.5	577.7	588.6	(183.3)	14.2	(4.8)	(314.0)	(145.4)	99.3	(125.6)	(5.3)	28.1	(0.8)
Dŵr Cymru	288.6	299.4	331.9	342.8	360.5	(174.5)	(157.8)	(44.5)	10.6	(107.9)	(1.6)	1.8	0.0	(0.4)	(0.8)
Northumbrian	250.6	286.0	319.5	313.8	333.1	(17.6)	(91.6)	(57.2)	(75.3)	(83.0)	(9.2)	(7.8)	(3.4)	(0.2)	(6.3)
Severn Trent	639.7	639.1	686.7	724.6	671.3	(127.2)	(87.0)	(123.2)	(589.1)	(323.2)	(16.3)	4.0	(248.7)	(172.9)	228.7
South West	199.0	215.1	199.6	241.4	259.9	(89.8)	(73.5)	(292.8)	(87.4)	(44.2)	16.7	6.1	17.8	9.3	78.7
Southern	280.5	330.2	353.6	349.8	362.5	(163.2)	(38.1)	(88.0)	(316.5)	(217.6)	160.9	159.7	(11.5)	(111.4)	80.8
Thames	737.3	761.5	817.5	783.8	924.1	(157.8)	1.0	(212.9)	(623.7)	(1,454.6)	(10.8)	(3.5)	14.8	80.6	(23.6)
United Utilities	767.1	674.1	848.3	942.8	958.1	(522.3)	(558.7)	(156.9)	(135.4)	(324.9)	(37.0)	19.7	(7.0)	37.1	(62.5)
Wessex	223.3	225.9	239.3	244.9	264.9	(79.5)	(71.5)	(21.0)	(81.8)	(122.7)	(4.0)	92.1	(62.3)	236.6	34.4
Yorkshire	435.7	476.5	469.0	447.4	517.1	(90.1)	(84.0)	(244.2)	(896.4)	(114.7)	(6.1)	8.2	2.1	(5.2)	(2.4)
Total WaSCs	4,344.7	4,499.6	4,833.0	4,969.0	5,240.0	(1,605.3)	(1,147.1)	(1,245.4)	(3,108.9)	(2,938.2)	192.1	154.7	(303.4)	101.7	326.1
Water only companies															
Bournemouth & W Hampshire	17.4	17.8	19.5	18.4	22.1	(0.3)	2.1	(17.6)	(34.1)	32.8	1.3	1.4	4.9	(5.6)	4.2
Bristol	37.5	37.7	36.2	44.1	47.7	(73.4)	1.7	(25.7)	(7.8)	(16.8)	(1.8)	0.0	(0.6)	1.8	(2.5)
Cambridge	7.9	6.2	11.5	7.8	6.0	7.9	(24.4)	2.0	(0.4)	(1.5)	4.7	0.0	0.5	0.7	(0.2)
Dee Valley	10.8	9.0	8.3	11.1	8.5	(2.1)	(1.4)	(0.2)	(2.9)	(2.0)	(0.1)	(0.1)	(0.0)	0.1	(0.4)
Folkestone & Dover	8.4	9.5	9.1	9.1	10.4	(2.2)	(1.2)	(6.8)	(2.5)	(0.6)	0.0	0.3	(1.0)	0.6	(0.5)
Mid Kent	25.3	24.5	26.3	27.8	27.2	(12.1)	(12.5)	(9.9)	(11.4)	(16.5)	(0.6)	0.0	0.1	0.5	(1.3)
Portsmouth	18.1	17.4	17.5	19.0	15.8	1.4	(0.3)	4.8	1.2	(2.5)	0.8	(0.3)	0.1	2.8	(0.0)
South East	58.2	59.7	63.1	65.3	65.8	(16.0)	(18.2)	(32.6)	(31.5)	(16.1)	7.9	2.7	(22.8)	5.6	(2.2)
South Staffordshire	31.6	28.4	37.6	37.7	36.2	(7.8)	(3.5)	12.9	(13.8)	(7.2)	(9.0)	(1.1)	27.7	(14.7)	(8.0)
Sutton & East Surrey	25.0	25.9	22.0	25.9	28.3	(5.4)	(6.3)	2.7	(15.7)	(4.0)	3.7	(2.5)	1.8	(4.5)	0.3
Tendring Hundred	9.9	10.6	8.6	8.7	7.8	0.8	2.1	(0.3)	(1.3)	(2.2)	(0.3)	0.4	(0.3)	(0.9)	0.2
Three Valleys	95.2	81.5	118.5	112.6	114.8	(16.1)	(3.4)	23.6	(15.1)	(36.8)	2.1	2.1	(1.3)	(0.8)	0.2
Total WoCs	345.2	328.3	378.2	387.5	390.6	(125.2)	(65.5)	(47.2)	(135.2)	(73.5)	8.6	2.9	9.1	(14.3)	(10.4)
Industry	4,689.8	4,827.9	5,211.3	5,356.5	5,630.6	(1,730.5)	(1,212.6)	(1,292.6)	(3,244.0)	(3,011.7)	200.7	157.6	(294.3)	87.3	315.7

Table 7 sets out the sectors' aggregate current cost balance sheet at 31 March for each of the past five years.

Table 7 Current cost balance sheet at 31 March

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2006-07 to 2007-08 change £m
Fixed assets						
Tangible assets	242,285	247,013	247,793	249,204	250,975	1,772
Third party contributions since 1989-90	(4,349)	(4,598)	(4,934)	(5,193)	(5,449)	(256)
Net fixed assets	237,936	242,414	242,859	244,011	245,526	1,516
Total working capital	(61)	266	(484)	(687)	(581)	106
Cash and investments	2,898	3,186	1,973	3,118	2,506	(612)
Borrowings	(25,938)	(27,306)	(27,517)	(31,334)	(33,335)	(2,001)
Non-trade debtors less creditors	1,028	1,036	2,029	2,827	4,091	1,264
Provisions for liabilities and charges	(106)	(126)	(165)	(291)	(313)	(22)
Deferred tax provision	(3,112)	(3,226)	(3,648)	(3,423)	(3,045)	378
Net assets employed	212,646	216,246	215,047	214,221	214,851	630
Capital and reserves						
Called up share capital	6,291	6,100	6,199	5,914	5,684	(229)
Share premium	1,279	1,244	933	890	852	(38)
Profit and loss account	(330)	(83)	(701)	(1,811)	(1,400)	411
Current cost reserve	204,998	208,591	208,230	208,820	209,310	490
Other reserves	408	395	386	408	404	(4)
Total capital and reserves	212,646	216,246	215,047	214,221	214,851	630

Net debt for the water and sewerage sectors now stands at £30.8 billion, an increase of £2.6 billion (9%) on last year. This is 29% higher than at 31 March 2003 and reflects the considerable cash outflows from both the capital investment and financial restructuring of the companies since then. This has driven a rise in gearing levels. Each company's net debt and gearing for this period is set out in table 8.

Table 8 Net debt and gearing by company at 31 March

2007-08 prices	Net debt					Gearing – net debt/RCV				
	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2003-04 %	2004-05 %	2005-06 %	2006-07 %	2007-08 %
Water and sewerage companies										
Anglian	4,017.0	4,365.5	3,848.5	4,255.4	4,487.8	82.2	89.7	78.6	85.5	88.1
Dŵr Cymru	2,485.1	2,452.4	2,439.6	2,551.2	2,514.3	83.4	79.6	73.7	74.3	71.2
Northumbrian	1,583.6	1,631.0	1,654.6	1,668.7	1,710.1	59.5	61.5	58.0	57.1	57.5
Severn Trent	2,633.8	2,657.3	2,702.7	3,237.4	3,480.1	48.9	48.2	47.2	55.1	57.8
South West	1,098.4	1,147.5	1,392.9	1,400.5	1,405.4	54.6	55.2	61.2	59.6	58.4
Southern	2,293.6	2,279.4	2,623.8	2,853.5	3,013.9	85.5	85.6	95.8	94.4	92.8
Thames	2,764.5	2,684.0	2,842.1	3,358.0	4,746.5	47.9	46.6	44.4	49.8	67.9
United Utilities	3,263.5	3,729.1	3,548.5	3,501.7	3,906.9	52.9	58.7	51.3	48.8	52.9
Wessex	1,233.1	1,266.7	1,258.6	1,282.1	1,358.3	67.9	70.0	63.1	62.2	64.3
Yorkshire	1,435.4	1,475.5	1,687.2	2,502.7	2,564.3	39.7	39.8	42.2	60.6	60.4
Total WaSCs	22,808.0	23,688.5	23,998.5	26,611.2	29,187.6	60.2	61.6	58.4	62.3	66.3
Water only companies										
Bournemouth & W Hampshire	26.0	23.1	70.2	103.3	69.5	20.9	18.2	52.3	78.0	52.6
Bristol	161.3	154.2	192.7	194.4	192.6	67.4	58.1	75.6	71.9	70.2
Cambridge	6.6	30.9	28.2	27.3	27.9	13.0	57.5	51.9	50.1	50.7
Dee Valley	27.4	29.1	28.9	31.2	32.6	50.5	55.2	48.6	49.7	53.8
Folkestone & Dover	20.3	20.9	27.1	27.7	27.3	33.9	34.3	42.4	40.4	40.6
Mid Kent	163.2	167.9	178.9	187.9	204.9	81.1	78.1	77.4	75.8	80.3
Portsmouth	80.5	80.7	76.3	76.4	79.1	75.9	79.5	73.2	69.9	71.2
South East	179.1	407.7	454.2	475.0	485.7	34.3	78.8	82.2	84.0	87.0
South Staffordshire	121.4	124.7	160.0	141.6	147.1	65.2	66.8	80.5	69.9	71.7
Sutton & East Surrey	71.0	79.1	92.0	108.3	113.2	51.3	52.9	59.4	68.2	71.4
Tendring Hundred	11.3	8.8	8.9	9.7	11.2	18.2	14.3	15.6	17.4	19.6
Three Valleys	230.6	244.3	227.9	221.8	249.7	34.8	36.0	32.5	30.3	33.4
Total WoCs	1,098.4	1,371.3	1,545.4	1,604.6	1,640.8	45.6	55.7	60.2	60.3	61.2
Industry	23,906.1	25,057.8	25,543.9	28,215.8	30,828.4	59.3	61.2	58.5	62.2	66.0

During the 1994 price review we established the regulatory capital value (RCV) as a new measure of each company's capital base. This uses the companies' market valuation (including debt) at privatisation. We then adjust this to take account of the net new capital expenditure assumed at the time of initial price setting and at each subsequent price review (after allowing for current cost depreciation).

Table 9 shows each company's RCV and its return on capital measured by its RCV for each year over the period 2003-08. The pre-tax return on capital for the sectors in 2007-08, based on the current cost operating profit and RCV was 6.5%, compared with the 6.4% achieved in 2006-07. The pre-tax return assumed in price limits for 2007-08 was 7.1%. The infrastructure renewals charges are the single biggest cost variance compared with our expectation.

Table 9 Return on capital measured by regulatory capital value by company

2007-08 prices	Average regulatory capital value					Return on capital employed				
	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2003-04 %	2004-05 %	2005-06 %	2006-07 %	2007-08 %
Water and sewerage companies										
Anglian	4,739.5	4,825.4	4,809.6	4,854.5	4,952.0	5.8	5.5	5.8	6.7	6.4
Dŵr Cymru	2,835.3	3,000.3	3,183.8	3,316.2	3,424.2	4.1	4.6	5.7	5.2	5.1
Northumbrian	2,568.5	2,629.5	2,755.0	2,841.3	2,901.4	4.4	6.0	6.7	6.4	6.2
Severn Trent	5,198.1	5,391.5	5,593.0	5,701.0	5,848.7	6.6	5.7	6.9	7.2	5.4
South West	1,928.7	2,023.8	2,189.6	2,274.3	2,340.1	6.4	4.9	4.8	6.0	6.4
Southern	2,590.3	2,645.0	2,631.1	2,834.2	3,083.7	5.2	5.4	6.7	7.0	5.7
Thames	5,610.4	5,707.9	6,151.6	6,468.3	6,754.8	5.9	5.8	6.8	5.2	6.8
United Utilities	6,021.8	6,196.0	6,716.4	6,928.1	7,158.8	5.8	6.5	6.6	6.9	7.3
Wessex	1,747.5	1,794.0	1,925.2	1,994.7	2,053.7	7.1	7.2	7.5	7.6	8.2
Yorkshire	3,491.6	3,621.4	3,846.1	3,996.8	4,117.8	6.0	6.6	6.6	5.6	7.3
Total WaSCs	36,731.7	37,834.8	39,801.2	41,209.5	42,635.4	5.8	5.8	6.5	6.4	6.5
Water only companies										
Bournemouth & W Hampshire	116.8	124.1	132.9	131.1	130.0	6.4	7.0	7.3	8.9	9.6
Bristol	223.9	248.0	248.6	258.3	267.9	7.6	5.0	7.7	6.5	6.3
Cambridge	49.1	51.6	53.3	53.5	53.9	24.2	9.8	7.9	8.9	8.3
Dee Valley	52.5	52.9	56.2	60.1	60.6	8.7	9.7	6.3	4.5	4.9
Folkestone & Dover	56.6	59.7	60.7	65.1	66.8	7.7	8.9	9.2	8.3	8.6
Mid Kent	195.3	206.0	219.2	235.6	247.4	7.9	6.4	6.7	6.0	5.8
Portsmouth	105.0	102.7	102.8	105.0	108.4	9.0	8.9	5.9	7.8	5.1
South East	509.2	514.9	533.6	549.8	552.6	5.6	3.6	8.6	5.8	6.2
South Staffordshire	176.4	184.4	193.1	197.4	200.6	7.4	7.9	9.2	8.5	8.5
Sutton & East Surrey	132.1	142.4	150.2	154.3	156.0	7.0	7.1	7.1	7.0	6.5
Tendring Hundred	60.1	61.2	56.5	55.5	55.7	9.2	10.1	11.2	9.4	9.1
Three Valleys	631.0	663.7	680.8	704.5	727.2	4.9	7.4	9.6	7.1	7.3
Total WoCs	2,308.0	2,411.6	2,487.9	2,570.3	2,626.9	6.8	6.5	8.4	6.9	6.9
Industry	39,039.8	40,246.3	42,289.1	43,779.8	45,263.0	5.8	5.9	6.6	6.4	6.5

Table 10 shows the returns that investors and lenders received (for example, dividends and interest as a percentage of the RCV). Returns on this basis are 6.4% this year. This is much lower than the 10% seen in 2006-07, when six companies paid special dividends (see table 13). Table 11 shows the returns on capital based on the average net modern equivalent asset (MEA) values for each year over the period 2003-08. An MEA value is the cost of replacing an old asset with a technically up-to-date asset with the same service capability, but allowing for the remaining service potential of the old asset compared with the new one.

Table 10 Dividends reported plus interest payable as a percentage of regulatory capital value

2007-08 prices	Dividends reported ²					Interest payable					Dividends plus interest payable as a percentage of capital value				
	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2003-04 %	2004-05 %	2005-06 %	2006-07 %	2007-08 %
Water and sewerage companies															
Anglian	283.2	278.2	325.4	458.7	285.5	59.7	71.0	67.5	60.8	102.0	7.2	7.2	8.2	10.7	7.8
Dŵr Cymru	16.0	15.5	0.0	0.0	0.0	171.4	159.1	163.5	158.8	189.0	6.6	5.8	5.1	4.8	5.5
Northumbrian	112.0	70.8	36.1	71.4	72.6	91.6	91.1	94.8	95.9	86.6	7.9	6.2	4.8	5.9	5.5
Severn Trent	180.6	163.0	165.1	678.9	260.9	141.5	145.0	139.8	149.7	166.8	6.2	5.7	5.5	14.5	7.3
South West	86.4	88.1	213.8	78.1	68.7	55.5	56.9	104.3	60.6	64.9	7.4	7.2	14.5	6.1	5.7
Southern	71.1	60.7	45.2	61.6	64.8	106.8	113.7	136.2	134.8	145.0	6.9	6.6	6.9	6.9	6.8
Thames	149.8	152.0	291.9	547.5	93.7	145.5	151.0	143.9	176.5	171.5	5.3	5.3	7.1	11.2	3.9
United Utilities	235.7	234.0	240.6	277.0	296.6	219.0	241.7	258.2	143.5	193.6	7.6	7.7	7.4	6.1	6.8
Wessex	48.5	46.7	56.4	91.2	104.0	68.8	75.0	73.8	67.7	69.4	6.7	6.8	6.8	8.0	8.4
Yorkshire	114.6	117.2	289.8	861.2	111.2	85.7	85.1	88.3	100.9	144.6	5.7	5.6	9.8	24.1	6.2
Total WaSCs	1,298.0	1,226.1	1,664.2	3,125.7	1,358.0	1,145.6	1,189.7	1,270.3	1,149.1	1,333.4	6.7	6.4	7.4	10.4	6.3
Water only companies															
Bournemouth & W Hampshire ³	4.2	5.3	4.4	5.9	5.7	1.2	1.3	19.3	4.1	4.6	4.6	5.3	17.8	7.6	8.0
Bristol	8.3	9.0	10.9	6.3	11.6	7.2	7.4	7.0	6.5	8.5	6.9	6.6	7.2	5.0	7.5
Cambridge	2.7	26.5	0.0	2.4	2.4	1.2	0.9	1.4	0.6	1.9	7.9	53.1	2.6	5.6	7.9
Dee Valley	1.5	1.4	1.4	1.3	1.3	2.5	2.1	2.1	2.1	2.4	7.5	6.8	6.1	5.7	6.1
Folkestone & Dover	2.6	3.5	4.1	3.2	3.4	1.1	1.3	1.0	1.1	1.5	6.5	8.0	8.5	6.7	7.4
Mid Kent	5.5	4.9	7.1	4.9	6.8	8.1	8.7	8.0	8.9	14.0	7.0	6.6	6.9	5.9	8.4
Portsmouth	4.8	4.2	3.9	4.5	4.1	2.4	1.9	(0.6)	(1.0)	(1.0)	6.8	5.9	3.2	3.4	2.8
South East	16.5	26.5	32.3	42.8	22.1	9.7	11.4	27.0	16.5	21.2	5.1	7.4	11.1	10.8	7.8
South Staffordshire ⁴	4.8	9.2	6.5	19.2	11.9	7.5	7.5	37.2	6.8	7.3	6.9	9.1	22.6	13.1	9.6
Sutton & East Surrey	6.8	6.6	5.4	15.2	5.4	5.9	5.9	7.0	7.8	8.8	9.7	8.8	8.2	14.9	9.1
Tendring Hundred	3.6	4.2	3.8	4.0	3.2	0.5	0.6	0.4	0.4	0.4	6.9	7.9	7.5	7.9	6.5
Three Valleys	30.4	30.8	30.4	28.6	30.9	12.7	14.9	12.7	11.9	11.4	6.8	6.9	6.3	5.7	5.8
Total WoCs	91.7	132.1	110.1	138.3	108.8	59.9	63.9	122.5	65.7	81.0	6.6	8.1	9.3	7.9	7.2
Industry	1,389.7	1,358.3	1,774.3	3,264.0	1,466.8	1,205.6	1,253.8	1,392.8	1,214.8	1,414.4	6.6	6.5	7.5	10.2	6.4

Notes:

1. From 2005-06 onwards, dividends are reported on a different basis because of a new UK accounting standard (FRS 21). Under this standard, any dividend declared post-year end, even if it relates to that year's performance, should not be recognised in the accounts for that year. Therefore, the 2005-06 dividend figure includes amounts relating to 2004-05 that were declared and paid in 2005-06.
2. Dividends reported include special dividends.
3. In 2005-06, interest payable includes £15.5 million relating to the premium paid on the redemption of its preference shares. If this was excluded, the return would be 6.6%.
4. In 2005-06, interest payable includes £31 million relating to an exceptional refinancing loss. If this was excluded, the return would be 7.1%.

Table 11 Return on capital by service measured by average MEA – industry

2007-08 prices		2003-04	2004-05	2005-06	2006-07	2007-08
Water service						
Current cost operating profit	£bn	0.86	1.00	1.25	1.24	1.35
Average net MEA – infrastructure	£bn	75.15	75.36	75.51	75.98	76.21
Average net MEA – non-infrastructure	£bn	12.60	12.94	13.31	13.38	13.62
Average net MEA value – all assets	£bn	87.73	88.27	88.81	89.35	89.84
Return on capital employed	%	1.00	0.99	1.42	1.39	1.50
Sewerage service						
Current cost operating profit	£bn	1.42	1.37	1.54	1.56	1.60
Average net MEA – infrastructure	£bn	135.10	135.42	135.53	136.84	138.75
Average net MEA – non-infrastructure	£bn	19.00	19.26	19.62	20.42	21.51
Average net MEA value – all assets	£bn	154.11	154.68	155.15	157.27	160.25
Return on capital employed	%	0.87	0.87	0.87	0.97	1.00
Total						
Current cost operating profit	£bn	2.28	2.37	2.78	2.80	2.95
Average net MEA – infrastructure	£bn	210.68	212.20	213.93	214.79	214.96
Average net MEA – non-infrastructure	£bn	32.22	33.36	34.38	173.42	173.88
Average net MEA value – all assets	£bn	242.89	245.54	248.31	249.40	250.09
Return on capital employed	%	0.92	0.92	0.92	1.12	1.18

1.1 Dividends

Dividends represent companies' largest cash flow after capital expenditure. Each company is required to set out its dividend policy in its regulatory accounts.

Dividends declared in 2007-08 (excluding special dividends) were 14% higher than the previous year at £1.47 billion. No special dividends were paid in the year. Table 12 shows the related dividend covers on a current cost and historic cost basis. An analysis of special dividends paid by companies over the period 2003-08 is set out in table 13.

Table 12 Dividend covers by company

	Dividend cover (current cost basis)					Dividend cover (historic cost basis)				
	2003-04	2004-05	2005-06	2006-07	2007-08	2003-04	2004-05	2005-06	2006-07	2007-08
Water and sewerage companies										
Anglian	1.1	1.0	0.7	0.5	0.7	1.2	1.0	0.8	0.7	1.0
Dŵr Cymru	(0.4)	3.3	n/a	n/a	n/a	(1.1)	1.9	n/a	n/a	n/a
Northumbrian	0.7	1.4	2.3	1.9	1.3	0.7	1.2	2.4	1.6	1.4
Severn Trent	1.2	1.5	1.4	0.5	0.8	1.1	1.2	1.2	0.4	0.6
South West	1.0	0.7	0.2	1.5	1.8	0.8	0.6	0.1	1.0	1.4
Southern	0.6	1.0	1.3	2.0	1.6	0.8	1.2	1.4	1.5	1.3
Thames	1.3	1.4	0.9	0.4	3.7	1.3	1.3	0.9	0.3	4.0
United Utilities	1.2	1.0	0.7	1.5	1.0	1.1	0.9	0.7	1.2	1.2
Wessex	1.9	1.9	1.4	1.4	1.0	1.5	1.2	1.2	1.0	0.9
Yorkshire	1.2	1.5	0.5	0.2	1.9	1.4	1.6	0.6	0.2	1.5
Total WaSCs	1.1	1.2	0.8	0.6	1.3	1.1	1.1	0.8	0.6	1.3
Water only companies										
Bournemouth & W Hampshire	1.2	1.2	(2.6)	1.5	1.6	1.7	1.6	(1.9)	1.4	1.3
Bristol	1.2	0.8	0.8	2.2	0.9	1.5	1.0	1.1	2.3	1.1
Cambridge	3.5	0.1	n/a	2.0	2.4	3.7	0.1	n/a	1.5	2.1
Dee Valley	(0.2)	0.5	(0.1)	(1.1)	1.3	1.3	2.0	1.6	1.0	2.5
Folkestone & Dover	1.0	0.9	0.8	1.3	1.5	1.3	1.0	0.9	1.2	1.4
Mid Kent	1.8	1.9	1.1	3.1	1.6	1.6	1.4	1.0	2.0	1.1
Portsmouth	1.1	1.3	1.1	1.5	1.6	1.2	1.4	1.3	1.8	2.0
South East	1.4	0.3	0.5	0.5	(0.9)	1.6	0.4	0.6	0.5	0.8
South Staffordshire	1.1	0.8	(1.8)	0.3	0.6	1.8	1.0	(1.7)	0.5	1.0
Sutton & East Surrey	0.6	1.4	0.7	0.1	0.3	0.7	1.4	0.6	0.3	0.6
Tendring Hundred	1.0	0.9	1.1	0.9	1.1	1.1	1.0	1.1	0.9	1.2
Three Valleys	0.5	0.9	1.4	1.2	1.6	0.7	0.9	1.3	0.9	1.5
Total WoCs	1.0	0.7	0.7	0.9	1.2	1.3	0.8	0.7	0.8	1.2
Industry	1.1	1.2	0.8	0.7	1.3	1.1	1.1	0.8	0.6	1.3

Table 13 Analysis of special dividends

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	Total £m
Increased gearing						
Cambridge		24				24
South West			157	57		214
Anglian				221		221
Severn Trent				600		600
Thames				348		348
Yorkshire				747		747
Sutton & East Surrey				12		12
Efficiency savings						
Yorkshire			174			174
Proceeds from land sales						
South East			8			8
Total	0	24	338	1,985	0	2,347

1.2 Accounting charges

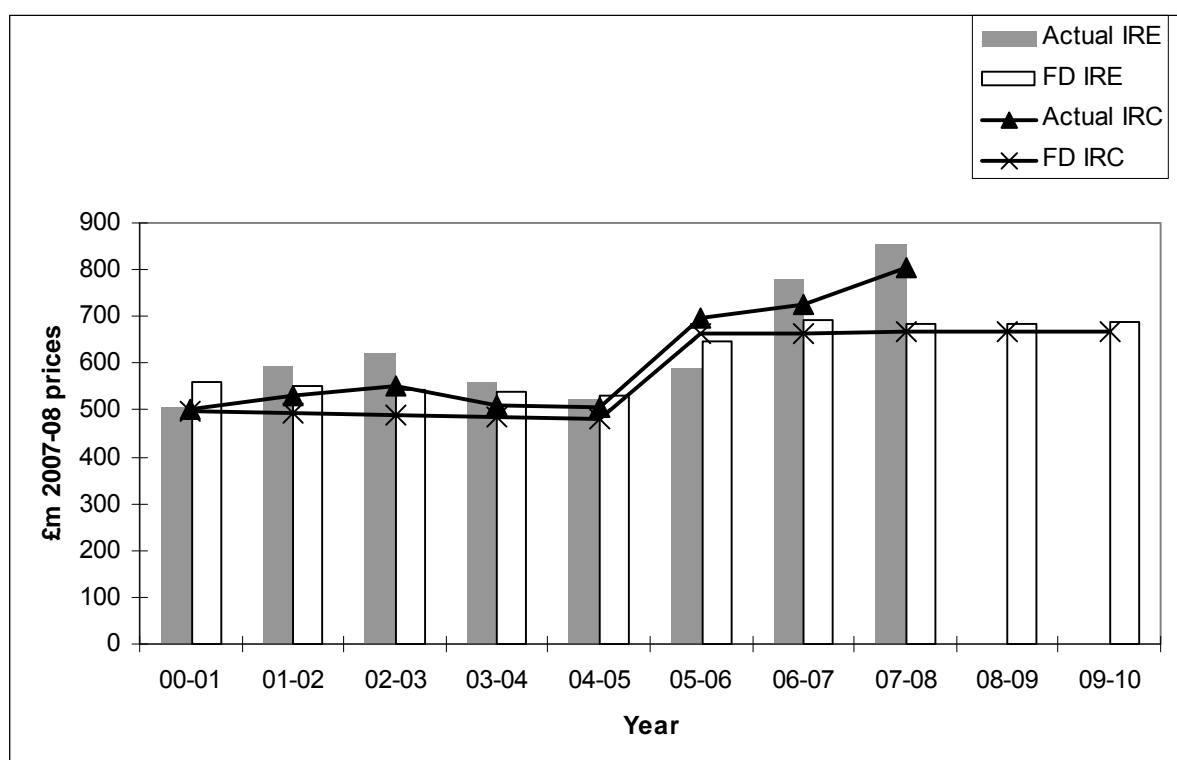
We use current cost depreciation (CCD) to derive the appropriate accounting charge in customers' bills to cover the capital maintenance needs of each company's above-ground assets. For underground assets we use an infrastructure renewals charge (IRC).

CCD is the most significant component of capital maintenance charges. Over the long term, the CCD charged should be comparable to the capital expenditure required to maintain and replace the assets. In 2007-08, the CCD charge was 1.8% higher than in 2006-07. This is broadly in line with what we assumed when we set price limits in 2004, as is the cumulative charge over the last three years.

The water and sewerage sectors adopted infrastructure renewals accounting before privatisation, as it more accurately represents the manner in which infrastructure assets are managed, operated and maintained than conventional depreciation policies. Table 14 shows the infrastructure renewals expenditure (IRE) and infrastructure renewals charges (IRC) by service for each year for the period 2003-08. Figure 1 sets out the actual IRE and IRC that the sectors reported for each year over the period 2000-08, together with our assumptions when we set price limits in 1999 and 2004.

Table 14 Comparison of infrastructure renewals expenditure and charges 2003-08

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2006-07 to 2007-08 change %
Water service						
Infrastructure renewals expenditure	342	341	369	511	558	9.3
Infrastructure renewals charge	399	377	456	457	505	10.4
Difference	(57)	(35)	(87)	53	53	
Sewerage service						
Infrastructure renewals expenditure	216	180	219	270	298	10.4
Infrastructure renewals charge	110	129	239	268	301	12.4
Difference	106	51	(20)	2	(4)	
Total						
Infrastructure renewals expenditure	559	521	588	780	856	9.7
Infrastructure renewals charge	509	505	695	725	806	11.2
Difference	50	16	(107)	55	50	

Figure 1 Comparison of infrastructure renewals expenditure and charges


We would expect a fairly constant IRC under infrastructure renewals accounting if networks are stable. But if, say, the network required higher levels of expenditure on a long-term basis, then we would expect this to be reflected in higher IRC levels. Companies' IRCs should equal their medium- to long-term views of their IRE.

When we set price limits for 2005-10, we recognised that higher levels of expenditure would be required in the future. There has been sustained growth in IRE in the first three years of the price setting period to £856 million in 2007-08, which is some 64% higher than the 2004-05 level.

There has been a significant increase in IRC in 2007-08 of 11% to £806 million. However, over the period 2005-08 the cumulative IRC is almost exactly equal to the IRE. The higher levels of IRC reflect future expectations of IRE and, for some companies, changes in accounting policy in order that the IRC is reflective of a longer-term view.

2. Operating expenditure

Total operating expenditure for the water and sewerage sectors in 2007-08 was £3.4 billion (excluding exceptional items). This was £125 million lower than in 2006-07 and represents a 4% decrease in real terms. It is £67 million (2%) less than we assumed in price limits for 2007-08 and £319 million (9%) less than the companies set out in their 2004 business plans. Total operating expenditure in 2007-08 was £113 million lower than in 2003-04 (3% in real terms). This was the year we used at the 2004 periodic review to establish the base level of costs.

Table 15 shows the trend at the industry level by service, while table 16 shows the performance of individual companies.

Table 15 Total operating expenditure by service

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	2006-07 to 2007-08 change £m
Water service	1,820	1,767	1,888	1,946	1,872	(74)
Sewerage service	1,459	1,487	1,531	1,571	1,520	(51)
Total	3,279	3,255	3,419	3,517	3,392	(125)

Notes:

1. The numbers above do not reconcile to table 1, because exceptional items, excluded from the above, are as reported in June returns and do not correspond to those stated in table 1, which are reported under Ofwat regulatory accounting guidelines.
2. Numbers may not add due to rounding.

Table 16 Total operating expenditure by company

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	% change since 2003-04
Water and sewerage companies						
Anglian	330.0	319.2	335.5	337.4	328.5	(0.5)
Dŵr Cymru	242.3	232.6	221.7	229.1	227.3	(6.2)
Northumbrian	238.2	235.2	240.3	248.7	237.3	(0.4)
Severn Trent	442.0	467.6	477.7	492.1	475.2	7.5
South West	119.8	127.8	137.2	142.9	144.0	20.2
Southern	196.4	189.1	186.4	195.9	198.6	1.1
Thames	556.4	541.7	640.1	665.9	569.7	2.4
United Utilities	449.2	460.7	459.9	460.3	471.8	5.0
Wessex	101.2	106.7	112.6	116.0	112.8	11.5
Yorkshire	251.1	241.2	265.8	274.2	270.7	7.8
Total WaSCs	2,926.5	2,921.7	3,077.3	3,162.5	3,035.7	3.7
Water only companies						
Bournemouth & W Hampshire	15.6	15.0	14.6	14.6	14.5	(7.3)
Bristol	39.9	39.7	40.6	42.0	42.7	6.9
Cambridge	10.1	9.6	9.8	10.6	12.1	19.4
Dee Valley	9.7	9.2	9.5	10.4	10.2	5.4
Folkestone & Dover	8.1	7.5	7.6	8.2	8.2	0.8
Mid Kent	19.0	18.2	20.9	20.1	17.9	(5.5)
Portsmouth	17.8	17.4	20.5	18.8	19.8	11.4
South East	56.7	51.8	51.3	52.3	52.0	(8.3)
South Staffordshire	37.8	35.6	39.5	39.3	38.9	2.9
Sutton & East Surrey	24.3	22.8	24.3	23.5	25.0	3.0
Tending Hundred	6.5	6.0	5.7	6.2	6.1	(5.5)
Three Valleys	107.3	100.2	97.1	108.6	109.0	1.6
Total WoCs	352.7	332.9	341.4	354.5	356.4	1.0
Industry	3,279.2	3,254.6	3,418.7	3,516.9	3,392.0	3.4

Notes:

1. Numbers may not add due to rounding.
2. Excludes exceptional items, but includes third party expenditure.

Table 17 shows operating expenditure by functional service and by type of expenditure within each function for 2003-04 and 2007-08.

Almost all areas of operating expenditure across the water and sewerage sectors are lower than reported last year. The most significant reduction compared with 2006-07 is for energy costs, which are 9% lower. There was a fall in energy costs in 2007-08 compared to 2006-07. Some companies have continued to benefit from energy contracts with prices that were lower than the then current rates. Although there is a significant year-on-year reduction in power costs, they are 6% above what we assumed in our final determinations. The remaining reductions are distributed across the other areas of expenditure.

Table 17 Industry total operating expenditure by service by function

	2003-04								2007-08								
	Water service			Sewerage service					Industry total	Water service			Sewerage service				Industry total
	Water resources and treatment	Water distribution	Water service total	Sewerage	Sewage treatment	Sludge treatment and disposal	Sewerage service total	Water resources and treatment		Water distribution	Water service total	Sewerage	Sewage treatment	Sludge treatment and disposal	Sewerage service total		
2007-08 prices	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Employment costs	87	122	208	44	88	47	179	387	80	98	178	46	90	45	181	359	
Power	59	78	138	23	78	27	129	266	89	104	193	36	116	28	179	372	
Hired and contracted services	42	150	192	77	57	102	237	428	36	164	201	79	59	94	232	433	
Materials and consumables	52	18	71	6	29	33	68	139	57	12	69	6	30	36	72	141	
Service charges	103	0	103	14	36	0	51	154	109	0	109	14	34	0	48	157	
Other direct costs	31	22	54	6	6	19	30	84	43	21	64	6	7	15	28	92	
Total direct costs	374	391	765	170	295	228	694	1,458	414	399	813	187	335	217	740	1,553	
General and support expenditure	150	192	342	69	151	88	308	650	138	203	341	75	147	78	301	642	
Functional expenditure	524	583	1,107	239	446	316	1,002	2,109	552	602	1,154	262	483	296	1,041	2,195	
Customer services			193				158	352			200				175	374	
Scientific services			81				36	117			69				29	98	
Other business services			30				20	50			29				20	50	
Total business activities			304				215	519			298				224	522	
Local authority rates			229				118	347			234				137	370	
Doubtful debts			87				99	186			96				104	200	
Total operating expenditure less third party services			1,727				1,433	3,160			1,782				1,506	3,288	
Third party services operating expenditure			93				26	119			90				15	104	
Total operating expenditure			1,820				1,459	3,279			1,872				1,520	3,392	

Note:

Numbers may not add due to rounding.

3. Capital investment

Since privatisation in 1990, the water and sewerage sectors in England and Wales have invested approximately £75 billion. This equals average annual capital investment of more than £4.2 billion, compared with an equivalent investment figure of about £2 billion a year during the 1980s. In 2007-08, the companies made capital investment equivalent to 53% of their turnover; this is high when compared with other industries. Even so, overall capital expenditure is still some 9% behind our expectations for the first three years, which is only partly explained by efficiencies. There have been delays in delivering schemes because of planning issues and rephasing of schemes within the programme. But companies have caught up on capital maintenance, which is 5% above what we expected by now. There had been a particularly slow start on maintenance in the first year of the price setting period.

The aggregate gross capital investment in 2007-08 was £4.9 billion, compared with £4.5 billion in 2006-07. We expected companies to invest £4.7 billion (gross) in 2007-08, which means that companies invested 4% more than our final determination assumptions in 2007-08.

3.1 Capital investment by service

Table 18 shows capital investment at industry level for each year for the period 2003-08.

Table 18 Gross capital investment by service – industry

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	Five-year total £m
Water service	1,913	1,820	1,780	2,285	2,462	10,260
Sewerage service	2,333	2,159	1,886	2,248	2,451	11,076
Industry total	4,246	3,979	3,666	4,533	4,913	21,336

Notes:

1. All investment is stated gross of capital contributions, including IRE which was previously reported as net of capital contributions. As a result of this, expenditure in this table does not match previously reported data.
2. The above table has been adjusted into 2007-08 prices using year-average RPI.
3. Assets adopted at nil cost are excluded from gross capital investment in tables 18-22.

- Investment in the water service in 2007-08 increased by 8% compared with 2006-07.
- Investment in the distribution system has continued to make up the majority of expenditure in the water service. This reflects the increase in companies' mains renewal and relining activities.
- Investment in the sewerage service for the same period showed an increase of about 9%. This relates to increased levels of sewer rehabilitation and an increase in maintenance on sewage treatment works to achieve stable serviceability.
- During the first three years of this price-setting period, the water and sewerage sectors' capital maintenance expenditure was about 5% higher than that projected in price limits. As a result of the significant investment during 2007-08, companies are now investing in line with our assumptions in the water service and investments are 10% higher than our assumptions in the sewerage service. The increase in investment reflects companies' efforts to improve their sewerage networks and serviceability of their sewage treatment works.
- At an industry level, supply/demand balance cumulative expenditure to date is about 25% lower than what we projected when we set price limits in 2004. The companies have been unable to catch up on delays from the first two years and there continues to be less developer activity.
- In addition, quality enhancement cumulative expenditure to date is 28% lower at an industry level than we assumed when we set price limits. Companies have made only minor progress in catching up with delays from the first and second years of this price setting period. Most of the variance is as a result of reprofiling of expenditure and delays while companies optimise the solutions. Despite these delays, companies report that they are on target to meet their statutory obligations.
- At an industry level, enhanced service level cumulative expenditure to date (that is, all investment associated with improving service to consumers) is 14% higher than the assumptions we made when we set price limits. This is mainly as a result of increased investment to alleviate flooding from sewers.

Table 19 shows the expenditure breakdown by purpose for the water and sewerage sectors, while tables 20a and 20b show the breakdown at company level.

Table 19 Gross capital investment by purpose category – industry

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	Five-year total £m
Water service						
Base service:						
– IRE Maintenance of underground assets	374	369	395	533	579	2,250
– MNI Maintenance of above-ground assets	505	485	500	666	654	2,811
Improving and maintaining the supply/demand balance	445	506	469	559	680	2,656
Quality improvement programmes	587	456	415	519	543	2,519
Enhanced service levels	2	4	2	8	7	24
Water service total	1,913	1,820	1,780	2,285	2,462	10,260
Sewerage service						
Base service:						
– IRE Maintenance of underground assets	246	207	241	295	324	1,311
– MNI Maintenance of above-ground assets	824	649	787	1,001	1,007	4,268
Improving and maintaining the supply/demand balance	111	109	100	146	175	641
Quality improvement programmes	1,070	1,088	619	614	735	4,126
Enhanced service levels	83	105	140	192	209	728
Sewerage service total	2,333	2,159	1,886	2,248	2,451	11,076
Industry total	4,246	3,979	3,666	4,533	4,913	21,336

Notes:

1. All investment is stated gross of capital contributions, including IRE which was previously reported as net of capital contributions.
2. The above table has been adjusted into 2007-08 prices using year average RPI.
3. Assets adopted at nil cost are excluded from gross capital investment in tables 18-22.
4. In the water service, security of supply expenditure has been reported in the supply/demand balance category to align with the PR04 final determination assumptions. Historic expenditure has been updated to allow a comparison to be made.

Table 20a Gross capital investment by purpose category 2007-08 – water and sewerage companies

2007-08 prices	Base service: maintenance of under- ground assets £m	Base service: maintenance of above- ground assets £m	Improving and maintaining the supply/ demand balance £m	Quality enhancement programmes £m	Enhanced service levels £m	Total investment £m
Water service						
Anglian	41.5	45.2	72.8	30.8	0.8	191.0
Dŵr Cymru	45.0	41.3	7.2	49.2	0.0	142.7
Northumbrian	24.1	55.9	29.5	41.1	0.0	150.5
Severn Trent	76.2	64.5	63.1	35.4	6.1	245.3
South West	15.6	19.6	17.1	53.0	0.0	105.3
Southern	25.7	29.5	19.7	1.7	0.0	76.5
Thames	131.1	95.5	314.5	54.1	0.0	595.1
United Utilities	65.9	98.7	32.0	155.9	0.0	352.5
Wessex	26.1	42.0	15.8	14.7	0.0	98.6
Yorkshire	37.9	49.4	10.8	59.5	0.0	157.6
Total	489	541	582	495	7	2,115
Sewerage service						
Anglian	35.4	90.2	13.9	75.8	13.2	228.4
Dŵr Cymru	33.4	53.6	12.4	48.6	11.5	159.5
Northumbrian	16.0	54.1	12.8	18.7	3.6	105.3
Severn Trent	45.1	141.5	17.7	109.2	8.0	321.5
South West	12.4	31.9	12.4	16.1	1.6	74.4
Southern	25.8	147.7	23.2	102.4	21.3	320.3
Thames	56.4	190.2	34.8	31.6	99.7	412.8
United Utilities	64.1	158.2	22.0	199.4	28.7	470.8
Wessex	18.1	56.4	11.0	30.0	20.5	136.0
Yorkshire	17.2	83.6	15.2	103.3	0.8	220.1
Total	324	1,007	175	735	209	2,451

Notes:

1. All investment is stated gross of capital contributions, including IRE which was previously reported as net of capital contributions.
2. Assets adopted at nil cost are excluded from gross capital investment in tables 18-22.
3. In the water service, security of supply expenditure has been reported in the supply/demand balance category to align with the PR04 final determination assumptions. Historic expenditure has been updated to allow a comparison to be made.

Table 20b Gross capital investment by purpose category 2007-08 – water only companies

2007-08 prices	Base service: maintenance of underground assets £m	Base service: maintenance of above-ground assets £m	Improving and maintaining the supply/demand balance £m	Quality improvement programmes £m	Enhanced service levels £m	Total investment £m
Bournemouth & W Hampshire	1.7	4.7	4.8	0.0	0.0	11.2
Bristol	10.7	11.8	6.8	20.4	-0.1	49.6
Cambridge	1.4	1.5	2.9	0.5	0.0	6.4
Dee Valley	1.6	6.4	1.1	0.0	0.0	9.0
Folkestone & Dover	0.9	2.2	1.4	0.0	0.0	4.5
Mid Kent	4.6	8.4	16.2	2.4	0.0	31.6
Portsmouth	4.8	1.3	1.6	4.3	0.0	12.0
South East	11.2	17.3	26.0	1.5	0.0	56.0
South Staffordshire	10.7	10.6	9.6	0.0	0.0	30.9
Sutton & East Surrey	8.3	9.2	4.2	0.0	0.0	21.7
Tendring Hundred	1.1	4.6	0.4	0.0	0.0	6.1
Three Valleys	32.7	34.5	22.2	18.8	0.0	108.2
Total	90	112	97	48	0	347

Notes:

1. All investment is stated gross of capital contributions, including IRE which was previously reported as net of capital contributions.
2. Assets adopted at nil cost are excluded from gross capital investment in tables 18-22.
3. In the water service, security of supply expenditure has been reported in the supply/demand balance category to align with the PR04 final determination assumptions. Historic expenditure has been updated to allow a comparison to be made.

Table 21 sets out the capital investment trends by service area at industry level for each year for the period 2003-08, while table 22 shows each company's expenditure by service area in 2007-08.

Table 21 Gross capital investment by service area – industry

2007-08 prices	2003-04 £m	2004-05 £m	2005-06 £m	2006-07 £m	2007-08 £m	Five-year total £m
Water service						
Resources	173	137	86	124	137	656
Treatment	453	395	349	531	540	2,268
Distribution	1,112	1,074	1,150	1,413	1,568	6,318
General	175	214	195	217	217	1,019
Water service total	1,913	1,820	1,780	2,285	2,462	10,260
Sewerage service						
Sewerage	920	844	755	905	908	4,333
Sewage treatment	1,263	1,210	958	1,166	1,342	5,938
Sewerage general	149	104	173	177	201	803
Sewerage service total	2,333	2,159	1,886	2,248	2,451	11,075
Industry total	4,246	3,979	3,666	4,533	4,913	21,336

Notes:

1. All investment is stated gross of capital contributions, including IRE which was previously reported as net of capital contributions.
2. The above table has been adjusted into 2007-08 prices using year average RPI.
3. Assets adopted at nil cost are excluded from gross capital investment in tables 18-22.
4. In the water service, all IRE grants and contributions have been accounted for in the distribution category (although it is acknowledged that a small proportion of them may relate to water resources).
5. In the sewerage service, all IRE grants and contributions are included within the sewerage category.
6. Industry totals do not exactly match tables 18-20 due to rounding.

Table 22 Gross capital investment by service area 2007-08 – by company

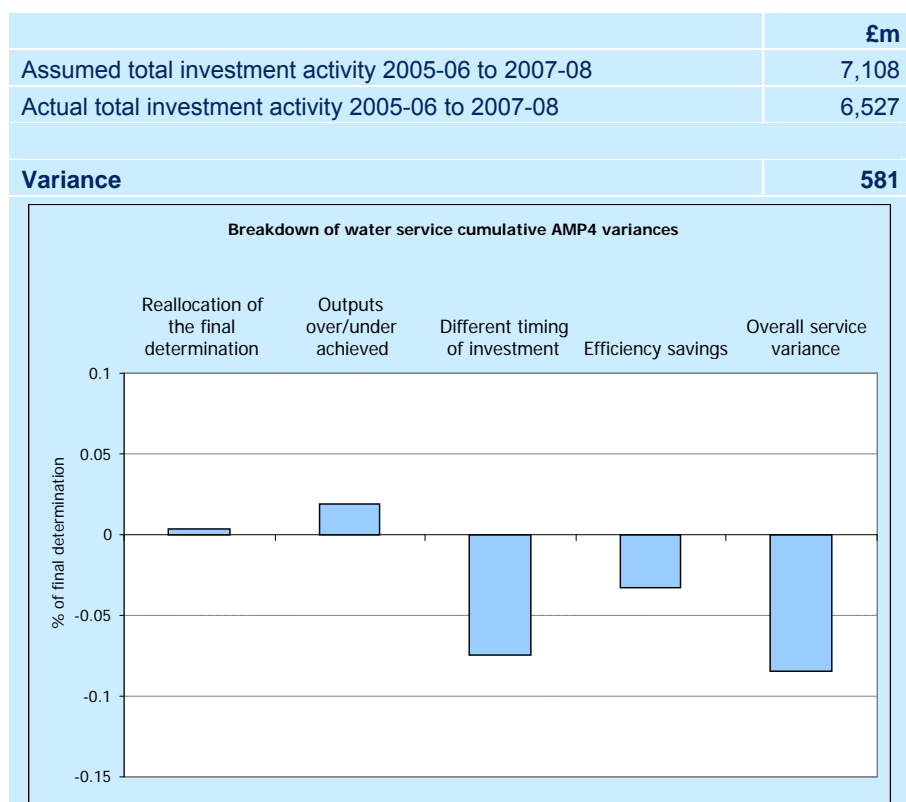
2007-08 prices	Water resources £m	Water treatment £m	Water distribution £m	Water general £m	Water total £m	Sewerage £m	Sewage treatment £m	Sewerage general £m	Sewerage total £m
Water and sewerage companies									
Anglian	10.5	51.7	115.9	12.9	191.0	84.8	124.3	19.3	228.4
Dŵr Cymru	4.4	23.9	95.1	19.3	142.7	88.5	52.1	18.9	159.5
Northumbrian	13.0	32.2	88.2	17.1	150.5	50.4	45.3	9.6	105.3
Severn Trent	0.7	44.0	174.8	25.8	245.3	111.2	184.6	25.7	321.5
South West	2.5	12.8	78.3	11.6	105.3	29.9	35.7	8.8	74.4
Southern	4.6	19.9	37.9	14.1	76.5	88.9	204.2	27.3	320.3
Thames	34.6	93.5	454.7	12.3	595.1	196.7	198.5	17.6	412.8
United Utilities	27.8	122.3	166.2	36.1	352.5	157.4	275.7	39.2	470.8
Wessex	5.9	32.7	52.5	7.6	98.6	57.5	66.1	12.4	135.9
Yorkshire	10.7	30.1	94.9	21.9	157.6	43.1	155.2	21.9	220.2
Total WaSCs	115	463	1,359	179	2,115	908	1,342	201	2,451
Water only companies									
Bournemouth & W Hampshire	1.4	2.1	6.2	1.5	11.2				
Bristol	5.5	18.6	21.1	4.4	49.6				
Cambridge	0.1	0.6	4.9	0.8	6.4				
Dee Valley	0.1	5.6	2.8	0.6	9.1				
Folkestone & Dover	0.3	0.2	2.5	1.4	4.5				
Mid Kent	2.5	6.4	20.7	2.0	31.6				
Portsmouth	0.6	4.7	5.5	1.2	12.0				
South East	6.2	5.0	35.6	9.2	56.0				
South Staffordshire	0.9	3.2	23.2	3.6	30.9				
Sutton & East Surrey	0.8	6.6	12.4	1.9	21.8				
Tendring Hundred	0.0	0.1	5.5	0.5	6.1				
Three Valleys	4.0	23.8	69.4	11.0	108.2				
Total WoCs	22	77	210	38	347				
Industry total	137	540	1,568	217	2,462	908	1,342	201	2,451

Notes:

1. All investment is stated gross of capital contributions, including IRE which was previously reported as net of capital contributions.
2. Assets adopted at nil cost are excluded from gross capital investment in tables 18-22.
3. In the water service, all IRE grants and contributions have been accounted for in the distribution category (although it is acknowledged that a small proportion of them may relate to water resources).
4. In the sewerage service, all IRE grants and contributions are included within the sewerage category.

Figures 2a and 2b illustrate the breakdown of the 9% cumulative shortfall for the current price limit period. The companies reported this year that approximately 60% of this discrepancy is because of changes to the timings of the protected schemes, which continues to be as a result of planning delays and companies reprioritising their programmes. Much of the remainder of the discrepancy is associated with forecast efficiency savings. Companies have reported activities such as supply chain management and re-engineering scheme solutions as the main source of these efficiency savings.

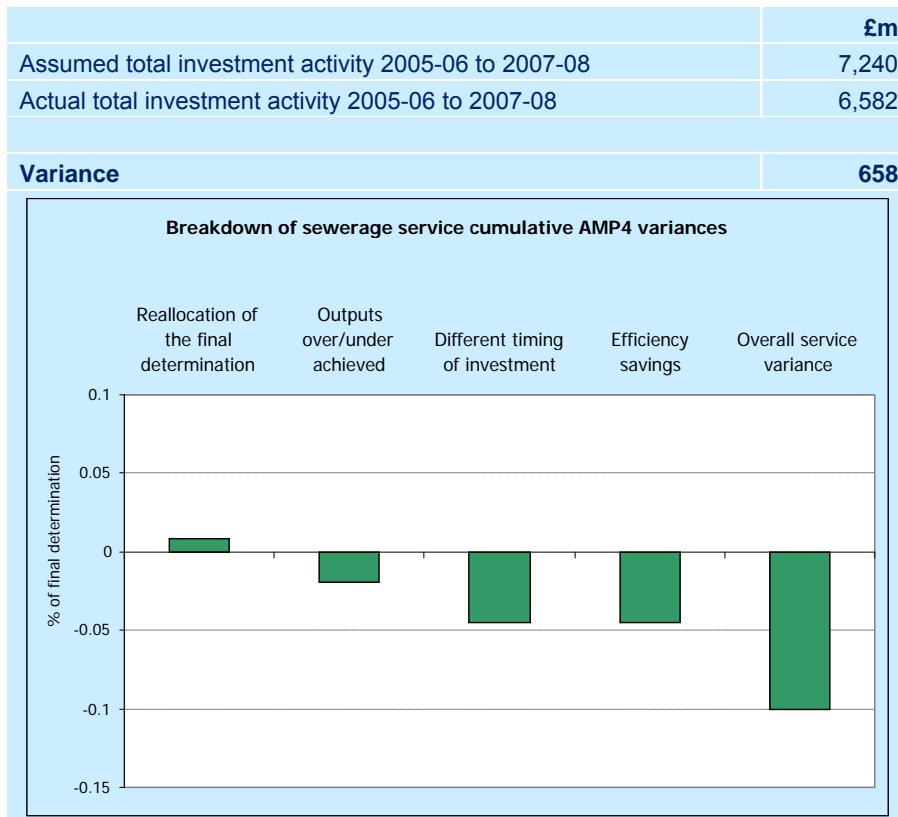
Figure 2a Breakdown of the variances in gross capital investment 2005-10 – water service



Note:

Actual investment and final determination assumptions are both reported gross of grants and contributions.

Figure 2b Breakdown of the variances in gross capital investment 2005-10 – sewerage service



Note:

Actual investment and final determination assumptions are both reported gross of grants and contributions.

4. Transfer pricing

Water companies have a statutory duty to trade at arm's length with associate companies in their group and with their parent company. This is to make sure that price limits are set on the basis of the actual costs of providing water and sewerage services to customers and not costs inflated by cross-subsidy. It also stops transactions taking place on preferential terms which would potentially distort markets and could be anti-competitive.

Table 23 shows each company's expenditure with its associates in 2007-08. In 2007-08, the level of expenditure with associates in the water and sewerage sectors fell to £278.4 million, compared with £461.9 million (at 2007-08 prices) in 2006-07. The table also includes our assessment of compliance with our transfer pricing guideline, 'Regulatory Accounting Guideline 5.04'. Our assessment lags by one year to allow us to review and discuss issues with the companies. This ensures our assessment is made after a thorough analysis of issues. Compliance continued to improve in 2006-07.

The significant decrease in total expenditure with associates in the sectors between 2006-07 and 2007-08 is driven by decreases at Thames Water Utilities and United Utilities Water. These in turn reflected the fact that services previously provided by associates were brought in-house and also group restructuring, which meant that trading arrangements were no longer with associates.

We visited United Utilities Water during the year as part of our assessment of compliance with its December 2006 section 19 undertaking. This undertaking required it to take steps to bring it into compliance with its licence conditions relating to trade with associates. Our discussions with United Utilities Water and analysis of information submitted by its auditor allowed us to confirm that the company had complied with the undertaking.

Our assessment of United Utilities Water's compliance with RAG 5.04 for 2006-07 reflects the fact that non-compliant trading arrangements which were the subject of the undertaking were ongoing during that year. We expect that United Utilities Water's compliance with the undertaking, and the steps which it has taken to address our other concerns raised in relation to trade in 2006-07, will help improve its compliance with RAG 5.04 in 2007-08.

We will continue to monitor all companies to make sure that trade is at arm's length.

Table 23 Trade with other companies within the group

2007-08 prices	Total value of expenditure with other group companies 2007-08 £m	Trade as a % of appointed business turnover		Compliance with RAG 5.04 2006-07
		2007-08	2006-07	
Water and sewerage companies				
Anglian	52.1	5.5	5.3	●
Dŵr Cymru	–	–	–	●
Northumbrian	7.7	1.3	3.1	●
Severn Trent	28.0	2.2	3.4	▸
South West	15.6	3.8	4.1	●
Southern	–	–	0.1	●
Thames	51.7	3.6	8.1	●
United Utilities	50.8	3.6	9.2	○
Wessex	12.9	3.3	8.6	▸
Yorkshire	25.0	3.2	3.3	●
Total WaSCs	244.0	2.9	5.2	
Water only companies				
Bournemouth & W Hampshire	0.9	2.3	2.5	●
Bristol	3.7	4.2	3.8	●
Cambridge	0.3	1.6	1.7	▸
Dee Valley	–	–	–	●
Folkestone & Dover	1.4	7.7	5.8	●
Mid Kent	–	–	1.0	●
Portsmouth	0.1	0.3	0.4	●
South East	1.9	1.6	1.2	●
South Staffordshire	19.3	25.2	28.2	●
Sutton & East Surrey	0.1	0.3	0.2	●
Tendring Hundred	1.4	10.2	9.3	●
Three Valleys	5.3	2.3	2.4	●
Total WoCs	34.4	4.6	4.9	
Industry total/average	278.4	3.0	5.1	

Key:

- Satisfactory compliance with RAG 5.04.
- Some areas to be improved.
- Significant improvement required.

Note:

Numbers may not add due to rounding.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.



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